CAPITA

HOUSING AND CONSULTANCY

Rotherham MBC

# HRA Business Plan – Review

July 2016

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# Contents

# 1. Introduction

1.1 Rotherham Metropolitan Borough Council is in the process of preparing its HRA business plan financial model for the period beginning 2016/17. Capita's Housing & Consultancy practice has been commissioned to provide specific assistance, as follows:

- Review the council's inputs to determine whether they have been correctly entered into the model
- Transfer data onto the latest Capita HRA Business Plan financial model;
- Review the Council's inputs and recommend any changes where appropriate.

1.2 This paper is being provided along with a populated version of the latest business plan model.

# 2. Changes to assumptions

2.1 We have populated the new business plan model using the same inputs as the council have used in populating the previous version of the model but with the following exceptions:

1. Imp 2 – Rent Model Data (cells D11:D40, E11:E40, F11:F40, R11:R40 and T11:T40) – we have entered the annual rents, in money terms on a 52 week basis, for the three property categories used in the model as well as the average target rent and limit rent. The opening rents and real growth/reductions automatically feed through to the relevant input cells in Inc 1- Stock & Rent. The limit rents feed through into the relevant input cells in Exp 4 – Rent Rebates.

2. Inc 3 – Misc Income (cells L54:L83) – we have updated the additional income generated from letting new tenancies at target with the latest information provided by the council.

3. Inc 5 – Other Stock Changes (cells H12:H16) – the original model included 475 new dwellings in these input cells. These have been removed from here and entered into New Build and Acquisition inputs which will the use of RTB receipts to finance up to 30% of eligible development or acquisition costs.

4. Exp 1 – Management & Serv (cell I35) – we have amended the variable management cost per unit from £1,007 to £1,000 and added this to N-Build and SYHA Leased stock categories. The revised management cost of £1,000 per unit is based upon the annual budget of £20,658,200 divided by the average housing stock in year 1 of 20,656 dwellings.

5. Exp 3 – Misc Expences (cells L10:L39) – These cells in the original contained £2.0m per year at current prices to account for the requirement to pay the high value voids levy to the government. This has been moved to a new input sheet Fin 2 – High Value Voids Levy which ensures that the payments to government are treated as capital expenditure.

6. R&M 1 – Assumptions (cells AB11:AB14) – Expenditure of £44.375m on the acquisition of new dwellings was removed and entered as expenditure eligible for retained RTB receipt financing in New Build and Acquisition Inputs (cells J95:M95).

7. R&M 1 – Assumptions (cells X69:X82 and T79:T82) – Repairs and maintenance expenditure of £500 per unit was added to the N-Build stock category along with decent homes expenditure of £1,000 per unit from year 11.

8. New Build and Acquisition Inputs (cells I277:N277, I307:N307, I322:N322, I328:N328) – management costs of £1,000 per unit and repairs and maintenance of £500 per unit were added the acquired properties. Major repairs of £1,000 per unit were also added after 10 years.

9. Inc 4 - RTB (Maximum RTB Discount) – we have used £77,900 being the figure for 2016/17. The council's model included an assumption that the maximum discount would be £77,000. However, this won't have an impact while average RTB valuations remain significantly below the maximum discount.

10. Inc 4 - RTB (Other Changes) – The RTB inputs have been taken from Report 5 of the RTB Model which has also been updated and supplied as part of this review. The inputs reflect the quarterly and rather complex calculations required by the local authority capital finance regulations, as they pertain to RTB receipts. The new model has been populated in accordance with the updated RTB Model. These include:

| Assumption | New Model | Old Model |
|---|---|---|
| Cumulative Attributable Debt (Cell M137) | £8,288,323 | £2,820,268 |
| Cum. Assumed Debt B/fwd (Cell M172) | £3,406,180 | £1,523,595 |
| Cum. Allowable Debt B/fwd (Cell M177) | £4,882,143 | £1,296,673 |
| LA Share from previous qtr (Cell N213) | £191,258 | £159,990 |
| Prior Year receipts and expenditure (row 233) | Populated as per Report 5 of RTB Model | Not populated |

