

EAST HERTS COUNCIL

JOINT MEETING OF SCRUTINY COMMITTEES – 17 JANUARY 2017

REPORT BY THE HEAD OF HOUSING AND HEALTH AND HEAD OF FINANCE AND PROPERTY

HOUSING COMPANY BUSINESS PLAN

WARD(S) AFFECTED: ALL

Purpose/Summary of Report

- This report discusses the establishment of a housing company, wholly owned by East Herts Council, which would act as an investment vehicle, receiving five residential properties already owned by the council and purchasing another 20 in the open market over the coming five years.
- The primary aim is to provide revenue income for the council to offset diminishing government support and grants.
- In order to create an income stream, the proposed company would provide quality private rental housing opportunities.
- It would be for members, not the company, to direct the use of the income to support their priorities.
- The business case in front of members includes a detailed 30 year business plan for the investment vehicle drawing on external tax advice provided by PwC. The assumptions within the model have been thoroughly reviewed and, where necessary, amended following consideration by the Corporate Business Scrutiny Committee at its meeting of 29 November 2016.
- The report also draws on detailed advice from Trowers and Hamlins legal practice which confirms the basis on which the council is able to set up such a company.
- The 30 year business plan and associated sensitivity testing indicates that an investment vehicle can be formed which is viable given a range of assumptions concerning the trajectory of the local housing market and wider economic movements.
- The report invites the Joint Meeting of the Scrutiny Committees to scrutinise the business case and amended business plan.

RECOMMENDATIONS FOR THE JOINT MEETING OF SCRUTINY:

That:

(A)	The full business case and 30 year business plan be endorsed for approval by the Executive; and
(B)	A housing company based on the business case and business plan be recommended for approval by the Executive.

1.0 Background : Why set up a housing company?

1.1 East Herts Council's Corporate Strategic Plan 2016/17 – 2019/20 includes conducting feasibility work on the establishment of a housing company. In East Herts, a housing company to acquire homes to then let out in the private market as proposed could:

- create a revenue stream which members could use to deliver their priorities
- provide quality homes to rent in the private market
- be designed to, as well as provide housing, acquire and/or develop commercial premises should this be financially attractive.

1.2 This report lays out the business case for the council setting up a housing company. The business plan, included in the exempt **Essential Reference Paper "B"**, demonstrates the viability of the company acquiring a portfolio of homes for rental in the private market. For avoidance of doubt, the business plan does not envisage the development of new homes, just the acquisition and letting out of existing properties.

1.3 The council is required to set a balanced budget each year. In light of changes to government funding the council will need to generate more income itself and/or make savings to achieve this from 2017/18 onwards. This business plan demonstrates a means by which the council can generate a new source of income to contribute to replacing diminishing government funding, thus providing members with supplementary resources to further the council's corporate priorities to improve the health and wellbeing of our communities, enhance the quality of people's lives and enable a flourishing local economy.

2.0 Full Business Case for the Establishment of a Housing Company wholly-owned by East Herts Council

- 2.1 As considered by the Corporate Business Scrutiny Committee in August and discussed further by the Corporate Business Scrutiny Committee in November, the first element of work on setting up a housing company is to establish a viable business case for the acquisition of residential properties, including those currently held directly by the council, for letting in the private market.
- 2.2 Taking this first step would enable the company to start trading quickly. Having established an investment vehicle, members may wish to then consider the viability of housing development through a wholly-owned company. Development, however, is outside that scope of this report and the attached business plan.

Legal context

- 2.3 Trowers and Hamlins has provided detailed advice on the legal aspects of establishing a housing company; the information in this section of the report has been taken from the advice provided.
- 2.4 Section 1 of the Localism Act 2011 provides local authorities with the power to do anything an individual may do, subject to a number of limitations. This is referred to as the 'general power of competence'. A local authority may exercise the general power of competence for its own purpose, for a commercial purpose and/or for the benefit of others.
- 2.5 In exercising this power, a local authority is still subject to its general duties, such as the fiduciary duties it owes to its rate and local tax payers and to the public law requirements to exercise the general power of competence for a proper purpose.
- 2.6 Section 4 of the Localism Act 2011 requires that where a local authority exercises the general power of competence for a commercial purpose it ***must*** do this through a company.
- 2.7 Section 95 of the Local Government Act 2003 is also of relevance. The associated regulations, Regulation 2 of the Local Government (Best Value Authorities) (Power to Trade) (England) Order 2009, require a business case to be prepared and approved by the Council before a company starts trading. This report forms the first draft of a business case with the associated financial business plan also covered.

