DERBY HOMES BOARD
31 MARCH 2011

ITEM B4

IMPLEMENTING SELF FINANCING FOR COUNCIL HOUSING - URGENT DECISION

Report of the Director and Company Secretary

1. SUMMARY

The Board is invited to discuss the response of the Council relating to issues raised by Communities and Local Government (CLG) and by the Chartered Institute of Public Finance and Accountancy (CIPFA). Derby Homes' support for the response was authorised by the Chair and Vice Chair as an urgent action on 21 March (Appendix 1), following Council leadership approval on 15 March. The aim of this report is to highlight the key issues included in the response for the Board to discuss.

2. RECOMMENDATION

That the Board discusses the issues raised by CLG and CIPFA with respect to the implementation of self financing from 2012.

3. MATTER FOR CONSIDERATION

3.1 CLG released a document in February 2011 indicating the basis on which Councils will be required to implement self financing for council housing from April 2012. The essence of the proposals are that Councils will be expected to take on additional debt – in Derby's case the indicative figure is an increase to £226m – an increase of around £19m in debt from current subsidy calculation levels, in exchange for ceasing to have to pay negative subsidy in future. A few Councils would have their debt reduced where their need is greater than they can sustain from their rental income.

3.2 While the principles of the reform are welcome and the majority of the calculation is undertaken on a reasonable basis and therefore should be welcomed strongly, there are a few points which require clarification, further data to be returned to the CLG or specific policy issues that need to be raised. A draft response is attached as Appendix 2 to this report. This was discussed by the Council's leadership meeting on 15 March and approved in principle. The immediate task is to mention 'by the end of March' any future demolitions or disposals that are likely to arise over the next few years. In addition to this, other issues have been raised in the draft response to enquire further or to appeal for instance on lifting the debt cap for borrowing related to new build.

3.3 There is also a problem with the general approach to Right to Buy receipts, which if volumes increase would create a problem for the management of debt as we are getting a reduction in the initial debt based on an assumed level of future sales rather than a case by case receipt as they arise. If numbers increase beyond that assumed, the Council would be faced with a debt write off and a need to continue to finance disabled facilities grants, which would not be possible with only a 25% receipt being retained for local use.

3.4 In addition, CIPFA have issued two consultation documents relating to depreciation of assets and to the division of Council debt between the HRA and the general fund of the Council. These issues are critical to the future plans of the HRA and it will be necessary for the Council to determine the means by which each of these issues are resolved in detail. The principles set out by CIPFA are largely to be welcomed, although a couple of points are made in the proposed responses which might be considered further. In particular, it is suggested that the charge for depreciation needs to be limited to that required to sustain the components of the home into the future – which can then finance that spending - rather than additional depreciation for the full social housing value of the home. In addition, the treatment of debt charges is critical to the management of the HRA going forward. It is therefore important that the charge allocated to the HRA is reasonable and based on the needs of the HRA. CIPFA's proposals achieve that but may need to be adjusted at the margins in terms of charges relating to internal borrowing by the Council, in order to meet the overall objective of fairness between the HRA and general fund.

3.5 The proposed responses to each party are attached as Appendices 2 and 3 to this report.

3.6 Consideration of these issues by the Board is invited with a view to considering the implications of HRA reform.

4. CONSULTATION IMPLICATIONS

The demolitions proposed will of course need further consultation with the Council Cabinet and with specific individuals affected. The immediate scale is likely to be fairly limited, but there would be potentially a larger number of demolitions over a number of years should a funding package be successfully developed for the regeneration of Osmaston along the lines of the masterplan. Should these properties not be raised as potential demolitions, and consequently not removed from the debt settlement calculation, the HRA would be faced with a debt of approximately £18,000 per dwelling for each property demolished in future. Such a cost may be prohibitive in making redevelopment work, which could be a serious restraint on improving estates in future.

5. FINANCIAL AND BUSINESS PLAN IMPLICATIONS

5.1 The calculation of the final debt settlement due in January 2012 is critical to the final funds that will be available for the maintenance of council homes into the future. Every property that can be removed from the list will reduce debt by around £18,000. The proposals on the debt cap would add £2.15m to the headroom available within the debt cap which will help in the earlier years of the new arrangements when funding will probably be tighter than in later years.

5.2 The proposed settlement does not allow adequate compensation for rent limitation as a result of past government decisions pushing many tenants' rents below where they now would have been had rent restructuring continued unabated. It is proposed that a further £2m should be removed from the Council's debt settlement in recognition of this.

