

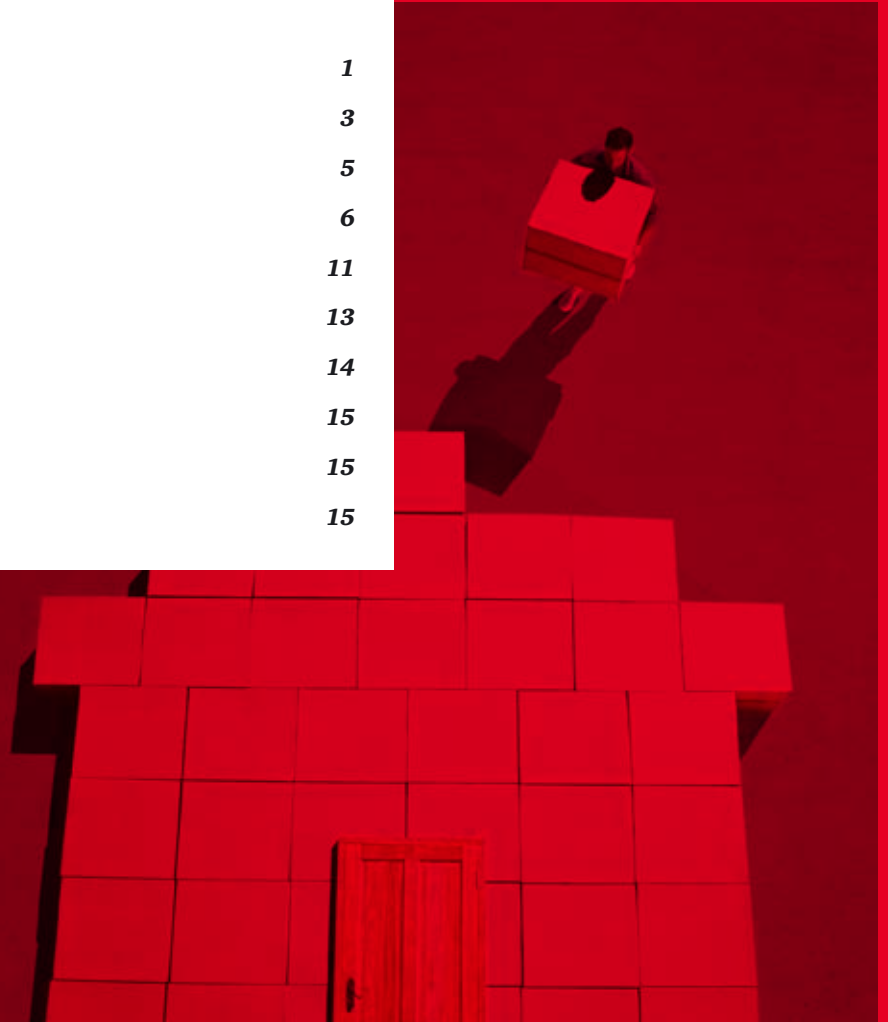
Making the most of HRA reform

Talking Points



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Foreword

As the legislation to reform the Housing Revenue Account concludes its passage through Parliament we thought it would be useful to examine the opportunities and risks arising from the changes. In particular, we wanted to better understand the impact of the reforms over time and explore the extent to which a new self-financing regime could increase investment in affordable housing.

While we recognise that HRA reform will affect councils in different parts of the country in different ways and that the changes will be shaped by other factors (notably public spending and borrowing constraints, housing benefit reforms, capital market conditions, and the push for more localism), we have started from a position that the new regime is a positive step.

The reforms are complex and some aspects are controversial, but overall the legislation has cross-party support.

Moreover, many local authorities (with registered providers and developers) are actively exploring ways to make the most of HRA reform.

The Smith Institute has been tracking HRA reform since it was first introduced in 2009. PwC has meanwhile been advising Government on the shape and scope of the reforms and working with councils on what the financial effects might be. We wanted to combine our expertise and look beyond the technical details in the Bill and associated guidance and look at the medium to long term investment prospects. How much investment will HRA reform unlock? And how should councils best prepare themselves?