Provision of homes of different tenures

- 2.8 This report is concerned solely with the business case and a 30 year business plan for an investment vehicle to acquire existing

properties and let them out at market rents. It is recognised that members may wish at a future stage to explore the case for the company moving on to *build* properties. If the company were to develop new homes, there would be a requirement to provide affordable homes in line with the council's planning policies. Under such circumstances, mixed tenure developments would be expected consisting of homes for rent and sale in the private sector, along with affordable rented and low cost home ownership homes in line with planning requirements.

- 2.9 Although the current proposal is concerned with acquisition for private rent, the council asked Trowers and Hamlins to clarify the position of the company regarding the provision of market versus affordable housing. Trowers and Hamlins drew particular attention to the Ministerial Statement about the establishment of local housing companies issued in March 2015 by the then Housing Minister. The Ministerial Statement stated, amongst other things, that the Government would not support local housing companies where such companies are established for the purposes of avoiding the right-to-buy or the borrowing restrictions imposed by Government on housing revenue accounts, that is, the accounts in which stock-holding authorities manage their council housing. Trowers and Hamlins advised that restrictions and requirements which are contained in any other legislation are not overridden by the council's reliance upon the general power of competence.
- 2.10 The housing company proposed in this report is *not* envisaged as a vehicle for circumventing the right-to-buy or borrowing caps placed on stock-holding councils. In connection with the Ministerial Statement, on the basis of the instructions given by the council, Trowers and Hamlins is comfortable that the council's rationale for establishing and participating in the proposed company is not for improper purposes and the clear intention to make a profit and provide market housing raises no cause for concern. Officers would add that, as is the case for all housing developers, any profit derived from housing development will need to take account of the provision of affordable housing required by East Herts Council's planning policies, which are, in part, predicated on meeting local need and demand for affordable housing.
- 2.11 In this way, the commercial focus of the company and the local need for affordable housing to be delivered through the planning process are not in conflict.

Form of company and proposed governance arrangements

- 2.12 The Localism Act 2011 defines which forms of company a local authority can use to trade. These are; a company limited by shares, a company limited by guarantee and a community benefit society. Of note, a limited liability partnership is not an available legal structure.
- 2.13 The legal advice provided by Trowers and Hamlins is that the company should be a company limited by shares. This form of company complies with the ability to trade provisions set out within the Localism Act 2011. East Herts Council will own the entire share capital. There are certain requirements that will apply to the company, some of which are statutory such as the obligation to file annual returns and accounts, while others the council will be able to determine itself, including the governance arrangements.
- 2.14 While yet to be determined, it is proposed that the governance of the housing company would include:
- East Herts Council being the sole shareholder, with full Council making decisions reserved for the shareholder in the company's articles of association and shareholder agreement. Such decisions would include the approval of the company's business plan on an annual basis
 - a group of three elected members forming a shareholder advisory group, appointed by the Leader of the Council acting in consultation with the Chief Executive, to exercise oversight of the company's reports and performance, provide strategic guidance and advise the full Council when it is exercising its rights and responsibilities as the shareholder
 - the company's Board of Directors – the body which manages the affairs of the company on a day-to-day basis. It is proposed that in the first instance all directors shall be officers of the council, who would not receive any additional remuneration for this role. In time, there may be provision for additional independent directors appointed for their expertise in regarding to housing, development, finance and the like; independent directors may require some remuneration.
- 2.15 While the company's Board of Directors would manage the company's affairs on a day-to-day basis, the council would have a number of ways in which it could legitimately guide the activity of

the company, including:

