DERBY CITY COUNCIL

COUNCIL CABINET
6 JULY 2010

ITEM 8

Report of the Strategic Director of Resources

Reform of the Housing Revenue Account Subsidy System

SUMMARY

1.1 The government published a 'prospectus' for the reform of the Housing Revenue Account, HRA, Subsidy System, HRASS, on 25th March and requested responses to the consultation contained within it by 6 July – we have received confirmation from the Department for Communities and Local Government, CLG, that our response will be given due consideration if we respond by 7 July.

1.2 Overall, the Council's HRA is currently in surplus but will lose the benefit of additional funds currently available as a result of the Arms Length Management Organisation, ALMO, settlement from next financial year. This will mean that the Council will start to make significant payments of negative subsidy at that point.

1.3 The offer from the government implied by the prospectus, is that debt would remain around current levels but be capped at that level. This is clearly better than the alternative that would see increasing levels of negative subsidy paid to the government over time.

1.4 There are some concerns set out in a proposed consultation response attached at Appendix 2 and overall, the recommendation included in this report is to strongly welcome the proposals, but to also plead for some technical adjustments to the calculations rather than the principles proposed.

1.5 The Coalition Government's Housing Minister has stated that he wishes to 'review the review' started by the previous Labour Government, but accepts that the current system is in need of reform. He has also signalled that the government is minded to continue with the process already begun and to consider responses to this consultation with a view to implementation. The principles being followed in the prospectus do allow delegation to local level, and also generate an overall capital receipt for central government.

RECOMMENDATIONS

2.1 To approve the consultation response to the Government attached at Appendix 2.

2.2 In the event of the reform being implemented, to adopt the policy on application of future Right to Buy receipts set out in paragraph 5.6 of this report.

SUPPORTING INFORMATION

Background

3.1 Around five years ago, the government began a process of reviewing the future of the Housing Revenue Account, HRA, after the initial phase of the decent homes programme had ended and that investment had been completed. It involved considering whether there was a better way of organising Council housing and if greater freedoms and flexibilities could be given to Councils and / or their Arms Length Management Organisations, ALMOs, in future.

3.2 That work indicated that one of the key issues for Council housing, however it was organised, was the system of financing it and in particular the way that the existing Housing Revenue Account Subsidy System, HRASS, worked against normal business planning and operations. The government therefore undertook to review the operation of the HRASS and to see if it could be improved or even abolished and replaced with a new system.

3.3 The review was published in 2009 and a consultation held on its conclusions. These were that the system needed to be fundamentally reformed or abolished, but that straight abolition would not be possible or desirable without some form of reallocation of debt.

3.4 If the HRASS were to remain in place, its operation – broadly financially neutral at national level in recent years - would steadily place a greater burden on local authorities and their tenants over the years as rental income increases at a greater rate than costs. This tendency has been exacerbated by the rent restructuring process which has increased rents in real terms, and will continue to increase rents in the local authority sector until they are broadly comparable with Registered Social Landlord, RSL, rents. Over the next few years the continued operation of HRASS will mean that the government would start to get net revenue from Council homes through the ongoing operation of HRASS.

3.5 The government proposed in 2009 that further detailed work should be undertaken to reach an appropriate settlement with local government as a whole on this issue with a view to abolishing HRASS. In exchange for this, the government would need to reallocate debts across all local authorities with those currently paying large sums of negative subsidy facing an increase in debt, and others getting a reduction.

3.6 This debt burden would be calculated so that all local authorities would be better off than if the existing system continued and they would have a sustainable financial position going forward over the next 30 years or so – which is not the case at present beyond a few years in most cases.

3.7 When the review of HRASS was announced in late 2008, the Council and Derby Homes agreed to commission an updated Stock Condition Survey, SCS, and a ‘desktop’ review of the HRA’s financial position from independent consultants.

The SCS, indicated three possible levels of continued investment by the HRA being:

- to sustain stock at a basic level
- a ‘basic plus’ level and
- an aspirational level.

3.8 The report identified that, even at the basic level of spending the existing level of funding available with the operation of HRASS would mean that the HRA would run out of funds by 2013/14. The two higher levels are therefore unattainable within the existing system. Indeed, the basic level is not achievable and the existing HRA business plan is required to set a much lower level of investment in order to maintain a positive HRA balance.

3.9 A rough comparison between the spending on major repairs planned under the existing business plan and that required by the SCS is that there is a shortfall of around £400m over the next 30 years. In practice this would mean that essential maintenance works may have to be deferred and replacements of kitchens, bathrooms, windows, and so on would certainly have to be reduced in frequency in order to contain expenditure within the means available.

