Clackmannanshire Council – HRA Review

A Brief Analysis of the Latest Housing Revenue Account

March 2013

A Review for TIS by

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Contents

Overview

1. Work was carried out looking at the latest Housing Revenue Account (HRA) issued by the council on 21 February 2013.

2. Our analysis involved firstly checking the robustness and integrity of the model supplied by the council (making sure their sums add up) and secondly ensuring the assumptions concerning rent increases and the capital programme were affordable with acceptable levels of debt.

3. Finally, we also carried out sensitivity analysis which means we applied alternative levels of inflation and cost increases to establish areas where the planned approach could be vulnerable to changes in future economic conditions.

1. Robustness and Integrity of the Model

1.1 The council supplied a summary HRA model and provided a more detailed budget that allowed us to reconcile the 2013/14 opening balances. Following this, we were able to check the soundness of the model. We concluded that all the various figures linked correctly etc.

1.2 We only discovered a couple of small errors on the model concerning the calculation of principal repayments leading to a small change in outstanding loan balances, However, this is not significant and actually shows an improved position. For example, the closing loan balance at the end of year 30 should be £5.698M (or £1,037 per unit) rather than £6,477 shown (£1,179 per unit).

1.3 We have some issues around the use of cost inflation and new build/Off the shelf stock numbers and costs. This will be addressed in the next section.

1.4 To summarise, the model submitted to us (before our analysis) shows a positive position going forward with reasonable levels of rent increase, an active capital programme with new build and affordable levels of debt.

1.5 Our own comments and calculations on the model are shown at Appendix A (in red). This also includes related information concerning the project.

1.6 In conclusion though, we were impressed with the HRA model submitted to us and in terms of presentation is one of the best we have come across for simplicity and ease of understanding.

2. Soundness of Assumptions

2.1 A number of direct opening balances are used for initial years in the model and we secured an additional (more detailed) file to help us reconcile these figures. The council were very helpful in assisting us with this.

2.2 The council rely on a number of assumptions. These are shown in the table below.

Category	**Assumption**
Inflation	September 2012 rate of 3% used (RPI)
Rent Increases	RPI+1% for 2014/15, RPI+0.75% for 2015/16, RPI+0.5% for 2016/17 then RPI thereafter for the remaining period (2017/18 onwards).
Capital Programme	Increased by RPI from year 7 onwards (2019/20)
Repairs and Maintenance and Other Expenses	2014/15 inflated in line with RPI then 1.5% ongoing
Supervision and Management	Based on 3 year budgets to 2015/16 then 1.5% thereafter (2016/17 onwards).
Reserves as % of rental income	No lower than 4% using CIPFA guidance
New Housing	605 units shown as being available over 30 years
Borrowing (council figures)	Peak borrowing of £34.830M (£6,866 per unit) in year 9 (2021/22). Borrowing at the end of year 30 (2042/43) is £6.477M (£1,179 per unit). Full repayment takes place in year 42.

2.3 On the face of it, this is a good plan with sound financing leaving the option open for even higher levels of new build. However, while we are happy with the way the plan is constructed and what it is trying to achieve, we have some concerns over the realism of increases below the rate of inflation for some key costs.

2.4 We have taken each of the assumptions above and subjected them to a brief analysis.

Inflation

2.5 Inflation is based on the RPI rate at September 2012 of 3%. However, as this is in effect a cash flow plan, a number of years in some of the categories show a rate of cost increase below the rate of inflation. This has helped to produce a sound set of financial figures with the ability to deliver a substantial capital programme with new build. We are unsure how realistic these assumptions are over the longer-term. This will be explored in more detail by category below and in the sensitivity testing section.

Rent Increases

2.6 The level of rent increases shown in the table appears reasonable and certainly below increases we have seen in other councils. Increases of only RPI from 2017/18 onwards will be particularly welcomed by tenants.

Capital Programme

2.7 The programme is a full one and includes provision for new build throughout the 30 year period of the plan. However, we have some concerns over the absence of any inflation in the first 6 years of the programme and some discrepancies between the number of new build units to be built/acquired and their costs (this will be examined in more detail in the New Housing section below).

2.8 Costs are apparently shown without any inflation in the first 6 years until year 7 (2019/20) when they are inflated each year at RPI (3%). We would normally expect all costs to be inflated from year 1. This means in the first 6 years (provided they have not been inflated separately and then directly entered by the council) costs are at today's prices and effectively reduce in real terms over the first 6 years of the plan.

2.9 The costs for year 7 onwards also are only inflated at 3% on the non-inflated value at year 6. Normally, we would expect the full cumulative effect of inflation to be provided for.

Repairs and Maintenance and other Expenses

2.10 Costs are inflated at 3% for 2014/15 and then only increase by 1.5% (1.5% below the rate of inflation) for year 2015/16 onwards.

2.11 This assumes real terms cuts each year to the budget which does not seem realistic over the longer-term. The council should explain their reasoning for this approach.

