Epping Forest District Council
Council Housing: a real future
Report on the implications of the HRA reform prospectus

1. Introduction

1.1 CLG published its long awaited voluntary 'offer' to local authority landlords on 25th March. The offer is in the form of a prospectus setting out the terms within which the government plans to implement the dismantling of the Housing Revenue Account (HRA) subsidy system and introduce a system of self financing from April 2011 on a voluntary basis.

1.2 Work has been carried out to model the impact of the reform proposals for Epping Forest District Council. This note sets out the main findings of the modelling work, highlights the main Epping Forest-specific issues to arise and provides a summary commentary on the proposals within the prospectus, with the aim of informing the council's response to the consultation, which is due by 6th July.

1.3 It is intended that officers will arrange for briefings to all Members and Tenants and Leaseholders Federation in order to discuss the issues raised in this paper as part of the Council's process of generating its response and we look forward to participation as requested in due course.

2. The HRA Prospectus

2.1 The reform proposal has been produced following the Review of Council Housing Finance which concluded in the summer of 2009 and following last autumn's consultation.

2.2 The proposal is based on moving towards a 'self financing' HRA system in which negative or positive subsidy is exchanged for a single one-off adjustment of housing debt following which rental surpluses and Right to Buy receipts are retained 100% by local authorities.

2.3 The allocation of debt is the Net Present Value[1] of a cashflow estimate of rents and revenue costs for all authorities over 30 years, based on subsidy rent assumptions which achieve convergence with targets by 2016 and subsidy allowance assumptions which include an uplift of funding. By linking the debt allocation to current and future subsidy assumptions, the government is making the settlement 'neutral' in national expenditure terms.

<u>The National Picture</u>

[1] Net Present Value or NPV: a financial technique to calculate the value of a future income stream (eg for a business) and convert it into a single amount at today's prices

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2.4 Nationally, the total value of future rental surpluses in an unreformed system is estimated to be £34-35bn. Current debt is £21.5bn (forecast at 31st March 2011). Therefore the value of future surpluses is in the region of £13-14bn.

2.5 The total proposed allocation of debt is £25.1bn based on increased allowances of 5% for management and maintenance (M&M) and 28% for major repairs, with a discount factor[2] of 7%. This means that the government could be said to be capturing £3.6bn of surpluses up front and allowing all future surpluses to remain in local HRAs.

2.6 The prospectus identifies that the discount factor for recent stock transfers is lower at 6.5% - which applied to this settlement would result in a debt allocation of £26.3bn. The difference of £1.2bn is therefore treated as 'reduced debt' and there is an explicit reference to authorities setting out some ideas as to how to utilise the headroom from this debt 'reduction' towards new build. Nationally, the prospectus refers to '10,000 properties per year in five years'; although it is not clear how this figure has been developed, authorities are encouraged to set out some outline options in their responses.

2.7 From a revenue perspective, although higher than current debt, the proposed debt allocation is lower than might have been expected following the consultation period last autumn. At a national level, the distribution of increased allowances through the debt mechanism represents an increase in spending power for council housing that is not in line with public expenditure pressures elsewhere. This highlights that the proposal is a 'deal', in which government takes surpluses up front in order to reduce debt elsewhere in the public sector.

2.8 Where the proposals do reflect the significant spending pressures in the economy as a whole is on capital investment and borrowing. The new system would see supported borrowing replaced with a system of capital grants and the ability for HRA business plans to use prudential borrowing on a long term basis.

2.9 Research for last year's consultation identified outstanding backlogs for decent homes and other investment at around £6bn. The prospectus has cut back on this, focusing on the completion of decent homes mainly for later-round ALMO authorities. A figure of £3bn for capital grants is referred, although this would be subject to future spending reviews.

2.10 In addition to the level and uncertainty around the availability of future capital grants, the proposals also act to restrict future borrowing. Although the government has rejected the idea of setting borrowing limits annually, the prospectus contains an absolute restriction on future borrowing above the level of the initial allocation of debt. It is expected that this cap will last until at least into the spending review period after next (i.e. till after 2014).

[2] Discount factors in NPV calculations represent the time value of money: in this case, the discount factor represents an assumed level of interest costs.