3.10 Another conclusion of the report was that stock transfer was also not a viable solution for the Council as it would need to find around £117m plus an ongoing cost of around £1m a year to finance such a change. The best opportunity for an improved financial position for the HRA is therefore reform of the HRASS.

3.11 In the meantime, the Council has set its HRA budget on the current basis including HRASS, and has restored some additional capital funding through increased service charges for smoke alarms and grounds maintenance, with short term protection for tenants as base rents have been reduced by equivalent amounts to the increased service charges. In addition, the transfer of the building repairs teams from Environmental Services to Derby Homes direct management from 1 June 2010 should lead to additional efficiency and greater output from the resources of the repairs account.

HRASS reform proposals by Government March 2010

4.1 In March 2010, the government issued a detailed ‘prospectus’ for the reform of the HRASS, which takes the form of a further consultation with local authorities.

If the government confirms the proposals following the consultation, the Minister is able under existing legislation to make agreements with individual authorities to allow them to exit the HRAS system from 2011/12. It has been made clear that the basis for this would not be individually negotiable but would be on standard terms agreed between the Department for Communities and Local Government – CLG - and the Local Government Association - LGA. The alternative route to implementation of the proposals would be to impose a system nationwide following legislation but this would not be practical until at least 2012/13 and probably later.

A proposed consultation response for Derby is appended at Appendix 2.

4.2 The government’s proposals are to abolish the HRASS, and to rebalance the financial implications of doing so by adjusting councils’ individual debt levels. At national level, the debt burden on Councils as a whole is massive and is proposed to be increased further by around £3.6bn from around £21.5bn to £25.1bn.

4.3 The government has acknowledged that there are capital backlogs across the country of at least £3.2bn. It is hoped that the funding gained by the government by the reallocation of debt will be used to fill in that gap in funding through a system of capital grants, but this is subject to the next Comprehensive Spending Review – CSR - which at this stage is unknown. The impact of this for Derby will be less than for those Authorities where there remains a significant backlog of Decent Homes work still to be undertaken.

4.4 If the £3.2bn national bid to retain funding which the prospectus describes as a ‘central element of its deliberations on meeting investment priorities’ was to be secured in the CSR, the net debt implied by the settlement would be almost in line with the notional national debt for housing held by Local Authorities. Such a balance would clearly be more acceptable than the proposed additional burden for Councils indicated in the settlement alone.

4.5 The more rent and the lower costs that are expected at this stage, the greater the debt burden will be for each Council, and therefore the greater the government receipt will be. The speed of reaching rent restructuring and the discount rate applied to the whole model are the two key variables within the financial modelling. The discount rate is the amount by which future cash flows – both income and expenditure - are discounted back to current values to indicate their existing worth – for instance a 7% discount rate means that £1 in next year is worth £1/1.07 = 93.5p, and £1 in two years time is £1/1.07/1.07 = 87.3p. The higher the discount rate, the lower the future surpluses will be in terms of their current or net present value, NPV. The lower this measure is, the lower the initial debt that can apparently be supported by that net rent, leaving local authorities with lower overall debt as a result. The higher the discount rate therefore the better is the settlement.

4.6 In reality, the discount rate in effect sets a benchmark for interest rates in the future on the new total debt – if we can achieve lower interest rates than the discount rate we will have more resources, but if they were to increase beyond the discount rate we would have fewer. Currently we can borrow at around 5% although there is obviously a possibility that this could increase in future should government debt become more expensive. The proposed settlement though would not see a significant change to our debt position, so much of the debt would be existing debts, reducing this risk to a marginal one in our case. Clearly other authorities that might be taking on hundreds of millions of new debt would have a much greater exposure if interest rates were to increase.

4.7 Rent restructuring is assumed to be completed by 2015/16 although this remains an ambitious target to be met as it implies substantial real terms increases in rents, a significant portion of which will have to be met by central government through housing benefit.

4.8 If the reality is that the government places further restriction on rent increases in future, and the implied level of increase were not permitted, the debt placed on Councils would have been higher than it should have been. This is possibly the largest risk facing the Council under the self financing option at this stage. Assurances are needed that the assumptions made in the settlement will be adhered to or that compensation would be offered for any reduction in Councils’ ability to set rents in accordance with the policy as determined.

4.9 There are two options in the proposals for a discount rate. These are 6.5% and 7%. The 6.5% is broadly comparable with the rate being used on stock transfers and is not unreasonable as a measure. For comparison, the Council uses a discount rate of 6.0875% when assessing business cases for capital projects. It is also the Council's current policy to use an internal charge of 6% when assessing the long term impact of borrowing when considering a capital investment. Interest rates rise and fall but are usually contained within 6% in recent years, so a 6.5% discount rate is acceptable in principle.

