**APPENDIX B**

**SOUTHWARK RESPONSE TO CLG CONSULTATION**

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## Consultation on the Draft HRA Self-financing Determinations

Response of the London Borough of Southwark.

Southwark has always supported the move to self-financing HRA's, but write to express concern at the settlement figures and methodology indicated in the draft Self-financing Determinations for 2012/13. In particular:

- Volatility in initial allowances caused by a weighting change in the personal social services Area Cost Adjustment.
- Change and lack of transparency in the second stage of allowance uplifts.
- Inadequacy of the affordability caps and limits adjustment to compensate for lost rental income.
- Inequality across authorities in the interest rate on debt and the reinforcement of this in the March 2012 debt transaction.

One of the main problems with the current subsidy system and which self-financing is supposed to eliminate, is the removal of rent increase resources to government. However, in a year where our tenants face an 8% average rent increase, we again suffer a loss of resources, as our debt charge saving and rental income increase is less than the uplifted depreciation charge and loss of subsidy income as table 1 below indicates.

**Table 1 – Southwark Gains and Losses 2011/12 to 2012/13**

| | | £m |
|---|---|---|
| Losses: | Subsidy income | 26.0 |
| | Increased depreciation | 9.6 |
| | | 35.6 |
| Gains: | Debt charge saving | (14.5) |
| | Rent increase | (15.3) |
| | | (29.8) |
| **Net loss** | | **5.8** |

Another problem under the current subsidy system which we would expect self-financing to eliminate is volatility of the annual settlement. Unfortunately the draft settlement allows a significant final year's movement in allowance factors to be effectively multiplied up by being projected over many years. This unduly affects the future finances of Southwark and other London authorities.

**Southwark Affordable Debt Allocation**

In total our opening debt allocation (valuation) is now some £78m (15.6%) higher than indicated in February 2011.

The attached appendix details the Indicative Debt Total by LA cash flow and NPV changes between the February and November models. The appendix shows Management & Maintenance and MRA changes reduce their cash flow by around £8.5m p.a. in the long-term and have increased debt on those allowance elements by £107m.

Table 2 below analyses the effect of stock number changes (reduction of an average 3.33% on NPV of stock) and other movements on the affordable debt elements. Stock changes reduce debt by £17m; *other changes increase debt by £95m* – £53m due to the effect of the September RPI on rent resources, £12m due to premia changes and £30m due to reduction in management and maintenance allowances. The extra £30m debt that relates to allowance reductions, where we expected inflation changes to reduce debt by over £6m, is largely due to regional cost weighting movements and generates a huge extra burden on our HRA.

**Table 2 – Southwark allocated debt at February and November 2011**

| 2012 Opening Debt Allocation | @ Feb 11 £m | Stock no effect £m | Inflation /Other £m | Total Change £m | @ Nov 11 £m |
|---|---|---|---|---|---|
| Rent | 2,840 | (94) | 53 | 41 | 2,799 |
| Management and Maintenance | (1,659) | 55 | 15 | 70 | (1,589) |
| MRA | (663) | 22 | 15 | 37 | (626) |
| Premia | (17) | | 12 | (5) | (5) |
| **Total Debt** | **501** | **(17)** | **95** | **78** | **579** |

**Initial Allowance Calculation and Regional Cost Indices**

An initial calculation produces uplifted interim allowances based on the subsidy methodology.

We were surprised by the Area Cost Adjustment factor for London, applied to allowances, moving downward from 1.25 to 1.20 in a year with a pay freeze. The reduction is nearly all due to the estimated labour share weighting for the social services area block being changed from 80% to 65% (.25 was 80% of +.3151 additional Inner London labour costs and .20 is 65% of the .305 latest factor). So when relative labour costs have only reduced by 0.7% the index has reduced by 4% because of a change in a weighting percentage. We strongly contend that year to year volatility of this sort should not be built into the settlement.

The maintenance/repair BCIS factor for Inner London has also reduced, from 1.21 to 1.19.

As our crime and similar local statistics have not moved much we would have expected around a 2.5% inflation increase in the first stage of allowance uplifts. Because of changes in regional cost indices, this stage of our allowance uplift at 1.3% falls well below the expected 2.5% uplift, and £33.67 per property (£1.3m) below the February indication at 2.2% inflation (see table 3 below).

**Table 3 – Southwark changes in initial allowances February and November 11**

| Per property £ | **2010/11 level** | **Feb Initial** | **Initial uplift** | **Nov Initial** | **Initial uplift** |
|---|---|---|---|---|---|
| Management | 1,122.30 | 1,146.99 | +2.2% | 1,134.87 | +1.1% |
| Maintenance | 1,548.17 | 1,582.23 | +2.2% | 1,574.29 | +1.7% |
| Major Repairs | 986.72 | 1,008.43 | +2.2% | 994.82 | +0.8% |
| Total | 3,657.19 | 3,737.65 | | 3,703.98 | |
| | | +£80.46 | +2.2% | +£46.79 | +1.3% |
| Loss since Feb 11 | | | | £33.67 | |

**Additional Need-to-Spend Resources**
The settlement model's Base Data worksheet indicates uplifts necessary in the initial Management, Maintenance and Major Repairs Allowances as a result of need-to-spend studies. Southwark was indicated to receive an extra £570.47 per property in total allowances in February (see table 4 below), yet the November figures show this reducing to only £532.07. There are no calculations in the worksheet to demonstrate how these were allocated each time and it is disappointing that this aspect of the calculations has changed, resulting in a further £1.1m p.a. unexpected shift in allocations.