2.11 Effectively, therefore, self financing HRA plans will need to be based largely on revenue and receipts with reliance on borrowing restricted to any existing gap between actual debt and supported debt. Most authorities are unlikely to be in a position to receive grants. The settlement might therefore be said to be ‘*Revenue-Positive*’ and ‘*Capital-Challenging*’.

2.12 There are a host of technicalities associated with the implementation of the new arrangements, including a proposal to report a memorandum HRA balance sheet and various options for the treatment of depreciation, debt repayment and treasury management. Where relevant for Epping Forest, these are highlighted below.

2.13 The proposals are intended to be a ‘once and for all’ settlement. A self financing agreement would be signed under clause 313 of the Housing and Regeneration Act 2008. However, as council housing will continue to be ‘on balance sheet’ for public expenditure purposes, the government will retain the right to ‘open up’ settlements in the future. The circumstances in which this might take place are not set out and it is essential that self financing agreements are very clear about these circumstances. One obvious example is change to future rent policies i.e. if rents increase higher or lower than assumed in the settlement, the debt calculation might be reopened.

3. Epping Forest’s modelling: main assumptions

3.1 A model has been produced for Epping Forest launched from 2010/11 and based on the existing HRA Five Year Forecast, with the following key assumptions:

- Balanced to 2010/11 HRA budget and 2010/11 capital programme
- Rents converge (with similar housing provider properties) in 2015/16 (with no property-by-property adjustment for caps and limits[3])
- Roll forward of management and maintenance expenditure with inflation (i.e. no real terms investment or efficiencies, with the exception of management costs at 0.5% above RPI)
- Roll forward of non-rent income with inflation
- General inflation (RPI) of 2%
- Long term debt interest rates of 6% (early years in line with current rates)

3.2 A critical assumption relates to the stock investment and capital needs for the stock over the longer term. These have been factored into the business plan based on the asset management system and data the Council holds, which has been updated by officers from the original survey completed by Savills in 2004. The 30 year capital profile amounts to around £35k/unit and this is in line with benchmarks, as would be expected from the survey process that has been undertaken.

[3] Caps and Limits refer to restrictions on individual rent increases of RPI plus 0.5% plus 2% and not breaching a set rent (for housing benefit purposes) for a property, dependant on the number of bedrooms

3.3 The modelling provides a headline sense of the viability of self financing given the debt settlement and no access to capital grants. The plan is developed in two core scenarios: one with debt maintained and one with revenue surpluses set aside to repay debt.

4. Proposed settlement for Epping Forest

4.1 The headline debt settlement from the CLG for Epping Forest amounts to £164.441m. This is based on uplifted M&M allowances of 3.1%, uplifted MRA of 25.6%, resulting in a consolidated average uplift of 10.1%.

4.2 Epping Forest's M&M increase is larger than for the rest of the Eastern region's average of 2.6% and is lower than the national average due to the lower percentage of flats in Epping Forest, particularly high-rise. The MRA uplift is lower than the national average and the region's 31%.

4.3 The £164.441m settlement is based on a 7% discount factor. A reduced discount factor of 6.5% would give a settlement of £172.361m, a difference of £7.92m. The prospectus asks authorities to outline suggestions for how they might use this 'headroom' to deliver more housing. No new build has been included in the plans below but scope exists given the outputs to develop plans.

4.4 Given a settlement of £164.441m, the debt adjustment for Epping Forest is £180.447m which is arrived at by offsetting the existing HRA 'surplus' or negative HRACFR[4] of £22.803m. This results in an 'opening self financing debt at 1/4/2011' of £157.644m. The existing differential between subsidy-debt (Subsidy CFR[4]) of £164.441m and actual debt (HRACFR) of £157.644m is therefore retained as borrowing potential within the new system for Epping Forest.

5. Headline outputs

5.1 The headline outputs for two core approaches to self financing are set out below. The CLG debt profile is shown for comparative purposes. These are (i) the maintenance of debt with continued refinancing (i.e. only paying interest) and (ii) the repayment of debt from future surpluses.