- as the shareholder – appointing and removing directors, signing off the company’s annual business plan, and signing off any changes to the company’s Memorandum and Articles of Association, and making any offer decisions reserved for the shareholder in the article and shareholder agreement
- as a funder – deciding whether or not to make loans to the company. It is considered that it would be difficult for the newly formed company to secure affordable loans by any other means. Note: loans must be at commercial rates so as not to contravene State Aid regulations
- as an owner of properties and/or land owner – making available properties and/or land to the company. Note: disposal must be at market value so as not to contravene State Aid regulations and to satisfy the council’s Local Government Act 1972 Section 123 duty to obtain the best consideration that can be reasonably obtained
- as a planning authority – should the company build homes in the future, as with any housing developer, the council would assess whether a particular proposal by the company meets planning requirements including acceptable levels of affordable housing and/or other s106 contributions as required by the council’s planning policies
- as a strategic housing authority – again, should the company build homes in the future, as when working with any housing developer, the council would direct the required affordable housing mix and/or the need for specialist housing on sites in line with the relevant planning policies.

2.16 It is envisaged that the company would not employ its own staff during its early stages of operation, and indeed perhaps not unless approval is given in future to embark on housing development. It is believed that the necessary skills, at the initial stages, are available in-house or readily available in the local market, notably regarding property management.

Would a holding company be beneficial?

2.17 The report to Corporate Business Scrutiny in August raised the possibility of establishing a holding company to bring together the council’s interests in the various companies in which it currently has, or it anticipated to have, a share.

- 2.18 Trowers and Hamlins' report observed that a holding company could possibly enable a more streamlined approach to governance within East Herts Council, however, the report went on to conclude that, *"we would advise that at this point there appears to us to be insufficient justification from a governance or legal perspective for the establishment of a holding company alongside the establishment of the Company (noting that we are not advising on tax matters)."*
- 2.19 From a tax point of view, PwC have brought to the council's attention that the transfer of shares by the council to a holding company would incur Stamp Duty Reserve Tax at 0.5%.
- 2.20 Given this above advice, officers believe there is not a compelling case for creating a holding company at this stage but that this should be kept under review.

3.0 Financial Business Plan

- 3.1 A detailed 30 year business plan has been developed by the Heads of Housing and Health and Finance and Property. All the assumptions behind the model have been thoroughly reviewed at the request of the Corporate Business Scrutiny Committee following its meeting on 29 November 2016.
- 3.2 This review has amended a number of inputs. The detailed basis for all the assumptions in the model is given in **Essential Reference Paper "B"**. Of note, since the earlier model presented to the Corporate Business Scrutiny Committee:
- based on a review of local data, the figure representing the local average property price has increased slightly, while the assumed monthly rent achievable has decreased slightly
 - the cost of day-to-day repairs has been increased following a review of figures provided by a number of authorities, although the assumed cost of required works prior to the first let has reduced slightly, again based on discussion with other authorities.
- 3.3 Assumptions regarding tax have been included based on advice from PwC. The model is based on the acquisition of 25 properties over the first five years of the company's operation, with each of these homes let out in the private rental market.
- 3.4 The full business plan is included at **Essential Reference Paper "B"** – this appendix is exempt from consideration in public because it contains commercially sensitive information regarding

the assumed value of council assets and assumptions regarding costs that would be incurred in the open market.

- 3.5 The information presented in **Essential Reference Paper “B”** includes (a) income statement for the company showing income and expenditure, and profit and loss, and (b) the cash flows to and from the council.

Resources to be made available to the company

- 3.6 The business plan in **Essential Reference Paper “B”** details the funding assumptions which have been considered as part of the external legal and tax advice received. Of note, the council would provide:

- equity to the company representing 35% of resources required to acquire 25 properties;
- a loan to the company for the remaining 65% of resources needed. The model assumes the loan is repayable at 4.25% above base rate on an interest only basis, that is, an interest rate of 4.5%, with the principal repayable at year 30.

How does the company create an income stream for the council?

- 3.7 In outline terms, East Herts Council would receive a revenue income stream from:
- **interest on loans to the company.** The council has the power to make loans; commercial rates would have to be applied to be compliant with State Aid regulations. Commercial interest rates would be at a higher level of interest than the councils’ own cost of borrowing and/or interest accruing on cash held on deposit by the council, thus a revenue stream flowing to the council is created
 - **purchase of services from the council.** The company may wish to purchase services such as project management, legal, HR or IT support from the council. Regulation on ‘transfer pricing’ dictate that this should be a cost plus no more than 5%. At this stage the assumption has been made that the council would be able to support these services from within existing staff resources
 - **distributions of profit made by the company through dividends.** The company will derive an income from (a) rental income, net of management and maintenance costs

ground rents, and (b), in time, disposal of homes at an uplifted value. These profits, net of tax, would be distributed to the council as the sole shareholder. Note: subject to future member approval, the company could develop homes and thus make a profit on properties specifically developed for sale.

