APPENDIX A

Self-Financing and Southwark

A1. Since the Local Government and Housing Act 1989 came into force, housing finance has been subject to a subsidy method of support from central government. In a similar vein to general fund block grant, the government created a notional housing account for each authority, including allowances for management and maintenance, and latterly also for major repairs. Since 2002 a guideline rent level was also calculated. Where allowances outweighed guideline rent, the government would provide housing subsidy to cover the difference. However, if rents were estimated to over-provide for allowances, then that excess was to be remitted back to central government as "Negative Subsidy".

A2. Over time, the parameters used by government in this calculation have become increasingly disconnected to the realities of providing a social housing service, with an increasing number of authorities falling into negative subsidy. This has had the effect of pushing the notional national account closer and closer to surplus – i.e. the sector has more resource taken out of it than central government puts in – colloquially a "tax on tenants".

A3. The previous government accepted that subsidy had become no longer 'fit for purpose', and in June 2006 began what became a fairly lengthy process of designing a replacement settlement for the sector.

A4. The HRA subsidy system was based on a notional HRA for each local housing authority, this notional account being built up from:

Expenditure Allowances: • Management; • Maintenance; and • Major Repairs	weighted for the type of stock and for local factors such as crime rates and regional cost levels
plus Debt Charge Allowance	based on the accumulated supported borrowing and the actual average interest rate on this
less Guideline Rent clawback	based on rents moving according to government guidelines, since 2002/03 converging to a formula rent for each property

A5. From year to year, uplifts have been applied – expenditure allowances are uplifted for HM Treasury's inflation rate and guideline rent is uplifted by RPI + 0.5% + a staged move towards average formula rent for the authority. <u>N.B. these two uplifts are not the same.</u>

A6. Because guideline rent is generally uplifted by more than expenditure allowances, the tendency has been for notional HRA deficits to reduce each year, with many authorities moving into surplus and having to pay subsidy to CLG. The system has the effect of removing rent proceeds above inflation from local authority landlords, passing these to HM Treasury, unlike the position for housing associations, who keep all rent increase proceeds.

A7. Many years of restrictions on capital expenditure, such as the limits on retention of capital receipts, has also led to a degree of stagnation on the supply-side of local authority housing, particularly with reference to serving the levels of historic debt incurred or inherited from previous providers.

A8. CIPFA have noted the following checklist of issues with the subsidy system:

- It is based on notional allowances that are not related to actual spending;
- It is a national system administered locally;
- Resources are insufficient to maintain the homes & meet tenants' requirements;
- It is a complex system that has developed over 20 years;
- Resources within the system are being taken into the Treasury which is seen as unfair;
- Rents & services are not related;
- There is limited local autonomy;
- Annual housing subsidy determinations are issued;
- Limited business planning is possible;
- Capital receipts pooling may not still be relevant;
- The HRA ring-fence & 'Circular 8/95' are not now entirely fit for purpose; and
- There could be greater incentives to improve performance.

[Source, Technical Information Service, September 2009]

A9. The previous government conducted several rounds of consultation on replacing the subsidy system, starting in June 2006 by establishing a pilot study whereby local housing authorities could individually leave the subsidy system if they met certain financial criteria. Soon after their election the coalition government confirmed their intention to complete this process, and 1 April 2012 has been set as the date of implementation. From that date CLG will cease operating the HRA revenue subsidy system. Local housing authorities will instead have a one-off adjustment to their HRA debt on or around 28 March 2012. The adjustment is intended to leave HRA debt at a level where the debt charges will be affordable from the surplus of rents over running costs of the tenanted stock. Calculations are predicated on a 30-year business planning horizon.

A10. Self-financing is intended to operate in future years without the need for revenue subsidy transactions between authorities and central government. Future expenditure allowance and rent projections have been fed into cash-flow forecasts to indicate the annual revenue surplus of each authority's HRA if without debt charges. Authorities will then be allocated a new level of debt equal to the net present value of revenue surpluses for the next 30 years.

A11. The government has consulted on the mechanisms for the physical transfer of debt between itself and local housing authorities as set out below:

3. Settlement payments

PAYMENTS TO THE SECRETARY OF STATE

3.1. Where the self-financing valuation for a local housing authority is greater than the SCFR for that authority, the authority must pay to the Secretary of State the amount by which the self financing valuation exceeds the SCFR. Where the SCFR is a negative amount it has been treated as nil for the purposes of this calculation.

3.2 The local housing authorities required to make a payment to the Secretary of State on or before 28 March 2012 and the amounts payable are set out at Annex A to this determination. Payments must be made as cleared funds via electronic banking transfers on or before 28 March 2012.

PAYMENTS TO LOCAL HOUSING AUTHORITIES

3.3 Where the self-financing valuation for a local housing authority is less than the SCFR for that authority, the Secretary of State will make a payment to the authority equal to the amount by which the SCFR exceeds the self financing valuation.