# 3. Comparison of financial projections

3.1 The new model is provided along with this report and is named 'RMBC-*HRA SF Model 2016 v1 – Scenario 1a*'.

3.2 The outputs from the models are compared in the table below:

| Ouput | New Model £'000 | Old Model £'000 |
|---|---|---|
| HRA Balances at Year 30 | 154,237 | 174,412 |
| Major Repairs Reserve Balance at Year 30 | 8,385 | 30,643 |
| | | |
| Capital Financing Shortfall | 31,044 | 36,260 |
| In Years | 4 to 8 | 3 to 8 |

3.3 In the new model the cumulative HRA balances in year 30 have fallen by £20.175m from £174.412m to £154.237m as a result of the changes made to the assumptions. This is illustrated in the following reconciliation:

| | £'000 |
|---|---|
| HRA Balances - Original Model | 174,412 |
| HRA Balances – New Model | 154,237 |
| Reduction in Balances | 20,175 |

| Analysis of Variances: | £'000 | £'000 | Notes |
|---|---|---|---|
| Rental income | | (121) | Bad debts on new build 1% lower for years 1 to 8 in new model |
| Relet rents | | 38 | Latest estimate of income from relets at target in new model |
| Management costs: | | | |
| • Existing stock | 2,716 | | £1,000 per unit added to N-Build and SYHA Leased units in new model |
| • New build units | 17,168 | | £1,000 per unit added to new build inputs in new model |
| | | 19,884 | |
| Repairs costs: | | | |
| • Existing N-Build units | 2,677 | | £500 per unit added in new model |
| • New build units | 8,923 | | £500 per unit added to new build inputs in new model |
| | | 11,600 | |
| | | | |
| High value void levy | | (81,136) | Treated as capital expenditure in new model |
| RCCO | | 71,888 | Additional RCCO to finance high value void levy and additional capital expenditure on new build properties subject to minimum working balance |
| Interest on RTB receipts | | (1,748) | Reduced interest on returned RTB receipts in new model as receipts now used to finance new build |
| Interest on balances | | (231) | Additional interest in new model due to changes above |
| Total Reduction in Balances | | 20,175 | |

3.4 The unused balance on the Major Repairs Reserve (MRR) after 30 years has also fallen by £22.258m from £30.643m in the old model to £8.385m in the latest version. This is because the MRR has been used to finance additional capital expenditure in years 26 to 30 on works to acquired properties and the high value voids levy.

3.5 The capital programme is not fully financed in either the new or old models. Both models assume that there will be no additional borrowing to finance the capital programme and the annual direct revenue financing is constrained by the minimum working balance specified in the model inputs. The shortfall in resources is show in the table below:

| Year | Year | New Model £'000 | Old Model £'000 |
|---|---|---|---|
| 3 | 2018/19 | - | 2,576 |
| 4 | 2019/20 | 10,725 | 13,262 |
| 5 | 2020/21 | 11,847 | 13,695 |
| 6 | 2021/22 | 2,394 | 1,780 |
| 7 | 2022/23 | 3,446 | 2,872 |
| 8 | 2023/24 | 2,632 | 2,075 |
| Total | | 31,044 | 36,260 |

3.6 The HRA borrowing remains constant at £304.125m throughout the 30 year business plan. The HRA debt cap is £336.623m and so the HRA has unused borrowing capacity of £32.498m. However, this does not mean that HRA capital resources could be increased by £32.498m because the financing costs of any additional borrowing would reduce the HRA's capacity to use direct revenue financing.

3.7 By using additional borrowing to finance the capital programme in the new model the shortfall could be reduced from £31.044m in years 4 to 8 to just £5.034m arising in years 8 to 9. The HRA debt would remain at the debt cap in years 4 to 9 after which the additional borrowing could be repaid in year 23. Thereafter the HRA debt would continue at the current level of £304.125m. HRA balances after 30 years would be £104.253m with the MRR balance unchanged at £8.385m.