In order to enrich our analysis we consulted local politicians and officers, civil servants, funders, as well as other key players in the housing sector. We also held roundtable discussions on HRA reform in London and Birmingham, both of which were highly successful. We would like to thank everyone who has

contributed to this report, especially those who participated in the roundtables. This Talking Points publication is intended to highlight the challenges and opportunities afforded by the self-financing of council (and other affordable) housing. Its focus is on unlocking investment from the creation of surplus rental incomes, and how this might be achieved. We believe that surplus rental incomes could, over time, be sufficient to not only improve the quality of HRA housing and fund regeneration programmes, but also fund significant increases in supply.

Furthermore, making the most of HRA reform may become a measure of how far councils are willing and able to embrace financial devolution.

Finally, we would like to thank the two authors of the report, Joe Reeves and Simon Martin, who are the leading local authority housing experts at PwC.

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June 2011

Summary

- HRA reform will put councils in control of their housing assets – which are forecast to generate more than £300bn of rental income over the next 30 years.
- Efficient operation of the HRA could lead to the build up of some £50bn of new investment resources across the country, over 30 years (£25bn in today's money). Councils can now look at their housing as a real asset capable of generating additional investment resources.
- Councils will be able to shape their “housing business” to deliver against their local service and investment priorities.
- In the past, meaningful HRA strategic financial planning has not been possible – it will now be essential.
- There are a range of alternative options for unlocking HRA investment capacity, that are consistent with government's current priority to control the national debt.

Introduction

On 1 April 2012, the Government is set to abolish the Housing Revenue Account subsidy system and introduce self-financing for council housing. This represents one of the most radical reforms of public housing policy for many years, and the effects will be far reaching.

Pressure to reform the current HRA subsidy system – through which central government assesses the amount of spending and subsidy required – has been building up for more than a decade. Despite technical adjustments the system had become more and more opaque and discredited. In March 2010 the Labour housing minister, John Healey, announced plans to reform the HRA in a consultation prospectus – “Council housing; a real future”.

The reaction from councils and other social housing providers was broadly positive, although some local authorities expressed concern about the reallocation of some £25bn of existing council housing debt.

The new housing minister, Grant Shapps, announced in October 2010 that the reform proposals would be taken forward in the government’s Localism Bill, which has now passed through committee and report stages in the House of Commons and is scheduled to pass to the House of Lords in the summer.

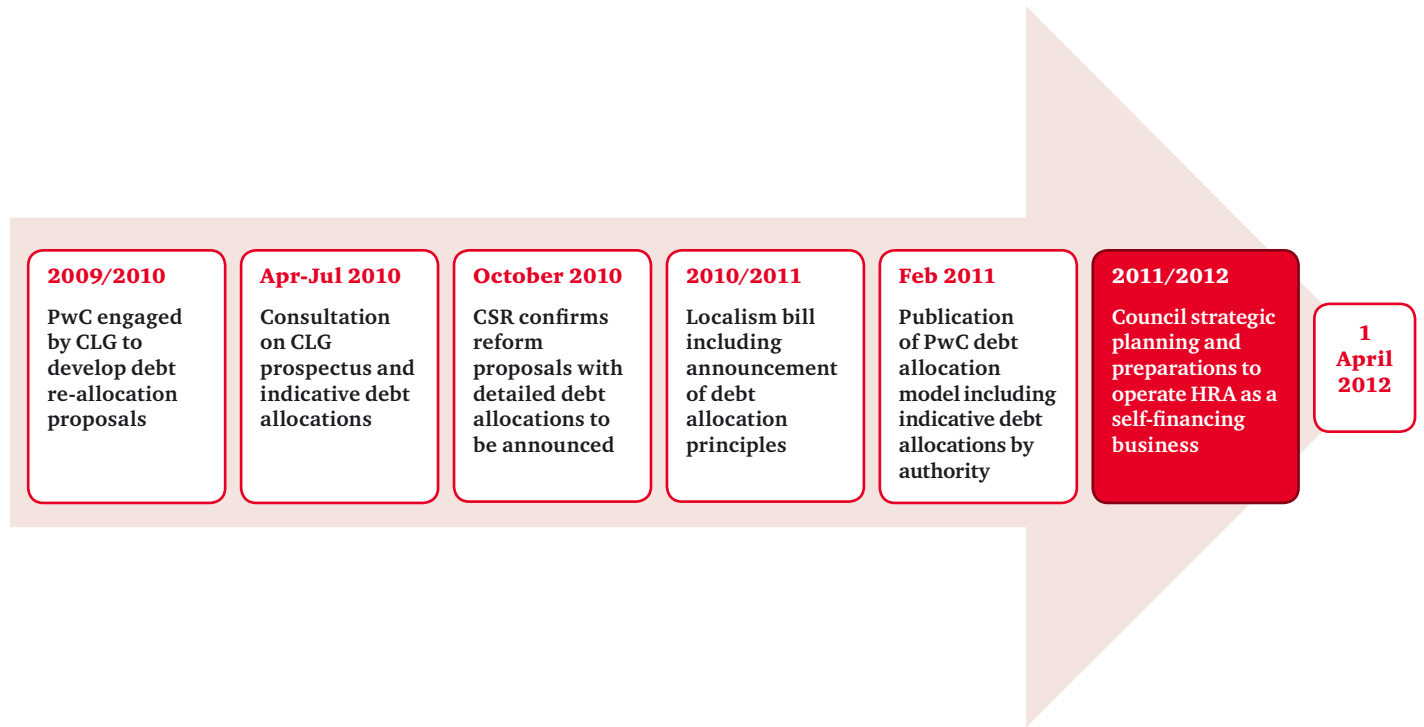
Under the new system, it is forecast that over the next 30 years councils will control over £300bn of rental income, and they could build up some £50bn of new investment capacity (£25bn in today’s money). They will have increased capacity to invest in housing assets but at the same time they will be responsible for long term investment planning and will have to work within centrally imposed funding constraints. In a time of funding cuts and weak market confidence, HRA reform is seen by some councils as a viable means of delivering much needed investment in new and improved social and affordable housing.