3.4 Payments will be made on 28 March 2012 as follows and in this priority until the full payment has been made:

PUBLIC WORKS LOAN BOARD LOANS

3.4.1 The Secretary of State will redeem an equal percentage of all Public Works Loan Board (PWLB) loans held by the authority. The percentage for each authority will be calculated according to the value of PWLB loans held by the authority on the date of the transaction. Annex B to this determination lists the local authorities to which this applies and the amounts for payment by the Secretary of State.

3.4.2 Any charges for the early repayment of these loans will be met by the Secretary of State. The Secretary of State will set any discounts for early repayment of loans against these charges.

AUTHORITIES WHERE THE SETTLEMENT PAYMENT IS GREATER THAN THE VALUE OF LOANS HELD WITH PWLB

3.4.3 Where an authority's PWLB debt is less than the settlement payment, the Secretary of State will redeem all the loans held with the PWLB and pay the balance of the settlement payment to the local authority.

3.4.4 Local authorities will be required to use this balance payment in accordance with conditions stipulated in letters issued by the Secretary of State to local authorities receiving these payments.

A12. The expenditure allowance levels in the projections are substantially higher than currently and the discount rate of 6.5% p.a. used in the net present value calculation is relatively generous. Both of these reduce the affordable debt level to be settled, which would otherwise be quite high if based on current rent policies and expenditure allowances.

A13. An increased depreciation payment, from revenue towards capital funding, will be required. This is intended to cover average annual replacement costs of the various dwelling elements as they come up for renewal in future, although will not cover backlogs. Following ongoing advice/consultation with CIPFA, CLG have indicated that LA's will have a five-year transitional period available to move towards using a component replacement costs methodology.

A14. CIPFA's technical advice on this matter is not yet finalised, but currently broadly favours the component-based approach. During this period as a concession authorities would be allowed to adjust depreciation to an 'enhanced' Major Repairs Allowance level in the self-financing valuation if it helps affordability – though this is a risk for Southwark as this figure is potentially higher than a "pure" component-based one.

A15. In February 2011, the government released indicative figures regarding the level of debt adjustments likely to be required in order to prepare each local housing authority for self-financing from April 2012. As the first column below notes, for Southwark this indicated a reduction in debt from £775.0m to £500.9m, a movement of £274.1m. Officers modelled the likely reduction in debt charges associated with servicing this lower level of debt and offset the subsidy lost by the ending of the old system.

A16. On 21 November 2011, revised figures were issued, and the debt reduction offered in settlement by government was itself reduced, from £274.1m to £195.2m. Government are now only prepared to write down Southwark's debt to a level of £578.7m, instead of the £500.9m originally proposed. Alongside other changes, this means that the council will be expected to bear an average debt per dwelling of £14,901, as opposed to the original figure of £12,735.

	Feb 2011	**Nov 2011**	**Change**
Stock (CLG debt model)	39,337	38,839	(498)
Allowance uplift	17.8%	16.0%	(1.8%)
Subsidy Capital Financing Requirement	£775.0m	£773.9m	(£1.1m)
Self-Financing Opening Debt (see below)	£500.9m	£578.7m	£77.8m
Debt redemption	**(£274.1m)**	**(£195.2m)**	**£78.9m**
Debt Cap	£500.9m	£580.9m	£80.0m
Debt per dwelling	£12,735	£14,901	£2,166

A17. The total debt that government assume Southwark can self-finance is made up of the following elements (each is a net present value calculation over the 30-year life-span of the HRA business plan under self-financing). Government assumptions as to the council's total rent debit have fallen by £41m, whilst allowances have also been reduced by £118.7m, leading to a net increase in debt levels of £77.8m.

	Feb 2011 £m	**Nov 2011 £m**	**Change £m**
Guideline Rent	2,840.3	2,799.4	(40.9)
Management & Maintenance Allowances	(1,659.1)	(1,589.2)	69.9
Major Repairs Allowance	(663.3)	(626.4)	36.9
Premia/Debt Management Expenses	(17.0)	(5.1)	11.9
Total Self-Financing Opening Debt	**500.9**	**578.7**	**77.8**

A18. Where authorities have repaid part of their supported HRA debt in the past they will be allowed to prudentially borrow up to a cap set at the accumulated supported borrowing level. Southwark has scope to borrow up to £125.9m within its cap but only if resources can be found to meet the additional debt charges (which average 11% per annum; e.g. £10m equals £1.1m revenue charges).

A19. Rent restructuring will continue, so rents will be expected to rise by RPI + 0.5% each year plus the move to reach formula rent by 2015/16. Affordability caps and limits apply, so many individual rents will not converge until after 2015/16. Current estimates are that only 44% of rents will converge in that year, with a further 12% doing so in 2016/17. By 2010/21, the number converged will be around 80% of the total number of tenanted properties.

A20. With rents linked in the long-term to RPI + 0.5% (and in the short term to around 2% above this), income should rise faster than costs and so the council can expect an improving financial position year-on-year. Once the newly self-financed HRA moves into surplus this could provide additional support for further capital investment.

A21. Under the previous system, Southwark was in receipt of subsidy, but this was diminishing every year, and other things being equal, the council would move into a negative subsidy position in only a few years time – meaning a contribution to the national pot, not income from it. It is important therefore to measure the reaction to self-financing against this alternative outcome.

