Communities and Local Government

# Self-financing of council housing services: Summary of findings of a modelling exercise

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# Self-financing of council housing services: Summary of findings of a modelling exercise

This is a report on the findings of a project to examine the costs, benefits and practicalities of allowing local authorities to leave the Housing Revenue Account subsidy system. It has been prepared by members of the two project groups.

The project is of an exploratory nature and this report does not suggest a commitment by any of the organisations involved about the future management of their housing services.

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Department for Communities and Local Government: London

Department for Communities and Local Government
Eland House
Bressenden Place
London
SW1E 5DU
Telephone: 020 7944 4400
Website: www.communities.gov.uk

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# 1. Executive summary

In autumn 2006 six local authorities – three of them with Arms Length Management Organisations (ALMOs) – were invited by Communities and Local Government to take part in an exercise to test the costs and benefits of operating outside the redistributive national Housing Revenue Account (HRA) subsidy system. This paper sets out the findings of the project.

The six authorities produced model 30 year business plans based on a one-off settlement with central Government which would allow them to leave the national system. The premise was that, once out of the system, councils would keep all their rental income. Councils which were expected to make operating surpluses under the current system would not pay these into the national pot. And councils which were expected to have a revenue shortfall would not receive any subsidies.

The exercise examined whether the settlement price for leaving the system could meet two objectives: putting the councils in a position to finance their investment programme and service their debt over the 30 years of the business plan, but set at a level which broadly matched the resources which would have been provided if the council had remained within the HRA subsidy system.

## 1.1 The price of leaving the HRA subsidy system

The starting point was to calculate the value of the surplus payments into the HRA subsidy system – or the subsidies received from the system – which each of the six might expect over the next 30 years. To do this, a series of assumptions had to be made about elements in the formula that determines what each council pays or receives each year. The main assumptions were that current policy on rents and spending needs would continue over 30 years.

This 30 year cash flow was next converted into a lump sum, the settlement price, payable at the start of the business plan. To reflect the present value of these future cash flows, a discount factor was applied. This settlement price is then either added to or deducted from existing HRA debt, depending on whether it is a positive or negative value – ie depending on whether the council is a net contributor to or beneficiary of the subsidy system over the 30 years. The sum of the existing debt and the settlement price is therefore the opening debt level for a self-financing council.

## 1.2 Testing the viability of self-financing business plans

The six modelling authorities established their investment needs, using a range of different scenarios. The base case reflected the minimum investment needed to maintain decent homes and meet other basic needs of the stock and neighbourhoods.

To indicate the viability of a self-financing settlement, the models use an approach which shows the debt profile over the 30 years of the business plan. A rising level of debt indicates that spending needs are greater than income, suggesting that a plan is

unaffordable. A constant or falling level of debt indicates that the plan is probably affordable.

The model assumes income that is not needed to spend on maintaining decent homes and the basic sustainability of the stock is used to repay debt. This approach illustrates the viability of the business plans. However, in reality, some or all of this surplus might instead be used to deliver extra services. The debt profile therefore indicates the point at which these extra services could start to be delivered and the scope to fund them.

The opening debt level shapes this debt profile. And the settlement price drives the opening debt level. The model first tested the viability of the opening debt levels which would be produced if the settlement was set at the price indicated by the core assumptions about rents and spending needs in the HRA subsidy system. For all six authorities, the debt profile suggested that the business plan would be unaffordable. This was in particular driven by the forecast future build up of rental surpluses within the subsidy system implied by the continuation of current policy towards rents and allowances. This assumes that rents will rise more quickly than allowances, driving up the surplus payments within the system and therefore the cost of leaving it.

## 1.3 Establishing a viable level of opening debt

The models then established the opening level of debt which would be needed to produce a viable business plan. For all six authorities this would require a lower level of opening debt than indicated by the original settlement calculation.

The project considered the reason for the gap between the two sets of figures. The first reason is that the business plans for all authorities indicate they need a level of investment over 30 years which is higher than the spending needs assumed in the HRA subsidy system. In other words, their plans for basic sustainability would not be deliverable within the HRA subsidy system if current policies are maintained.

Secondly, the modelling work indicates particular problems for authorities with large amounts of debt, including future supported capital expenditure (for example those in the middle of ALMO decent homes programmes). This is related to the principle in the original modelling work that all subsidies, including debt support, should be treated in the same manner for the purposes of establishing the settlement price. Just as the subsidies and surplus payments related to the running costs of the stock are forecast over 30 years and capitalised, so are the interest payments on HRA debt which Government would meet through the subsidy system. However, as the present value of 30 years of interest payments is less than the value of the debt, a settlement on the original calculation basis would leave an amount of debt on year one with no income stream to support it.

To address these problems the exercise examined alternative approaches to establishing the settlement price. Any changes to the allowances within the HRA subsidy system would of course impact on the value of the settlement. The exercise considered whether any other justifications could be made for a different settlement price, including an element to reflect the transfer of risk. It also looked at a different

approach to the HRA debt which is currently supported by the subsidy system. By separating this element out from the allowances made for running costs, self-financing might be made viable for with-debt authorities who appear to be disadvantaged under the original approach.

## 1.4 Public spending implications

The project addressed Government concerns about levels of public borrowing and spending on housing. Borrowing undertaken by a self-financing authority would still be local authority prudential borrowing and would count against overall public spending. The HRA subsidy system exerts significant control over borrowing and spending, which would be lost if an authority left the system. The modelling authorities proposed a form of long term borrowing agreement which could operate within the context of the existing prudential code which covers local authority borrowing. This could provide predictability and some control over spending and borrowing plans by self-financing authorities without undermining the principle of self-financing. In addition, the modelling work suggests that business plans would not depend on a significant increase in overall borrowing and that, in many cases, there would be opportunities to repay debt, debt that is currently only serviced with interest support through the subsidy system.

## 1.5 Potential benefits of a localised system

As well as testing the affordability of a business plan based on different settlement levels, the project examined claims about the inherent benefits of a localised system of housing finance. The six modelling authorities concluded that self-financing would:

- help them *plan for the long term* by freeing them from the unpredictability of a complex system of national resource redistribution

- enhance *effective local decision making* by allowing them more freedom to allocate their rental income between different areas of service, and between services and stock investment

- *enable more effective active asset management* and taking of long term decisions about the use of assets, including the reuse and redevelopment of land and dwellings and the development of new housing

- *improve access to private finance* by increasing opportunities to use land and other assets within HRAs more effectively, for example to diversify tenure and design type to transform estates and to lever in private finance through partnerships with developers, through shared ownership and house sales

- *deliver greater efficiency* through: better rates from long term partnering arrangements, with the predictability of resources allowing contractors to plan labour and develop a long term approach to the supply chain; long term planning which allows client side overheads to be reduced permanently; reductions in the cost of patching up elements prior to their eventual renewal; the ability to package works effectively over the long term; and the placing of environmental works into planned sustainability programmes.

These benefits are related to the form of financing and decision making, not to securing a bigger share of national housing resources. But in order to deliver the benefits, some changes would nevertheless be necessary to create an opening level of debt from which a sustainable self-financing business plan could be produced.

The modelling work undertaken for this project has been designed to allow different factors and inputs to be substituted easily. The impact of changes or proposed changes to the housing finance system can therefore be readily tested.

## 1.6 Next steps

This project has highlighted the potential efficiencies and benefits that locally based self-financing business plans could deliver. The project has also highlighted the gap between what the current subsidy system is delivering and what will be required if the stock is to be adequately maintained into the long term. This has in part influenced the Government to announce a fundamental review of the housing revenue subsidy system.

The review of the HRA subsidy system is intended to recommend a sustainable, long term system for financing council housing. The evidence from the current project is that self-financing could play a significant part in achieving this. The evidence gathered and presented in this report should inform the work of the review and offers a model for a possible alternative to the current system.

# 2. Background to the exercise

## 2.1 Devolving housing capital finance

The notion of offering additional freedoms and flexibilities to high performing local authorities is consistent with the Government's wider policy aims to secure service and performance improvement through devolving decision making. It has been established within the local authority arena for some years.

The idea of providing incentives to improve performance within the Housing Revenue Account arena was raised in a Government consultation paper of August 2002: *The blues skies debate: the way forward for housing capital finance*. This paper covered the Government's proposals for the application of the principles within the Local Government Act 2003 to the HRA, in particular the introduction of the Prudential Code and pooling for capital receipts.

In the paper, the Government committed to explore options for local authorities to:

*"retain the benefits of future rent increases, neither receive subsidy nor pay over surpluses and to undergo a debt restructuring... As this would involve considerably greater freedom (and risks), it might only be available to high performing councils as a form of earned autonomy."*

The proposals were widely welcomed by the housing sector.

## 2.2 The review of Arms Length Management Organisations (ALMOs)

The proposal was taken forward as part of a review of the long term viability of ALMOs commissioned by the Government which ran from September 2004 and which reported in June 2006. The terms of reference for this review included:

*"[explore] options for increased freedoms and flexibilities for ALMOs including financial freedoms… looking at the legal, financial and policy implications having regard to public expenditure considerations."*

A report on possible financial freedoms, jointly commissioned by the Chartered Institute of Housing, the National Federation of ALMOs and HouseMark, was submitted to the review. This incorporated some preliminary financial modelling for six volunteer ALMO authorities. The report, *ALMOs: a new future for council housing*, was considered as part of the review and the outcomes taken forward when the review was concluded.

The outcome of the review was published in June 2006 alongside the Government consultation *From decent homes to sustainable communities*. As one of a range of commitments to increase the flexibility of local authorities in facilitating the long term

sustainability of neighbourhoods and communities, the Government announced it would set up a project to:

"*…look at the costs and benefits of allowing some excellent councils and councils with excellent ALMOs the freedom to operate outside the HRA subsidy system. We intend to invite six local authorities, some of whom have retained their management in-house and some who have established ALMOs, to work with us to examine further these proposals*."

## 2.3 The rationale for self-financing

The Government wanted to test claims that a devolved model of financing local housing services would improve performance. This is linked to claims that the current framework hinders the ability of local authorities to:

- *plan for the long term:* given that financial and subsidy settlements are affected by short term movements in public expenditure planning and have an inherent degree of unpredictability implied by a complex system of resource redistribution
- *carry out effective local decision making*: the resource distribution within the HRA subsidy system is mainly formula-based and is designed to control the way in which local authorities allocate their rental income between different areas of service (for example between housing management, day to day maintenance and investment in major repairs)
- *carry out effective active asset management and estate transformation*: the unpredictable nature of subsidy resource allocations, it is argued, militates against the development of effective asset management strategies where for example long term decisions about the better use of assets through reuse and redevelopment of land and dwellings could be taken
- *increase the supply of new affordable housing*: there are powerful disincentives to the development of new housing within the HRA subsidy system operating through the pooling of rents and through the capital regulations on receipts from Right to Buy disposals
- *access private finance*: providing opportunities to use land and other assets within HRAs more effectively, to diversify tenure and design type to transform estates and to lever in private finance through partnerships with developers, through shared ownership and house sales
- *deliver greater efficiency*: short term resource horizons may lead to short term programmes and higher unit costs of investment.

# 3. Structure and terms of reference of the project

## 3.1 Membership and functions of the project groups

The core of the project has been the production of model 30 year self-financing business plans, based on some key principles and assumptions. The project has also considered legal, accounting, governance, regulatory and other issues related to self-financing.

Communities and Local Government set up two project groups to take forward the work:

### The modelling group

The modelling group consists of representatives of the local authorities and ALMOs invited to develop model business plans, as well as a consultant jointly employed by the modelling authorities to support and coordinate their work.

The authorities and ALMOs are:

- Cambridge City Council
- Carrick District Council with Carrick Housing Limited
- Darlington Borough Council
- London Borough of Hounslow with Hounslow Homes
- Sheffield City Council with Sheffield Homes
- Warwick District Council

The six local authorities and ALMOs invited to take part in the exercise were all classed as excellent under Comprehensive Performance Assessment (CPA) and housing assessments. They also cover a wide range of different circumstances, allowing the project to test the viability of self-financing for different types of authorities. These include differences in:

- subsidy levels and allowances
- stock size and condition
- relative deprivation
- urban and rural conditions
- housing affordability
- volume of stock lost through Right to Buy.

Table 1 shows the characteristics of the six authorities in 2006/2007, the base year for the project.