HRA reform: Policy objectives

- To increase local transparency and abolish the current opaque system under which there is little connection between the level of rent charged and the resources councils have to spend locally.
- To give councils financial autonomy and therefore more accountability for the provision of housing services.
- To end decades of complex central control and allow council housing to be managed and financed locally.
- To ensure councils have the incentives to actively manage their housing stock on a long term basis rather than simply react to an uncertain annual funding formula.

Source: Implementing self-financing for council housing, DCLG, 1 February 2011

HRA Reform timeline



Reforming the HRA

Currently the HRA subsidy system redistributes significant resources annually between local and central Government. In 2011 it is forecast that some 175 councils across England will collect almost £7bn of rent from the 1.8m homes in local authority ownership.

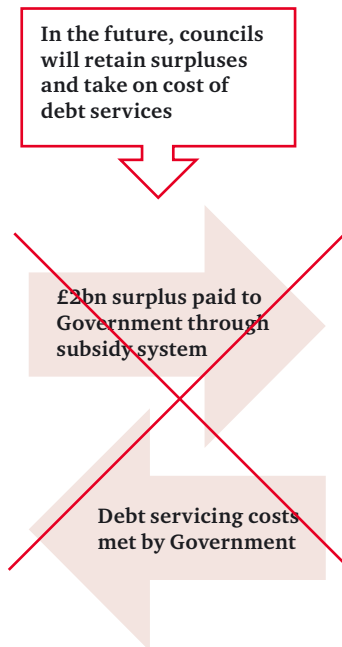
Through the HRA subsidy system the rental income is paid to Government, in return for which some £5bn of allowances for management, maintenance and investment is paid to councils.

Government then meets the cost of £21bn of council housing debt. Under this system, which is widely regarded as complex and unfair, councils do not have any certainty as to what level of funding they will receive from one year to the next and are consequently unable to properly manage new housing stock.

The process of reform of the HRA subsidy system is set for implementation in April 2012.

Under the proposals, councils will keep the rental income they generate and will be responsible for deciding how they use it to meet their local housing needs. In return for this councils will be allocated a share of some £28bn of debt. Unlike current housing debt this will be “real” debt that they will be responsible for managing and servicing.

The national picture



HRA reform principles

- Annual subsidy system ending from 2012/13
- Councils to keep rents and be responsible for all housing expenditure
- Once and for all debt settlement – councils responsible for long term business plan including debt servicing
- Debt allocations typically £10k-£30k per property, largely depending on local rent levels and regional costs
- Nationally some £28bn of debt likely to be allocated to councils

Local financial impact

Strategic financial planning

Today, councils have limited ability to develop any meaningful long term financial planning for their housing. They do not retain their rental income and are reliant on a centrally determined annual (and uncertain) allocation of Government subsidy.