5.3 The right to buy proposals are that the government will continue to receive 75% of all future right to buy receipts. A factor has been removed from the debt settlement (£862m nationally) to reflect projected sales based on current levels. Should levels increase again the HRA would have a huge financial difficulty as a result. This proposal is against the spirit of the local control of the HRA that otherwise underpins the settlement. Even if this amount were to be added back to the settlement – increasing the immediate receipt to government at a time when the cash is needed to reduce the national debt – the receipts should be retained locally. Without this income, both the HRA and the general fund of the Council will suffer as the HRA will have inadequate funds to repay outstanding debts on sales, and the general fund will not be able to get the benefit towards Disabled Facilities Grants which it has been using to top up the government grant for that purpose which is insufficient to meet the level of demand. This continues to be the major issue between the government and the Local Government Association on the reform.

6. LEGAL AND CONFIDENTIALITY IMPLICATIONS

At this stage, individual properties have not been identified for demolition. Further discussions will be needed with the CLG and the Council about the possibility. At this stage we are just indicating that certain properties may be demolished in addition to those already scheduled by the Council.

7. ENVIRONMENTAL IMPLICATIONS

Should demolitions be approved eventually and redevelopments go ahead, significant improvements in environmental standards can be expected. At this stage we are just requesting the exclusion of projected demolitions and disposals from the debt settlement. Decisions on this will be a matter for the Council after proper consultation.

8. RISK IMPLICATIONS

The new arrangements will result in greater risks being borne by the HRA in future, in particular with respect to interest rates increasing over time. The scale of the benefit in terms of additional financial freedoms should outweigh these new risks. It is expected that the HRA will become financially sustainable with sufficient funds available to maintain homes to the decent homes standard, although there may be less than first indicated and less than required by the long term stock condition survey undertaken a couple of years ago. The Council no longer has any choice in the matter as this is a matter of primary legislation through the Localism Bill. Assuming that bill passes, the changes will be imposed next year. The new risks will therefore have to be managed.

The areas listed below have no implications directly arising from this report

- Personnel
- Equalities Impact Assessment
- Health & Safety
- Policy Review

If Board members or others would like to discuss this report ahead of the meeting please contact the author, or the Chief Executive, phil.davies@derbyhomes.org - Tel 01332 888520

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Background Information:	Consultation on depreciation CIPFA Consultation on treatment of debt CIPFA Implementing self financing for Council Housing CLG
Supporting Information:	None.

derby homes

REPORT OF THE CHIEF EXECUTIVE IN RESPECT OF AN URGENT MATTER REQUIRING A DECISION OF THE BOARD

SUBJECT: IMPLEMENTING SELF FINANCING FOR COUNCIL HOUSING

SUMMARY OF REPORT

1. The Council needs to respond to both Communities and Local Government (CLG) and Chartered Institute of Public Finance and Accountancy (CIPFA) consultations by the end of the month. Derby Homes' support is sought to continue the usual pattern of partnership with Derby Homes in responses from the Council on matters affecting the HRA. Formally the Council is required to respond on these issues and the responses approved by the Council are attached.

RECOMMENDATION

2. That the Council's responses to both CLG and CIPFA be endorsed by Derby Homes.

REASON FOR URGENCY

3 The next formal meeting of Derby Homes' Board is on 31 March. As a consequence, Derby Homes' support would be needed in advance in order to meet the deadlines of both CLG and CIPFA.

DATE OF NEXT COMMITTEE MEETING:

DATE CHAIR AND VICE CHAIR(S) OF BOARD CONSULTED:

I approve of the above

Signed .... Date 21 – 3 – 2011
(Chair)

Signed .... Date 21 – 3 – 2011
(Vice-Chair)

I hereby approve the proposed action on the grounds of urgency and in exercise of powers delegated to me by the Board and Derby Homes Governance Arrangements Part VI Section 2.2.

Signed .... Date 21.3.11
(Chief Executive)

Contact Officer David Enticott **Telephone** 888529

Appendix 2

Derby City Council

Response to Communities and Local Government

Implementing self financing for council housing

Issues with the proposed self financing settlement for council housing

Derby City Council would like to raise a number of points relating to the detailed implementation of the self financing settlement. Derby Homes has been consulted and supports the comments in this reponse. While we are both supportive of the overall change and of the vast majority of the proposals, we would like to comment on the following:

National Policy Issues

- Right to Buy
- Future demolitions and regeneration
- Debt cap
- Caps and Limits adjustment

Local Issues within the framework proposed

- Demolitions proposed by the Council and current status of consultation
- Debt cap adjustment relating to new build
- Caps and limits adjustment as it applies to Derby

National Policy Issues

Right to Buy

The main thrust of the proposals – and one that we support – is to create a system that is locally controlled and can be run as a normal business in terms of income and expenditure being reapplied locally. The proposals for the government to continue to retain 75% of right to buy receipts runs directly counter to this principle. Indeed, it could – if sales were to increase above the level expected in the calculation of the settlement – mean that business plans become completely unsustainable. When a sale occurs, currently we apply the 25% share of the net receipt to Disabled Facilities Grants in the private sector. Under the original proposals to retain the whole value of receipts, this policy could have continued. The first call on any share of receipts in future will have to be to reduce the debt held by the HRA in order to avoid making the business plan unsustainable. Should the receipt be only 25% then it is likely that this will leave nothing or very little to be able to fund DFGs in future.

