

# SECTOR

HOUSING AND CONSULTANCY SERVICES

## HRA self-financing

London Borough of Brent  
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# 1. Introduction

## 1.1. Background

In the autumn of 2008 the (then) Government announced that it was conducting a review of the way in which the Housing Revenue Account was funded. In the summer of 2009 it consulted on the “principles” of a scheme of self financing but provided no real financial detail.

This consultation was followed just before the 2010 General Election with a second stage consultation on the financial detail of the self-financing proposals. The incoming coalition government allowed the consultation to run its course then conducted its own “review of the review”, after which it laid out slightly modified plans to introduce a self-financing system for all council housing in England from April 2012. These plans were outlined in the CLG document: *Implementing self-financing for council housing* (February 2011) and the subsequent paper *Self Financing: Planning the transition* (July 2011).

At the end of November 2011 the CLG issued the draft determination of self financing valuations, which provided the financial settlement for authorities at the outset of the new arrangements.

The introduction of HRA self-financing was the most fundamental reform of housing finance since 1989.

## 1.2. What is HRA self-financing?

HRA self-financing aims to solve a number of weaknesses associated with the previous HRA subsidy system. That system had been in place for some time (it was introduced by the 1989 Local Government and Housing Act), and was altered and adjusted on an annual basis by successive governments. Its weaknesses included:

- Annual settlements, which caused funding uncertainty and discouraged long term strategic decision-making
- The costs of debt were largely met by subsidy and so there was a lack of incentive for authorities to manage their debt actively
- An increasingly unpopular national redistribution of resources, which saw the vast majority of authorities paying into a national pot
- The system was not transparent and was very difficult to understand

The self-financing settlement abolished the subsidy system and redistributed debt between authorities on the basis of a Government assessment of their ability to service the debt. This had the effect of increasing the debt held by most authorities, but in return they no longer had to pay into the national pot.

The changes mean that all authorities now get to keep all of the rent they receive from tenants. However, authorities are also now fully responsible for managing their owned income and expenditure and no longer have the “safety net” previously provided by the subsidy system, if anything should go wrong.

## 2. The self-financing settlement

### 2.1. The rationale

The self-financing settlement calculated a self financing valuation for each local authority, based on the net present value of projected cashflows over 30 years. The projected cashflows used were based on adjusted subsidy allowances and guideline rents for each authority. The idea was to use the valuation as a basis for redistributing the national housing debt, so that it was more closely allocated in line with an authority’s ability to repay the debt

### 2.2. How was the self-financing debt calculated?

The adjusted allowances included:

- Management and Maintenance
- Major Repairs, including Disabled Facilities Allowances
- Debt Management Costs
- The impact of projected right to buy sales

These were allowances deducted from assumed income (based on subsidy guideline rents) to show the net assumed income for each year, which was then discounted to provide a ‘valuation’ for each authority’s stock. This valuation represented the opening debt allocation for the authority on day one of self-financing. The valuation was deducted from its assumed existing council housing debt (as used in the subsidy system). Authorities took on debt where the valuation was higher than their assumed subsidy debt. If the assumed subsidy debt was higher than the valuation, then some of the Council’s debt was repaid.

### 2.3. The settlement for Brent

Brent was in the minority of authorities that had debt repaid as part of the self-financing debt settlement. The council’s debt under the subsidy system was assumed to be £397.3m but the self-financing valuation indicated a debt of £199.3m. Accordingly, the authority’s debt was reduced by £198m.

As well as allocating debt to authorities, the self-financing settlement also imposed a cap on future levels of debt. This measure was at the insistence of HM Treasury and forms part of the system of national controls over local authority debt. In almost all cases the debt cap was set at the level of the self-financing valuation, and for Brent the debt cap is £199.3m.

While the debt cap is set at the level of the self-financing valuation, it remains higher than the actual debt held by Brent, after the self-financing debt reduction. This was because the authority's actual debt was £59.3m lower than assumed in the self-financing calculation.

## 3. HRA business planning

### 3.1. Why produce an HRA business plan?

The HRA subsidy system was abolished on introduction of the HRA self-financing regime. This means that authorities now get to keep all of the rent they generate from tenants and use it to pay for improvements to their stock, new stock and better services for tenants. However, it also means that there is no longer a subsidy system to help protect councils from changes in economic conditions, or from the effects of weak decisions.

