MEDWAY COUNCIL
HOUSING REVENUE ACCOUNT BUSINESS PLAN 2020/21:
UPDATED REVIEW ON PROJECTIONS & CAPACITY

Introduction

This revisit of the plan comes after the last review of the plan undertaken in June 2020 taking into account the latest forecasts, assumptions and stock investment requirements.

The model is launched from April 2020 (2020.21 financial year) and runs for 30 years to March 2050. The first year of the plan is balanced exactly to the revised HRA Revenue Budget for 2020.21 based on the Round 2 and the HRA Capital Programme for 2020.21.

For 2021.22 the HRA Revenue Budget reflects the initial budget process for next financial year. Assumptions have been made about the following "big picture" factors, all of which fundamentally affect the level of viability and sustainability of the plan. These are:

- The loss of properties through the Right to Buy
- The investment into the Development Phase 4, a total investment in 23 new homes and the acquisition of 26 units in Ingram Road
- The latest capital investment requirements which total £197.2million (£153.8million without inflation and adjustment for stock losses and gains) on its existing properties
- Repayment of loans through an MRP mechanism, based on revised annuity values.

In terms of government policy, the plan allows for the latest social rent policy of four years of CPI+1% rent increases. Our modelling then works on the basis of CPI only after this basis, which is a prudent assumption.

Overall headlines – Baseline Position

In overall terms, the plan is able to be fully funded over the 30-year term, generating revenue surpluses in the HRA totalling **£44.4million**, and a closing debt balance of **£48.03million**. This compares to an opening HRA balance of £5.1million and debt of £41.3million. The plan, therefore generates the capacity to invest additional sums towards the delivery of new homes and/or improved services.

As part of this review we have modelled a scenario that takes into account the costs of development ensuring that stock numbers grow year on year by a net 1%, for 10 years, after allowing for right to buys and also implementing energy efficiency works.

Key Baseline Assumptions

The following schedule is not exhaustive - however this lists the main assumptions affecting the viability of the plan.

HRA Budget assumptions

The table below shows the revised 2020.21 budgets and proposed budgets for 2021.21 to which the plan is based upon:

	2020.21	2021.22
Dwelling rents	12,896,808	13,232,921
Non-dwelling rents	238,106	208,004
Service charge income	1,118,893	1,314,532
Other income and contributions	15,200	35,525
Total income	**14,269,007**	**14,790,982**
Repairs & maintenance	2,152,967	2,264,616
Management (incl RRT)	4,858,172	4,850,810
Bad debts	50,000	50,000
Depreciation	3,850,000	3,608,085
Debt management	63,364	63,364
Total costs	**10,974,503**	**10,836,875**
Net income from services	**3,294,504**	**3,954,107**
Interest payable	(1,746,602)	(1,885,569)
Interest income	69,000	600
Net income/expenditure before appropriations	**1,616,902**	**2,069,138**
Set aside for debt repayment	(339,869)	(410,434)
Revenue contributions to capital	(960,202)	(2,251,276)
Allocation to/from other reserves	0	0
Other appropriations	0	0
Net HRA Surplus/(Deficit)	**316,831**	**(592,572)**
HRA Balance brought forward	**5,144,944**	**5,461,775**
HRA surplus/deficit	316,831	(592,572)
Use of Balances for Acquistion of Property	0	0
HRA Balance carried forward	**5,461,775**	**4,869,203**

The revenue contributions to capital allow for additional use of reserves to cover expenditure for acquisitions in 2020.21.

1. The model is launched with opening properties of 3,002 with right to buy sales adjusted to reflect the 12 projected in 2020.21, then 15 per annum for 4 years then reducing by 1 every five years throughout the plan – total loss 371 properties over the 30 years of the plan. Stock additions total 26 for Ingram Road and a further 28 in 2021.22 as part of Phase 4 of new development.
2. Net stock loss over the term is therefore 10%, though at this stage the model does not assume a reduction in base costs for management, repair costs for these losses (only capital works).
3. Average stock rents are £83.09/week at April 2020, increasing by 1.5% in April 2021, and then increasing by CPI+1% to 2024 following by CPI only for the remainder of the plan.
4. Long-term void rates are 0.5% and bad debt provision of £50,000 is included within the management costs equivalent to 0.4% of net rental income.