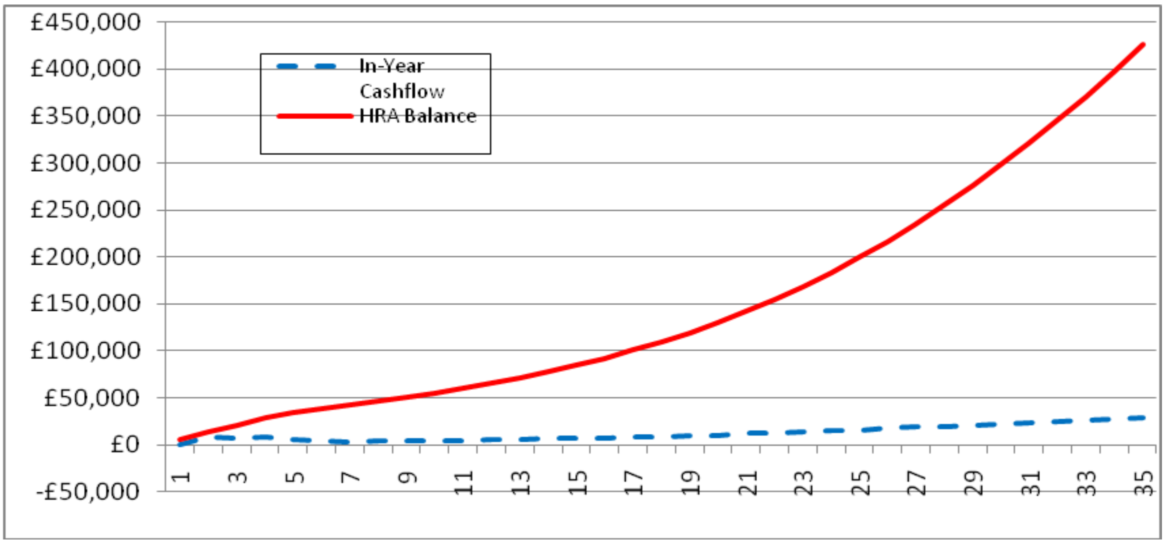
5.2 This shows that both plans are financially viable and meet all expenditure needs in each year of the 35 years covered by the plans. There is no borrowing required throughout to meet the stock investment needs over the first 10 years.

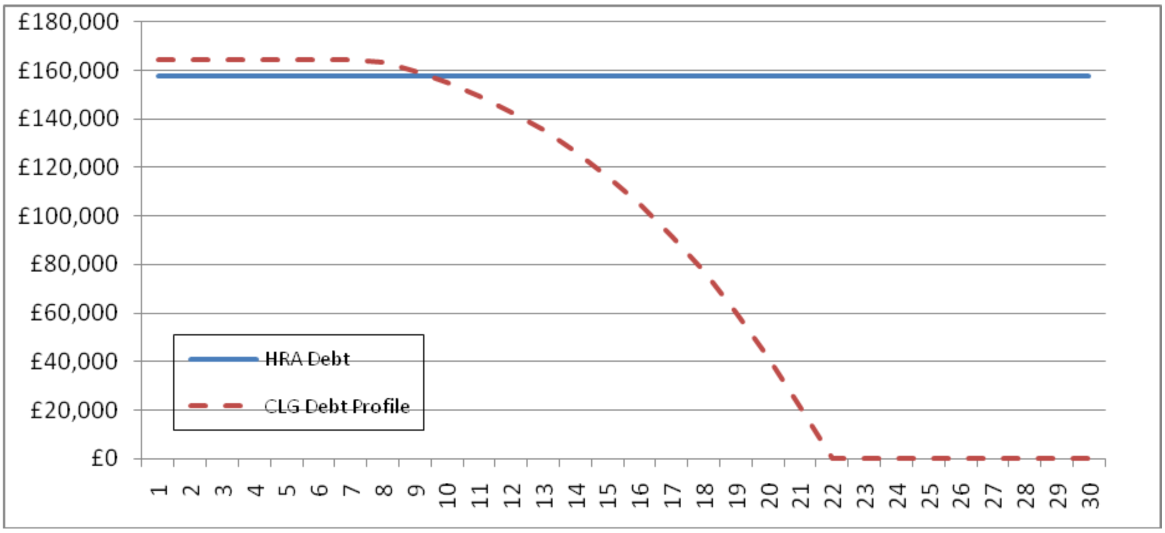
5.3 If debt is maintained as in (i) at £157.644m, reserves build to above £400m after 35 years. Charts 1a and 1b show the outcome.

[4] The HRACFR is the actual element of the council's overall surplus or debt relating specifically to Housing. The SubsidyCFR is the assumed level of surplus or debt within the current subsidy system for the council's HRA.