**Table 1:** Characteristics of modelling authorities

| Authority | Stock at 1/4/2006 | ALMO? | HRA subsidy (2006/7) | Region and type | Housing debt (2006/7) |
|---|---|---|---|---|---|
| Sheffield | 48,437 | Yes | £26.1m | Y-H – Met | £550m |
| Hounslow | 13,709 | Yes | £5.7m | London BC | £231m |
| Cambridge | 7,652 | No | -£9.1m | East – DC | Debt free |
| Warwick | 5,677 | No | -£5.5m | WM – DC | Debt free |
| Darlington | 5,596 | No | -£0.4m | NE – Unitary | £29m |
| Carrick | 3,727 | Yes | -£0.1m | SW – DC | £27m |

## 3.2 The contact group

The contact group comprised representatives from a range of professional and other stakeholder organisations:

- Audit Commission
- Chartered Institute of Housing
- Chartered Institute of Public Finance and Accountancy
- Communities and Local Government
- HM Treasury
- Local Government Association
- London Councils
- National Federation of ALMOs
- Tenant Participation Advisory Service
- Tribal Consulting
- Trowers & Hamlins solicitors.

The contact group examined a range of matters related to a self-financing settlement, including financial, legal, governance, regulatory and accounting issues. The contact group also reviewed outputs from the modelling group.

# 4. Principles and methodology of a self-financing settlement

## 4.1 A one-off settlement with no return to the HRA subsidy system

The objective of self-financing was to provide a stable financial framework which would allow authorities to plan more effectively for the long term, thereby enabling improvements in efficiency and asset management. The underlying principle was that an authority should be financially no better or worse off under self-financing than it would have been if it remained in the HRA subsidy system, in terms of its share of national resources. Any subsequent efficiencies the authority could make as a result of self-financing would be retained by the authority, but these benefits would not be at the expense of other authorities remaining in the subsidy system.

The following rules and assumptions were drawn up to determine the size of the financial settlement required for an authority to become self-financing.

The mechanism for an authority to leave the HRA subsidy system (referred to also in this report as HRAS) would be via a one off and final settlement. This settlement would entail an adjustment to the level of HRA debt based on a 30 year business plan.

The intention would be to leave the authority with a revised level of opening housing debt (on day one) which could be serviced from future income streams taking into account the delivery of services and stock investment within the business plan.

Where an authority would have subsidy payable to the national pool over the longer term, the expectation would be that the authority would buy out of paying future subsidy surpluses through a one off payment to Communities and Local Government, thereby increasing their housing debt.

Where an authority could expect to have received subsidy from Government over the longer term, the expectation is that the HRA would require debt to be reduced by Government in lieu of providing future subsidy.

Once the debt had been adjusted, there would no longer be a requirement to pay surpluses to, nor an entitlement to receive subsidy from, Government. This would be intended to be a one-off, binding adjustment with no return to the subsidy system.

The basis for the calculation of the settlement/adjustment has been a key area of inquiry within the project, exploring the financial implications for both authorities and for Government of different approaches and methodologies.

## 4.2 The net present value (NPV) of HRA subsidy over 30 years

The Government would wish to ensure that authorities remaining within the subsidy system are not disadvantaged by the departure of others, and to ensure that those authorities that leave do not receive a greater share of national resources than those who remain.

For this reason, a key principle of the approach to self-financing is fiscal neutrality to Government. The Government's proposed approach to securing this has been to base the settlement on the net present value (NPV) of HRA subsidy over 30 years. On this basis, the value of the NPV of HRA subsidy would represent the adjustment to the level of housing debt on day one.

Alternative methodologies have been considered as part of the project and these are set out later.

## 4.3 Future subsidy assumptions

The Government's spending plans are typically set out over a three-year spending review period. However, calculating an NPV of subsidy requires assumptions about the future treatment of housing subsidy to be made over a 30 year period. For modelling purposes, the majority of the work within the project has been based on a start year of 2006/07 updated for the actual subsidy determination for 2007/08.

Table 2 schedules the key assumptions made.

**Table 2: Schedule of assumptions utilised in calculation of NPV settlement**

| HRAS component | Assumption of future change | Values |
|---|---|---|
| Guideline rents | RPI+0.5% following convergence with formula rents in 2011/12 | Formula rents increase by RPI at 2.8% pa to 2011 then 2.7% pa thereafter |
| Rental Constraint Allowance (or equivalent) | Compensation for rent increases constrained by government policy and caps and limits | |
| Rent rebate subsidy limitation | Limit rents converge with formula rents in 2011/12 | |
| Management and Maintenance Allowances | Convergence with Y1 target allowances by 2012 | GDP deflator of 2.7% all years |
| Major Repairs Allowance | | GDP deflator of 2.7% all years |
| Subsidy CFR | Increased by Supported Capital Expenditure through regional housing boards and the ALMO programme; no SCE beyond 2010/11 | Interest charges based on local Consolidated Rate of Interest forecasts |
| Premiums and discounts | Included as they would have been under the HRAS system | |
| ALMO allowance (round 1 and round 2) | | Payable at 8% until 2010/11 and at local interest thereafter |

The assumptions are consistent with the medium term planning targets set within the Comprehensive Spending Review 2007 for public expenditure totals from 2008 to 2011. The assumptions beyond 2011 reflect an assumed continuation of the policy to allow guideline rents to converge to formula rents by 2012, for formula rents to increase in real terms by 0.5% per annum, and for expenditure allowances to increase in line with inflation.

Supported Capital Expenditure is included to the extent that there is agreement from Regional Housing Boards and via the ALMO programme.

The pooling of Right to Buy receipts is excluded on the basis that this will continue for housing stock that is already owned by an authority at the time it becomes self-financing. The forecast of subsidy components does however provide for an estimate of stock reductions through the Right to Buy. For the purposes of forecasting the national subsidy surpluses the assumption is for sales of 16,000 in 2006-07 with numbers reducing evenly to 5,000 per annum from 2015-16. Within each of the model business plans, forecasts have been based on local information.

Different assumptions used within the draft and final subsidy determinations for 2008/09 reflecting updated actual values for the 2008/09 financial year include:

- the extension of the convergence date for rent restructuring to 2016/17
- the replacement of the Rental Constraint Allowance with a Caps and Limits adjustment on guideline rent.

As the project work pre-dated this determination, these latest assumptions are not reflected in the modelling outputs set out in Section 7. However, an indication of their impact is set out for information in Table 7 below.

## 4.4 Discount rate

The future of subsidy has been projected in cash (ie nominal or outturn) terms, that is including provision for general inflation over 30 years.

As a future flow of cash (income less expenditure) over a period is commuted into one sum, the calculation requires a discount factor or rate to reflect the time value of money. The discount factor used for the calculation of the net present value of subsidy is a compounded sum of:

- the Treasury Test Discount Rate: 3.5% – the real return expected for all project appraisals within Government
- the long term inflation rate: 2.7%, the GDP deflator representing the Government's long term target for economic growth.

The factor in use is therefore 6.3%.

Other factors were considered during the project. The modelling group has presented a case for a higher rate to reflect the transfer or risk from Government to a local authority and this was considered as part of the project.

## 4.5 A revenue subsidy forecast

The principle of fiscal neutrality is focused on the future of HRAS in *revenue* terms for local authorities.

The forecast of subsidy therefore provides for an assumption of future property movements through Right to Buy, acquisitions and demolitions and partial stock transfers.

However, the elements of any capital receipts from Right to Buy sales (pooled or un-pooled) are not included. The assumptions about the treatment of receipts from Right to Buy sales of properties in place on day one of settlement are as they currently operate: 25% retained by the local authority and 75% pooled to Government.

A different approach has been applied for new properties built or acquired within business plans post-settlement, reflecting the proposal in the housing Green Paper that the capital receipts from new properties should in future be retained in full by a council.

Capital receipts from the disposal of other assets or non-Right to Buy disposal of dwellings are not included. These would be available for expenditure locally as currently provided for within the Capital Allowance arrangements within the Capital Financing Regulations.

## 4.6 Revenue support for debt charges

The forward forecast of HRA subsidy includes revenue support provided to service interest payments on housing debt (represented by the Subsidy Capital Financing Requirement (SCFR)).

Since 2004, provision for set aside to reduce the SCFR has not been included within HRAS and this has been maintained.

The methodology has highlighted some issues of principle in the treatment of debt and debt support which have been the subject of detailed analysis within the project. The outcomes from these analyses are set out later.

## 4.7 Treatment of PFI

While none of the case study authorities have any HRA PFI schemes in place, a small number of authorities nationally are in receipt of HRA PFI subsidy.

PFI subsidy payments support the annual unitary charge a privately financed contractor makes on the local authority. Subsidy support is provided on an annual fixed basis and contributes to the capital element of contracts.

PFI subsidy payments are a key part of a long term agreement between the Government and a local authority. A legally binding agreement exists between the local authority and the private sector contractor.

Some initial modelling carried out by members of the contact group highlighted the difficulties of incorporating PFI subsidy into a general self-financing settlement based on the NPV of subsidy. As a matter of principle therefore, it is appropriate to separate the treatment of future PFI subsidy from any HRA settlement based on the NPV of subsidy (excluding PFI). The presumption is that an authority with a PFI scheme wishing to explore self-financing would assume that PFI subsidy would be addressed separately.

## 4.8 Legislative considerations

The 1989 Local Government and Housing Act provides for authorities owning properties held within the HRA to be subject to an HRA subsidy determination made by the Secretary of State. The legislation allows for the determination to require the authority concerned to pay or receive a stated amount or have a determination of zero. Taking an authority out of the requirement to pay in or entitlement to receive HRA subsidy would require the adoption of suitable legislative arrangements as set out in what is currently clause 269 of the Housing and Regeneration Bill.

It is proposed that there would be a formal self-financing agreement between the Government (formally the Secretary of State) and the local authority.

The agreement needs to be expressed in terms which are clear and unequivocal. On the one hand, the local authority will want to know that there is no likelihood of the local authority in future being required to make subsidy payments (notwithstanding the one-off adjustment to leave the subsidy system) and on the other the Government will want to ensure that the local authority will not seek to re-enter the subsidy system if circumstances change and assumptions prove false.

The agreement should therefore be clear about the circumstances under which a return to the subsidy system or any future payments into the system could be triggered. Uncertainty would discourage participation in self-financing.

The underlying principle is that the self-financing settlement is a one-off deal which allocates risk on a ‘full and final’ basis. Two obvious examples of risks are around stock condition and interest rates. The local authority will look to its stock condition surveyors to provide the key figures for a business plan on which it can rely. Likewise, the local authority will take the risk on interest rate fluctuations in a self-financing HRA context as it currently does for the remainder of its non-HRA debt.

There might need to be recourse if, for example, the Government were to change rent policy in ways which cause the business plan to be unworkable – a more detailed discussion is set out below (Section 9).

A way needs to be found to provide for future changes in the law. Changes might fall into two categories: policy and case law. If housing policy were to change (inevitable in a 30 year time frame), so as substantially to increase the costs for a local authority, the self-financing settlement may no longer be financially viable. The same could obviously be true if existing law were to be interpreted in ways which could not reasonably have been expected at the point at which the agreement were made.

It may be that in both these instances (but particularly the latter) the agreement would simply reflect that the local authority has carried out its sensitivity testing on the robustness of the agreement and rely on any out-performance of the business plan to counteract any unexpected pressures. An approach similar to that adopted in the standardised drafting for "change in law" risk in PFI contracts may be appropriate in the event that a risk share agreement is to be adopted.

The agreement will also need to address the potential levels of borrowing. HM Treasury will be concerned to ensure that the result of a settlement is not such as to lead actually or potentially to levels of borrowing which impact adversely on local or national finance policy. A detailed discussion of the management of borrowing and debt in a self-financing context is set out at 8.4 and 8.5.

Within the agreement, there would need to be some flexibility in the limitation so as to anticipate changing requirements over a 30 year time frame and to provide a mechanism for the local authority to negotiate changes with Government that meet future needs on a regular basis. Indeed the provisions in the Housing and Regeneration Bill which would enable self-financing permit changes to be made to the agreement where there is consent by both parties (ie the local authority concerned and the Secretary of State) to the change.

Right to Buy and other receipts are excluded from the self-financing settlement. It is assumed that Right to Buy receipts for the stock in place at the point of settlement will be subject to current policy while other capital receipts will continue to be subject to the Capital Allowance arrangements within the Capital Financing Regulations.