4.7 The 7% option is therefore considered to be fairly generous, but is offered subject to accepting a need to undertake greater levels of new build than would be possible under the 6.5% option. We should welcome this as it will help to re-establish limited levels of new build of Council housing for the future. Early indications are that we would be able to invest considerable additional sums into new build proposals, depending on availability of land and grants from the Homes and Communities Agency, HCA, to support plans as well as the welcome additional funding implied by a 7% discount rate.

4.8 The proposed debt adjustments for Derby are:

Current notional debt	- £111.5m	
Current ALMO debt	- £97.1m	
Current total notional debt	- £208.6m	
Proposed debt @ 6.5%	- £211.8m	
Increased debt from settlement		**+ £3.2m**
Proposed debt @ 7%	- £202.3m	
Reduced debt from settlement		**- £6.3m**

4.9 Our actual HRA debt is slightly lower than the above notional figures at £189m reflecting much earlier decisions to repay some debt. This figure is not taken into account in the settlement but would be the base figure from which the adjustment is made, so a £6.3m reduction in debt would see actual debt starting at £182.7m.

4.10 A 7% settlement would represent a £9.5m better settlement for Derby. This money could perhaps be set aside specifically for new build projects within the HRA. In itself this would build around 80 homes but this could be stretched further by the addition of grants from the HCA, and/or cheap or free/subsidised land, and also by the surplus that such new homes would themselves generate.

4.11 In terms of the total that could be sustained, initial modelling indicates that a programme around the current level of losses of Council homes through Right to Buys of about 25 a year could be sustained with grants from the HCA, perhaps more depending on availability of land and the level of those grants. In reality, each proposal would have to be considered on its own merits and within the context of wider regeneration proposals for individual areas. Overall, though, the Council would have an increased ability to invest in HRA property to complement wider plans.

Right to Buy

5.1 At present, Councils have to pay over 75% of receipts relating to right to buy sales to the government and can retain the other 25% for its own use. The Council currently spends this funding on the housing capital programme - largely on supporting the Disabled Facilities Grant, DFG at its current level of £1.4m a year. At present there is very limited income from Right to Buys – we sold 25 homes in 2009/10 at a value net of discounts of £1579k, so could only retain £394k to support the housing capital programme. This figure used to be well in excess of £1m and has contributed to the pressure that the housing capital programme is now under as a result of reducing funding.

5.2 In future, the proposal is that Authorities would be able to retain 100% of the receipt, but that there would be a restriction on the use of 75% of them to affordable housing and regeneration purposes. In our case, even at current levels, this would be worth around an additional £1185k a year. This is clearly a major element of the benefit that these proposals will bring to the sustainability of the HRA in the future.

5.3 It is proposed that the first call on the proceeds of any sale in future would be a write down of the appropriate level of debt. For old stock this would start at around £15k a unit – the average debt outstanding at present, and for new stock it would be much higher – around £120k. In the latter case, therefore, it would probably be necessary to apply the whole receipt to reducing HRA debt, while in the former case, there would still be a considerable net receipt left for use.

5.4 Using an illustrative example, a sale worth £60k after right to buy – RTB - discount would have previously generated a usable receipt of £15k. In future, the same receipt – for old stock – would generate a debt reduction of £15k, £15k available to support the housing capital programme as now and a balance of £30k for affordable housing and regeneration. In modelling the future HRA position, it has been assumed that this balance will be applied to the HRA in order to maintain the stock and generate some further new build replacement.

5.5 While it is possible that the excess could be used for other housing purposes, it is proposed at this stage that such receipts are reapplied to the HRA. In the case of any sales of new stock completed after 2009/10, it is proposed that the entire receipt should be applied to reducing HRA debt incurred in building that property, and only any excess receipt above this level should be divided between other uses.

5.6 In essence therefore, it is proposed that the policy would be –

For existing stock as at 1 April 2010

The receipt net of discounts and administration costs would be applied as follows:

1. 25% to support the housing capital programme including Disabled Facilities Grants as now
2. Average debt per stock (approx £15,000 at the moment) – reducing HRA debt
3. Balance to HRA

For new stock

1. Debt relating to that stock applied to reduce HRA debt
2. If any remainder, up to 25% of the net value to general fund housing capital programme
3. Any further remainder to HRA

5.7 The reasons for this are to preserve the existing funding for DFGs in particular into the future and to reduce debt pro rata to sales where possible in order to reduce debt when the stock reduces in future. The balance would then support the whole HRA investment plan.