Summary of outputs from the 30 year business plan

3.8 In summary, the business plan demonstrates that (refer to Table 1 in Essential Reference Paper B for the assumptions used in the business plan):

- from year one, the council receives an income stream from interest on loans, recharges and receipt of dividends:
- the annual income to the council rises from £52,672 in year one, to £254,121 a year by year 5, £270,062 a year by year 15 and £353,870 by year 30 – see *Table 3(i) to (iii) ‘Cash Flows to East Herts Council’ in Essential Reference Paper “B”*
- the income to the council offsets the opportunity cost lost to the council in terms of interest foregone on the equity and loan rising from £11,042 in year one to £55,752 a year from year five of the business plan onwards once the full equity and loan have been drawn down.
- revenue income to the council (assuming all profits after tax are paid as dividends to the council) over the 30 year lifetime of the business plan totals £8.47m.
- the value of the property portfolio of 25 homes rises over time such that:
 - the property portfolio is modelled to be worth £40.5m, at year 30 given historic average property value appreciation rates
 - after repayment of the initial loan at year 30, the value of council’s *equity stake* would have risen to £29.8m to at year 30.
 - the total income to the council, that is, the annual revenue income over 30 years combined with the value of the equity stake at year 30 would be £41.5m. This equates to an average return on the capital resources

used (equity and loan) of 5.86% a year over the 30 years of the business plan

- the company is able to make a profit from rental income net of running costs and taxes:
 - of note, assuming the company's finances minimise exposure to corporation tax, the company is able to create a profit with access to an overdraft facility of up to £13k in the first three years, with an average after tax profit of £23k a year in years 4 to 15 and £72k a year thereafter.

Sensitivity testing

3.9 Prudent assumptions have been made in the base case modelling discussed above. Sensitivity testing has been conducted, however, to assess the impact of:

- lower than modelled property price inflation over the 30 year business plan period
- purchase of lower value homes
- the combination of adverse inflation and repairs costs movements
- interest rate increases stemming from increases in the base rate
- acquisition of properties later in the first year of operation, rather than at year start.

3.10 The impacts on key outputs from the business plan model are displayed in exempt Essential Reference Papers C and D.

Impact of lower house price inflation

3.11 Broadly every 15 years, there is a period of house price deflation in the UK. There was a 'crash' in the early 1990s and another downturn following the 2008 credit crunch. Prices have, however, always rallied strongly giving robust capital growth over a longer time frame.

3.12 Analysis of house prices over the last 30 years shows:

- the average annual rate of property price inflation in the South East of England (East Herts only data are not available) from 1990 to 2010, that is from the pre-1990s

crash to just after the 2008 credit crunch is 4.11% per year

- taking running five year averages for each year between 2000 and 2016, including 2008 and 2009 in which local house prices fell, the average annual increase during the lowest quartile five year period in East Herts is 2.39%.

3.13 Even if property price inflation were to run at just 2.39% a year for the entirety of the next 30 years, the business plan is still viable, giving an implied annual rate of return of 3.42% a year on the council's resources over the lifetime of the plan. Refer to Essential Reference Paper C for more details.

Impact of lower initial purchase prices

3.14 Some other authorities have chosen to purchase properties outside of their boundaries where house prices are lower. To assess the impact of this here, sensitivity modelling has been conducted based on the acquisition of 15 properties in East Herts and ten in lower value areas. (So as to gather actual property price and rental income, this sensitivity testing is based on five properties in Stevenage and five in Harlow. These areas have been chosen for modelling purposes only; there is no implication that properties should be acquired in these areas.)

3.15 The key impact of acquiring homes in different areas is that although the lower initial acquisition costs would, of course, reduce the need for council resources (equity and loan), the lower rents mean that the income available is correspondingly lower. See Essential Reference Paper C for more details.