The Housing Green Paper proposed allowing all local authorities to keep the full capital receipts from sales of new properties they build or acquire in future. If this change is made it would encourage self-financing authorities to consider options for investing in new build. Without such changes, self-financing authorities would be unlikely to make the investment in new supply they have identified in model business plans.

# 5. Impact on the HRA subsidy system

## 5.1 Neutrality/equality of treatment with those in the subsidy system

The purpose of the project has been to test the benefits that would come from the freedom to operate outside the HRA subsidy system. In order to compare this with delivery through the subsidy system, the exercise has aimed for a model which is fiscally neutral in terms of the share of housing resources.

The NPV approach is intended to ensure that a self-financing authority will receive a level of Government resources equivalent to that which they would have received within the subsidy system. However, the modelling has demonstrated that an NPV based on assumptions that current levels of funding would continue over the period of the business plan would not be sufficient to deliver sustainable housing services.

This points to potential funding difficulties over the medium term within the HRA subsidy system. But it also highlights difficulties in projecting forward 30 years from an annual determination which is only intended to take account of current needs.

Recognition that current levels of funding through the HRA subsidy system only reflect short term needs could in theory lead to a self-financing settlement that incorporates some additional funding to reflect expectations about investment needs in future years. Other arguments for justifying a higher level of resources for self-financing authorities are:

- to include an element of risk transfer priced into the settlement
- a recognition of the improved service outcomes that self-financing could potentially deliver.

In recent years, allowances for assumed need to spend have not kept pace with rises in assumed income. This has led to the subsidy system being forecast to move into surplus nationally from 2008-09. The Treasury takes forecasts of deficits or surpluses in the HRAS into account when agreeing the overall level of resources available for housing in the spending review settlement for Communities and Local Government. This means that changes to the HRAS have a direct effect on the level of resources available to housing nationally.

Higher assumed surpluses will push up the cost of the self-financing settlement to local authorities who would be expected to pay in surpluses, and reduce the payment from Government for those who would receive subsidies.

Within the overall national context, the position for individual authorities varies not only in line with the general trend in future surpluses but also in the relative position within the redistribution framework. In recent years, there has also often been considerable variation between draft and final settlements within each financial year.

Authorities find it difficult to plan ahead effectively given a trend towards increased unpredictability in allowances.

## 5.2 Impact of changes to the subsidy system

Changes to policies on rents and allowances within the HRA subsidy system would generate different levels of surplus or deficit to be reflected in a self-financing settlement. There would be no additional cost attributable to self-financing of such changes.

If allowances were increased, they would reduce the level of surpluses and improve the viability of self-financing settlements, but with the effect of reducing the overall level of resources available to central Government for other housing investment.

Lower assumptions about future rent increases would reduce the forecast surpluses. This would not have a net impact on the resources available to self-financing authorities, but it would change the financial profile. Self-financing councils would take on less debt (or would receive a larger level of debt reduction) but would in exchange have a lower net income stream. The wider effect would however be to reduce the level of resources available to central Government for other housing investment.

It remains to be seen what decisions Government will make about the future of the HRA subsidy system, given the evidence about expenditure needs and the income that current rent policy would generate. The evidence on the unsustainability of the current subsidy system has in part convinced Government of the merits of a fundamental review of the subsidy system announced by the Housing Minister on 12 December 2007.

# 6. Relationship to the general fund

Local authorities considering operating their housing finances outside the HRA subsidy system would want to understand the potential impact on their overall finances. This chapter looks at the operation of the Housing Revenue Account and the impact on the General Fund under a self-financing arrangement.

Self-financing authorities would leave the Housing Revenue Account subsidy system, but their HRA itself would be maintained, and with it the ring-fence and all the related measures within the Local Government and Housing Act 1989.

The HRA is ring-fenced within the authority's General Fund, meaning that the income and expenditure on council housing in the HRA must balance; all other service delivery is accounted for in the General Fund. This section sets out the main areas where an authority's General Fund might be affected by a self-financing arrangement for the HRA. It also looks at the assumed level of contributions from leaseholders.

## 6.1 Interplay between HRA CFR, Subsidy CFR and overall level of debt

Subsidy Capital Financing Requirement (SCFR) is recognised as the attributable housing debt and used for subsidy payments and the base for Large Scale Voluntary Transfer (LSVT) settlements.

The Housing Revenue Account Capital Financing Requirement (HRACFR) is used for charging interest between General Fund and HRA. Where HRACFR is positive, interest is charged by the General Fund to HRA at the Consolidated Rate of Interest (CRI). The CRI includes external interest paid and interest on internal General Fund resources used temporarily in lieu of external borrowing; the latter amount is often referred to as "internal lending".

Where new borrowing takes place to support capital expenditure on either HRA or General Fund, this will impact on the CRI. If borrowing is solely for HRA purposes, the CRI is affected for both the HRA and General Fund charges and vice versa. The implications of this could be significant where "settlement debt" is taken on.

In certain circumstances, it is possible that an authority has no actual debt but has a positive measure of HRACFR. In this situation there would be "internal lending" between the General Fund and HRA. While there are no external debt charges payable by the authority, the General Fund receives interest from HRA on the internal lending and this is shown as a debt payment contribution (via the Item 8 debit) in the HRA. Providing no borrowing is undertaken and no receipts or revenue set aside against the housing debt, the position would continue indefinitely. The General Fund would continue to receive interest from the HRA rather than from external investments. Depending on market rates there could be a small differential between these two alternatives.

When General Fund resources are applied for their intended purpose, the local authority will need to borrow to cover the existing HRACFR requirement. The General Fund would lose investment interest as a result of General Fund activity. HRA would incur external interest charges.

If new housing debt were to be taken on at settlement or in the future, the interest costs would be borne by the HRA. If new debt is taken on by both HRA and General Fund, the costs would be split pro rata.

## 6.2 Direct implications

The most likely source of direct implication for the General Fund will therefore be as a result of a significant change in debt levels up or down upon settlement. In some circumstances this would enable positive treasury management to lower average overall debt interest rates payable by the authority. The consolidated rates of interest at the modelling group authorities vary as shown in Table 3.

**Table 3:** Summary of estimated overall debt position for the six modelling authorities

| **Authority** | **HRACFR (1/4/06) £m** | **Of which est. ALMO borrowing £m** | **Overall CFR (estimated) £m** | **Consolidated rate of interest 2006/07** | **Notes** |
|---|---|---|---|---|---|
| Carrick | 27 | 23 | 30 | 5.1% | |
| Darlington | 29 | - | 50 | 4.6% | |
| Hounslow | 231 | 100 | 340 | 5.6% | |
| Sheffield | 552 | 97 | 900 | 6.6% | |
| Cambridge | 1 | - | - | n/a | Debt free |
| Warwick | 0 | - | - | n/a | Debt free |

The ability to lower average interest rates across the authority has benefits for the General Fund, irrespective of self-financing, and the HRA in a self-financing context. Currently, the subsidy calculation is adjusted to reflect any changes in interest rates for the HRA.

Using examples from Table 3, a 0.5% change in interest rate for the General Fund proportion of the debt at Hounslow could have an impact of up to £0.5m per year where new lower priced borrowing would be taken on at settlement. This though is only because of current market conditions.

The opposite effect would occur in Darlington, where new borrowing is likely to be above the current CRI and therefore increase costs to the General Fund unless government intervention prevented this.

### 6.2.1 Local authority treasury management

Debt Management Expenses are incurred by an authority with borrowing.
A proportion of these are properly chargeable to the HRA. If there is more debt, or in future there is borrowing where there is currently debt free status, this may affect the actual costs of treasury management for the authority. This will also affect the incidence of charges between the General Fund and the HRA. These are not likely to be significant but would arise as a direct impact of any change in debt levels at settlement.

### 6.2.2 Share of Right to Buy receipts

The modelling exercise has shown that only a small minority of authorities allocate useable Right to Buy receipts to HRA capital programmes and that in most cases the General Fund capital programme places heavy reliance on the 25% element being available to support other housing and regeneration expenditure. Any change to the availability of these receipts to the General Fund would be a "deal breaker" for most authorities.

While there is no reason why self-financing of itself would imply changes to the pooling regime as it affects the availability of the 25% useable element, authorities would want to see this confirmed. If this does not appear in the self-financing agreement authorities would want some other assurance that 100% of receipts arising from disposals of HRA assets would be appropriately available to the HRA moving forward (for newly built or acquired assets financed within a self-financing business plan) as proposed in the Housing Green Paper of July 2007.

## 6.3 Indirect implications

### 6.3.1 Recharges and the HRA ring fence

A move to self-financing should have no direct implications for the revenue charges and recharges between the General Fund and HRA save for the treasury management costs identified above. However, on the basis that a self-financing HRA has greater long term stability and viability than the HRA in subsidy, there is the possibility that financial challenges on General Fund revenue accounts might result in pressure to increase recharges from the General Fund to the HRA.

It will be important to ensure that charges between the accounts continue to reflect the statutory ring fence and that finance and audit professionals continue to ensure transparency in these charges. A self-financing HRA should not be utilised to support General Fund expenditure and services and a restatement or update of ring fence policy would be a useful addition to any guidance to an authority which became self-financing.

### 6.3.2 General Fund service expenditure

There might be longer term, indirect, implications on General Fund service expenditure arising from the HRA being in a stronger, more viable position. These could arise from the potential to take better asset management decisions within the housing asset base as a result of being self-financing. Some of the areas identified could include:

- reduction in costly temporary accommodation as a more sustainable approach to provision could be adopted within a self-financing HRA
- reduction in Supporting People costs arising from the ability to generate capital investment in supported housing in a self-financing context
- ability to increase supply would go some way to reducing pressure on the housing register and enable more proactivity in the lettings process
- careful asset management planning would ensure that new developments added to the ability to meet priority housing need within each authority area.

## 6.4 Leaseholders and owner occupiers

The assumed level of contributions from leaseholders is also a factor in the business plan modelling exercise as it is possible that a self-financing authority may have plans to improve individual properties to higher standards than might be the case under the existing subsidy system. These plans could be affected by the need for a contribution towards the cost of works to structural common parts of an estate from leaseholders (and potentially other owner-occupiers). This issue becomes most difficult to deal with when the proportion of tenants to leaseholders is low, as is the case in many authorities (especially London boroughs).

Local authorities have powers to cap service charges to leaseholders in certain limited circumstances. A Statutory Direction issued in 1997 and updated in 1999 and 2000 applies Mandatory Capping of £10,000 per leaseholder in any rolling five year period to prescribed regeneration initiatives e.g. PFI, unless the local authority considers that the works to the leaseholder's property have resulted in a benefit to the property exceeding £10,000. Another Direction issued in 1997 gives authorities discretion to cap service charges that meet a specific range of criteria, the most important of which is that levying a charge would cause "exceptional" financial hardship to the leaseholder.

Given that most leaseholders have equity in their property it is very difficult for local authorities to use this direction to cap charges. There is currently no indication that a new Direction will be issued by Communities and Local Government to apply Mandatory Capping of Leaseholders charges to any investment arising from a self-financing business plan.

A further issue is that local authorities need to inform leaseholders of the estimated costs that will be incurred on their estates over the next five years when they purchase. Any increases in this amount that may result from self-financing in the short term may therefore be irrecoverable.

It is possible that regeneration initiatives may also involve freehold houses on an estate. Given the probable difficulties of recovering expenditure from freeholders, that in theory needs to be anticipated in a self-financing settlement but the costs are likely to be much lower than those relating to structural common parts. In most cases the issue may be regarded as insignificant.

Assuming that no new directions are issued by the Government then the assessment of contributions from leaseholders for a self-financing business plan is subject to the same risks as an authority remaining within the subsidy system.

# 7. Outputs from the modelling work

## 7.1 The principles of the modelling: a two stage analysis

The financial modelling has been undertaken in a two stage process in line with the approach set out by Communities and Local Government at the beginning of the project:

- to establish the basis for settlement and the debt adjustment given assumptions about the future behaviour of housing subsidy
- to prepare long term business plans based on the actual plans which authorities might wish to develop if released from HRAS.

The outputs from the two stages shape the financial implications of self-financing for authorities and for Government. The form of the financial reporting is summarised below.

### 7.1.1 Stage 1: establish NPV of subsidy

The approach adopted has been to forward forecast the assumptions of subsidy as set out in section 4.3 and express this as a single debt adjustment payable to or from Government.