With HRA reform, the financial picture will change fundamentally because:

- Councils will be able to keep the net rental income that their housing generates (rental income less associated management, maintenance and investment costs)
- Funding for management, maintenance and repairs included in the new system is 14 per cent higher than under the current subsidy system – an increase of more than £500m per year.


- In return, councils will be allocated a level of debt that they will be responsible for servicing and managing from their net rental income

To meet the new responsibilities of HRA reform and to make the most of the financial freedoms that follow, councils will need to:

- Develop new long term asset management plans
- Identify investment needs
- Develop short, medium and long term funding solutions

HRA today

- ‘Looks after itself’ - it is self-contained, cannot go into deficit, with funding determined by central government
- Annual subsidy determinations provide constraints on spending and borrowing
- No need for active debt management strategy as government covers debt costs
- Inflation and interest rate risks absorbed by government
- Asset management strategy dependent on limited capital resources provided by central Government
- No real scope for strategic planning as reliance on annual governments subsidy payments



Significant shift in responsibility and resources to local authorities

HRA in the future

- End of central government funding of housing investment– long term asset management risk is the sole responsibility of councils
- Councils entirely responsible for their own debt management strategy including level, cost and profile of debt
- Need for proactive debt management, particularly in the early years
- Councils will need to develop a new strategic financial framework for the HRA
- Significant potential investment capacity, but councils need to operate within centrally determined borrowing constraints

The debt allocations

A central theme of the HRA reforms is the allocation to each council of a level of HRA debt that they will be responsible for managing from their housing assets. Proposed government debt allocations have been calculated for each council using a common financial model based on the surplus rental income likely to be available at each council.

While actual debt levels won't be finalised until later this year, when information is available on inflation and local authority housing stock numbers, the principle of the calculation is set.

The result is indicative debt allocations largely between £10,000 and £30,000 per property, with higher debt levels typically in London, in the east and south east where rent levels are higher.

Managing HRA debt

The concept of “real” HRA debt that councils are responsible for managing and servicing over the long term is new – and for many councils this will be a new discipline. In some cases there will be a natural inclination to pay down debt as soon as possible – even though there is no requirement to reduce debt below the opening level. In fact in most cases it would not represent sound business practice to do so.

As well as being allocated a level of HRA debt, councils will also have control over the revenue streams generated from their HRA assets – the principle underlying the calculation of the individual debt allocations is that each council will start with a level they can manage from their asset base. So long as an authority's HRA assets receive the investment necessary to maintain their value, there is no reason why the opening level of debt could not be sustained over the medium to long term.

HRA reform – debt allocation by region

Region	Properties '000	Allocation £m	Per property £000
London	422	7,227	17
South East	187	4,093	22
South West	102	1,461	14
East	157	3,577	23
West Midlands	210	3,514	17
East Midlands	185	2,672	14
North West	113	1,474	13
North East	117	1,476	13
Yorkshire & Humber	238	2,924	12
Total	1,730	28,418	
Average			16

Source: PwC self financing model, DCLG 1 February 2011

Servicing debt from net rental income

Sometimes overlooked in the detail on HRA debt separation and accounting technicalities, is the fundamental shift in resources from national to local level that HRA reform represents. Current Government rent policy is for target council rents to increase by 0.5% above inflation (under the current HRA subsidy system the entire benefit of the above inflationary rent rises are passed to central Government).

Under HRA reform, local authorities will keep the full benefit of all future rent increases.