This will cause a real problem for the general fund of the Council – a principle that has rightly been avoided in other aspects of the proposals.

It is not too late to reconsider this proposal at no cost to the government. Indeed, should the government adjust the debt settlement by the value placed in the latest proposals the immediate net receipt to the government would increase by £862m. While this would leave Councils and the government no better and no worse off in the longer term should the government's forecast of numbers be correct, it would allow Councils to plan knowing that they can deal with reducing debt and maintaining other spending such as DFGs.

We are sure that there must be a way to ensure that at least the current commitment to not making the general fund worse off – at a time when it is under severe pressure anyway – can be maintained whilst potentially making the receipt to government still larger in the short term.

Future demolitions and regeneration

Apart from the Right to Buy issue above, the main issue that will emerge over time with the proposals is that demolition and regeneration proposals will need to be able to be sustained into the future. Should demolition or regeneration be required, the HRA will potentially lose a considerable amount of income where there is a net loss of stock numbers. As the debt will remain relating to the demolished stock, there will be a need to find the equivalent to the debt outstanding each time there is a loss through any means. This issue has rightly been recognised in the proposals in terms of allowing an adjustment with respect to plans already in place. The wider issue is that further proposals will be much more difficult to deliver as there will be a need to maintain the income from the stock for the future in order to service the debt. The proposals need to have a means whereby longer term plans – such as Derby's current masterplan options for Osmaston – can be allowed for in addition to the firm plans that we already have. Such plans take a long time to come about, and will be difficult to finance in any case – to add a need to eliminate HRA debt will be a problem. Some form of capital funding may be necessary to make these changes in future. We would urge the government to be as flexible as possible in terms of future changes to stock levels.

Debt Cap

We acknowledge that there is a need for some sort of limit on debt – it has to be sustainable. Registered Social Landlords are effectively restrained by their financial position and their bankers' covenants, and Councils will have to continue to be responsible in their attitude to debt. It is currently unclear how the debt cap will develop after the next four years. Will it continue to be set in cash terms at the initial debt cap level or will it be adjusted to allow for inflation at least? If the debt cap was set in real terms or by reference to ratios of debt to income for instance then longer term planning would be more flexible than the current assumption of an absolute cash cap which is in effect a reducing cap in real terms.

Caps and Limits adjustment

The modelling undertaken on the potential settlement continues to include calculations based on an average rent to calculate the caps and limits adjustment for the future. In reality, each tenant is on a different point in the move over time towards convergence of rents. As a result, many tenants will – if the current limit on rents and service charge increases of RPI+0.5%+£2 a week remains – be protected from the full formula rent for a very long time and well beyond the 2015/16 assumed by the government. Individual calculations could be supplied by Councils on the basis of the formula – and checked by external auditors – that would tell the real position. The current proposals in effect underestimate the real rental losses to Councils and hence overstate the debt that can be supported.

Local Impacts for Derby

Demolitions and Disposals

Derby currently has a number of properties scheduled for demolition or disposal that we would want to bring to your attention to make sure they will be excluded from the final settlement in January 2012:

- Britannia Court – disposal or demolition
- Oakvale House – disposal
- Isle of Wight Blocks Alvaston – final block remaining

In addition we are actively considering both overall masterplanning for Osmaston which will involve over time up to 900 council homes being demolished and a specific plan relating to a site which will be freed up as a result of a new Travellers site due this year. These plans do not yet have property specific consultation but this is intended to occur this year. As for the national policy comments above, it would make the necessary transformation of these areas much more difficult if the debt on such properties were to remain as well as debt on new developments. Indeed, it is possible that it could make the project(s) unviable. We would welcome further discussion on these plans and the extent to which this issue could be tackled.

Debt Cap relating to new build

In the modelling published there appears to be no adjustment to Derby's figures for the new build undertaken by Derby City Council and Derby Homes over the last few years under the government's new build programmes. The debt incurred by the Council on these programmes is or will be as follows:

- Council new build phase 1 - £1.65m
- ALMO new build - £0.2m
- Further Council new build (St David's Close) - £0.3m

Total £2.15m

As a result, we would like to request that the debt cap be increased for Derby by £2.15m to reflect these approved investments over the last few years, in line with the proposals.