This adjustment has then been reflected in revised opening debt levels from which business plan forecasts are launched.

### 7.1.2 Stage 2: develop prospective long term self-financing business plans

The modelling authorities have generated spending plans based on a range of scenarios and which reflect both liabilities towards existing stock investment needs and investment in new development.

The generation of a self-financing business plan in this context is based on the assumptions listed in Table 4. All self-financing specimen and scenario business plans have 2006/07 budgets as their starting point and provide for specific short and medium spending plans within existing HRA business plans (if appropriate).

**Table 4:** Assumptions made for business plans

| **Component** | **Assumption of future change** |
|---|---|
| Property movements | Right to Buy sales in line with existing forecasts; other disposals according to local plans and planned partial stock transfer disposals |
| Rents | Equal annual steps to average formula rents by 2011/12 subject to estimated average caps and limits (RPI+0.5%+£2) |
| Service charges and other income | Increases in line with rent increases with no (further) de-pooling of service charges factored into plans |
| Management costs | Inflation only increases but with no adjustment for RTB stock losses |

| **Table 4 (cont):** Assumptions made for business plans | |
|---|---|
| Maintenance costs | Inflation only increases adjusted where appropriate for stock losses through Right to Buy |
| Use of SCE and unsupported borrowing | Borrowing in line with allocations from ALMO and other SCE; only in one authority are there assumptions of limited prudential borrowing to achieve the decent homes standard by 2010 |
| Interest rates, premiums and discounts | Forward forecast as per subsidy forecasts |

### 7.1.3 Explanatory note on the presentation of financial viability reporting

All forecasts within the modelling have been established so that the variation of all factors and inputs can be analysed. A key principle has been to set out a forecast of the potential financial viability of various scenarios and various levels of settlement.

The method of presentation to demonstrate viability or otherwise that has been adopted is to show forecast debt profiles over 30 years.

- A rising debt profile throughout 30 years indicates that the HRA business plan would be unaffordable to the authority
- A debt profile reducing towards zero (ie. debt able to be repaid) at 30 years indicates long term sustainability of the business plan. A reducing debt profile indicates the availability of headroom for flexible future planning
- A debt profile which has been reduced to zero within 30 years indicates a high degree of financial viability and the availability of resources for additional investment in services and the stock.

The core methodology in modelling the outputs is therefore that rental or operating surpluses available after resources have been committed to service delivery and stock investment needs are available to reduce debt. Future surpluses could of course alternatively be utilised for additional expenditure (ie not to reduce debt) or to bank to build reserves and it is recognised that in practice an authority would have the flexibility to determine its approach to debt on an ongoing basis. The presentation of a debt profile in the way set out below serves simply to highlight financial viability in a visually accessible manner.

## 7.2 Establishment of data requirements

A key factor affecting the future viability of self-financing plans is the extent to which actual expenditure on services and stock investment may be higher than the assumptions of expenditure allowances within the settlement according to the NPV of subsidy.

While future actual rents converge quickly with future guideline and formula rents (subject to the revised arrangements within the 2008/09 determination), the

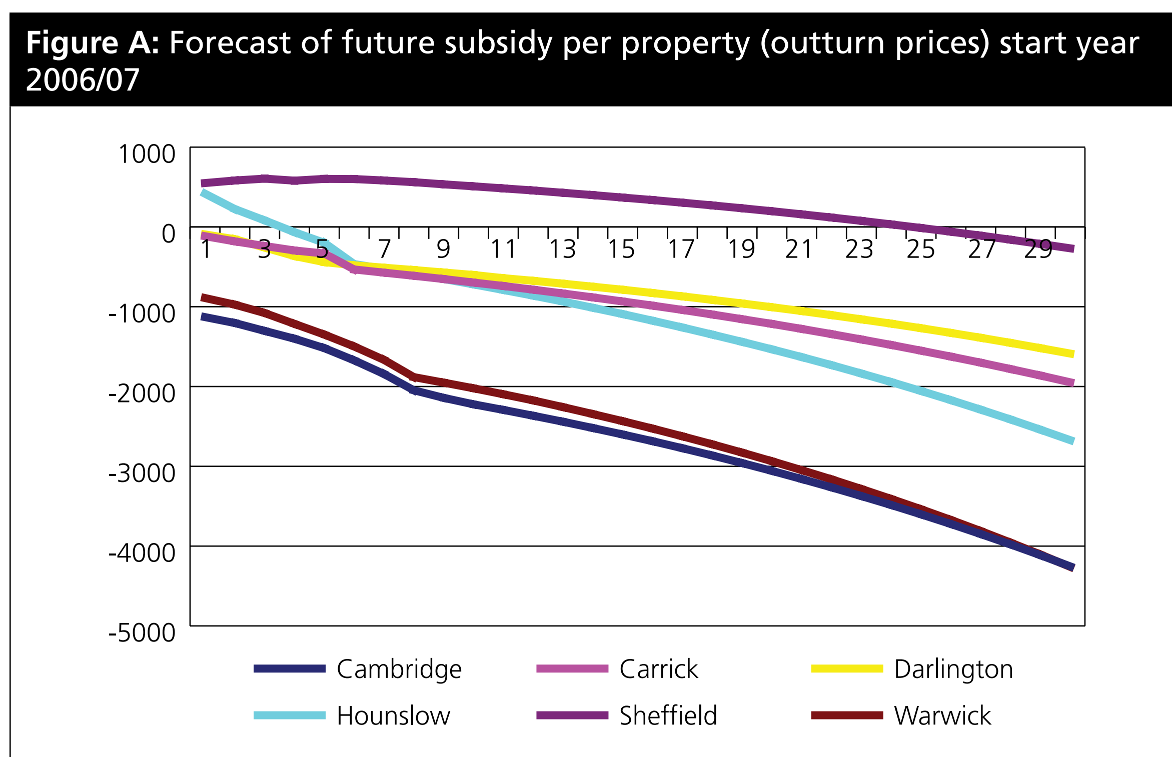
experiences of the modelling authorities vary according to the level of management and maintenance costs. For some authorities, actual costs are higher than allowances; for others, actual costs are below allowances.

However, for *all* authorities, the need for future capital maintenance and investment to maintain the decent homes standard is higher than the likely future level of capital resources within the subsidy system. Within the modelling, the authorities therefore developed two core planning scenarios which reflect these differences. Broadly, these are based on the difference between the Major Repairs Allowance and the minimum stock investment needs identified in stock condition surveys, each of which were updated by the authorities as part of the project work. These are explained in more detail at section 7.5 below.

## 7.3 The future under subsidy and the NPV of subsidy

The forward forecast of subsidy shows growing future net rental surpluses. Figure A below sets out the core subsidy forecast, in per property terms, for each of the modelling authorities. This forecast is consistent with the national subsidy forecast set out in section 5.1 above.

**Figure A:** Forecast of future subsidy per property (outturn prices) start year 2006/07



The net present values of these subsidy streams are set out in table 5 below.

**Table 5:** NPV of subsidy for the six modelling authorities using core assumptions

| | Cambridge | Carrick | Darlington | Hounslow | Sheffield | Warwick | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| **Subsidy NPV** | 232.7 | 38.0 | 49.4 | 142. | -276.9 | 159.8 | **345.5** |

Table 5 shows that debt taken on at five of the modelling authorities would total £622m and debt write down at Sheffield would be £277m.

## 7.4 Sensitivities

Two variations set out below illustrate the sensitivity of the debt adjustment calculation to changes in assumptions:

- roll forward to future years (for reference 2007/08)
- formula rent increases at RPI only or RPI+1%.

Table 6 shows the Subsidy NPV calculation, applied with a start year of 2007/08.

**Table 6:** NPV of subsidy using 2007/08 as the start year

| | Cambridge | Carrick | Darlington | Hounslow | Sheffield | Warwick | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| **Subsidy NPV – 2007/08** | 247.2 | 43.0 | 52.7 | 163.2 | -263.9 | 188.1 | **430.3** |
| **Increase in debt adjustment** | 14.4 | 5.0 | 3.3 | 20.8 | 13.0 | 28.3 | **84.8** |

Table 6 highlights the implications of rising subsidy surpluses on potential self-financing calculations. A roll forward of the starting date to 2007-2008 increases the aggregate debt settlement of the six local authorities by £85m. Preliminary estimates indicate that this would increase by a further £100m if the starting date was 2008/2009. This highlights both the sensitivity and volatility of the movement in subsidy settlements and therefore the difficulties authorities have in planning for future investment in these circumstances.

By means of illustration, Table 7 also shows the Subsidy NPV calculation applied with varying real increases in formula rents.

**Table 7:** NPV of subsidy using different approaches to future rent increases

| | **Cambridge** | **Carrick** | **Darlington** | **Hounslow** | **Sheffield** | **Warwick** | **Total** |
|---|---|---|---|---|---|---|---|
| **Subsidy NPV** | £m | £m | £m | £m | £m | £m | £m |
| **With rents RPI+1%** | 259.4 | 48.6 | 64.0 | 198.5 | -165.9 | 180.0 | **584.6** |
| **With rents RPI+0.5%** | 232.7 | 38.0 | 49.4 | 142.5 | -276.9 | 159.8 | **345.5** |
| **With rents RPI+0%** | 207.4 | 28.1 | 35.8 | 90.4 | -380.0 | 140.7 | **122.4** |

The tables show the impact for Government of changes to assumptions and that increased net rental surpluses in cash terms increase the net debt adjustment considerably upwards on settlement and vice versa.

Fundability of actual plans would be unaffected as actual net rentals would be in line with the assumptions applied within the NPV calculation, ie the higher or lower income over the period of the business plan would be balanced against a higher or lower level of opening debt.

## 7.5 The difference between "M" and "S"

As set out above, the need for future capital maintenance and investment to maintain the decent homes standard is higher than the likely future level of capital resources within the subsidy system. The two modelling scenarios developed to test this are:

- scenario "M": a theoretical scenario based on future capital spending at the level of Major Repairs Allowances (and Supported Capital Expenditure in the short term)

- scenario "S": based on stock condition survey information, updated by all authorities as part of this project. The S level of spend is deemed a minimum investment liability to maintain decent homes and meet other basic needs of the stock and neighbourhoods. On average across the six modelling authorities, M is lower than S by a factor of around 40% as set out in Table 8.

**Table 8:** Comparison of scenarios "M" and "S" for the six modelling authorities

| | Cambridge | Carrick | Darlington | Hounslow | Sheffield | Warwick | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| **Total amount of M over 30 years** | 288.9 | 99.6 | 175.0 | 478.3 | 1,456.5 | 197.8 | 2,696.1 |
| **Total amount of S over 30 year** | 361.0 | 122.8 | 203.4 | 729.9 | 2,326.7 | 277.2 | 4,021.0 |
| **30 years difference** | 72.1 | 23.3 | 28.4 | 251.6 | 870.2 | 79.4 | 1,324.9 |
| | | | | | | | |
| **NPV of M** | 79.6 | 37.6 | 56.3 | 172.5 | 458.2 | 60.1 | 864.3 |
| **NPV of S** | 140.9 | 48.8 | 86.1 | 292.2 | 830.6 | 109.2 | 1,507.8 |
| **Difference** | 61.3 | 11.2 | 29.8 | 119.7 | 372.4 | 49.1 | 643.5 |
| **%age difference** | 44% | 23% | 35% | 41% | 45% | 45% | 43% |

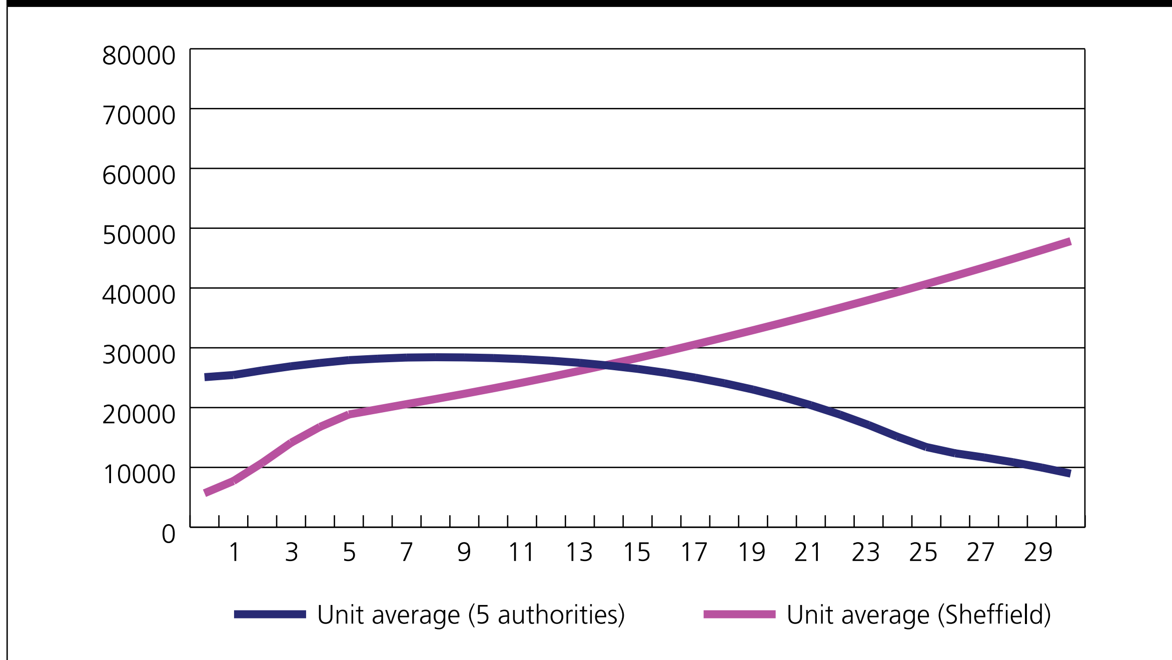
If a settlement is based on an assumed level of M spending but actual unavoidable spending needs are at S, this would threaten the financial viability of self-financing business plans.