A22. The table below sets out the opposite effects of the removal of subsidy and the reduction in debt charges on Southwark – the former is a fall in income of £26.0m from 2011/12, whilst the debt settlement figures outlined above will result in a reduction in expenditure on debt interest of £13.9m.

	2011/12 £m	**2012/13 £m**	**2013/14 £m (est)**	**2014/15 £m (est)**
Management Allowance	(44.2)			
Maintenance Allowance	(60.9)			
Major Repairs Allowance	(38.8)			
Rent Clawback	179.9			
Rent Caps & Limits	(7.3)			
Debt Charge Subsidy	(54.7)			
Sub-Total Subsidy	**(26.0)**			
Debt Interest	44.9	31.0	31.4	31.4
Debt Management Expenses	0.3	0.3	0.3	0.3
Premia Repayments	0.9	0.3	0.2	–
Premia Contingency	1.2	–	–	–
Depreciation	38.8	44.9	45.5	46.1
Sub-Total Debt Charges	**86.1**	**76.5**	**77.4**	**77.9**
Total	**60.1**	**76.5**	**77.4**	**77.9**
Change from previous year	–	16.4	0.9	0.5

A23. September RPI at 5.6% has been factored into the figures noted above, and the debt settlement figures as revised by government have a material impact.

A24. The settlement is based on the thirty-year future revenue position of the HRA. There is a worse revenue position at the start of the thirty years than at the end, because rent income is expected to increase faster than expenditure costs. Thus debt charges that may be affordable towards the middle and end of the thirty years may not be supportable at the beginning, when rent levels are some way below formula.

A25. Whilst the debt levels from April 2012 will be based on the future revenue surplus, the actual external loans making up the debt from April 2012 will be a proportion of existing historic debt and hence local average actual interest rates will continue. Southwark has a large element of debt borrowed in the 1970's at over 9% interest and has an average interest rate of nearly 7% – this is above the 6.5% assumed in the settlement as affordable, and will not change in the short-term.

A26. Self-financing requires us to adopt a component-based approach to calculating depreciation within the HRA. The required level of depreciation (a charge to revenue, transferred to capital funding) has a significant cost implication. The new level must either be at an enhanced Major Repairs Allowance level 12.1% above that used for the stock in 2011/12 on a transitional basis or at the detailed total annual average cost of replacing all building elements. However, a depreciation charge higher than the old Major Repairs Allowance, whilst creating revenue cost pressure will provide extra capital funding.

A27. A further complication is that self-financing requires an expansion of the asset base to be depreciated, as the previously used MRA proxy figure relates to the dwelling stock only, and not any non-dwellings, nor assets created or enhanced by adaptation for disability purposes. The depreciation charge of £44.9m calculated by the council using a componentisation method would be £6.1m greater than the current MRA for 2011/12 (a 16.0% increase year-on-year). The enhanced MRA method would result in a £9.6m year-on-year increase in the charge (24.7%). The table below summarises the three positions, current, component and enhanced:

Depreciation	Current 2011/12 £m	Component 2012/13 £m	% over 2011/12 %	Enhanced MRA 2012/13 £m	% over 2011/12 %
Stock	38.8	39.9	3.1%	43.5	12.1%
Adaptations		3.1	–	3.0	–
Non-Dwellings		1.9	–	1.9	–
Total	**38.8**	**44.9**	**16.0%**	**48.4**	**24.7%**
Change from 2011/12		6.1		9.6	

A28. The above factors make it likely that the Year One position under self-financing will be significantly worse than the last subsidy year, requiring substantial savings to balance the budget – at least in 2012/13. The revised projection is set out below:

	February 2011 £m	November 2011 £m
Subsidy loss	26.0	26.0
Debt Charges reduction	(17.3)	(13.9)
Reduction in premia payments	(1.7)	(1.8)
Increase in depreciation	6.2	6.1
Net Loss in 2012/13	**13.2**	**16.4**

A29. Future growth in rents is largely dependent on each September's Retail Price Index level. This can be volatile and can go down (e.g. in 2009 after a VAT reduction). Any future reduction in the September annual RPI would hit the following year's revenue position as uplifted costs might not be covered by rent income. Conversely, high increases in RPI, such as the 5.6% recently announced for September 2011, whilst benefiting the HRA can lead to high rent increases for tenants.

A30. The risks listed above are more numerous than the benefits, but much of that risk is time-limited, being particularly relevant to the first few years of the self-financing arrangement. It is important not to lose sight of the intention that self-financing is designed to operate over a 30-year timeframe, and with that in mind ought to give far greater levels of stability and certainty to projecting social housing financing requirements for the future.

A31. A further overarching point is that the emphasis is now on moves towards income stream maximisation within Southwark, as the thirty-year plan makes certain key assumptions regarding income levels from the outset of self-financing which would have exponential effects on the self-financed HRA's viability were it not to meet them, hence requiring strict adherence to the rent restructuring timetable for convergence by 2015/16.