Caps and Limits adjustment

The modelling – as indicated under national issues above – of caps and limits for Derby understates the true cost of lost income through the constraint by using average rents rather than individual rents. The Net present value (using 6.5% discount rate) of the modelling effectively values the lost rent at £1.5m and reduces our proposed debt by that amount. Using the same assumptions as the model, we have reworked our individual rents and the real value on the same basis is £3.5m. Some of our tenants will be protected for over 10 years – at the end of that period our modelling suggests around 800 or around 6% of tenants will still not have converged to target rent by that time. It is suggested that individual calculations could be submitted to replace the modelled figures on a similar basis and that an adjustment to debt would be appropriate to model the real loss of income. In our case, this would mean a reduction in debt of £2m.

While there remain these issues, the overall thrust of the proposals – giving local control of the issues and a direct relationship with tenants and so on remain the right thing to do. The inclusion of funds for aids and adaptations in the final settlement is particularly welcome, as it was difficult to see how this was to be funded in future before this change was made. However, the increased modelling assumption of 3.5% inflation on rents compared to 2.3% for spending makes the debt settlement much higher than it would otherwise have been. The net receipt to government is now very substantial and the level of debt on council housing will be higher than the equivalent debt on Registered Social Landlords. In effect, Councils will have to be more efficient than their counterparts in social housing in order to sustain their housing into the future. Derby City Council and Derby Homes welcome this challenge and look forward to implementing the imminent changes. We hope that the issues raised in this response can be considered and acted upon by the government.

Response to CIPFA consultation on proposed capital finance arrangements under the new housing finance system.

Derby City Council and Derby Homes continue to welcome the move to self financing for Council housing from 2012/13. The issues raised in this response are of a generally technical nature and do not undermine the fundamentals of the current government proposals which continue to be generally welcomed, although there is a fundamental accounting issue with the treatment of right to buy sales on which we would welcome further advice and clarification.

Depreciation

Unlike in the current system, where depreciation is effectively reversed and replaced with a minimum revenue provision of nil and a Major repairs allowance focussed on major repairs costs, the new system will impose depreciation as a real cost to the operating account. It is therefore crucial that the calculation is reasonable. In effect, the change to recent advice from CLG on valuations for HRA purposes which reduces the nominal value considerably will help to bring the different means of valuing HRA stock more closely together. Currently, the 50% open market value adjustment for EUVSH means that the real value is overstated considerably. When Tenanted Market Value calculations – based on the price that a business could be bought out for on a sustainable basis – or the calculations used as the basis of HRA reform, or measures based on current sales values less discount less 75% pooling are used, these all result in hugely lower figures than 50% of market value.

As a result, the likely opening figures for depreciation will be much lower than is currently charged. This is welcome as it would avoid having an immediate problem with impairment if a lower value was suggested at a later date. In effect, the government is suggesting both a value for the business in its debt settlement figures, and also a level of uplifted MRA which can be used as a reasonable guide as to the likely level of need in future – and that this ought to be fairly closely aligned with the value of depreciation calculated and charged to the HRA.

In effect, depreciation will be a real charge and should enable HRAs to fund future major repairs properly. This is all to be welcomed.

The main issues appear to be around impairment, right to buys and the ‘non componentised’ elements of the depreciation charge.

Should there be a further major impairment of values – there was one in 2008/09 relating to reduction in open market values and there is likely to be another in 2010/11 as a result of updated advice from CLG (34% OMV for east midlands for example). These are in effect reversed in current accounting arrangements. In future, a further significant charge to revenue as a result of impairment would be a concern. If there is a means of avoiding such an outcome, it should be considered.

On right to buys, it is of concern that on sale of a property, the income to the Council will be only 25% of the net receipt. If the depreciated value of the property is to be written out of assets, how is this to be financed? It would have to be funded from the receipt in normal business – or there would be losses on disposal should the receipt prove inadequate. The knock on effect, though, will be that the vast majority of receipts outside the South East will be inadequate to both cover debt and release funds to support the Council's overall capital programme as currently happens. In effect, outside of the South East the impact will be to reduce funding for other capital – for instance in Derby this funding is used to support the private sector Disabled Facilities Grant. If this funding is no longer available there would be a reduction in the spend undertaken in that area resulting in a reduction in service. The alternative would be that this funding leaks from the HRA and the HRA is then faced with a loss on each sale. Should losses increase above the level assumed, there would be a huge problem for the HRA – the business plan could become unsustainable. It would be much clearer to have normal business and accounting principles apply – as they do for the rest of the proposals – leaving a higher debt with authorities initially and apply proper accounting practice on sales. As things stand, it is hard to understand how a sale is to be formally treated in the accounts. On technical grounds alone it should be suggested that we proper accounting for sales would imply that sale receipts have to be applied to setting aside funds for the reduction of debt on disposal. This would comply more fully with IFRS and place the business plan on a better basis by increasing the debt by the amount assumed, but leaving receipts with local authorities as they fall. If in future, RTB receipts took off to a material degree above the projected level, the government would be able to re-open the settlement.