## 7.6 Base business planning based on the "M" scenario

The initial base business planning scenario is to apply spending at the theoretical level of M to a debt settlement based on the NPV of subsidy.

This scenario highlights the core financial position of self-financing business plans. The chart below shows a consolidated per unit debt profile for the five authorities without significant up front supported borrowing and for Sheffield where there is a significant undrawn amount of ALMO SCE.

**Figure B:** Debt profiles per unit (outturn prices) arising from theoretical spending at M based on Subsidy NPV settlement




The chart shows that:

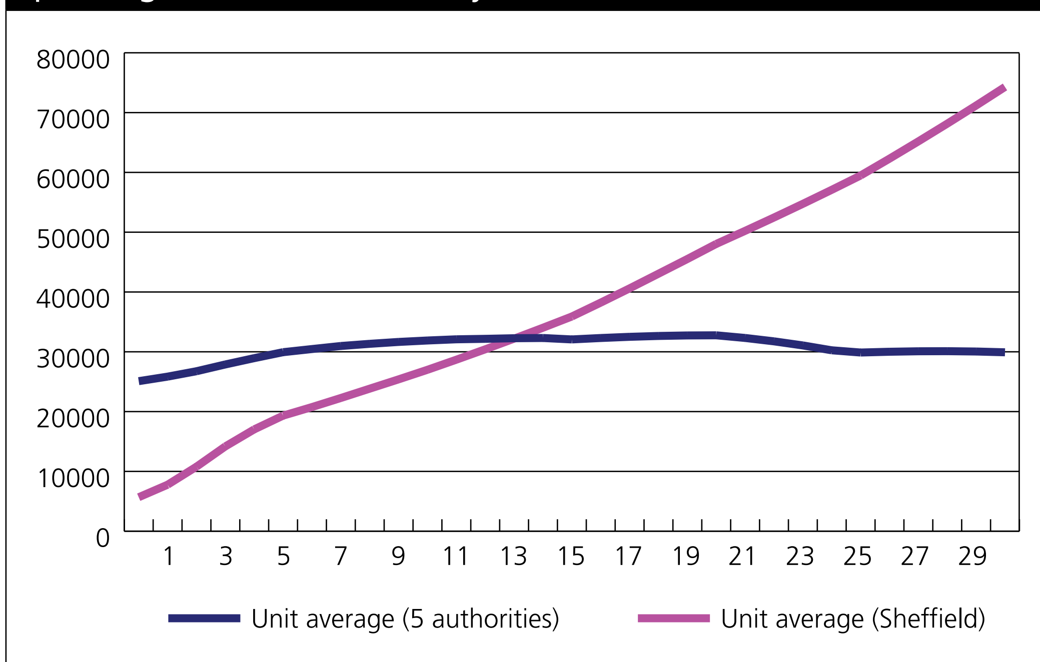
- for all authorities, the debt profile increases in the short to medium term, even though capital spending is only at the level of M (ie the MRA)
- for five authorities, on average, future rental surpluses provide headroom for future investment from around year eight
- for Sheffield, debt increases throughout the 30 years as expenditure liabilities would need to be met through increased borrowing.

The outcome for Sheffield, and authorities in their position, has implications for the nature of the settlement calculation and the treatment of debt.

## 7.7 Base business planning based on "S"

The modelling authorities have argued that in practice, spending would actually be at the level of S based on meeting actual stock investment needs. Figure C shows the impact of spending at S given a settlement based on the NPV of Subsidy.

**Figure C:** Debt profiles per unit (outturn prices) arising from spending at S based on Subsidy NPV settlement




The chart shows that:

- for five authorities, spending at S leads to an increased level of borrowing in the longer term and that average debt profiles begin to reduce only after year 21
- there is little or no room for risk management in the average debt profile
- debt is higher at year 30 than at day one
- for Sheffield, the rising debt position is exacerbated.

At this spending level, in order to achieve sustainable business plans for each authority, the opening debt level would need to be reduced and therefore the debt adjustment at settlement provided to/from Government would need to be reduced/increased.

## 7.8 Issues arising on the treatment of debt

Triggered particularly by the outputs for Sheffield, a key area of investigation within the project has been to explore the reasons why the base business plan for an authority with considerable forthcoming SCE appears unviable.

The issue arises from the treatment of debt and interest support within the subsidy calculation.

- revenue subsidy is provided to support interest payments on assumed levels of housing debt (the Subsidy Capital Financing Requirement)

- the NPV of debt support is incorporated into the Subsidy NPV calculation and effectively writes down the opening debt level
- the NPV of debt support for interest payments over 30 years is insufficient to provide the resources to service the actual debt (for example, for £100m of debt, the NPV of interest support at 6.3%
for 30 years is £87m).

The implications are that higher debt authorities are disadvantaged as they would be carrying debt after day one of the settlement for which no resources to cover debt payments would have been made in the settlement. For Sheffield, the position is highlighted by the relatively high levels of debt and short term borrowing needs.

## 7.9 Potential alternative approaches

Alternative approaches to the calculation of the settlement adjustment have therefore been modelled within the project. In particular, the modelling group have modelled the impact of calculating debt settlements based on the cash flows generated by the stock taking into account net rental streams but keeping the debt element separate. The cash flow generated by the stock represents future operating surpluses.

This alternative differs from the Subsidy NPV approach in that:

- subsidy NPV results in a value which adjusts debt *from* current levels (ie the settlement price is added to existing debt)
- the NPV of operating surpluses results in a value of opening debt which would be moved *to* (ie the settlement price would be the opening debt level – subject to treatment of any difference between the Subsidy Capital Financing Requirement and actual debt).

If the core assumptions around future rents and allowances are unchanged, the impact of the alternative methodology for settlement is shown in Table 9 below.

**Table 9:** Impact of moving to a settlement based on operating surplus

| | Cambridge | Carrick | Darlington | Hounslow | Sheffield | Warwick | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| **Subsidy NPV** | 232.7 | 38.0 | 49.4 | 142.5 | -276.9 | 159.8 | **345.5** |
| **Operating surplus adjustment** | 233.0 | 32.2 | 38.7 | 91.0 | -464.4 | 159.1 | **89.6** |
| **Difference** | -0.3 | 5.8 | 10.7 | 51.5 | 187.5 | 0.7 | **255.9** |

The implications are that opening debt settlements would be lower by £256m.

This approach calculates the value of the cashflow generated by the stock, under which the opening debt level represents the value of the business but which, to

maintain neutrality with the subsidy system, uses the HRA subsidy assumptions about income and expenditure rather than stock surveys and other data.

The modelling authorities have proposed that an adjustment based on the NPV of operating surpluses in this way retains the principle of fiscal neutrality. Existing levels of housing debt are supported through the subsidy system, so this approach excludes from the settlement some debt along with the allowances that would have supported it, leaving councils no better off than under the current arrangements. An approach that transferred some debt to central Government would also remove the risks in calculating the appropriate sum to include in a settlement to represent the present value of future interest payments.

## 7.10 Sustainable business plans

The base business plans for self-financing taking into account the Subsidy NPV level of opening debt have implications for financial viability when actual spending needs might be at S compared to an assumption of M within the settlement.

Modelling has been undertaken to test the implications of a debt settlement based on the S level of spending need (ie the stock investment needs identified in stock condition surveys and the model business plans). The implications are shown in Table 10 below. Line 4 shows the extent to which the alternative approach described above, of separating out the existing HRA debt from the settlement, would narrow the gap.

**Table 10:** Summary of changes to settlements required for sustainable self-financing business plans

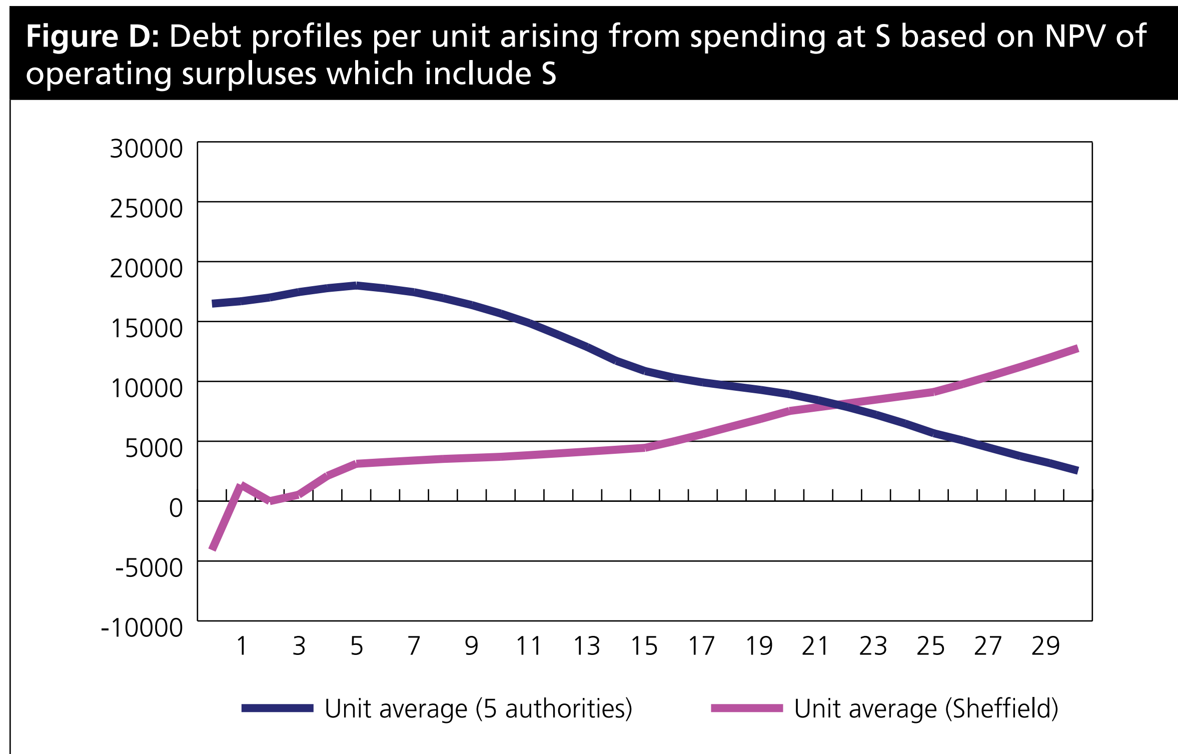
| | Cambridge | Carrick | Darlington | Hounslow | Sheffield | Warwick | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| **Subsidy NPV** | 232.7 | 38.0 | 49.4 | 142.5 | -276.9 | 159.8 | **345.5** |
| **Operating surplus adjustment to achieve sustainable BP** | 164.0 | 24.0 | 15.0 | 10.0 | -702.0 | 97.0 | **-392.0** |
| **Difference** | **68.7** | **14.0** | **34.4** | **132.5** | **425.1** | **62.8** | **737.5** |
| **Operating surplus adjustment at allowances level** | -0.3 | 5.8 | 10.7 | 51.5 | 187.5 | 0.7 | **255.9** |
| **Adjustment to allowance assumptions implied for sustainable BP** | -69.0 | -8.2 | -23.7 | -81.0 | -237.6 | -62.1 | **-481.6** |

Table 10 highlights that for what the modelling group argue would be a sustainable approach to self-financing:

- debt adjustments would need to be reduced to £310m for those authorities taking debt on
- depending upon timing, there may be a need for complete debt write down at Sheffield
- the overall reduction in opening debt settlements of £737m would in part be covered through the adoption of an approach based on the cashflow generated by the stock, treating debt separately (£256m) which the modelling group have argued maintains the principle of fiscal neutrality
- assumptions towards future subsidy net rentals (ie the level of assumed rents less assumed expenditure allowances) would need to be adjusted by £482m to achieve sustainable business plans.