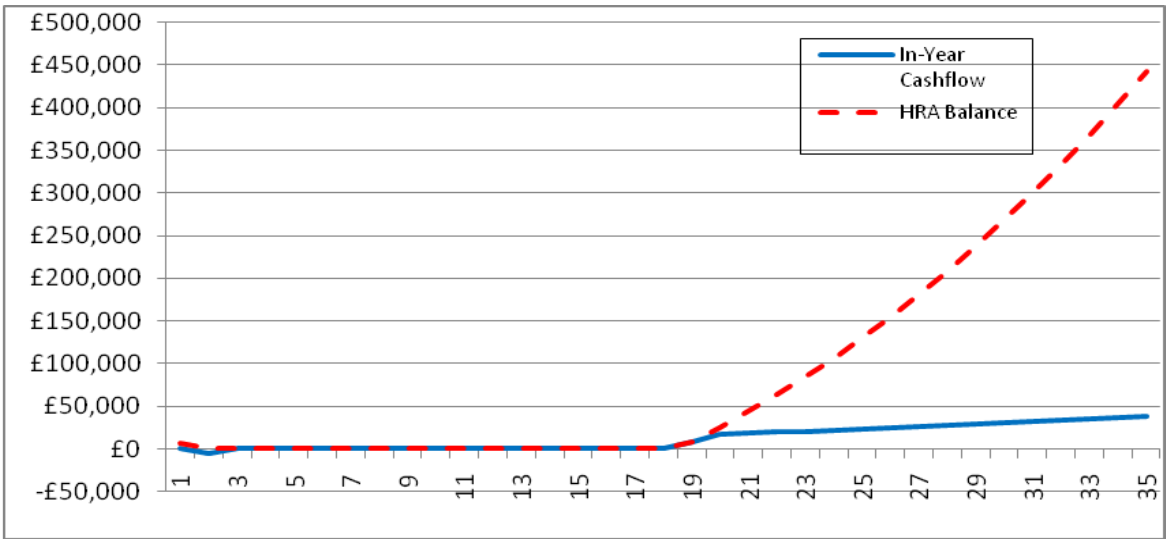
5.4 If revenue surpluses are set aside to repay debt, repayment can be achieved after 18 years (compared to the CLG's assumption of 22 years) and reserves also built to nearly £450m after 35 years. Charts 2a and 2b show the outcome.

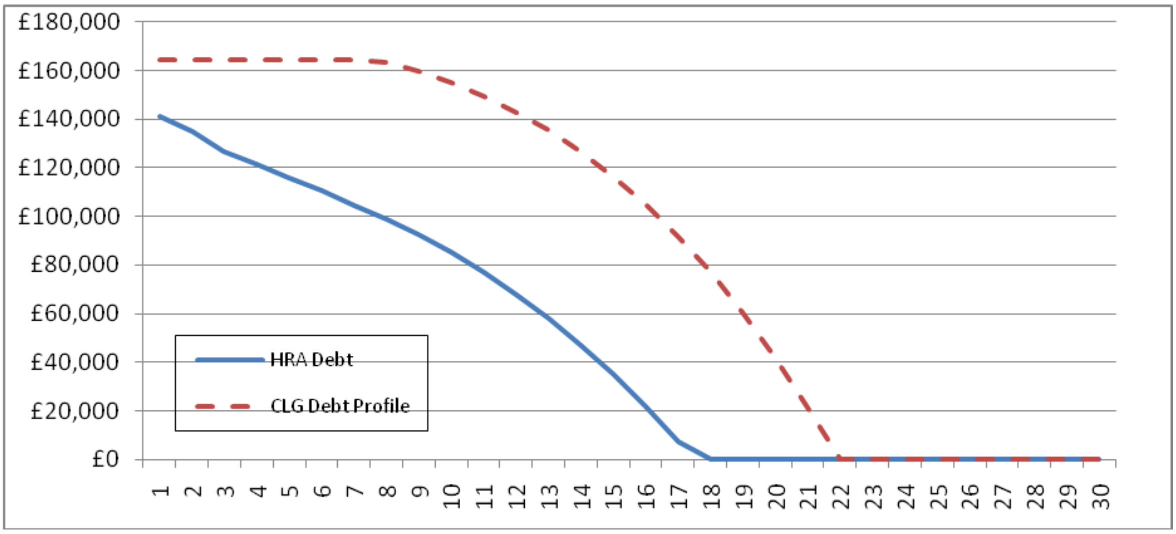
Charts 1a and 1b: Self financing revenue and debt profiles £'000: no set aside