Overall benefits for Derby

6.1 The main benefit of the proposals is in the HRA's ability to invest in both existing and new stock for the future. Compared to the existing plans, the central projection is for benefits in terms of additional spending over 30 years to be in the hundreds of millions – on the central projection we might be able to spend around £400m more than currently planned over that period – albeit that the current plans are not adequate in the medium term, so we are not likely to be able to fund much more than the 'basic' level listed by the stock condition survey last year - as a result of better funding levels implied in the settlement, control of our own interest costs and rents and keeping all of projected Right to Buy receipts. This is not to say that this full amount will be realised as there are a lot of uncertainties within a 30 year projection, and the sensitivities are quite large.

6.2 Without such a change, the current system will be in significant difficulty within a few years and backlogs for tenants will arise both here and at other Authorities across the country.

The government has realised that something has to be done to reform the system, and this option appears to give all stakeholders some benefit , and offers hope of a sustainable system for Council Housing into the future.

Risks

7.1 In exchange for the benefits of higher allowances implied in the calculated debt, retention of capital receipts and a more generous discount rate, the government is expecting both a commitment to some new building but also to taking on additional risks as well as a commitment to implement higher rents through rent restructuring.

7.2 **Rents**

Rent restructuring would be set to be completed by 2015/16 – giving a period of only 4 years to catch up the balance of the difference between current rents and target rents. Each tenant is at a different point on this restructuring path, but for an average tenant, there is an implication of a real terms above inflation increase of around 12% over the next four years. Some tenants may find that rent restructuring takes rather longer than the official deadline as their rent is even further away from their target. These increases will have to take place anyway under the current policy – the only issue is the pace of change to get to the higher rents. Current government policy is to converge by 2012/13.

7.3 In previous consultations with tenants' groups, the message from tenants has consistently been to accept higher rent increases in order to protect and improve services that tenants receive through the HRA generating not only the direct resources from tenants but also from the government in the form of additional housing benefit payable as a result of higher rents. While the increases appear steep in terms of a percentage, the actual real terms increases would be around 3% above inflation for 4 years which on an average rent of £59 a week would be about £1.80 a week above inflation.

7.4 In effect these increases would be restoring the actual rent charged to what the government's rent restructuring policy deems to be the 'correct' rent and spreading this increase as evenly as possible over a slightly longer period. The current rent cap of RPI + 0.5% + £2 a week would also remain, restricting any excessive increases. Consultation has taken place with the Derby Association of Community Partners, DACP, representing tenants and leaseholders, at a meeting in May and a motion to welcome the proposals was supported unanimously by the tenants present.

7.5 There is also an issue here for the Council, as this expected rent increase set within the calculation of the settlement will effectively require us to implement the rent restructuring policy in line with the expected increases or face significant shortfalls in resources to support the maintenance of the stock. The main benefit of the HRASS has been that when the government has insisted on lowering or capping rental increases as it has often done before, it has in effect had to compensate authorities in full for reducing the amount required to be raised by increasing rents according to the rent restructuring formula. Any such government decision has led directly to an increase in HRAS being paid by the government.

7.6 As a consequence of abolition of HRASS, once the agreement has been reached, the risk of failing to increase rents at the agreed rate under rent restructuring would then fall on individual Councils instead of the government. The sums involved are significant – for instance a 2% reduction in the expected increase in rents would lose the Council about £0.8m of rent each year and such losses would tend to be cumulative – and they would also lead to higher subsequent rises in later years.

7.7 With a fixed date for the end of rent restructuring, the final years could become very difficult to implement. Such losses would be a considerable concern for Councils and would directly impact on our ability to invest both in new and current stock. It is easy to see that a decision to restrict rent increases might be attractive to the government where there was no financial cost of implementing such restraint – indeed there would be a financial benefit as Housing Benefit costs would be lower.

7.8 In effect, rent capping puts back the date for final convergence to target rents. In the current system, there is a method of compensation through HRASS. It would be possible for the government to work out a specific system of compensation for this issue alone should they so choose, or they could commit not to interfere with the rent setting process after this settlement.

It would be very helpful if the government could make a statement of their intentions in this area so that this risk can be mitigated or at least assessed more fully. At the moment, this is the single largest risk that the Council would be taking on as a result of the proposed settlement.