3.8 A fully financed capital programme could be achieved by deferring some of the capital expenditure in years 8 and 9 until later years. This is illustrated in the following table:

| Years | Re-phased Capital Spend £'000 |
|---|---|
| 8 | -3,327 |
| 9 | -1,035 |
| 10 | +1,218 |
| 11 to 15 | +3,144 |

Note: Costs shown at current prices

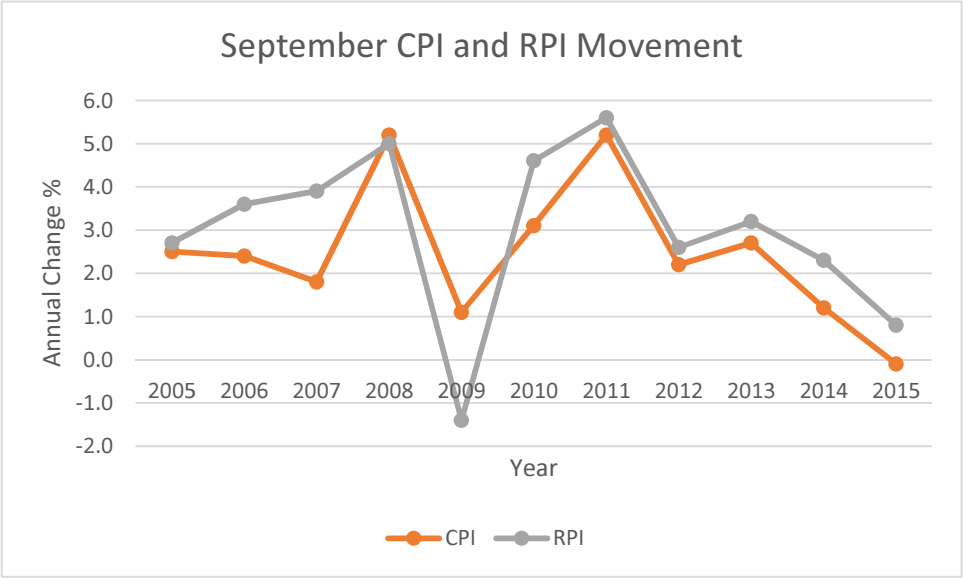
3.9 Reducing the capital programme by £3.327m in year 8 and by £1.035m in year 9 and reinstating this expenditure in years 10 to 15 would allow the programme to be fully financed by using the existing HRA borrowing capacity. In this scenario HRA borrowing would increase to reach the cap in year 8 and remain there until year 11 with all of this additional borrowing repaid in year 23. HRA balances at year 30 would fall to £93.973m because of the additional borrowing costs and MRR balance after 30 years would remain at £8.385m.

# 4. Observations

4.1 During the process of populating the new model we have identified the following areas for review which potentially impact on the projections provided by the business plan model.

4.2 **Inflation** – The model currently assumes that inflation measured by the Consumer Prices Index (CPI) is line with the government's inflation target of 2.0% per year. The model also assumes that inflation measured by the Retail Prices Index (RPI) will be the same. The distinction between these measures of inflation is important because future rent increases after the enforced 1% rent reductions for 4 years are likely to be linked to the September CPI while cost inflation is often driven by movements in the RPI. This is particularly true for repairs contracts.

The RPI generally increases at a faster rate than the CPI so that costs increase relative to rental income. The annual increases in both the CPI and RPI from September 2005 to September 2015 are compared in the Following chart.




Since 2005 the annual increase in the RPI has been higher than the increase in the CPI in all but 2 years, 2008 and 2009. Since then the average increase in the RPI has been 0.8% higher than the CPI. The gap in September 2015 was 0.9% down from 1.1 in September 2014.