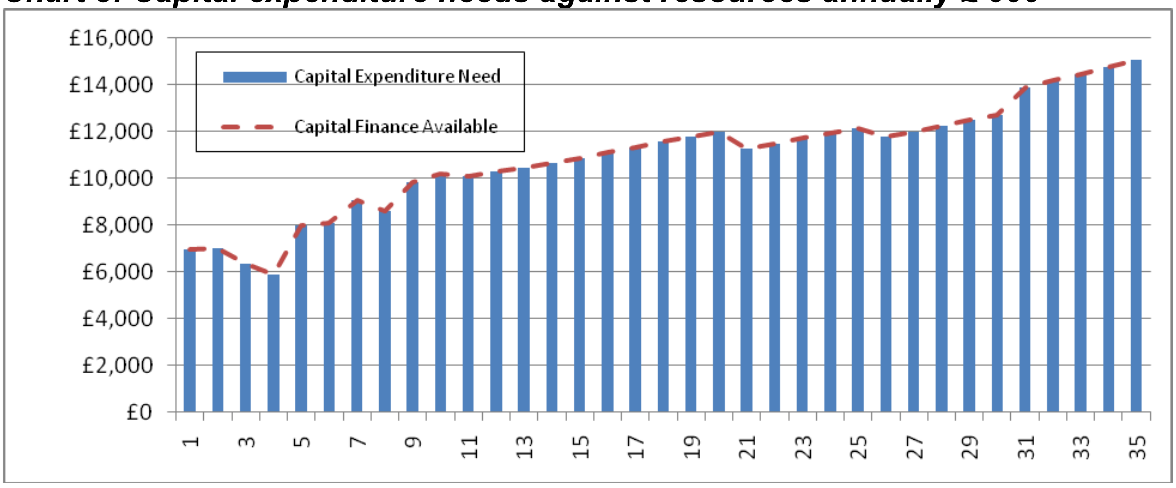
Charts 2a and 2b: Self financing revenue and debt profiles with set aside £'000





The Council's assessed capital investment needs, based on property surveys, are able to be met in every year of the plan. Chart 3 highlights the position.

Chart 3: Capital expenditure needs against resources annually £'000



6. Sensitivities

6.1 The plan is viable and resilient to changes in key assumptions. Some key headlines are set out below.

6.2 If interest rates were 7% not 6%, the debt repayment plan redeems debt by year 19 (compared to year 28). Overall the plan remains viable with considerable reserves at year 35.

6.3 Real inflation in capital costs (1% pa for 10 years) results with debt repayment pushed out to year 19. Overall the plan remains viable with considerable reserves at year 35.

6.4 Real inflation in management and maintenance costs (additional 1% pa for 10 years) reduces revenue surpluses but results in the plan remaining viable with considerable reserves at year 35and debt repaid by year 20.

6.5 If rent convergence was unable to be achieved until 2022 (say), this also has the effect of reducing revenue surpluses but debt repayment would be achieved by year 20. Overall the viability of the plan remains virtually unaffected in the long term.

7. Summary of modelling outcomes

7.1 In general, self financing based on a debt adjustment of £180.447m is viable for Epping Forest. There is in fact some room for manoeuvre for additional investment or service improvements over 30 years, given the plan's resilience as demonstrated above.

7.2 The principle reasons for the positive model for Epping Forest are:

- Rents are £7.20 below target[5] in 2010/11 hence the self financing plan builds headroom against current operating costs quickly in the period to convergence.
- Net forecast actual M&M costs in 2010/11 are £9.71m, after service charge income and non-dwelling rents, higher compared to assumed M&M (after uplifts) in the settlement of £11.34m.
- Debt begins some £6.8m below settlement – this allows the necessary borrowing to be undertaken to meet needs in the early years.
- The HRA and Major Repairs Reserve have combined balances of £11.2m

7.3 This means that although capital spending needs are £35k/unit over 30 years compared to uplifted MRA/unit of £29k/unit, there is sufficient headroom in the plan to achieve all the capital needs, subject to the sensitivities above. These could include new build and other environmental enhancements.