7.9 There is a technical issue with the calculation of the settlement that has been included in the response relating to the way in which the CLG model calculates the impact of the 'caps and limits' adjustment – effectively compensation within the subsidy system for holding down rents below the rent restructuring policy as a result of central government decisions. In effect the calculation had to be done on an average basis rather than property by property as the calculation of 1.8m rent restructuring calculations for 10 years would be too lengthy to undertake. The CLG understandably therefore attempted to estimate the impact using averages, but appears to have consequently overestimated the amount of rent that can actually be raised following rent restructuring policy and the £2 a week cap in particular. As a result, the Council's debt is believed to be overstated by around £3m on the 7% discount factor basis. It will be suggested that Councils could supply figures to CLG to enable them to adjust their calculations to allow for a more accurate means of calculation.

7.10 **Interest Rates**

The other significant risk being taken on is the management of debt and interest rates on that debt. At the moment, the Council's debt is costing around 4% in interest, but the underlying cost of new borrowing and the long term debt portfolio is between 4.5% and 5%. The business plans that are being drawn up for the HRA are being based on 6% - which could be the underlying long term cost of debts in the future – which allows an element of prudence in terms of debt costs for the moment. As a consequence, while the risk of interest rates increasing and impacting on the HRA is quite high, the extent to which it might damage the core business plans being considered is limited. Only if interest rates rise above 6% would there be any risk to the plans as currently contemplated. Should interest rates remain low, savings in interest payments will be made, and this would allow debt to be written down faster than expected. This in turn would enable greater investment whether in existing or new stock.

Housing Revenue Account Debt

8.1 The proposals would not see a significant change in the level of Derby's debt - only a marginal increase or decrease. The system, however, would change significantly. At the moment, Councils are required to 'pool' all debt and to make charges to the HRA and General Fund, GF, according to regulations relating to the HRASS. These interest costs are then included in the calculation of HRAS. The lower that debt costs are, the lower the HRAS that can be claimed – or more negative subsidy that has to be paid. There is therefore little incentive within the HRA at present to reduce interest costs – although there is an incentive in terms of general fund costs where any savings generated are retained by the Council.

8.2 It is proposed that in future, debt is separated into two pools – for the general fund and the HRA. This would allow for a much clearer separation of the issues faced by each part of the Council's debt, and for those issues to be managed accordingly. The cost of servicing each debt pool would be clearly separated by dividing existing debts between the HRA and GF and adding new debts solely to the relevant pool. These issues are complex and will require further clarification, but the ability to manage two pools of debt should not be a problem for the Council. In practice, the HRA will be able to manage its own debt and relate this to its own asset position. A nominal or memorandum balance sheet for the HRA is also proposed by the government in order that these issues can be seen more clearly in future, rather than being subsumed into the overall Council debt and assets as at present.

8.3 **Housing Revenue Account Debt Cap**
The government proposes to implement a debt cap on the HRA equivalent to the opening debt in the settlement. This is to counteract the Treasury's concern about a potentially large increase in borrowing to fund new build and reinvestment in the current stock.

8.4 Such debts would add to the overall national debt at a time when this is clearly of concern. In principle, this restriction on borrowing is unnecessary given the Chartered Institute of Public Finance, CIPFA, prudential borrowing code whereby only borrowing that is sustainable into the future should be undertaken. Given the scale of the change and the ability of housing to generate at least some income from investment in new stock – albeit insufficient to support the whole investment – there is a potential for considerable new debt being taken on, and the Treasury's concern is therefore understandable if not supported.

8.5 This means that the Council would not be permitted to exceed the above mentioned initial debt level of £202.3m for a 7% settlement, or £211.8m for a 6.5% settlement. This would be restrictive at least until debt can be brought down by generating sufficient net income. In particular the first few years of the plan will be much tighter than later years. In most stock transfers, the key debt figure is not so much the initial debt but the 'peak' debt after a few years before the debt starts to reduce. This pattern is also found in many other long term deals such as Private Finance Initiatives. One part of the proposed response therefore is to suggest that the debt cap is adjusted to reflect projected peak debt rather than initial debt. This would be in keeping with the Government's own proposal and plans and allow slightly more investment in the earlier years.

8.6 As drafted it would appear that the initial debt is lower under the 7% option, so the difference between that option and the 6.5% option while welcome is effectively reduced by the equivalent fall in the debt cap. It is therefore proposed that we should suggest that the government should agree to use the peak debt generated by the 6.5% model for each Authority, while adjusting debt using the initial debt from the 7% model. For Derby the debt cap would increase from £202.3m to £226.4m, potentially enabling a higher degree of investment and debt in the earlier years than would otherwise be the case.