Figure D shows the debt profiles implied by a theoretical self-financing plan based on the above methodology for settlement and spending at S.

**Figure D:** Debt profiles per unit arising from spending at S based on NPV of operating surpluses which include S




The chart shows the improved fundability of self-financing plans which deliver increased investment compared to HRA subsidy while allowing for the development of future headroom to deliver additional investment.

## 7.11 Developing long term self-financing plans

The rationale for self-financing is based on the additional benefits and greater efficiency that can be delivered through locally based long term business plans. The plans created by the authorities show how self-financing can deliver on:

- better planning for the long term
- more effective local decision making
- effective active asset management and estate transformation
- increasing the supply of new affordable housing, in part through accessing private finance
- delivering greater efficiency, particularly in investment planning.

### 7.11.1 Delivering efficiencies

Each of the modelling authorities therefore analysed the scope to improve efficiency inherent within a longer term business planning context with greater predictability over income streams. These have covered:

- **better rates** through long term partnering arrangements, with predictability of resources, allowing contractors to plan labour and develop a long term approach to the supply chain
- **efficiencies in the client side:** long term planning could allow client side overheads to be reduced permanently
- reduce the **cost of patching up** elements prior to their eventual renewal
- **packaging works:** the ability to package works effectively over the long term allows efficiencies to be delivered
- **environmental programmes:** placing environmental works into planned sustainability programmes.

Efficiencies have been estimated at around 10% of gross stock condition survey investment over the longer term, a total of £382m in cash terms for all six authorities. As the assumptions within stock condition surveys generally provide for long term planning and programming, some of the net efficiencies from self-financing are a result of avoiding inefficiencies in programmes arising from unpredictability within the subsidy system.

### 7.11.2 Delivering long term benefits

Each of the modelling authorities has also developed scenarios which represent what their asset management and business plans might look like in a real self-financing context. Predictability of future income streams allows investment in longer term

sustainability, spend to save schemes and could bring forward the prospect of wide ranging regeneration, redevelopment and better asset usage in neighbourhoods.

The approach within each plan identified:

- additional investment beyond the basic stock condition survey, including investment in reducing carbon emissions, reducing fuel poverty for tenants and investment in the environment
- development (or acquisition) of new properties to replace those lost to rent via the Right to Buy
- redevelopment of some estates to reduce future maintenance liabilities (for example towards non-traditionally built stock) and to take advantage of opportunities to increase densities and diversify stock types and tenure.

The authorities have been keen to promote, where appropriate, exemplar schemes where private finance is raised through building for outright and shared equity sales alongside homes for social rent. For Hounslow, plans include the development of ALMO-owned properties.

A summary of the potential benefits set out in self-financing plans is included in Table 11 below.

**Table 11:** Schedule of additional development and redevelopments within proposed self-financing business plans

| | **New Build/Acquisition** | **Reprovision** |
|---|---|---|
| Cambridge | 1,050 rent + 435 shared ownership | 398 –> 900 |
| Carrick | 300 rent/shared ownership | – |
| Darlington | 200 | 211 –> 257 |
| Hounslow | 660 rent + 440 shared ownership | 161 + 150 conversions |
| Sheffield | 1,000 | 1,500 –> 3,150 |
| Warwick | 348 rent + 50 shared ownership | 105 |

The numbers within this table refer to the financial scope within business plans and have not been developed, nor tested in detail, with any specific schemes in mind.

The table shows the additional properties from reprovision and new build/acquisition within the self-financing plans. The financing of new build and redevelopment would be from a combination of private sales receipts and net rental cross subsidy from the critical mass of existing stock, both aimed at minimising the reliance upon prudential borrowing. Section 8.3 below shows the mix of funding taking into account the availability of headroom as shown in Figure D above.

## 7.12 Other considerations

Within the project, detailed consideration has been given to the following issues which have emerged.

### 7.12.1 Transfer of risk

As a self-financing HRA continues to represent public expenditure, the risks of future income shortfalls continue to be public sector risks.

However, there is a transfer of some significant risk elements to the local authority from central Government, particularly:

- interest rate risk: this is currently provided for at the national level within the HRA subsidy system
- liabilities towards stock maintenance: these are effectively covered at the national level through the allocation of expenditure allowances through MRA and SCE.

A degree of risk transfer is reflected within the arrangements for stock transfer. Government may therefore feel it appropriate to reflect this increased local risk within the self-financing settlement.

Modelling has been developed to test the implications of adopting a different discount factor. Table 12 shows the impact on the Subsidy NPV settlement calculation of adopting a 7.3% rate.

**Table 12:** Impact on NPV of subsidy of changed discount factors

| | Cambridge | Carrick | Darlington | Hounslow | Sheffield | Warwick | Total |
|---|---|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m | £m | £m |
| **Subsidy NPV @ 6.3%** | 232.7 | 38.0 | 49.4 | 142.5 | -276.9 | 159.8 | **345.5** |
| **Subsidy NPV @ 7.3%** | 205.4 | 32.9 | 41.0 | 119.7 | -260.6 | 140.4 | **278.8** |
| **Difference** | 27.3 | 5.1 | 8.4 | 22.8 | -16.3 | 19.4 | **66.7** |

### 7.12.2 Securing local support for self-financing

Each authority would want to consult fully with local stakeholders prior to a self-financing settlement. Key stakeholders include tenants and residents, members and officers of the authority and the ALMO board (if in place).

The modelling group have reported a hearts and minds issue around the scale of debt take on (or write down), particularly when setting out plans for self-financing where additional investment in the short term might be limited by the circumstances of the settlement.

### 7.12.3 Treatment of Right to Buy and other receipts

The current approach to the treatment of capital receipts from the sale/disposal of existing HRA land and property reflected within the 2003 Capital Financing Regulations (as amended) would be unaffected by a move to self-financing:

- for Right to Buy disposals of existing property: 75% pooling applies
- for partial stock transfers: although no pooling applies, net receipts are subject to a levy and housing debt is written down
- for other disposals: the regulations relating to Capital Allowances apply, whereby pooling is avoided providing receipts are reinvested into affordable housing and/or regeneration.

Of the usable 25% of Right to Buy receipts retained by authorities, the majority is allocated to schemes outside the HRA, for example to provide for affordable housing through housing associations.

The modelling carried out within the project has reflected the retention of 25% of Right to Buy receipts from existing properties by the authority and existing practice towards the use of future usable Right to Buy receipts.

Forecast Right to Buy disposals are reflected in the NPV settlement through an assumption of reducing property numbers. There is a risk to authorities if disposals are greater than provided for in the settlement and vice versa.

For newly built or acquired properties funded from business plans after the self-financing settlement, the modelling reflects the 100% retention of receipts from Right to Buy and other disposals within the HRA. The expectation is that powers in the Local Government Act 2003 would be used to implement the proposal in the Housing Green Paper to allow councils to retain Right to Buy receipts from such properties in full.

### 7.12.4 Staged payments

Consideration has been given to the potential for staged payments of debt take-on (or write down) by authorities or Government.

The settlement is intended in principle to be a "once and for all" adjustment. Neither authorities nor Government have therefore yet been convinced of the merits of staged payments. However, there may be circumstances in which an approach to the staging of payments could be adopted in the early stages of self-financing, in particular should self-financing be piloted prior to full implementation. In this latter case, the specific circumstances would need to be reflected in the self-financing agreement.

### 7.12.5 Some circumstances in which authorities might not wish to go self-financing

The modelling authorities have identified some circumstances in which they may not wish to go self-financing. Authorities should have the ability to finance expenditure which would have been available in subsidy, including Supported Capital Expenditure and Major Repairs Allowance.

The long term benefit of self-financing to an authority is agreed by all the modelling authorities. The size of the opening debt settlement and ability to invest in quick wins is, however, seen as a critical factor in establishing the case for self-financing locally. If the debt settlement serves to limit capital expenditure to that which could have been reasonably expected within the next three years, there may be difficulty in making the case.

Although likely to arise in certain instances only, an adverse revenue impact on the General Fund and a reduction in the availability of resources for non-HRA capital programmes would not be seen as acceptable to authorities.

# 8. Impact on public borrowing and spending

## 8.1 Control of overall levels of public expenditure, borrowing and debt

The Government has a legitimate interest in controlling public expenditure, public borrowing and the overall levels of public debt.

Borrowing undertaken within self-financing HRA business plans is, in public expenditure terms, local authority prudential borrowing which scores against the key fiscal measure of affordability, Public Sector Net Borrowing (PSNB), being the difference between expenditure plans and income/revenues.

The key public expenditure considerations arising from a potential self-financing settlement are summarised below.

**Fiscal neutrality:** if an authority pays or receives the NPV of forecast future subsidy or surplus payments in order to leave the HRA subsidy system it should be considered neutral in public finance terms. If an authority's settlement was more favourable than that indicated by the NPV of future subsidy, the difference would be deemed a cost to Government. A neutral settlement would not normally need to be staged over a period of years or require any "pairing" of in-subsidy and in-surplus authorities to balance out cash flows.

As the modelling within the project has indicated that current allowances within HRA subsidy system are insufficient to sustain stock in the long term, a neutral settlement which is sufficient to make self-financing affordable would require prior uplift in the level of allowances for all councils.

The principle of fiscal neutrality to Government contrasts with the tenanted market value basis used for stock transfer, which values the stock by comparing future income and expenditure streams. Though self-financing as an activity in itself should not require additional funding, authorities would expect the settlement to include a premium where there is a genuine transfer of risk.

**Changes after settlement:** there are some assumptions within the NPV calculation which, if proved inaccurate or if changed by policy, could give rise to subsequent adjustments. These would include for example changes to rent policy or policies which required new works or services to council properties and which gave rise to extra funding for councils within the subsidy system. Self-financing local authorities should be eligible to bid on equal terms with councils remaining within the subsidy system for any additional financial support provided by government to deliver such programmes outside the subsidy allowances.

**The impact of borrowing and spending by self-financing LAs:** the modelling has highlighted the scope for self-financing authorities to take on new debt or to increase spending. The modelling also shows the potential to pay off debt. Any increase in the net debt level of self-financing authorities in aggregate would count as increased public expenditure.

Government's broad order of preference for the financing of capital expenditure is as follows:

1 receipts

2 revenue

3 borrowing

This has been reflected in the modelling work.

Though each form of finance has public expenditure implications, treatment within the national finances means that only borrowing is required to be funded from the PSNB. The modelling has shown that capital expenditure can be increased significantly and the reliance on borrowing as a proportion of the financing could reduce in the longer term as rental streams increased and private finance receipts are levered in from new supply.

From a Government perspective, it might be desirable to set borrowing limits within individual self-financing settlements, based on individual circumstances and net debt levels of the self-financing authorities overall. This could allow some councils to take on more debt and require others to pay debt off and allow the public expenditure implications of the net impact of self-financing overall to be managed.

Government would expect to maintain some control over rents, particularly as this has a big impact on housing benefit costs. Assumptions about future rents would also be one of the main factors influencing the settlement price, so Government would expect councils to honour promises about rent levels. As a broad principle, extra spending that it is met from extra rental income from more properties is neutral in public finance terms.

## 8.2 Implications of self-financing business plans for public borrowing capacity

Within the HRA subsidy system, the borrowing capacity within an authority's HRA is constrained by the allowances and the requirement to recycle assumed rental surpluses within the system. Depending upon the needs of the stock and services locally, release from HRA subsidy system could allow future rental surpluses to finance increased borrowing.