The HRA business plan provides long term financial forecasts of the effects of the council's spending, investment and rent-setting decisions, based on the authority's current income, expenditure and investment expectations. This hard data is combined with key assumptions on how costs and incomes might change in future to produce projections of what the authority can reasonably expect to happen, using the best available information.

Through sensitivity analysis the HRA business plan also demonstrates what happens to the HRA if key assumptions prove to be inaccurate (e.g. if inflation runs at a higher or lower rate, if pay rises are higher or lower than expected, or if an alternative rent increase is set). These sensitivities can be used as part of an essential early warning system that assesses the impact of potential changes in circumstances as they become apparent. This type of regular assessment is crucial in helping the authority to make early decisions that help to keep the HRA in balance, while delivering substantial levels of investment in council housing.

### 3.2. Brent's HRA business plan

Sector have produced a set of 30 year financial projections for Brent's HRA, based on the best available evidence and reasonable assumptions. The information we have used includes:

- The Brent rent roll
- The Council's own HRA budgets
- The stock condition survey prepared by Savills in 2011
- The actual loan portfolio for HRA debt
- Supplementary information prepared by Brent staff and the Brent Housing Partnership

In preparing the baseline business plan forecasts we have discussed and demonstrate the effects of different assumption levels with Brent staff. The sections below outline the key data and assumptions that we have used.

## 4. Key business planning assumptions for Brent

### 4.1. Summary of assumptions

The key assumptions used in preparing the baseline HRA business plan for Brent are described below:

#### Economic factors

We have assumed that general inflation will run at 2.5% pa throughout the business plan. However, since this is clearly an assumption that is outside of the authority's control we have also considered the effects of different inflation rates in our sensitivity analysis (see section 6, below).

The interest paid on any new borrowing undertaken by the authority to deliver its investment plans is also a key variable. We have assumed such borrowing would be at rates of between 4.25 and 5% in the baseline model.

#### Stock numbers

Our projections assume a stock of 8,960 tenanted dwellings at 1 April 2012. This includes 15 equivalent equity share units. We have also assumed a further 3,375 leasehold dwellings.

The main changes to stock numbers are expected to be as a result of the South Kilburn and Barham Park regeneration projects. Our forecasts show the effects of the stock reducing by 1,384 tenanted units and 246 leasehold dwellings over the first 10 years of the plan.

We have also allowed for a small number of right to buy sales, which reflect the levels of sales assumed in the self-financing settlement.

#### Rents & other income

Average rents have been assumed at £102.28 per week for a 52 week year. Rent increases are projected in line with rent restructuring for the next three years, after which increases will be at general inflation plus ½%. This is consistent with the current Government rent guidance.

Service charges and other income are projected to rise in line with inflation.

Void levels have been based on current rates of 1.56% a year. Rent loss from bad debts has been assumed at 1.3% in year 1 (in line with budget), but we have allowed for this to increase as a result of planned welfare reforms to 1.8% in year 2, 2.8% in year 3, 3.8% in year 4 and 4% from year 5. We have also allowed for a phased reduction in rent loss after the implementation of welfare reform, with levels returning to 3.5% in year 8 and 3.0% from year 9 onwards.

Rent loss assumptions are a key variable and difficult to predict at present. Accordingly, we have also tested the effects of alternative assumptions as part of our sensitivity analysis.

### Operating costs

Management and service costs have been based on the HRA budget, with provision for an additional £100,000 pa to be spent on implementing and managing the impact of welfare reform from 2013/14. We have also used existing budgets as the basis for day to day repairs, void works and cyclical maintenance.

### Capital programme

Throughout the plan we have assumed that £600,000 pa would be spent on aids and adaptations. For years one and two the business plan reflects capital investment in line with BHP spending plans. Thereafter, capital spending is based on the profile of stock condition works identified by Savills in their 2011 stock condition survey report.

There is no provision in the business plan for any new build or regeneration schemes.

### Capital resources

The business plan relies on the use of revenue contributions to capital outlay (RCCO) and borrowing (up to the level of its debt cap) to pay for the costs of investing in the stock. In calculating the level of RCCO available in any one year we have assumed that the HRA retains a minimum balance of £200 per tenanted property.