8.7 An alternative way of dealing with this if the debt cap is immutable as a principle for the government would be to adjust the starting debt downwards to reduce the initial debt by the difference between the peak debt and the initial debt. This would then mean that the debt cap would be consistent with the plans as set out. Without this adjustment, some investment in the early years would need to be postponed until capacity within the debt cap was evident. The proposals would therefore postpone investment over the next few years but would allow it in the longer run. It would also be helpful to have it clarified about how the cap would or could be adjusted in the longer term.

8.8 The debt cap is also not adjusted at the moment for the investment already approved by the HCA into new build. Without this adjustment, the investment made by the HRA into those properties will in effect count against the debt cap. As this was approved in advance of the prospectus this is not felt to be reasonable. A similar adjustment could also be made for future approved borrowings relating to further investments in additional building, and this has been put forward as a proposition as part of the response.

8.9 **Future Changes to inflation**

The Council would also be taking on inflation risk in terms of the future. The underlying assumption made by the government has been 2.5% a year, and if inflation were to be significantly higher than this for management and maintenance costs or lower than this for rents additional pressure would be placed on the HRA. Alternatively, lower costs and higher rents would generate additional resources. On balance, the fact that rents are higher than operational costs excluding debt servicing means that this risk will largely be self mitigating – if inflation increases, rents will go up at around the same speed as management and maintenance costs, although there are clearly issues about the cyclical nature of the building industry and there can be periods where this general assumption will not hold true.

Planning for the future

9.1 The impact of accepting the government's offer will be to increase the resources available for the future for the HRA. A new build programme – albeit initially limited in scale – should be possible on an ongoing basis each year subject to finding sufficient suitable sites. There will be a need to review the Council's policy of allocating suitable land as it arises whether through Council reviews of its own holdings or through s106 agreements to make sure that both Council developments and those by Registered Social Landlords can be sustained to generate more overall building than was achievable before.

9.2 It is expected at this stage that the Council should be able to finance at least 25 new build properties a year if we can obtain suitable grant funding from the HCA and obtain appropriate land – perhaps as much as twice this amount if things go well. At full cost without grant support the numbers achievable would clearly be a lot fewer.

9.3 New build – other than that financed by the initial £9.5m of funding in the form of lower debt – is unlikely to be financially viable without substantial subsidy or grants, as the rent that can be charged – normally less than £100 a week – will be substantially less than the ongoing cost of servicing any new debt. For instance, a 50 year loan to build at a cost of £100,000 say would cost around £6380 a year – or £127 a week. Even with no management or maintenance costs there would therefore need to be a subsidy. It is clear therefore that the demand to build new homes would have to be balanced with other supportive investments by the HRA and also be subsidised by grants and land benefits to reduce that subsidy within the HRA. Nonetheless, it is expected that a small programme of new build would clearly be possible as a result of the settlement and it would complement the programmes of further investment over time in the existing stock.

9.4 Derby Homes have been consulted on this response and their Board agreed to the outline of this response at their meeting of 27 May.

9.5 **Overall Position for Derby**

While there are significant risks being undertaken by the Council, this offer is the best that can be expected in the current economic climate, holds out the prospect of additional resources for Council housing, and gives it a sustainable future. The benefits that would be realised by this settlement should far exceed the risks in almost all scenarios. On this basis it is recommended that the Council should strongly support the government's proposals.

9.6 Without the improvement implied by the proposals, Council housing is likely to be facing a difficult future within a few years. Ideally, the government would give some form of assurance that rental policy will hold at the trajectory set out by the settlement, and that the debt cap would be lifted slightly from its current level to the peak debt implied by its own modelling, to be consistent with its desire to generate some limited additional Council housing new build.

9.7 Even with those caveats, the outcome of the review is clearly beneficial to the Council's HRA and it is suggested that it is strongly welcomed, with a view to volunteering for the initial round of opting out in 2011/12 if that option remains available.

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Background papers:	None
List of appendices:	Appendix 1 – Implications Appendix 2 – Response to consultation on future of the HRASS

IMPLICATIONS

Financial

1.1 As outlined in the report.

Legal

2.1 As outlined in the report.

Personnel

3.1 As outlined in the report.

Equalities Impact

4.1 As outlined in the report.

Corporate objectives and priorities for change

5.1 These recommendations, where relevant, are in line with approved budgets which accord with the Council's corporate priorities.

Appendix 2

Derby City Council - Consultation response

Questions

1. What are your views on the proposed methodology for assessing income and spending needs under self-financing and for valuing each council's business?