Supervision and Management

2.12 Costs for the first 3 years of the plan are entered directly from the 3 year budget so we assume they have been inflated at 3% for the period to 31 March 2016 (it certainly looks this way). From 2016/17 onwards, all costs are inflated at only 1.5% (1.5% below the rate of inflation). Again, this represents a year on year cut of 1.5% to the budget in real terms.

2.13 While in the current economic climate this may seem reasonable (and it looks like public sector cuts will be here for the foreseeable future) we are not sure how realistic this will be over the longer-term. We recommend the council revisit this assumption or explain their reasoning.

Reserves as a % of Rental Income

2.14 The Chartered Institute of Public Finance and Accountancy (the main accountancy body for the public services) issue bulletins on a regular basis outlining Local Authority accounting guidance.

2.15 The council have used specific guidance in this area to set a minimum level of reserves (reserves as a % of rental income) of no less than 4% each year. We consider this a prudent operating level.

2.16 Reserves actually increase beyond the 4% benchmark from year 15 onwards (2027/28).

New Housing

2.17 The plan provides for new council housing over 30 years (605 units in total with a total cash investment of £100,725 per unit).

2.18 We applaud the council's ambitions with regard to investment in new housing. The supply of new affordable housing by RSLs is set to reduce in future years so using its ability to encourage regeneration and further investment is a laudable strategic objective.

2.19 We do however have some issues in trying to reconcile the overall spend in the early years of the plan with the investment being made. For example, the capital programme shows an investment in new build housing of £1.25M per year but house numbers in the first 3 years do not appear to tie up with this expenditure.

2.20 In year 1 the council intend to construct or buy off the shelf 61 units, in year 2 61 and in year 3 units. No additional units are planned for years 4, 5 and 6 despite investment being shown. Moreover, even if we allow for the total new housing investment in years 1 to 6 of £7.75M, the costs to build/acquire the new units are only in the region of £62k per unit which seems on the low side. Work we are carrying out for another Scottish Council suggests the cost of building new social housing could be as high as £133k per unit although we accept some keenly priced tenders are being received at present also.

2.21 The council should explain their reasoning on this in more detail as future years' development costs also appear to be on the low side (even allowing for inflation - where provided).

Borrowing

2.22 Borrowing is perfectly affordable in the plan submitted by the council (although there is a small error in the calculations as mentioned previously). The borrowing can de described as "flat" which means no sharp increases or decreases over the life of the plan.

2.23 Borrowing reaches a peak of £6,866 per unit in year 9 (2021/22) then is gradually repaid each year only leaving a residual debt balance of £1,179 per unit at the end of the 30 year period. The residual balance is eventually repaid in year 44 (2057/58).

Overall View on the Council's Assumptions

2.24 We have two concerns with the plan.

2.25 Inflation is an issue as we would question the realism of below inflation increases over a 30 year period for management and maintenance costs. The council is able to maintain a comprehensive capital program at affordable rent and debt levels only by initiating real terms cuts to these costs for a substantial number of years. Our sensitivity testing in the next section will focus on inflating these costs at the quoted RPI of 3% to test the robustness of the plan to absorb such a change.

2.26 Also, no inflation is shown for capital costs in the first 6 years. Again, we would question the validity of this although the council may be banking on maintaining prices through lower tenders during this period. While we can see the logic of this in such a poor economic climate, this point should still be raised with council officials.

2.27 Secondly, we cannot quite tie up the new build stock numbers with the investment being made – especially in the early years. In addition, development costs for new build stock and off the shelf purchases look on the low side although we recognise some highly competitive tenders are being achieved in the current environment. Again, this subject should be raised with council staff.

3. Sensitivity Analysis

Areas of Sensitivity in the Plan

3.1 The council did not carry out any sensitivity analysis on the model presumably knowing this work would be carried out by FinancialEdge for TIS.

3.2 We have limited our sensitivity analysis to inflation and interest rates in the plan as the rental increases proposed appear on the reasonable side (but see 3.3 below) and also we need further clarification on the costs of new build housing – this will need to come from the council before we carry out sensitivity testing in this area.

3.3 The treatment of inflation is the major “talking point” of this plan and hence we have concentrated on this area to establish if the application of full inflation causes the plan to be unaffordable or only affordable with rent increases in excess of RPI for later years.

Interest Rates

3.4 The Council are able to access very competitive long-term financing for the HRA. This means a long term rate of 4.05% for new borrowing. We have tested the sensitivity of new borrowing on the plan by using slightly higher interest rates of 4.5% and 5%. We have not used rates higher than this because it is a fairly safe assumption the council will continue to be able to access competitive long term financing (certainly far more competitive than is available in the private sector).

3.5 We are not able to test increases on existing CDC housing borrowing so we are assuming - as this is existing debt subject to longer-term repayment profiles - current rates of interest rates on this borrowing will remain fairly stable throughout the repayment period.