[5] Target or Formula rent is the level of rent attributed under rent restructuring and is the level of rent to which actual will eventually converge to. Other housing providers rents have to abide by this system.

8. Comparing self financing to subsidy

8.1 Self financing business plans on the basis of the current proposals are almost universally better funded than plans based on an unreformed subsidy system. This is the case for Epping Forest and principally arises as a result of the following key factors:

- The benefits of all net rent increases are available to the plan – i.e. surpluses are not captured nationally and redistributed; this is the critical difference between the two futures as rental surpluses are expected to be rise sharply in the future.
- The allocation of uplifts for M&M and major repairs allowances gives additional spending power from day one.
- The interest charge on debt is at a rate lower than the discount factor used in the settlement calculation.
- The opening debt is lower than that identified in the settlement (due to the difference between the CFR measures).

8.2 In an unreformed system, the following are the main comparative outputs:

- Instead of fully funding capital needs, there is a capital shortfall over 30 years estimated at £105m out of a total spend of £310m (including inflation). The shortfall starts occurring after 11 years. This is based on the full investment standard, reducing this by 20% extends viability to 16 years
- The forecast HRA position is broadly in balance only for 26 years

9. Technical issues for Epping Forest

9.1 There are a number of technical issues which are still to be resolved at the national level. These include the treatment of depreciation and the approach to the separation of debt between the General Fund and HRA.

9.2 For Epping Forest, as for others, there is a need to generate a fair depreciation charge for the HRA and this will no longer benefit from a link to the MRA as with the current system. Councils are advised to work through the options in advance of work to be undertaken by CIPFA and the Audit Commission which is expected to be completed later in the year,

9.3 As the council is taking debt on, there are some options in terms of Treasury Management (for example long term fixed rate loans vs variable rate loans). It should be noted that the government has expressed a desire to move to a greater GF/HRA separation of debt and the council should work through the implications carefully.

9.4 We have however identified a key issue for Epping Forest. Whilst this report concentrates on the impact on the HRA in respect of this prospectus, there will be significant implications to the Council’s General Fund, as currently proposed. Currently the Council is considered as debt free overall with the following CFR position:

- General Fund £22.019million
- HRA -£22.803million
- Overall -£0.784million

9.5 As we understand under existing regulations, should Epping Forest's HRACFR change to £157.644million, the Council's standing would no longer be considered debt free with an overall positive CFR. Authorities that are not debt free are required to make debt repayments, known as Minimum Revenue Provisions (MRP). Currently for capital expenditure funded by borrowing before 2008 a 4% MRP should be applied.

9.6 In this instance the General Fund would have to make an MRP of 4%, calculated at £0.881million per annum, which it currently does not have to, resulting as additional expenditure for 2011.12 and beyond (though reducing as we assume there will be no further General Fund borrowing).

9.7 Furthermore as the General Fund currently benefits from the average overall CFR, with the HRA taking on debt, it is expected that the Consolidated Rate of Interest (CRI[6]) charged to the General fund could increase. A 1% increase could result in additional charges to the General Fund of £0.216million per annum.

9.8 Research has identified another Council, which is in a similar position to Epping Forest, who we understand have a form of dispensation from CLG that will prevent or significantly decrease this negative impact on the General Fund. We are seeking clarification of this from CLG and will work with officers to update stakeholders throughout this period of consultation.

9.9 If, however, additional costs were to fall onto the HRA in the form protecting the General Fund in the region of £1million per annum, the resulting effect on the HRA would mean repayment of debt would extend by 2 years.

9.10 Revised draft guidance on the operation of the HRA ring fence is included in the prospectus carrying with it some proposals around the treatment of certain types of expenditure. Councils are advised to work through whether this might create movements between the accounts to inform their response.

9.11 We understand that the Council's Director of Finance will be providing more detailed information to Members on the effects and implications on the Council's General Fund. This is the reason that our report concentrates on the implications to the HRA and avoids covering this very important matter in greater detail.

10. Risk and reward

[6] The CRI is the average rate of interest across the Councils debt or retained surpluses.

10.1 Moving to a self financing system significantly alters the risk profile in HRA business plans and the council housing service.

10.2 The risks of the current system focus on unpredictability and political intervention in the system (in the widest sense) and on the fact that significant revenue rental surpluses will leave Epping Forest to other parts of the country.