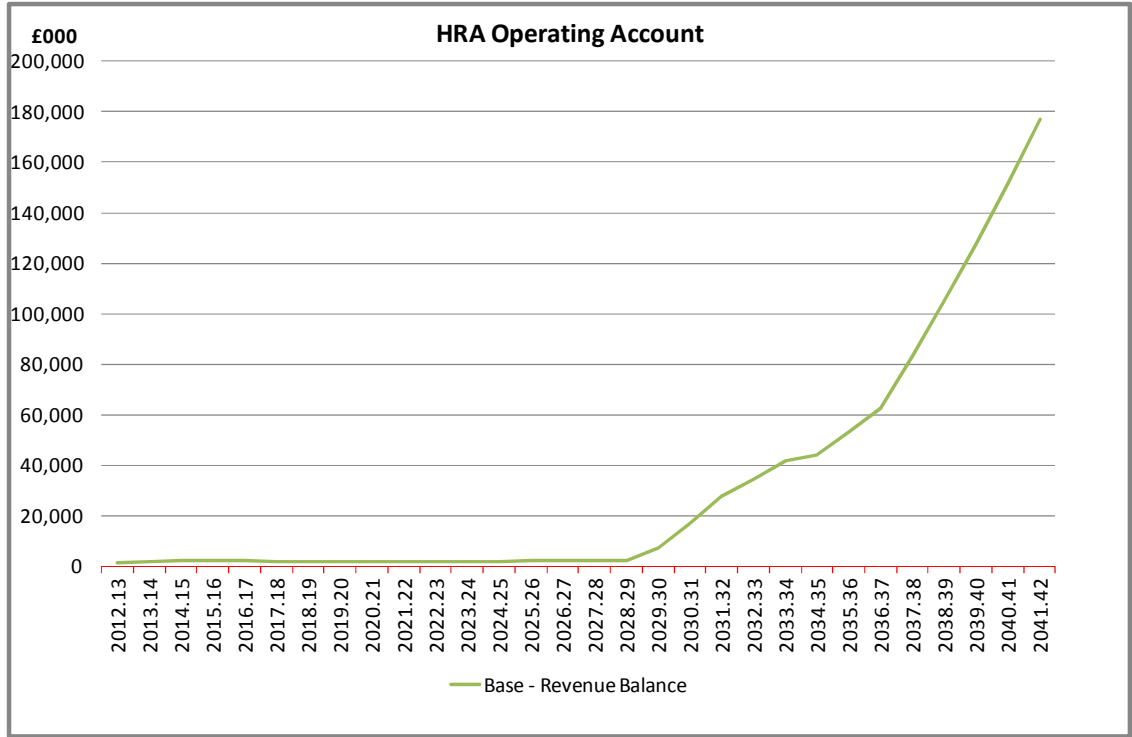
## 5. The baseline HRA business plan

### 5.1. Revenue position

The baseline HRA business plan for Brent forecasts strong positive cashflows from rents, which the authority would use to pay for both its operating costs and the assumed levels of capital investment. The cashflows also enable the Council to repay any additional debt required to finance the required investment in the existing stock, while maintaining a minimum revenue balance of £200 per dwelling.

The chart below shows the profile of revenue balances over the 30 year period covered by the business plan projections:

Figure 1. HRA revenue balances



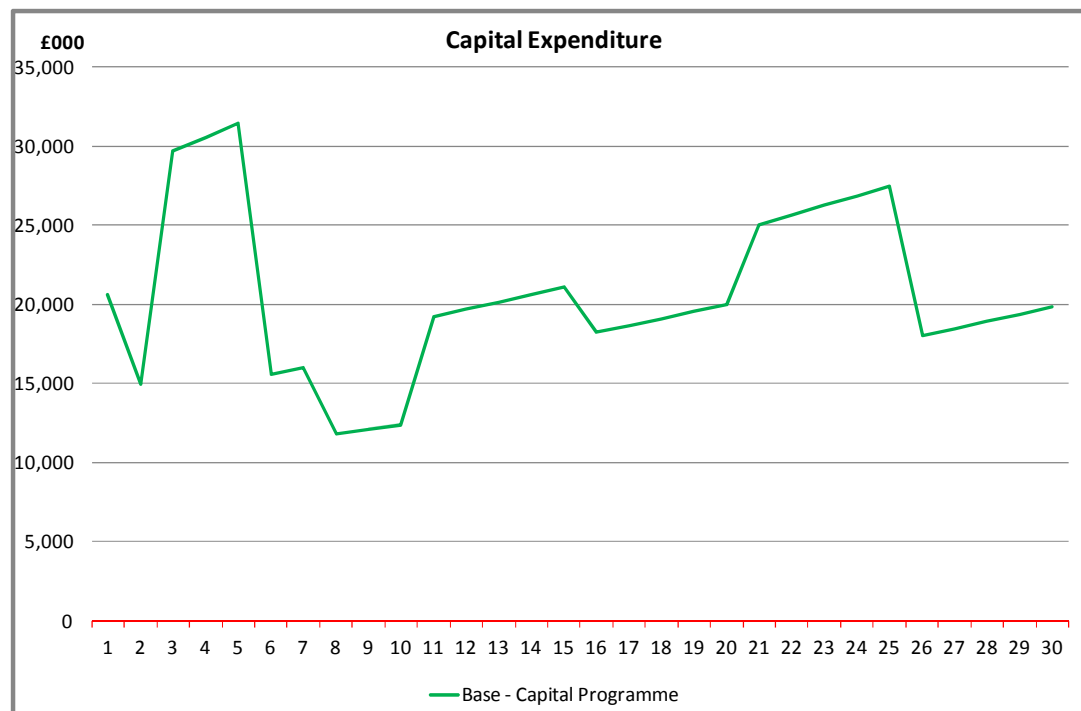
Under the baseline position HRA balances are held at the minimum level until additional debt taken out to deliver the stock investment programme has been repaid. Balances start to accumulate from 2029/30 (year 18 of the business plan).

5.2. Capital programme

The 30 year forecasts show that the Council is also able to deliver its capital programme in full, based on the current profile of works. The annual costs of delivering this programme (including the effects of prelims, fees, and inflation) are shown in the following table.



Figure 2. HRA capital programme



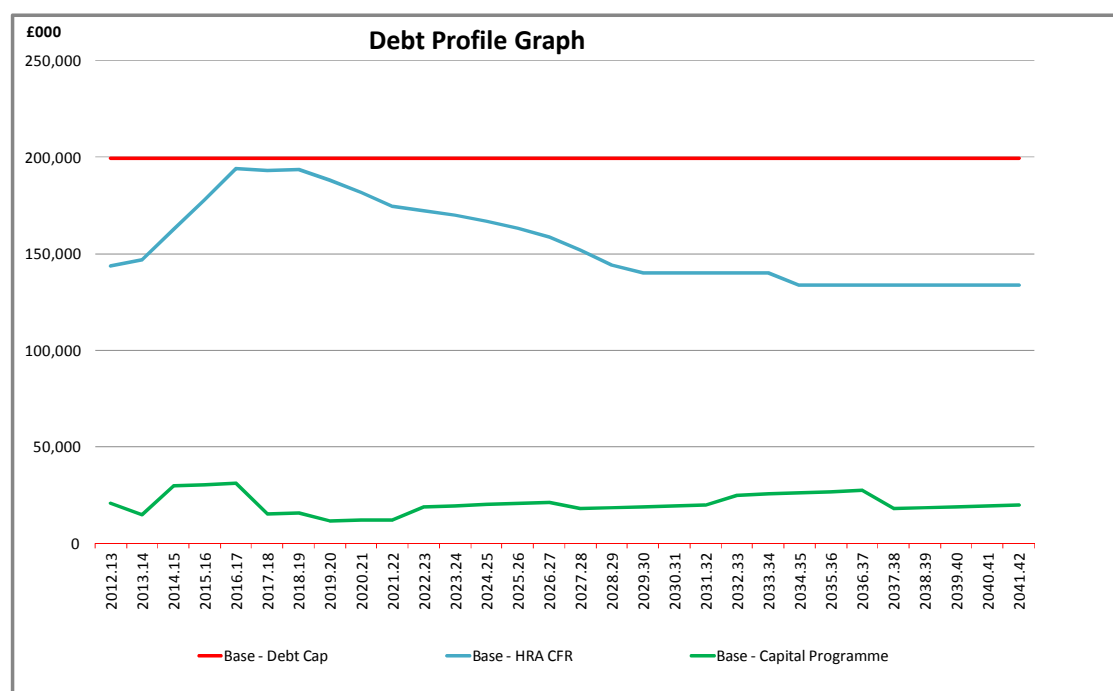
The peak in years 3 to 5 of this programme relates to delivery of the initial stock investment works identified by the 2011 stock condition survey.