This creates risks to Government's ability to ensure that the overall level of public spending is kept at a prudent level. The Sustainable Investment Rule requires public sector net debt, as a percentage of GDP, to be held at a stable and prudent level. The Government aims to maintain net debt below 40% of GDP over the economic cycle.

Within the self-financing settlement, assumptions on future expenditure and borrowing would be needed. In the short term, borrowing may need to be increased to finance both:

- additional short term investment expenditure to deliver greater long term sustainability
- the implications of actual buy out costs exceeding what would have been subsidy surpluses in the short term.

The Local Government Act 2003 provides Government with the scope to impose an overall control on prudential or unsupported borrowing by local authorities although this is a control which Government would not want to have to use.

It is important therefore to set out borrowing needs clearly in the short term so that these can be taken into account within public expenditure forecasts and that sufficient controls exist to protect the public finances in the longer term. The modelling authorities have therefore proposed that the self-financing agreement would provide for limits on the level of borrowing and debt linked to net income and that these would be regularly reviewed.

## 8.3 Typical expected borrowing requirements in business plans

The modelling has highlighted that the benefits of increased investment can be considerably greater than future reliance on borrowing. The financing and borrowing implications of all of the scenarios modelled by all of the authorities within their proposed self-financing business plans are set out in Table 13 below. The full modelling plans are based on minimum stock investment ("S") with additional investment in sustainability (for example reducing carbon emissions), new build and redevelopment.

**Table 13:** Summary of the way in which additional investment is financed in self-financing business plans

| | 30 year total of investment in existing stock | 30 year self-financing – all scenarios | Difference | |
|---|---|---|---|---|
| | Outturn £m | Outturn £m | Outturn £m | |
| **Stock investment (with self-financing efficiencies)** | 3,826 | 3,826 | – | |
| **Additional investment in new build, re-provision and sustainability** | – | 2,139 | 2,139 | |
| **Total capital investment included within Self-financing Business Plans** | 3,826 | 5,965 | 2,139 | |
| **Financed by:** | | | | %age |
| **Private finance/receipts/sales proceeds** | 88 | 782 | 694 | 33% |
| **Revenue** | 3,081 | 4,051 | 970 | 45% |
| **Borrowing** | 657 | 1,132 | 475 | 22% |
| **Total financing from self-financing HRAs** | 3,826 | 5,965 | 2,139 | |

At the maximum ambitions set out by the modelling authorities, additional investment of £2.139 billion beyond basic stock investment liabilities would be financed: 33% from receipts from sales/disposals, 45% from future net rental streams generated by increased property numbers and 22% from prudential borrowing.

## 8.4 Protecting public expenditure though a proposed self financing agreement

The modelling has made a case for additional investment and the modelling authorities have recognised that a proportion of this capital investment would be financed from borrowing. In these circumstances, it is appropriate for Government to exercise some control over both the level and predictability of future borrowing.

The modelling authorities have proposed a form of Long Term Borrowing Agreement in the context of the existing Prudential Code to give comfort to Government about future spending and borrowing plans. This would be part of the self-financing agreement. The proposed agreement has parallels with the housing association sector where detailed agreements between associations and funders are in place to ensure long term viability and fundability of debt.

The Prudential Code was introduced as part of the Local Government Act 2003. The system is based on the following principles:

- self assessment and regulation, backed by external audit, the provisions of S151 of the 1972 Local Government Act and Government step in powers
- control over borrowing and debt exercised through revenue rather than through specific approvals to borrow as previously
- a system of prudential indicators (PIs) which are set locally by the authority and which fall into two general categories
  - affordability – relating to the affordability of borrowing/debt to the authority
  - prudence – relating to treasury management
- affordability PIs which operate for the authority as a whole and specifically for the HRA
- PIs are generally set on a rolling three-year basis and reported to and agreed by the council annually as part of the usual financial cycle.

The existing HRA affordability prudential indicators for the HRA are limited in their effectiveness within the current system as they relate to a capital financing and revenue stream over which the authority has little or no control. However, the existing prudential framework provides a sound platform upon which to build the basis of a longer term self-financing agreement with Government, in effect strengthening the use of a valuable framework in the context of decisions taken for a real long term business plan.

## 8.5 Elements of a proposed long term borrowing agreement

There are five elements to the proposed long term borrowing agreement:

1. *Adoption of prudential indicators*: sufficient powers already exist in statute to control HRA reserves, surpluses and deficits. Defining a relationship between HRA interest charges and net operating surplus would give legitimate scope to develop revenue headroom for additional borrowing through efficiencies and cost reductions but also act as the primary method of managing the level of debt. This would mean the primary measure of control over future debt levels would be to define a maximum percentage of rental income which could be spent on interest/debt charges. The development of headroom for borrowing through savings in interest charges would emerge over time and be predictable and controllable given that interest rate policy is relatively stable.

2. *Period of agreement and review*: in line with current funding practice in the RSL sector and PFI contracts, an agreement could last for 30 years and have clauses for review periods to reset indicators on a regular basis. Review periods would ideally fit with the Spending Review cycle and therefore run over six years – there would therefore be four review processes during the lifetime of the agreement. The review process would be based on an updated Business Plan and be aimed at revising indicators only, not revisiting the agreement.

3. *Process for becoming self-financing*: in order to limit the potential for unpredictability in the system, ratios and indicators would not be seen as ends in themselves. The process of becoming self-financing could therefore be in four steps based on the agreement of a business plan and what this would mean for ratios rather than determining the ratios then deciding the plan; this would give additional comfort at the national level. In this way, the ratios are not trying to usurp prudential borrowing rules, which would still apply in the normal way. They are instead providing a level of predictability and control over future borrowing levels. The four steps would be as follows:

   I. identify the business plan

   II. demonstrate the differences between the plan and the in-subsidy alternative

   III. demonstrate that the plan is financially viable and has appropriate risk management

   IV. demonstrate the impact of the plan on PIs and ratios and agree these moving forward

4. *Control over the level of self-financing debt*: the level of self-financing debt might be monitored separately from the level of "subsidised" housing debt and a self-financing agreement would allow both suitable control and predictability over future debt levels for all self-financing councils as they leave the subsidy system. Agreements would allow the forward forecast of 30 years debt and borrowing ceilings at the authority level.

5. *Performance against plans*: agreements could cover the action to be taken should the business plan not be achieved and difficulties arise.

   The out-performance of a business plan should not be the subject of claw back as there are sufficient controls in the system of settlement and review to limit the possibility of the type of large scale out-performance as seen in some stock transfer organisations.

## 8.6 Meeting public expenditure objectives

Self-financing proposals are predicated on the delivery of more investment than the HRA subsidy system currently delivers, necessitating some extra spending including through borrowing. Additional spending in one area reduces Government's ability to invest elsewhere. The expectation is that provision for self-financing authorities would

need to be included within the overall spending review settlement for Communities and Local Government and would be part of their Departmental Expenditure Limit (DEL). This would mean that spending by self-financing authorities above the level assumed in the settlement would reduce the resources remaining for Communities and Local Government to invest in other housing programmes.

This provides the department with a strong incentive to ensure self-financing authorities keep to an affordable level of investment. Borrowing plans would be set out over a long term business plan and agreed with the department over a set period as part of the agreement of indicators. Government could then plan for new and additional borrowing over the financial cycle while ensuring that the delivery of sustainable investment is prioritised. Business plans would be predicated on the Government's broad preference for the financing of capital expenditure from, in order, receipts, revenue and borrowing.

Government control would be exercised primarily through the agreement; in addition it could be exerted through sensible forward planning of a self-financing programme, by limiting access to high performers, and by the existing fiduciary, audit and reserve powers incorporated into the Prudential Code. Government would also have the power to direct external auditors of authorities with self-financing HRAs to ensure compliance with the agreement.

Agreements would allow flexibility to meet the different needs and plans of authorities, within a framework that contains overall net borrowing. Net borrowing, defined as the net increase in self-financing debt levels, could be controlled through the suite of self-financing agreements, allowing planning and predictability in the future and over the financial cycle. The interrelationship between plans would be defined at the outset of the agreement but would be weaker than the interconnection and interdependency of authorities in the subsidy system.

Business plans would be based on viability and affordability as expressed in a series of agreed indicators, which is consistent with the prudential framework already in place and would be predicated on that framework.

Government could reserve the power to exert quick and flexible controls where activities threaten the national finances. This might be achieved by controlling the rate of sign up to agreements and the nature and predictability of the agreements entered into. Flexibility to intervene to support the national finances would operate over a three to six year timeframe which would be sufficient to address emerging issues.

# 9 Managing other risks in a self-financing authority

## 9.1 Future changes to assumptions

HRA self-financing status brings opportunities and benefits and at the same time introduces new responsibilities and risks.

The capacity to take on new borrowing has implications for an authority in terms of maintaining prudence and affordability, and nationally in terms of the aggregate effects of borrowing by self-financing authorities on levels of public sector debt. These are covered in Section 7 on outputs from the modelling work, and in Section 8 on the impact on public borrowing and spending.

The independence of self-financing exposes the authorities to risks, some of which would be cushioned if staying in the subsidy system. A one-off adjustment in lieu of future subsidy is based on assumptions about various external factors, for example interest rates and the scope to determine rental income. Assumptions may prove inaccurate, resulting in excessive or insufficient resources to deliver the business plan.

## 9.2 Windfall surpluses

If the assumptions made in reaching the opening settlement do not match real life conditions, and as a result the resources available significantly exceed those needed for successful delivery of the business plan, the Government may want a means to claw back a "windfall" surplus. This would depend on including provision for this in agreements.

As the intention is for the self-financing settlement to be financially neutral in comparison with councils remaining in the subsidy system, it is expected that the benefits that self-financing authorities derive from better performance management would not be subject to any claw back.

## 9.3 Making adjustments

Any financial benefits or losses arising from changes to policy or inaccurate assumptions could potentially be subject to a mechanism for sharing surpluses or additional costs. Examples of inaccurate assumptions caused by policy changes, where a subsequent adjustment might be expected, are:

- where changes in rent policy allow a self-financing authority to raise much more revenue than expected
- where new policy requires significant new works or services for which additional funding is made available to authorities remaining in the subsidy system.

Too many triggers for adjustments would undermine the principle of self-financing. They should be clearly defined and restricted in number. Business plans should be capable of responding to a reasonable range of external factors and short term fluctuations.

The approach adopted could have parallels with the impact that changes to national housing policy has on RSLs where the Housing Corporation has made specific arrangements to assist short term business plan viability (for example the impact of rent restructuring on certain transfer RSLs where higher rent increases had recently been assumed in the valuation).

Adopting a position on rent levels is made more difficult by uncertainty about the future of rent controls. Local authorities have limited flexibility within the subsidy system. There is no direct control on council rents; the most effective control, the limit rent, above which the council is not reimbursed by housing benefit, would continue to apply to self-financing authorities. Self-financing authorities would have incentives to put up rents within this envelope. The modelling authorities have developed their business plans on the basis of compliance with current Government rent policies, and the future of these policies has yet to be determined.

Table 14 suggests the impact of variations in some assumptions and some possible controls. As noted above, the principle of self-financing is that this should be a final settlement and that only in exceptional circumstances should there be mechanisms for subsequent financial adjustments. As a self-financing authority would be outside the HRA subsidy system, any further support from Government or payments to Government would be determined by the terms of the self-financing agreement, ie contractually based.