**Table 4 – Southwark second stage allowance uplift February and November 2011**

| Per property £ | **Feb initial*** | **Feb final** | **Nov initial** | **Nov Final** |
|---|---|---|---|---|
| Management | 1,146.99 | 1,372.20 | 1,134.87 | 1,343.66 |
| Maintenance | 1,582.23 | 1,706.33 | 1,574.29 | 1,701.55 |
| Major Repairs<br><br>Adaptations | 1,008.43 | 1,149.74<br><br>79.85 | 994.82 | 1,120.27<br><br>77.57 |
| **Total** | **3,737.65** | **4,308.12** | **3,703.98** | **4,243.05** |
| | | +£570.47 | | +£532.07 |
| Loss since Feb 11 | | | | £38.40 |

**Caps and Limits Guideline Rent Adjustment**
We still also believe that the adjustment for rent caps and limits, which is based on the effect on guideline moving to average formula rent, significantly understates the real situation. The real cases of rent loss due to caps and limits are outliers and their amounts do not reduce nearly as quickly as an average does in the CLG model. The model shows no Southwark reduction for caps and limits beyond 2016/17, yet our rent modelling shows that only 65% of our properties will have converged by 2017, losing us 3.5% (£7m) against formula in 2017/18.

We have also projected our subsidy caps and limits model forward for 10 years and caps to year 20 in order to calculate future subsidy entitlement on a per property basis. This shows very little decline in caps and limits loss to 2016/17, with caps continuing to have an effect well beyond that. Even if we assume that limit funding might continue only to year 5, with caps only beyond that, then it would lose us £53.7m in NPV, yet our adjustment is only £21.6m, giving us an extra debt of £32.1m for guideline rent that we are unable to collect.

**Table 5 – Southwark Caps and Limits Guideline Rent projections**

| | | Loss per week | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **NPV £k** | **y1** | **y2** | **y3** | **y4** | **y5** | **y6** | **y10** | **Y15** | **y20** |
| CLG model | 21,637 | 3.70 | 3.13 | 2.40 | 1.72 | 1.07 | - | - | - | - |
| LBS caps & limits y1-10 | 47,912 | 3.70 | 3.84 | 3.80 | 3.78 | 3.78 | 3.16 | 1.85 | n/k | n/k |
| Caps & limits y1-5, caps only y6+ | 53,671 | 3.70 | 3.84 | 3.80 | 3.78 | 3.78 | 0.51 | 0.45 | 0.38 | 0.33 |

## Consolidated Rate of Interest and Debt Repayment

The debt transaction in March, where it is a repayment, is proposed to apply pro-rata across existing debt, thus having no effect on affected authorities' consolidated rate of interest (CRI). This means there is not a level playing field in terms of debt charges across authorities and those with high CRI on historic debt are severely disadvantaged.

As has been stated previously, we have a CRI of around 6.9%, well above the 6.5% discount rate used for the self-financing settlement and further above the 5.5% used in CLG's indicative debt profile charts. Our interest rate will remain at this level until 2014, when we have a spike in our debt refinancing profile and will be subject to market rates at that point. A substantial part of our external debt was taken on in the 1980's at the time of GLC abolition and has been supported by subsidy since then. It does not seem fair that the interest on this debt is not fully allowed for in the new arrangements.

The proposed pro-rata reduction of £195.2m in our PWLB debt on 28 March 2012 targets both high and low interest debt and hence seems far from prudent in treasury management terms. We calculate that £42.8m of premia will be incurred and we would strongly recommend that repayment be targeted to derive maximum benefit for all parties in a way that is consistent with the Prudential regime.

Our existing debt falls into the following ranges:

Type A debt: £425.7m of loans taken out up to 1996 at 8% – 9.75%.
Type B debt: £336.0m of loans taken out since 1999 at 3.99% – 4.75%.

The overall average interest rate on these external loans is 6.93%.

The current pro-rata proposal would redeem £109.1m (25.6%) of type A debt, incurring £36.4m in premia, and £86.1m (25.6%) of type B debt, incurring £6.4m in premia, without deriving any benefit whatsoever to our CRI.

We strongly contend that no type B debt should be redeemed given that it is at or below current market rates and is not financially prudent to do so. We are able to supply more detailed debt repayment options on request, which would incur the same or less in premia and reduce our initial CRI to a more sustainable level.

At the same time we have examined the possibility of early debt repayment using our own resources as an alternative, but this is not feasible in the short-term given the premia costs involved. Any repayment prior to 28 March would incur premia for both HRA and General Fund that would have been around 25.6% repaid by the self-financing settlement and would also mean that even more of the type B (low interest) debt would be repaid that we wish to retain. After 28 March, the premia incurred would be charged to revenue, hence incurring a net cost in the HRA in the short-term. The Prudential Code does not permit borrowing for revenue purposes to spread this cost over a longer period.

**HRA CFR and Appropriations**

In pages 19-21 of the draft Determination booklet, HRA CFR is required to be adjusted by the full certified value of housing land and dwellings commencing or ceasing to be accounted in the HRA. This is more than the previous reserved percentages and whilst protecting the original owning account can create a windfall gain not directly required, particularly where the value is greater than the relevant self-financing debt on the asset. Conversely a potential new owning account may find the full value unaffordable and this will inhibit best use of Council assets, for instance giving up housing land to extend a school playground. Some flexibility is therefore desirable in setting the value to be transferred between CFR's.

**Right to Buy Consultation**

The Affordable Housing Regulation and Investment division of CLG published the consultation paper '***Reinvigorating Right to Buy and one for one replacement***' on 22 December 2011. Southwark will be responding to this consultation in due course, but it is of some concern that the detail of changes with the potential to have a profound impact on the underlying assumptions on rental income streams and stock levels is provided only days before the deadline of the self-financing consultation itself.

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