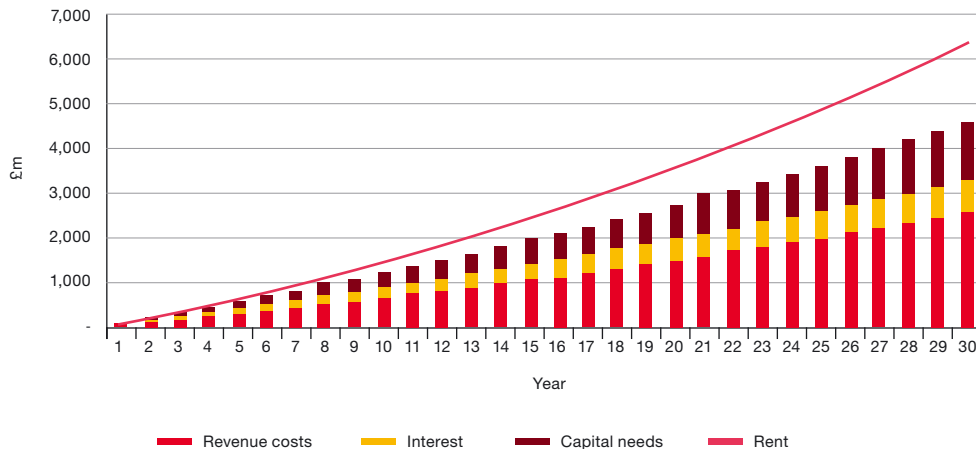
So, it is possible for councils to prepare financial projections on the basis that:

- Rental income increases by 0.5% above inflation
- Revenue costs increase by inflation
- Interest costs remain flat (ie reducing in real terms)

Unsurprisingly, using the above assumptions the resultant projections indicate that capital resources could increase over time at up to 10% per year, creating an ever increasing surplus when compared to capital needs.

HRA self-financing – potential increases in capital resources

Build up of surplus investment resources



Increasing surplus investment resources build up over time

Resulting from:

- Rents increase by more than inflation
- Costs increase by inflation
- Interest cost flat on debt remaining flat in money terms

Surplus HRA resources

Analysis shows that at most councils, the level of capital resources available from net rental income (after meeting interest costs) over the next 30 years is likely to be higher than that needed to meet typical life cycle investment needs.

But the compound effect of above inflationary rent increases means that any surpluses are likely to build up over the medium to long term.

Whilst many councils recognise that significant level of surpluses are likely to be available over time, their immediate challenge is how best to manage and invest in their housing over the next 5 to 8 years.

As a consequence, a number of authorities are starting to look at ways in which they may draw on some part of the future revenues that their assets will generate.

Scale of surpluses available to councils

The picture of surplus HRA resources building up over time will be repeated across almost all councils.

Based on the projections of income and costs that underpin the HRA debt allocations, over 30 years it is forecast that:

- If rent rises are implemented in line with government policy, councils are likely to have control of more than £300bn of rental income

- If rents increase in line with permitted guidelines and debt is held at the opening level and costs increase in line with inflation, the additional resources available to Councils could be as much as £50bn over a planning horizon of 30 years.
- On average this would represent additional investment capacity of some £30m for every 1,000 homes in HRAs nationally

HRA reform – new investment resources

Region	Rent £m	Surplus £m	Per property £000
London	101,576	15,618	37
South East	39,038	7,191	39
South West	18,231	2,761	27
East	32,183	6,124	39
West Midlands	38,064	6,177	29
East Midlands	31,577	4,986	27
North West	19,209	2,949	26
North East	19,323	2,688	23
Yorkshire & Humber	39,307	5,527	23
Total	338,508	54,023	
Average			31

Source: PwC self-financing model, DCLG 1 February 2011

Reality check

The reality is that there are risks associated with the freedoms and responsibilities transferred to councils. Councils will need to take a prudent view of their ability to increase rent levels, manage their costs and service their long term debt obligations.

Given that future investment headroom is heavily reliant on the scale of future rent increases, some councils have quite rightly identified the ability to increase rents as an area of significant business risk. On the government side, there is a clear position that the debt allocations are based on current government policy, and that any future restrictions in rent increases would be a reason to re-open (and reduce) the debt settlement.

At a local level it is possible that some members may look to set rents below government expectations, thereby significantly eroding the scale of surpluses the HRA can generate. Faced with this risk, some councils are reluctant to plan long term or consider ways they might use future surpluses to support investment.

However, the view of other councils is that the choice between lower rents and higher investment is one that needs to be debated at the local level. The point is that councils now have the opportunity to develop strategic investment plans and the ability to take long term investment decisions, based on rent levels over which they have greater control. More importantly, they understand the trade off between rents and investment, and the greater influence they will have over the investment decisions that will directly impact their tenants and their communities.

Against this backdrop, and in response to these opportunities and challenges, we would expect councils to develop medium to long term business plans. These should be influenced by investment needs, underpinned by risk analysis and integrated with funding solutions that are prudent, robust and sustainable.