### 5.3. Debt & financial headroom

Using the assumptions in Section 4 of this report the HRA would take on additional debt of £53.9m during the first 5 years of the business plan (2012/13 to 2016/17) to pay for the stock investment programme. This would result in a total peak debt of £193.9m in year 5 (2016/17), a figure that is £5.4m below the authority's debt cap. The business plan assumes that this additional debt would be borrowed from the Public Works Loans Board.

The baseline assumptions mean that debt would remain close to the peak debt level for years 6 and 7 (2017/18 to 2018/19), after which the authority would be able to start repaying the external debt taken on to pay for baseline stock investment. The additional debt taken on would be completely extinguished in 2029/30 (year 18). The authority's existing HRA debt would continue to be repaid in line with the due dates of existing loans. The chart below summarises these projections.

Figure 3. HRA debt profile



This chart also shows the capital programme (green line) alongside the debt curve (blue line). The initial peak in the level of capital investment from 2014/15 to 2016/17 is the reason for the increase in borrowing required. A further increase in capital spending in 2022/23 is also responsible for the rate of debt repayment slowing down slightly (shown by a flattening of the blue line).

As well as assessing the impact of the assumptions on debt levels, the above chart also shows the headroom available to the HRA for additional borrowing. This is the gap between debt (blue line) and the debt cap (red line). At the debt peak in year 5 borrowing headroom is £5.4m, which means that the authority could borrow up to this amount in the first five years and still observe its debt cap. Headroom remains near this level until year 7 and then increases gradually as debt is repaid. The business plan projects that borrowing headroom would increase to £24.7m by year 10 and to £59.3m by year 20.

The headroom projections suggest that the HRA could increase its baseline capital programme as follows and still remain within its debt cap:

Figure 4. HRA debt profile

Period	Total headroom	Potential total increase in capital programme
2012/13 to 2016/17	£5.4m	£5.4m
2017/18 to 2018/19	£5.9m	£0.5m
2019/20 to 2021/22	£24.7m	£18.8m
2022/23 to 2031/32	£59.3m	£34.6m

Restrictions on headroom caused by the debt cap represent the key constraint for the scale and timing of the authority's future HRA capital programme.

## 6. Sensitivity analysis

### 6.1. Sensitivities tested

Alongside the baseline assumptions we have conducted a number of sensitivity tests, designed to explore the impact of a range of different cost assumptions. The key sensitivities we have analysed are:

- General inflation is 1% higher, at 3.5%, in years 2 to 5
- Management costs rise in line with inflation from years 7 to 10
- Management costs rise at ½% above inflation from years 7 to 10
- Repairs, maintenance & major repairs costs rise at ½% above inflation from years 7 to 10
- A rent freeze is implemented in year 2 (2013/14)
- Rent loss peaks 2% higher, at 6%

Considering each of these in turn enables the authority to read the baseline financial projections in the context of potential changes, and so gives an indication of key risks and potential opportunities.

### 6.2. Results

The table below summarises the results of our analysis, showing snapshots of key measures at 5, 10 and 20 years:

Figure 5. Results of the sensitivity analysis

Sensitivity	Peak Debt		Year additional debt repaid	5 year snapshot			10 year snapshot			20 year snapshot		
	Total £m	Year		Revenue Balance £m	Capital Shortfall £m	Headroom £m	Revenue Balance £m	Capital Shortfall £m	Headroom £m	Revenue Balance £m	Capital Shortfall £m	Headroom £m
<b>A Baseline</b>	193.853	5 (2016.17)	18 (2029.30)	2.499	0.000	5.438	2.097	0.000	24.733	27.614	0.000	59.291
<b>B Inflation +1%</b>	194.631	5 (2016.17)	17 (2028.29)	2.580	0.000	4.660	2.190	0.000	26.410	35.385	0.000	59.291
<b>C Mgt costs + inflation</b>	199.291	7 (2018.19)	22 (2033.34)	2.530	0.000	2.150	2.051	0.264	13.812	2.559	0.264	49.363
<b>D Mgt costs +½%</b>	193.853	5 (2016.17)	18 (2029.30)	2.499	0.000	5.438	2.091	0.000	24.098	23.543	0.000	59.291
<b>E R&amp;M +½%</b>	193.853	5 (2016.17)	19 (2030.31)	2.499	0.000	5.438	2.087	0.000	23.886	17.863	0.000	59.291
<b>F Rent freeze in 2013/14</b>	199.291	6 (2017.18)	24 (2035.36)	2.531	0.000	0.407	2.051	2.050	13.840	2.557	2.050	48.950
<b>G Rent loss +2%</b>	198.476	7 (2018.19)	22 (2033.34)	2.527	0.000	2.963	2.055	0.000	15.108	2.564	0.000	52.432

Each of the sensitivities tested introduces costs or removes income from the forecast in a slightly different way. In all cases the sensitivities tested enable the authority to deliver services and its capital programme for the first five years. However, the effects are more pronounced when the 10 and 20 year snapshots are considered, not least because some of the sensitivities do not impact until the medium term (e.g. items D and E in the above figure).