**Table 14:** Examples of controls for particular variables

| Variable | Potential impact | Possible controls |
|---|---|---|
| Council increases rent above formula | Rent increases not factored into settlement, creating a surplus for the council funded in large part by an increase in HB payments by government | Limit rents restrict HB payments<br>Requirement in settlement to follow national rent policies<br>Regulation via OfTenant |
| Council reduces rents below formula | Rent reductions not factored into settlement, resulting in a loss of income for the council | There would be no additional subsidy to make up shortfall |
| Government imposes a rent lower than current formula | Rent reductions not factored into settlement, resulting in a loss of income for the council | Additional support from government to make up for shortfall |
| Interest rates higher than expected | Additional borrowing becomes more expensive<br>Historic debt at fixed rates would not change | Borrowing becomes less affordable, tending to reduce borrowing levels<br>Additional support if rates go above a ceiling |

| Table 14 (cont): Examples of controls for particular variables | | |
|---|---|---|
| Interest rates lower than expected | Additional borrowing becomes cheaper<br>Possible opportunity to re-finance | More borrowing possible within Prudential Code, tending to increase borrowing levels<br>Additional borrowing controls required in settlement |
| Increase in net borrowing through local policy choice | Finance for capital projects<br>Impact on PSBR | Additional borrowing controls in settlement |
| General inflation higher than expected | Rent rises are pegged to inflation, minimising impact on business plan<br>Value of opening debt eroded | |
| General inflation lower than expected | Burden of opening debt higher than expected | Could be countered by above-inflation rent rises or efficiencies |
| Cost inflation higher than expected | Adverse effect on business plan viability | Service cuts or efficiency savings |
| Cost inflation lower than expected | More resources available locally, service improvements | Improvements to services or new investments |
| Receipts from RTB sales higher or lower than expected | No compulsion to use RTB receipts on HRA housing | Could be subject to adjustment (clawback or additional support) |

## 9.4 Putting a price on risk

Members of the project groups have argued that the opening settlement should include a price that reflects the additional risks faced by a self-financing authority. It has also been argued that this risk transfer, though real, does not transfer risk outside the public sector and is therefore not directly comparable with a stock transfer. The Government's proposed method for determining the self-financing settlement, reflected in the base assumptions for the modelling work, does not include an element to reflect risk.

While close control is exerted over revenue and capital spending within the subsidy system, interest rate fluctuations are borne at the national level. With self-financing the risk would transfer to the authority. Although changes in expenditure are still reflected in the public sector, the modelling authorities felt it appropriate to consider the extent to which some element of risk transfer from national to local government should be reflected in the self-financing settlement or agreement.

## 9.5 Proposals by authorities for the mitigation of risk

Where possible, the self-financing agreement should set out the approach to risks and inaccurate assumptions. Proposals vary in that some put in place a change in the assumptions at the outset that allows the authority the capacity or headroom to accommodate the effects of, for example, higher interest rates. Others involve the

introduction at the outset of a mechanism or means by which subsequent action can be taken to make an adjustment.

## 9.6 Accelerated stock decreases on debt levels per unit

Currently this risk is borne at the national level as debt charges are covered within the subsidy system. In a self-financing context, the ability to replace lost properties in order to maintain revenue streams to service debt taken on at settlement, or to reduce debt upon disposal, would be important. Essentially a self-financing HRA would need to be built around the financial capacity to manage change and would need a proportion of capital receipts above the current 25% useable element, the flexibility to develop new properties to replace the rental stream, or other forms of flexibility build into the agreement from the outset.

## 9.7 Proposals to mitigate against future interest rate fluctuations

A higher discount rate would be attractive to negative subsidy authorities (those whose debt would increase on settlement) as a higher rate would reduce the "time value" of future net surpluses and therefore reduce the opening debt settlement. This could be used as an effective method of providing for risks on interest rate fluctuations for self-financing authorities.

Within stock transfers, the valuation process allows a considerable degree of inherent risk management to be built into the transfer business plan as discount rates are 6.5% in real terms (ie excluding general inflation). The equivalent rate used to model self-financing settlements is 3.5% (see 4.4 above). This highlights that there is little or no scope for the transfer of risk to be provided for within self-financing if the rate used is set so low – for example current long term borrowing might be expected to have a rate of between 4.7–5.3%.

As HRA interest charges are based on the average interest rate for an authority and levels are based on historical patterns of borrowing, the headroom to cope with interest rate fluctuations is extremely limited and in some cases actually non-existent.

It has been suggested that the interest rate within the subsidy debt support stream assumptions for the subsidy NPV are normalised to 5.9% or actual consolidated rates locally, whichever is the higher. This, however, focuses on the subsidy NPV rather than an approach to risk in a self-financing plan.

The level of headroom for risk management seen within stock transfers is neither appropriate nor necessarily desirable for a self-financing HRA. However, it is essential to allow for reasonable fluctuations in interest rates over the long term and for an

element of risk headroom to be reflected in a self-financing settlement. Options for approaches might be:

- reduce income or increase allowance assumptions within the Subsidy NPV
- reduce the inflation rates applied within the Subsidy NPV
- increase the discount factor within the Subsidy NPV.

The latter has been seen as the most appropriate way as it is not linked to any planned increase in actual net spending. It is therefore proposed that a factor of an extra 1% (and possibly more) is built into a higher rate discount factor to be utilised for the calculating of opening debt settlements (see Table 12).

Proposals (see Section 8) have been made to control public sector borrowing under self-financing by developing a long term agreement based on prudential indicators with regular review periods factored in. Control over interest rate costs could also be exercised through such an agreement. In addition, the average interest rate nature of the charge to the HRA will allow the opportunity to spot future business plan pressures well before they arise which could then be factored into the plan at the next review period.

## 9.8 Action in the event of financial failure

There is a possibility that a self-financing authority could run into financial difficulties. In order to protect tenants and local taxpayers, central Government might be obliged to offer financial support to the council as part of a package of special measures. Self-financing agreements are expected to include clauses which address this scenario, including what would happen on a fundamental breach of the terms of the agreement resulting in termination.

However Government would not want to rely on extreme measures at a point where things had reached a crisis point. It would want assurance that early signs of problems could be picked up and action taken to deal with these. The self-financing agreement between a local authority and Government should be designed to provide sufficient early warnings to prevent such a situation occurring.

# 10. Accounting issues

The project has considered a range of accounting issues in depth and has highlighted that there are no insuperable accounting barriers to the implementation of HRA self-financing. There are, however, a number of issues which would need to be worked through in detail if self-financing were to be implemented.

## 10.1 Issues around borrowing

A payment to buy out of HRAS would raise a number of accounting issues.

In cases where a one-off adjustment involved borrowing to finance such a payment, a problem arises over the nature of such borrowing. Under current capital controls, the new debt may count as borrowing for revenue purposes, to provide the consequent intangible benefit of being "self-financing" and of not having to make annual payments of negative housing subsidy thereafter. However, as the capital controls comprise regulations which were set up by statute, the simplest way forward would appear to be for the Government to allow such expenditure (to buy out of the system) to count as capital expenditure, rather in the way that regulations allow grant to a charity to be treated as capital. Then the debt would be seen as matching "legitimate" capital spend, not revenue.

An accounting issue also arises because such borrowing (as described above) would be taken on by the authority with no associated capital expenditure or asset. The circumstances and accounting transactions of a *reduction* in debt have been established within the overhanging debt arrangements for partial stock transfers. The usual accounting entries on borrowing for capital expenditure provide for an increase to debt levels to be matched either by:

- an increase in asset value (ie via purchase or via enhancement increasing value) or
- an adjustment to asset revaluation reserves.

In the case of debt take on at settlement, the usual accounting entries would not therefore apply.

The Chartered Institute of Public Finance and Accountancy (CIPFA) view expressed within the project has been that, assuming that it can be agreed that the substance of the transaction is that the buyout from the housing subsidy system represents a one-off payment for an asset, then there will be an accounting solution. The exact detail of this would need to be considered through the usual channels but essentially, a mechanism needs to be found to match the increase in debt levels, perhaps through the establishment of some form of "deferred charge" – though not using that exact terminology – which would represent the value to the local authority of no longer being in the subsidy system.

## 10.2 Further issues that may arise from the above proposed solutions

These issues would need to be referred to CIPFA's Treasury Management Panel for detailed resolution. They do not appear to be insurmountable, but they will require detailed and expert consideration. It is also suggested that leaving the historic debt within the subsidy system would be perhaps the easiest way to minimise the impact of these issues as follows:

- it may be that a *capitalisation direction* may be required in order to charge the cost as some form of "deferred charge"

- *the period of write down*: the approach may well be along the lines of the 30 years within the settlement

- *form of write down*: whether this should be by straight line depreciation or based on the assessed benefit each year according to an agreed schedule within the self-financing agreement

- the effect on the *level of overall authority debt (the Capital Financing Requirement) and set aside* would need to be considered. If there is any balance of HRA debt (in addition to the above payment), there is the issue that any set aside applicable on current debt would be zero but that there may be a requirement for set aside on the new debt

- the *charge to revenue* (amortising the "deferred charge") would be a charge to the HRA rather than General Fund service revenue account – this in turn raises issues about the legal ring fence around the HRA, which would need to be extended to allow for such payments to be charged to the HRA as it is not currently listed in legislation.

## 10.3 Potential revised treatment of Supported Capital Expenditure and debt

A settlement based on the NPV of subsidy interest payments would not always provide enough resources to clear the related housing debt. This contrasts with overhanging debt payments within stock transfers where the debt is fully redeemed. This is an issue requiring policy direction from Communities and Local Government.

## 10.4 Issues around the difference between SCFR, HRACFR and actual debt

Additional research has been commissioned to explore issues around the difference between SCE (for the HRA), the SCFR, HRACFR and actual debt.

## 10.5 Settlements which involve a reduction in debt

Settlements which involve a reduction in debt will need to include a contribution to premiums required to break existing loans.

## 10.6 Depreciation

Within HRAS, the Major Repairs Allowance is taken as a proxy for depreciation. Any variation in local depreciation policy as agreed by the local authority's Chief Financial Officer are adjusted for in the appropriations section of the HRA and therefore reversed from the account. The bottom line depreciation cost to the HRA is always therefore the level of MRA.

The project has confirmed that there should be no additional net cost arising from depreciation as a result of self-financing. The requirement to make a depreciation charge to net cost of services and then reverse out to ensure no net impact on the bottom line of the HRA will continue.

## 10.7 PWLB/market debt

When the debt settlement involves a reduction in debt, the project has investigated the extent to which the existing provisions for the clearance of overhanging debt under stock transfer are relevant. Within stock transfers, private market debt is not cleared by government. There could be a different treatment for self-financing, as the HRA would stay within the public sector and both PWLB and market debt refinancing is covered by the subsidy system. The debt reduction and cost to Government would be affected by the need to pay premiums on any premature debt redemption.

## 10.8 Debt pool

If there are no changes to the operation of a single loans pool for local authority borrowing "Item 8" interest charge to the HRA would continue to be made on the basis of the authority's Consolidated Rate of Interest. The HRA subsidy review will look at the operation of the HRA itself, as well as the subsidy system, and may wish to consider this.

## 10.9 Asset revaluations

Currently stock is re-valued on a rolling programme for resource accounting purposes. It is proposed that this would continue under self-financing.

# 11. Conclusions

The modelling work has shown that self-financing could bring improvements in efficiency, long term planning and asset management. It could attract private investment and provide opportunities for local authorities to add new homes to the housing stock.

The work has also demonstrated that, for one modelling authority in particular, and for a class of authorities in general, the level of starting debt would be too high under the base assumptions for the business plan to be viable. One reason for this is the way that future supported capital expenditure is accounted for, and proposals for tackling this have been made. Another reason, also emerging from the modelling work and applying to authorities generally, is that the NPV settlement is based on anticipated levels of future subsidy that are not sufficient to maintain a sustainable level of housing services within the HRA subsidy system.

So, at first sight, the modelling work appears to run into problems in that for many authorities the self-financing business plan would not be viable. However, the underlying cause relates to future funding problems that have their roots in the current levels of subsidy and the assumptions made about the system in the future. It is not a self-financing problem; rather it is a general problem which the self-financing exercise has highlighted.

The HRA subsidy system has, apart from internal redistribution, usually been a net consumer of Government funds. Calculations now suggest that it is reaching a turning point. Our forecasts show that if current assumptions about rents and allowances are maintained, the HRA will generate a surplus and that this will increase in size over the coming years.

In December the Housing Minister announced a wide ranging review of the HRA subsidy system, to be led jointly by officials in Communities and Local Government and HM Treasury. This will include various related issues, such as the future of rent policy, to which the outcomes of self-financing models are highly sensitive. The ministerial statement announcing this review in Parliament confirmed that it would build on the work of the self-financing project and would consider how self-financing might be implemented. The findings of the self-financing project will provide key evidence for the review.

The modelling work undertaken for this project has been designed to allow different factors and inputs to be substituted easily. The impact of changes or proposed changes to the housing finance system which emerge during the review can therefore be readily tested. The members of the self-financing project will welcome the opportunity to support the review and to use their work to help it set out a sustainable, long term system for financing council housing. The evidence from the current project is that self-financing could play a significant part in achieving this.

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