Investment delivery options

Investment needs and priorities

While the surpluses released through HRA reform will build up over time, many councils are faced with a need for resources today to meet urgent capital investment needs, that will help to:

- Redevelop and improve their existing stock and associated estates
- Reduce backlog investment needs and future maintenance costs
- Improve long term sustainability and viability

At the same time, there is a pressing requirement for new affordable housing and concerns that the affordable rent model coupled with reduced grant levels will not be able to deliver this housing. Against this backdrop the resources released through HRA reform are seen by some as a major opportunity for meeting urgent capital investment needs and delivering new social rented housing.

Unlocking HRA resources

While the reforms have the potential to generate some £50bn of new investment resources, we are at a time where the drive to reduce public sector debt overrides housing priorities. So, even though the thrust of the reforms is about devolving freedoms and responsibilities, this does not extend to the freedom for additional borrowing at a local level.

“

Self-financing will give council landlords direct control over a very large rental income stream. The prudential borrowing rules help ensure that any borrowing is affordable locally. However, our reforms must not jeopardise the Government's first priority, which is to reduce the national deficit. Borrowing by local authorities for housing purposes is included as part of the Public Sector Borrowing Requirement and so the borrowing arising from self-financing must be affordable nationally as well as locally. The prudential rules do not address this and so we will therefore limit the borrowing for council housing in each local authority.

Implementing self-financing for council housing
DCLG 1 February 2011

It is recognised that the borrowing limit could place pressure on some councils, particularly in the early years of self-financing. For a number of authorities, the new HRA regime will provide some borrowing headroom from day one of the reforms. For others prudential borrowing is not an option, so alternative delivery and funding routes would need to be explored.

Investment outside the confines of the HRA

The simplest way to ensure that HRA borrowing limits are not an obstacle to investment is for funding and delivery to be outside the HRA and off the balance sheet. But in most cases this would need the ownership of the underlying assets themselves to be outside the HRA. The most common example of such investment is that delivered by a Registered Provider after a housing stock transfer from a local authority.

There is a common view that stock transfer has largely run its course – if councils didn't transfer when the financial incentives were at their peak then why would they look to transfer now? But a number of councils are actively considering transfer as a means of securing investment, some of them revisiting the “community gateway” model to create a “mutual” or “community housing trust”.

Some councils are looking at other options, including the delivery of new housing outside the HRA – but in a way that sees them retain a measure of influence over housing management and rent policy. The crucial issue here is that (even with free land) social rented housing needs a financial subsidy – revenue from social rent will not cover construction, management and maintenance costs.

So for such schemes to be viable, they will need a level of capital subsidy either in the form of land or other capital receipt.

Investment within the HRA

For councils, the great prize from HRA reform will be the access it provides to the surplus rental income that is generated by the existing housing stock. Authorities will directly benefit from their efforts to control costs and generate efficiencies, and will have the freedom to determine where surplus investment capacity is most sensibly directed.

Councils will have control over their housing asset base, and the revenues it generates. But centrally imposed borrowing caps may limit their ability to maximise the leverage from those assets.

In such circumstances it is anticipated that some authorities will explore a range of delivery options that would help them meet their investment needs.

These are expected to include – development agreements, joint ventures, and design, build, and finance operate (DBFO) contracts that could run for 10 to 20 years or more.

Conclusions

A person is shown from behind, placing a brick on top of a tall, narrow tower of bricks. The tower is composed of many layers of bricks, and the person is standing on a wooden door that is part of the base of the tower. The background is a dark, solid color.

In a climate of funding cuts and other pressures on affordable housing, HRA reform is a “good news story”, which has the support of most councils.

The new self-financing system will mark a major change in social housing policy and have a lasting impact. Although there are still outstanding concerns with the proposals in the Localism Bill (notably over additional debt, future financial arrangements, and Right to Buy capital receipts) the consensus in the sector is that HRA reform will be

beneficial for councils, their tenants, and their communities.

Over time, the new system has the potential to unlock capacity to support the delivery of housing investment. However to fully reap the benefits, councils will need to adopt a new approach to HRA business planning.

Business planning needs to be influenced by investment need, underpinned by risk analysis and integrated with funding solutions that are prudent, robust and sustainable.

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Richard was a member of the HCA Housing Finance Group and sits on the Mayors Housing Investment Taskforce.



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