This sensitivity analysis demonstrates that:

- Any increase in net expenditure increases peak debt. This reduces capital headroom, removes the authority's capacity to borrow to pay for an enhanced capital programme and takes longer to repay the debt.
- Increasing management costs in line with inflation for the first 5 years (instead of cash-limiting them) would cause the authority to borrow up to its debt cap in year 7 (Sensitivity C, above). There would also be a small shortfall against the capital programme in year 7, under this sensitivity, which would need to be managed by rescheduling some works. This means there would be no headroom for additional capital works for the first 7 years of the business plan.
- Implementing a one year rent freeze (sensitivity F) has a significant impact on the health of the business plan. The reduced income available means that the authority reaches its debt cap in year 6 and is unable to pay for its stock investment programme in line with the current schedule. This would require the authority to delay delivery of works totalling £2m, unless it makes up for the rent freeze by implementing greater increases in the following years.

It is therefore very important that the authority keeps firm control of costs and maximises income in order to deliver its investment programme and generate resources to provide additional capital projects.

### 6.3. Key messages

Cost control is critical to delivering the authority's plans for investing in the stock, while maximising the resources available for other capital projects.

Ideally the authority should manage its HRA in line with its baseline HRA business plan. We also recommend introducing reporting and monitoring arrangements that keep track of progress against the business plan and review regularly the key assumptions. This will help the authority to ensure its business plan is kept up to date and will also help it to spot emerging risks and opportunities at an early stage. Early detection of risks and opportunities would put the authority in a stronger position for managing its exposure to risks and maximising the potential benefits from opportunities.

## 7. Conclusions & Recommendations

### 7.1. Conclusions

HRA self-financing has significant implications for the way council housing is managed. For the first time in over 20 years authorities are able to retain all of the income they receive in rent, but they are also now wholly responsible for keeping the HRA in balance, managing their housing debt and delivering their own capital programmes.

The balance of risk has also shifted. The safety net previous provided by the subsidy system is no more, and so authorities need to ensure that their decisions keep the HRA in balance, while delivering substantial stock investment programmes.

The baseline position for Brent shows that there are strong cashflows from current and future rents, based on implementation of the current National rent policy for council housing. These cashflows are sufficient for the authority to keep its HRA in balance and deliver the programme of stock investment works identified as part of its 2011 stock condition survey.

Our forecasts also show that heaviest need for investment in the existing stock is in the early years of the financial forecasts. This need to spend, along with a debt cap that restricts the authority's ability to borrow, means that there is limited headroom for the authority to borrow more to increase the size of its HRA capital programme over the medium term. However, this headroom starts to increase after delivery of the initial phase of the stock investment programme.

There are a number of factors that could affect delivery of the business plan. The key risks that we have identified are:

- Failure to exercise tight control of costs (both capital and revenue) can reduce the authority's ability to deliver its investment programme on time
- Implementation of lower rent increases than suggested by National policy for council housing rents also have a potentially significant adverse impact on the authority's ability to deliver its investment plans

Our sensitivity analysis helps to illustrate the potential risks facing the authority under self-financing. Maintaining an up to date HRA business plan along with regular review of the assumptions and further sensitivity form an essential part of the authority's early warning system for potential risks and opportunities.

It is also important that all capital and revenue budgets for the HRA are implemented within the framework set by the authority's business plan. This helps to ensure that services and improvements are delivered in line with the strategic plans.

## 7.2. Recommendations

We recommend that the Council notes the baseline position and sensitivity analysis outlined in sections 5 and 6 of this report.

We further recommend that the authority considers establishing its own mechanisms for regular review and agreement of the HRA business plan, which should incorporate:

- review of progress against the agreed business plan
- reassessment of business planning key assumptions
- testing of appropriate sensitivities
- identification of emerging risks and opportunities