Future inflation forecasts are published by HM Treasury in "Forecasts for the UK economy". The latest version of this document was published in July 2016 and contains details of 26 independent forecasts including the Office for Budget Responsibility (OBR). The forecasts for the 4$^{th}$ quarter of 2016 and 2017 are summarised in the table below. The median forecast anticipates that that gap in the 4$^{th}$ quarter of 2016 will be 0.8% which falls slightly to 0.6% in the 4$^{th}$ quarter of 2017. The OBR forecast suggests the gap will be 0.9% in 2016 and 2017.

As a rule of thumb Capita Asset Services generally recommend a gap of 0.5% in the long term for housing association business planning purposes.

| Year | Forecast | RPI % Increase | CPI % Increase | Gap % |
|---|---|---|---|---|
| 2016 | Highest | 3.4 | 3.0 | 0.4 |
| 2016 | Lowest | 1.1 | 0.2 | 0.9 |
| 2016 | Median | 2.1 | 1.3 | 0.8 |
| 2016 | OBR | 1.9 | 1.0 | 0.9 |
| | | | | |
| 2017 | Highest | 4.5 | 4.0 | 0.5 |
| 2017 | Lowest | 2.1 | 1.5 | 0.6 |
| 2017 | Median | 2.9 | 2.3 | 0.6 |
| 2017 | OBR | 2.6 | 1.7 | 0.9 |

Assuming a gap of 0.5% per year between the RPI and CPI from year 2 onwards reduces HRA balances to £29.132m at year at year 30 with a MRR balance of £9.705m. The shortfall in capital resources increases significantly to £43.678m from year 7 to year 25.

4.3 **Rental growth** – the business plan assumes that rents will reduce by 1% per year in nominal terms in line with the requirements of the Welfare reform and Work Act 2016. The final rent reduction takes effect from 1 April 2019. Thereafter, the business plan assumes that rents will increase by the CPI without any real growth. This is a reasonable assumption given that we do not know how the national rent policy will be look from 1 April 2020.

4.4 **Interest on returned RTB receipts** – The business plan currently assumes that the HRA will acquire 475 new properties during the first 5 years which will be partly financed 1-4-1 RTB receipts for replacement homes. Unspent receipts retained for 1-4-1 replacement of RTB sales need to be paid to the government after 3 years along with interest at 4.5%. The HRA cashflows include interest charged at 4.5% on RTB receipts returned to the government with effect from year 10. The total interest charged to the HRA is £15.052m.

To avoid the interest charge in future years the Council would either need to use retained receipts to finance new homes in the HRA, grant the receipts to another social landlord for them to finance new homes or to terminate the retention agreement with the government.

By assuming that the retention agreement terminates on 31st March 2022 the HRA would be subject to any interest payments on returned receipts. This would increase the HRA balances to £168.491m after 30 years. The MRR balance would remain unchanged at £8.385m and the shortfall in capital resources would be £31,044 in years 4 to 8.

4.5 **Management costs** – the business plan assumes that all of the management costs vary with stock numbers and so management costs are reducing annually, in real terms, by the impact of RTB sales. There is also a 1% real reduction applied to the management cost per unit in years 2 to 5 inclusive and the Council needs to ensure that these cost reductions can be delivered. If the real reductions are removed from the plan the HRA balances after 30 years would fall by £20.942m to £133.295m and the shortfall in capital resources would increase to £36.173m in years 4 to 9.

The variability of management costs is always difficult to gauge but in reality the costs are likely to be stepped. Some costs, like postage, will vary with the stock numbers while the cost of housing management staff is unlikely to vary unless there is a significant shift in housing stock numbers. Assuming that management costs are 80% fixed and 20%variable the HRA balances after 30 years would fall by £94.403m to £59.834m and the shortfall in capital resources would increase to £36.485m in years 4 to 9.