3.6 Using a rate of 4.5%, there is little sensitivity for new borrowing. Peak borrowing reaches £33.436M in year 9 (adjusted for the small error in the original calculations) and debt at the end of year 30 is £6.03M. This compares with the corrected debt at year 30 of £5.698M.

3.7 Using the slightly higher rate of 5%, again there is little sensitivity. Peak borrowing reaches £33.595M in year 9 (adjusted for the small error in the original calculations) and debt at the end of year 30 is £6.360M. This compares with the corrected debt at year 30 of £5.698M.

3.8 Based on these figures, for new borrowing, we conclude that the plan is robust in terms of new interest rates.

Inflation

3.9 We have approached this from three angles. Firstly, we tested the affordability of the plan using 3% RPI for all years for management and maintenance costs but left the capital program as it is (no inflation for the first 6 years).

3.10 Secondly, we have applied 3% RPI to management and maintenance costs as well as the first 5 years of the capital program.

3.11 Thirdly we have applied 3% RPI to management and maintenance costs, the first 5 years of the capital program and applied full cumulative inflation on the capital program from year 6 onwards.

3.12 The results from the 3 scenarios compared to the original (debt corrected) position is as follows.

Category	Existing (debt corrected) HRA	M & M (3%)	M & M (3%) + Capital (5 years at 3%)	M & M (3%) + Capital (full inflation of 3% - cumulative from year 6 onwards)
Cumulative Surplus (year 30)	83.358M	2.108M	1.748M	1.748M
Peak debt (total)	£33.297M	£47.264M	£51.879M	£116.209M
Peak debt (per unit)	£6,866	£8,829	£9,692	£21,117
Peak debt year	2021/22 (year 9)	2035/36 (year 23)	2035/36 (year 23)	2043/44 (year 31)
Debt at year 30 (total)	£5.698M	£38.724M	£44.757M	£113.228M
Debt at year 30 (per unit)	£1,037	£7,050	£8,148	£20,613
Full loan repayment year	2057/58 (year 44)	2072/73 (year 59)	2073/74 (year 60)	2073/74 (year 60)

Overall View on the Sensitivity of the Plan

3.13 At a push, the plan could withstand like for like inflation increases throughout for management and maintenance costs and the first 5 years of the capital programme (all at 3%). While debt per unit and repayment periods are increased, it is probably (just) on the right side of affordability. Nevertheless, any additional business plan risks that materialised may have to be mitigated by above inflation rent increases at some point. Additionally, if there is an aversion politically to the higher levels of debt and the significantly longer repayment periods then the plan may be deemed unaffordable in any case. If applicable, rent increases above the rate of inflation are inevitable.

3.14 Financing costs to income would still be below 20% throughout although the revised borrowing schedule would need to be tested against overall council prudential borrowing limits for an ultimate check on affordability.

3.15 The plan does become unaffordable if year 6 capital costs are adjusted for cumulative inflation as they form the base for subsequent inflation increases throughout the 30 year period. Financing costs to income are in excess of 20% from year 12 onwards and cumulative and unit debt levels are clearly unacceptable. The only way such an arrangement could "stack-up" is if rent increases above the rate of inflation were implemented for the whole (or part) of the period of 2017/18 onwards.

4. Conclusions

4.1 The council must be congratulated on producing an easy to follow and well constructed HRA model. There are a couple of small errors in the financing sections that have been corrected by us. This results in an improved financial position (lower debt than originally shown).

4.2 While we are happy with the opening balances of the plan and its robustness and integrity as an operational document, we have some concerns over the treatment of inflation. We do not believe the use of a 1.5% increase rate for management and maintenance cost is realistic as this represents a year on year cut in real terms (using a base RPI of 3%).

4.3 Similarly, no inflation is shown for capital costs in the first 5 years of the plan or cumulative inflation for year 6 onwards.

4.4 The council will need to clarify their thinking with new build costs and related stock numbers as we have some difficulty making sense of the timing of costs and the delivery of new units in the early years of the plan.

4.5 We undertook sensitivity testing of the plan for interest rates rises and the inclusion of full inflation. We can conclude the plan is still (just) affordable if full 3% inflation is restored for management and maintenance costs as well as the first 5 years of the capital plan, although it will be more vulnerable to other risks and the loan repayment period is a lot longer. However, if there is no appetite for this politically, then there may be no option but for rent increases above the rate of inflation to be applied in later years.

4.6 We do not believe it is affordable if capital costs from year 6 onwards are subjected to cumulative inflation from year 1. This may not be a major problem though as the council is still investing £8.3M at today's prices from year 6 onwards and while its value then will be lower, the resultant spend should still be sizeable enough to make a difference to council tenants in Clackmannanshire.

4.7 We suggest tenants, in particular, should discuss the treatment of inflation by the council and listen to their views on the approach they have taken. They need to hear evidence that management and maintenance costs are realistic and that the planned capital programme as well as new council housing can indeed be delivered without the need for "RPI plus" rent increases from year 5 onwards.