3.16 Over the 30 years of the business plan, the money generated is lower as a reflection of the £1m less of capital deployed, but the rate of return on the council's capital is virtually unchanged. For example, assuming the base position of property inflation averaging 6.45% a year, purchase of all 25 properties in East Herts as modelled would yield an implied annual return on this 5.86% a year for 30 years, with an implied annual return of 5.88% if properties were purchased across a wider area

3.17 In summary, the sensitivity analysis indicates that the business plan is robust enough to cope with significantly lower levels of capital appreciation with the rate of return little changed by the level of the council's capital deployed.

Impact of combined adverse inflation and maintenance costs movements

- 3.18 Further sensitivity testing has been conducted to specifically assess the impact on income flowing to the council of a combination of:
- lower levels of annual rental inflation
 - higher levels of maintenance costs coupled with higher levels of inflation on maintenance and improvements costs
 - lower levels of property price appreciation
 - lower levels of inflation on recharges
 - higher levels of bad debt.
- 3.19 The assumptions used in the sensitivity testing along with the impacts on key outputs from the business plan model are displayed in exempt **Essential Reference Paper “D”**.
- 3.20 In summary, the sensitivity testing shows that even in the ‘very pessimistic’ scenario, the business plan is still viable with the council receiving an income of £49.9k in year one, rising to over £200,000 a year from year five onwards.
- 3.21 In summary, the sensitivity analysis indicates that the business plan is robust enough to cope with very pessimistic changes in the economic environment in that cashflows to the council and capital growth are still achievable, albeit at lower levels than under the base case scenario. It is worth noting that if the annual review of the business plan to be signed off by the shareholder (East Herts Council) indicates unacceptable levels of revenue income or capital growth, the liquidity of the investment vehicle is such that if financially expedient, the company could recommend and shareholder could agree that the company should not acquire the full 25 properties envisaged in the model and/or should divest itself of some or all of the properties earlier than anticipated in the business plan.

Impact of interest rate increases

- 3.22 The business plan is predicated on the council lending sums to the company and charging interest on the loan(s). The modelling is based on an interest rate at 4.25% above the base rate. Unless the council extends loans with a fixed rate of interest, any increase in the base rate will be passed on to the company resulting in higher interest payments.
- 3.23 Modelling confirms that this will have two impacts which,

essentially, will cancel each other out:

- interest payments to the council will increase
- profits accruing in the company will decrease leading to reduced dividend payments to the council and/or a need for the company to use an 'overdraft facility' funded by the council from the increased interest payment.

3.24 Thus, increases in the interest rate will have negligible, if any, impact on the level of cash flowing to the council.

Impact of timing of property purchase within the financial year

3.25 The business plan modelling assumes that all properties are acquired and equity and loans are drawn down in full at the beginning of the year of acquisition, that is, years one to five inclusive.

3.26 Arguably, this is achievable once the company is operational as it can take the necessary steps *in the preceding year* to purchase or draw down loans ready to act as soon after the start of the coming financial year as possible.

3.27 This will not be possible in year one. In the first year, however, the company is receiving the council's five existing properties, rather than seeking to purchase them in the open market, thus the timing of the transfer (at full market value) is easier to predict. Modelling indicates that should the transfers happen towards the beginning of quarter 2 in the first year, the cash flow to the council in year one would be £38.9k (rather than £52.7k in the base case scenario). This later onset of trading has already been assumed in the Medium Term Financial Plan, MTFP, which estimates an income from the company of £33k in year one – see section 5 below for more details of the MTFP. Inclusion of resources from the company in the MTFP is, of course, subject to member approval to proceed with the housing company.

4.0 Consideration of alternative uses for the council's capital

4.1 A number of alternative uses for the resources the report proposes deploying to fund the housing company have been considered, principally:

- holding the cash on deposit in the bank
- investing further in property funds

- investing directly in commercial property.

4.2 It is standard practice to consider alternative uses of resources in terms of liquidity, security and yield offered.

Holding cash on deposit

4.3 While this option sees resources held in their most liquid and least risky form, the yields achievable for the foreseeable future are low. Currently, the council is receiving just 0.7% of monies held in short term investments.

Investing further in property funds

4.4 The council has invested £10m in each of two property funds, that is, £20m in total. This represents the limit set by the council for this form of investment in its Treasury Management Strategy, devised to be compliant with CIPFA's Prudential Code. While it is not impossible to raise this limit, the Code would suggest the need to balance investments as broadly as possible.