In general, the approach of rebalancing the elements of the existing system relating to rents, Major Repairs Allowance and Management and Maintenance Allowances is appropriate and has arrived at reasoned and reasonable conclusions. There are a few points on which the Council would wish to seek further clarification. Firstly the pace of rent restructuring and the implications that this has for tenants, and secondly the debt burden placed on the HRA as a consequence if rents were to be capped in future. 2015/16 as a target date is ambitious especially for places such as Derby where actual rents are in excess of 10% below target rents, implying real terms increases for the next two years in excess of 3%. While tenants will be protected by the overall rent cap of RPI + 0.5% + £2 a week, and this has been factored into the calculations on an average basis, there will be some for whom these increases will be very steep over the next few years.

There also remains a risk that rents may not be able to follow the path set out by the settlement. In that case, there would need to be some form of compensation as the value of the settlement will have been based on that assumption. Some form of reassurance on the rent policy to be followed and arrangements for compensation should this not be permitted in future would help to mitigate what might otherwise be perceived as a significant risk. Similarly if there are future changes to housing benefit levels or rules these may lead to reduced income levels, and increased arrears in rent. Some reassurance that compensation would be considered in this event would be welcome.

On checking our detailed figures, we believe that the assumed figures for the Council in terms of the caps and limits adjustment that was necessarily estimated for the purposes of the prospectus is understated. Calculating this individually from our current position gives a slightly different result and would imply a lower debt of £3m at a 7% discount factor. We would suggest that the proposal is not quite right in practice and should be recalculated to allow for more accurate data. Perhaps relevant figures could be requested as part of the base data return or by means of a separate survey, with data being subject to a specific audit? The same could apply to any proposals for demolition during 2010/11 that are known – and these could be checked for delivery within say 3 years of declaration – again to be specifically audited. Without this, there is the possibility that demolished homes would in effect attract initial debt on the basis of future rents that were clearly not going to arise.

2. What are your views on the proposals for the financial, regulatory and accounting framework for self-financing?

There are a couple of concerns in this area: debt cap and depreciation policy.

In principle, there should be no need for a specific debt cap relating to Housing. The CIPFA prudential code has worked well for containing borrowing by local authorities to affordable levels as experience over recent years has shown. The best solution would therefore be to restrain borrowing by reference to target levels of debt in relation to rent. Housing

Associations do not have specific debt caps but are in effect restrained by what they can borrow from banks – this in turn will depend on their business plans and their income levels.
If there is, nonetheless, to be a debt cap on the HRA, then that level needs to be set at a rate that is consistent with the offer and national policy. At the moment the current proposals are slightly inconsistent on two issues – the implied debt from the modelling in the prospectus and the treatment of approved new build and future new build.

Implied Debt from the modelling
There are two issues with the debt cap and its relation to the modelling in the prospectus– being set at the initial rather than implied peak level and the implications of the 7% discount rate proposed.

The methodology set out by the government sets out an initial debt and a trajectory which implies a peak debt which for most Councils is slightly higher than the initial debt. It is suggested that the appropriate conclusion is therefore that the debt cap should be set in line with the government's modelling and be set at the peak debt implied by the modelling.

The other issue is the debt cap as a result of a 7% discount rate. As a result of the difference between 6.5% and 7% discount rates, the initial debt will in all cases be lower, enabling a better financial position and therefore greater investment into new build. The Council fully supports this but would suggest that the debt cap should not be lowered by the same amount as is implied in setting the debt cap equal to the initial debt. Such an outcome would appear to counteract to some extent the desire to increase our ability to invest in new stock. Our suggestion is that the debt cap therefore be set at the peak debt in the 6.5% modelling while the debt adjustment be set at the initial debt in the 7% model. This would then allow the additional funding as a result of 7% discount rate not to be affected by the debt cap. Peak debt would allow Councils to invest in the earlier years in line with their needs rather than face a quite tight financial position for a few years before being able to invest in later years if things go according to plan.

An alternative approach which might be preferred should the issue of new borrowing after the initial settlement be a key priority, would be to make a suitable adjustment to the initial debt to enable the modelled peak debt to match the initial model's calculated result. This would lower initial debt to allow for the inevitable early restrictions to be eased and therefore be more consistent with the conclusions of the modelling. This option would enable Local Authorities to make limited initial investments in the early years of the plan and not be artificially restrained by the debt cap in those early years. At the moment the planned debt trajectory in the modelling is slightly inconsistent with the cap in the early years.

New build
Where Local Authorities have been given permission to undertake new build as part of the national programme approved by the HCA, the borrowing implied by that approval should be added to the modelled cap. Without this adjustment, we will be effectively required to finance existing plans from within a fixed sum that did not include that requirement, despite those plans being drawn up and approved by central government .