10.3 New risks are around increased Treasury Management, interest rate fluctuations and the fact that the council will have local responsibility for all spending (revenue and capital).

10.4 A robust risk management strategy is therefore an essential strategic document to support the asset management decisions within the business plan.

11. New Build

11.1 Contained within the announcement of this "offer" was a statement that by reducing the level of debt council's will be taking on they should be able to deliver 10,000 new homes a year. At this stage we are not certain as to whether council's debt settlements are dependent on the ability for you to deliver new homes within the HRA.

11.2 What could this mean in terms of delivery of new properties? We have interpreted this in two ways assuming build costs of £100k per unit at a high level:

11.3 Example 1

At 6% CRI the debt charge 'saved' are £475,200 per annum. Over 5 years this, combined with 50% grant could deliver nearly 47 properties, or 235 over 30 years.

There will obviously be benefits to the HRA of rental income from these properties, though these will be offset by management, maintenance and improvement costs.

11.4 Example 2

Further accurate modelling can be undertaken within the business plan model once more accurate knowledge around land availability, build costs and property types are known to help inform the response to CLG.

However by assuming build costs of £100,000, grant of 30%, rents of £85 and assumed levels of repairs and maintenance we estimate that 240 properties could be provided for. This analysis that taking account all income, expenditure and notional interest, the new build schemes would break-even over 30 years. When applying these schemes to the actual HRA Business plan, the debt repayment is extended by one year.

11.5 We are aware of the Council's decision in principle to recommence new build for social rented housing, subject to the problems referred to earlier with the General Fund's Capital Financing Requirement being overcome. Subject to the General Fund problem being overcome, the CLG's "offer" will allow the Council to Fund a social house-building programme, through a mixture of borrowing and grants from the Homes and Communities Agency (HCA).

12. Summary national issues

12.1 The large majority of authorities, like Epping Forest, will have a potentially viable plan and certainly one which has more resources compared to staying in an unreformed system. In this context, the overwhelming majority of authorities may well be minded to respond positively to the proposals for self financing on the terms that they appear in the prospectus. However, there are some national caveats.

12.2 Given that the prospectus has been issued at a time of considerable change with financial and policy uncertainty, there is the potential for the proposals not to proceed to implementation as planned. Three areas felt to be key are:

- The number and type of authorities that say 'no' to the proposals or are not in a position to respond positively – it is unclear whether CLG have a number in mind that might affect the future for those that do want to proceed.
- The outcome of the General Election and the policy uncertainty that this brings.
- The financial terms of the proposals will be subject to a Spending Review (or equivalent) in the autumn which might affect some of the assumptions.

12.3 Given the direction of travel of the recent political debate, it may be that the methodology within the settlement remains essentially intact but that there is a risk that the financial terms are affected by very close scrutiny by new policy makers.

13. Summary of Implications to Epping Forest

13.1 These are the key conclusions from our analysis of the implications to Epping Forest:

- The settlement of £164.441m results in a net debt take-on of £180.447m.
- The uplifts to the allowances to arrive at this figure are generally lower than the region and national averages
- The resulting take-on of debt and withdrawal from the subsidy system result in revenue surpluses to finance the resulting interest charges and facilitate debt repayment
- Epping Forest could repay the debt repayment within 18 years, though various factors could extend this period.

- The HRA will remain viable throughout this period with balances accruing after debt repayment.
- The Council's assessment of its stock investment needs can be fully met throughout the duration of the 35 year plan.
- The key reasons for the viability and resilience to changes in assumptions is that plan starts with balances in reserves, interest rates that can outperform those allowed for in the settlement.
- The financial position under self-financing is significantly improved compared to remaining within subsidy.
- The settlement offers the potential for HRA new build.
- There are significant negative implications to the General Fund, however, as the Council will lose its debt free status.

14. Summary of Key Issues for Epping Forest in responding to the prospectus

14.1 These are the key issues Epping Forest should focus upon in their response to the prospectus:

- The greatest implication to the Council is the effect to the General Fund and representation on this must be made as the prospectus does state that there should be no additional burden with the adjustment of debt.
- Questions could be raised in respect of the uplifts to allowances to arrive at the settlement, when making comparisons to neighbouring authorities.
- Clarification needs to be made around the ability to reopen debt and the circumstances that this would be enacted.
- With regard to HRA new build levels, clarification should be sort as to whether local targets might be set and the duration.

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