4.5 Over the last year, the two funds in which the council invests have each yielded around a 7% return from rental income and capital growth combined. There is, however, no guarantee that a rate of return at this level will persist over the longer term. For example, in their recently published *Key themes in UK real estate 2016/17* report, Savills, a leading real estate services provider, anticipates the annual average rental yield on UK office space being 4.3% over the coming three years, with capital value growth actually dipping in 2017 and 2018 before recovering in 2019.

4.6 In terms of liquidity, property funds rely on buyers for the units held. Furthermore, there is a fee of 2% of the total capital value attached to disposal. (By way of comparison, the figures quoted relating to the housing company business plan *include* the costs of disposal, that is, tax on the value of the appreciation and the costs of sale.)

Investing directly in commercial property

4.7 The council currently holds commercial property with a total value of £15m. Commercial holdings are not risk free and rely on the ability to readily rent out the properties while minimising upkeep costs. Liquidity of such investments is typically poorer than residential holdings which can more easily be sold on a property-by-property basis.

5.0 The housing company's potential contribution to the Medium Term Financial Plan, MTFP

- 5.1 Subject to a member decision of whether to proceed with establishing a housing company, officers have provisionally identified the contribution that the company could make to meeting the need for efficiencies/increased income in the MTFP.
- 5.2 The current version of the MTFP, which is itself subject to member approval, includes the following income estimates presented alongside the modelled income accruing to the council in the housing company business plan:

Year	MTFP estimate of housing company income to the council	Income to the council indicated in the 30 year business plan
2017/18	£33k	£52.7k
2018/19	£86k	£110.5k
2019/20	£127k	£157.4k

Note: The lower estimates in the MTFP make allowance for gradual acquisition/transfer of properties by the company in its first year of operation

- 5.3 The MTFP includes a savings target of £1.1m from 2018/19 which must be met in order to set a balanced budget. This may be met through increasing income, efficiency savings or organisational redevelopment.
- 5.4 The proposed housing company arguably represents an important means of addressing unmet funding requirements in the MTFP going forward.

6.0 Proposed timetable for establishing a housing company

- 6.1 The timetable below was presented to Corporate Business Scrutiny at its meeting of 29 November 2016. The timetable maximises the time members have to consider the business case and business plan modelling.

Key action		Date
Consideration of full business case (including proposed	Corporate Business Scrutiny	29 Nov 2016
	Joint Meeting of Scrutiny	17 Jan 2017

Key action		Date
governance arrangements) and 30 year business plan by:	Committees	
	Exec	7 Feb 2017
	Council	1 March 2017
Articles of Association and Shareholder Agreement completed		March 2017
Housing Company incorporated		March 2017
Housing Company starts trading		April 2017
Assess viability of housing development by the company		Mid 2017
Consideration of the case for housing development, <i>assuming a financial viable can be determined</i> , by Corporate Business Scrutiny Committee, Executive and Council		Late 2017 / early 2018
<i>Subject to a viable business plan and member approval</i> , inclusion of work on housing development in the housing company's Annual Business Plan 2018/19 put to Council		Feb / March 2018
<i>Subject to above</i> , commencement of housing development		Late 2018 / early 2019

6.2 As noted in the table above, should members wish, once the housing company is established, the focus of attention could turn to assessing the viability of housing development.

6.3 Housing development through a company would:

- see new homes built for market rent and sale
- include new affordable homes built and retained by the company (or a 'sister company' established for this purpose) as a requirement of East Herts Council's planning policies designed to meet local need and tackle demand on the housing register
- provide additional revenue streams for the council created in much the same way as discussed in this report.

6.4 The external advice provided to date by Trowers and Hamlins and Jonathan Geall, Head of Housing and Health, Extn: 1594. [jonathan.geall @eastherts.gov.uk](mailto:jonathan.geall@eastherts.gov.uk) housing development, hence officers envisage the investigation of the viability of housing development would be able to proceed swiftly should members wish to explore this further.

7.0 Implications/Consultations

7.1 Information on corporate issues and consultation associated with this report can be found within Essential Reference Paper A.

Background Papers

None.

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