In future cases where approved is sought and approved by Local Authorities from the HCA, similar specific 'approved' additions to the debt cap could be authorised. This principle could also be agreed to allow for some flexibility in the total amount of debt which would otherwise be fixed. The combination of these two adjustments would mitigate some of the least attractive elements of the debt cap proposals, whilst still maintaining the overall debt cap as a principle in terms of overall restraint.

Finally on the debt cap, it would be useful to clarify how the debt cap is to be adjusted in the longer term – is it to be fixed in absolute cash terms, or adjusted for inflation, or periodically – and if so, over what period(s) and with reference to what indicators?

Depreciation

Depreciation could be an issue unless it can be made clear that the current policy of matching the calculation of depreciation within the HRA to the calculation of the Major Repairs Allowance can continue or something quite similar. In future, it could be linked to the implied MRA per dwelling in the settlement for each year rather than an actual published amount. Without such a dispensation from normal accounting practice through accounting regulations (as happens now for MRP of zero), in theory all council homes would need to be depreciated fully under normal accounting arrangements. This could increase the charge to the operating account of the HRA by a material degree and could therefore have an impact on investment from time to time when depreciation exceeds the requirement in any particular year. In essence this should not be a huge issue as largely such funds are then reapplied to maintenance of properties over time, so there would only be an impact where such a charge was in excess of immediate need. In that case an amount would build up in the Major Repairs reserve and would be utilised when demand exceeded funds for a following year. Over time this should be smoothed out therefore. It could, however, combine with other factors – for instance the debt cap in the early years of the programme - placing a new restraint on funding in the short term. This is hopefully just a technical issue that needs to be considered to make sure that it will not prove a practical block to the intention to invest, but it could be material for many Authorities if not clarified successfully. It is hoped that the work being undertaken by CIPFA will result in a reasonable proposal that can be supported by specific accounting regulations from next year.

In general, we welcome the move to increased freedom for Local Authorities to determine their own business plans based on the real underlying business as it affects each Council. Responsibility is placed where it can best be managed and decisions made locally will have real impacts locally. If the proposals can be made to be consistent in terms of the debt cap, whilst in principle this should not be necessary, if the proposals can be amended to be more consistent with the offer and also flexible over time in line with authorisations given in terms of new build, the cap would be more understandable as a safeguard rather than as an artificial constraint on a logical and affordable business plan model.

3. How much new supply could this settlement enable you to deliver,
if combined with social housing grant?

In general, the Council is very supportive of the proposals for new build and wishes to make sure that we take full advantage of any potential for maintaining and indeed increasing slightly the size of the Council's stock in future.

The question, however, is difficult to give a straight answer to, as it is dependent on a number of variables largely outside the Council's control. The Council would be prepared to commit to investing the entire balance of any additional funding implied by the higher discount rate into a new build fund to be matched with HCA grants and further investment by the Council as an absolute minimum. The number of homes that this could generate would depend on the availability and price of land and the availability of HCA grant to part finance such investments. Without grant the numbers would be much more limited.

In modelling terms, initial views are that perhaps between 25 and 50 homes a year could be supported for a few years, perhaps more if interest rates remain low into the future. In practice, more might be possible and the timing / spread of such investments would be matched to available opportunities for investment which would not be evenly spread, and other demands on funds will arise from time to time. Derby Homes are already drawing up lists of potential areas for consideration and further opportunities will arise as regeneration plans are drawn up for specific areas. HCA Grants will be important to stretch the funding further. It would be helpful to have some indication of the expected financing model for future homes from the HCA as the amount of debt that can be supported by a target rent remains very limited – perhaps £30,000, and therefore new build cannot be self sustaining directly without some form of subsidy.

We would hope therefore to deliver at least between 25 and 50 homes a year if supported by the HCA in the form of grant, but these might be spread rather unevenly according to development and regeneration opportunities that arise. Should there be no future grants, the numbers possible would be much more limited. An adjustment to the debt cap for 'approved' investments would also be helpful to assist with future planning.

4. Do you favour a self-financing system for council housing or the continuation of a nationally redistributive subsidy system?

A self financing system for Council housing would be a clear improvement on the current system. The Council strongly welcomes the whole package proposed and would be very keen to be considered for any initial stage of implementation, having supported the development of these proposals from the outset.

5. Would you wish to proceed to early voluntary implementation of self-financing on the basis of the methodology and principles proposed in this document? Would you be ready to implement self financing in 2011-12? If not, how much time do you think is required to prepare for implementation?

Yes – subject to clarification of the issues raised in this response.

Yes we could be ready for 2011 we believe.

6. If you favour self-financing but do not wish to proceed on the basis of the proposals in this document, what are the reasons?

Not applicable