4.6 **Repairs and maintenance** – The revenue repairs and maintenance are assumed to vary with stock numbers but the costs within the capital programme are fixed, apart from void repairs, and do not vary with the impact of RTB sales. It seems reasonable to assume that any costs that relate to the fabric of the dwellings, such as the structure or other building components, will vary with the stock numbers while costs such as environmental improvements will not.

By making all of the costs 100% variable apart from disabled adaptations, garages and other costs the HRA balances after 30 years would increase by £55.363m to £209.600m and the shortfall in capital resources would fall to £25.278m in years 4 to 8. The MRR balance would also increase to by £14.292m to £22.677m.

4.7 **Higher value voids levy** – The last official advice from the DCLG on Higher Value Assets was: "Ministers have been considering when to publish some information about HVA. Publication before Parliamentary recess is now very tight. We will therefore explore options for publishing the information in the Autumn." It is possible that the levy won't be imposed until 2017/18 rather than 2016/17 as originally expected and so there may be a saving of £2.0m in the year 1 cashflows.

The HRA business assumes a levy of £2.0m per year at current prices. Brandon Lewis, when he was the Housing Minister, suggested that up to a third of local authority housing stock could be classed as higher value. Based upon the housing stock of 20,599 units at 1st April 2016 there could be potentially 6,866 higher value properties in the HRA. Assuming that void turnover rates are 5% would mean that 343 dwellings would be subject to the levy. Using the average RTB valuation of £70,136 per property the levy in year 1 of the scheme could be £24.057m (343 void dwellings x £70,136 per dwelling). Clearly, a levy of this magnitude would not be sustainable without the sale of higher value void properties. Due to the uncertainty we would recommend that the Council continues with the current assumption and updates the business plan once further information has been provided by the government.

4.8 **Pay to stay** - In a similar vein to the higher value voids levy, we understand that records from the Inland Revenue (in a suitable format) are unlikely to be available in advance of 2017/18 and there is a reluctance to try and implement the scheme during the year and so the commencement of pay to stay may be deferred until 2018/19, unless the local authorities are in a position to obtain the necessary data by some other means. At the moment the business does not include any additional costs associated with pay to stay but the position should be reviewed as more concrete information becomes available.

4.9 **New property acquisition costs in year 1** – we were unable to identify the costs of acquiring 50 new dwellings in year 1 of the business plan. It may be that this is included within the Repairs and Maintenance Inputs sheet (R&M1). The costs either need to be added to the business plan or identified separately in the new build input sheet.

# 5. Suggested changes to the base case

5.1 Based upon the review of the current assumptions we would recommend the following changes to the base case business plan:

1. RPI – Increase the RPI by 0.25% per year to reflect the potential gap between RPI and CPI. This is less than suggested by independent forecasters but it does add some protection against cost inflation.

2. Management cost – assume that 50% of management costs are fixed to reduce the risk of failing to drive through cost reductions needed as a result of RTB sales;

3. Repairs and maintenance – assume that all repairs and maintenance costs are variable with stock numbers apart from disabled adaptations, garages and other costs. This should largely reflect the potential savings from stock losses.

4. RTB retention agreement – assume that the agreement ends on 31st March 2022 to ensure that the HRA does not incur interest costs on unspent 1-4-1 receipts for replacement homes that need to be returned to the government.

5.2 The impact of these changes will be as follows:

- HRA balances at Year 30 of £99.244m;
- MRR balance at year 30 of £24.165m;
- Capital shortfall of £31.401m in years 4 to 8.

5.3 Additional borrowing subject to the debt cap would then have the following impact:

- HRA balances at Year 30 of £45.098m;
- MRR balance at year 30 of £24.165m;
- Capital shortfall of £5.755m in years 8 to 9;
- Additional borrowing of £32.498 m to reach debt cap;
- Additional borrowing could be repaid in year 25.

5.4 A copy of the model using these assumptions is attached with this report. See the "Inc 7 – Self Financing" input sheet for additional borrowing and repayments.