An alternative might be to at least cover both the debt per dwelling left in the HRA at that time, secondly 25% of the net receipt for the Local Authority to maintain current capital investment levels and freedoms, with the balance preferably reinvested in new stock or if necessary returned to the government for pooling. Should the latter be adopted, it might amount to about 50% of sales rather than 75% in the current proposals, but crucially it would allow debt repayment to be the first call on the receipts enabling the business plan to remain sustainable. The lower value of future receipts could be added back to the overall debt in the settlement if necessary - this would reduce the national debt as well. The government should consider this matter further in order to maintain a viable business planning and accounting environment. Without this change, the HRA is left in a strange accounting position where losses will hit the income and expenditure account in the future as each sale is made, resulting in an unpredictable planning environment and a difficult to sustain plan. If the plans could be amended in line with the remainder of the proposals which make sense in both management and accounting terms, this would help to support the long term planning principles of the reform which underpin the whole idea.

It is proposed that the following is adopted:

1. **That all right to buy receipts are retained by the Council with 25% able to be spent on any purpose**. If this is not possible, then
2. The government should require that the first call on the net receipt from right to buy will be the repayment of the average debt per dwelling in the HRA, then 25% of the net receipt will be retained by the local authority for capital purposes, and finally any balance is applied to the HRA – or if necessary pooled. An appropriate adjustment would be made to the final settlement to reflect this change.

Whilst not specifically an accounting issue, without this policy change, accounting difficulties will arise in dealing with the issue in future.

Non Componentised depreciation

The other comment offered is that the 'non-componentised' depreciation charge is really the difference between the value of the home (EUVSH) and the componentised depreciation charge which is the actual charge needed to maintain the home to the standard required in the long term – which should hopefully be similar to the uplifted MRA under the settlement. As a result, the non-componentised depreciation is really unnecessary as a compulsory charge to the revenue account, and realistically largely represents the value of land rather than depreciation of value per se. It is suggested therefore that it could be treated as a proxy for the land value – unless there is better evidence to the contrary – and not depreciated. This would prevent 'unnecessary' charges to the revenue account, and slightly more freedom in the application of funds than would otherwise be the case. This issue has been reduced in scale by the recent reductions in recommended EUVSH values compared to the open market, but could increase markedly in the future should the value of EUVSH be increased as a proportion of market value in future, or if market values markedly increase. Should these occur, a higher non componentised depreciation charge would be required which could only be applied to capital or the reduction of debt. In some cases this may not be the best use of those funds, and reductions elsewhere may be required just to set cash aside for this purpose. In our case the issue appears not to be big at this stage – it is the principle that is being queried.

It is proposed that in effect non componentised depreciation should be treated in effect as land value and not depreciated.

Debt Treatment

The proposal to split debts from 2012 onwards is generally welcomed as it will clarify the position and help with transparency. There appears to be a slight contradiction perhaps between the illustrated position which allocates fixed debt to the HRA and leaves the unallocated debt with the general fund and the current position which effectively splits the unallocated debt between the two as well. In effect, the HRA is getting all fixed debt initially – which may be beneficial to the general fund in the very short term but may work negatively in the longer term. It is suggested that it should be possible to allocate either all fixed debt, or the equivalent fixed debt and unallocated debt as at the end of 2011/12, should this approach be preferred locally. Another approach could be to allocate a notional variable rate debt between the HRA and GF for the relevant share of underborrowing relating to the HRA. Such a notional debt would carry interest based on the PWLB variable rate debt in place at the time.

These decisions would be corporate ones for the relevant Council. The decision should be demonstrably fair to both the HRA and general fund in allocating costs and risks between them. The proposed approach of two pools of debt is supported as the best way in which to manage two debt portfolios which could be materially different in terms of management.

In terms of the approach to the transition it may be that Councils may wish to undertake significant borrowing either slightly in advance or arrears of the actual date of 1st April – and on practical grounds it may be wise to allow Councils a period in which to pay to spread the administrative burden on the PWLB.