5. The forecast management costs for 2020.21 are used as a basis for forecasting forward, at CPI only, which matches long-term future rent increases. Service charges and other income increase with inflation only.
6. Repairs expenditure is not reduced in line with net reducing stock levels as a prudent assumption and is inflated at 0.5% above CPI for 5 years and then 0.25% above CPI beyond this for the duration of the plan. The current repairs contract protects the council from increases above 4%. Due to the reduction of planned painting programme in 2019.20 we have reinstated an annual provision for this of £200,000 in 2022.23.
7. The stock condition survey-based capital maintenance expenditure into the existing stock is based on outputs from the Codeman database, which is continually updated. The required levels of works are summarised below and are without any inflation or uplift allowances.

Category	Backlog	2020.21	2021.22	2022.23	2023.24	2024.25	Yrs 6-10	Yrs 11-15	Yrs 16-20	Yrs 21-25	Yrs 26-30	TOTAL
Cost of Low Priority Works	£3,285,196	£949,280	£874,691	£1,321,586	£787,527	£1,112,241	£3,327,331	£2,110,512	£1,292,770	£1,825,872	£2,981,540	**£19,868,546**
Cost of Medium Priority Works	£2,876,744	£2,562,401	£1,813,634	£2,066,157	£1,522,068	£1,733,945	£4,133,679	£2,734,657	£2,634,045	£1,937,469	£2,625,644	**£26,640,443**
Cost of High Priority Works	£1,268,435	£2,630,660	£2,173,425	£2,514,085	£2,343,611	£3,263,824	£16,255,556	£16,500,263	£12,455,699	£13,237,001	£13,707,655	**£86,350,214**
Contingency		£200,000	£200,000	£200,000	£200,000	£200,000	£1,000,000	£1,000,000	£1,000,000	£1,000,000	£1,000,000	**£6,000,000**
Fees	£928,797	£557,099	£557,719	£687,686	£531,651	£713,751	£2,714,571	£2,418,137	£1,797,814	£1,875,000	£2,164,355	**£14,946,579**
Total	**£8,359,172**	**£6,899,440**	**£5,619,469**	**£6,789,514**	**£5,384,857**	**£7,023,761**	**£27,431,137**	**£24,763,569**	**£19,180,328**	**£19,875,342**	**£22,479,194**	**£153,805,782**

8. For 2020.21 and 2021.22 we have matched the actual and provisional capital expenditure and funding for both investment in existing stock and new developments.

	2020.21	**2021.22**
Capital Programme (existing stock)	£5.638m	£5.963m
Purchases of New Stock	£5.355m	£4.645m
Acquisitions	£0.175m	£0.344m
New Developments (Phase 4)	£1.121m	££6.029m
Total	**£12.289m**	**£16.981m**

9. Shortfalls between expenditure in the table in note 7 above are factored into 2022.23 capital expenditure in the plan for a five-year period.
10. Given that gross stock losses are estimated at 7.5% the investment costs have been adjusted to reflect stock losses by a 50% variable factor, which provides a small level of contingency.
11. Total investment into existing stock is £197.2m throughout the plan (£153.8million at current prices) and equates to £51.2k per unit over 30 years. This is based on all categories of work (including the three levels of priority) to establish the base position for the model and test its viability in order meet these investment needs.
12. Depreciation to finance existing stock improvements is charged to the HRA at an equivalent £1,282 per unit, which is adjusted for inflation on a unit-cost basis throughout the plan.
13. Rent income from the development is included, with a standard range of costs added to existing management, repair and investment budgets. Development and acquisition expenditure is 30% funded, where possible, via retained '1-4-1' receipts for which the council has sufficient balances of.
14. Core CPI inflation is 2.0% pa in line with government forecasts. The only real inflation drivers to differ from the CPI baseline in the business plan relate to rent income (1% real terms increase for 4 years).
15. The average interest rate applied to the HRA debt level is c4% throughout. Any new borrowing as identified in the charts below is likely to be at c2-3%, therefore offering the potential for the overall interest rate to reduce. The average earned interest rate on credit balances is assumed to average 0.1% on all revenue balances then slowly rising to 1%
16. In line with previous iterations, the business plan does make provision for the part-repayment of loans as part of an MRP mechanism. The values have been calculated on annuity values provided by officers. It should be recognised that there is no statutory requirement for the repayment of debt, but given the 'one-pool' nature of the council's treasury management for both the HRA and General Fund, there may be need to revisit this if future borrowing is required.

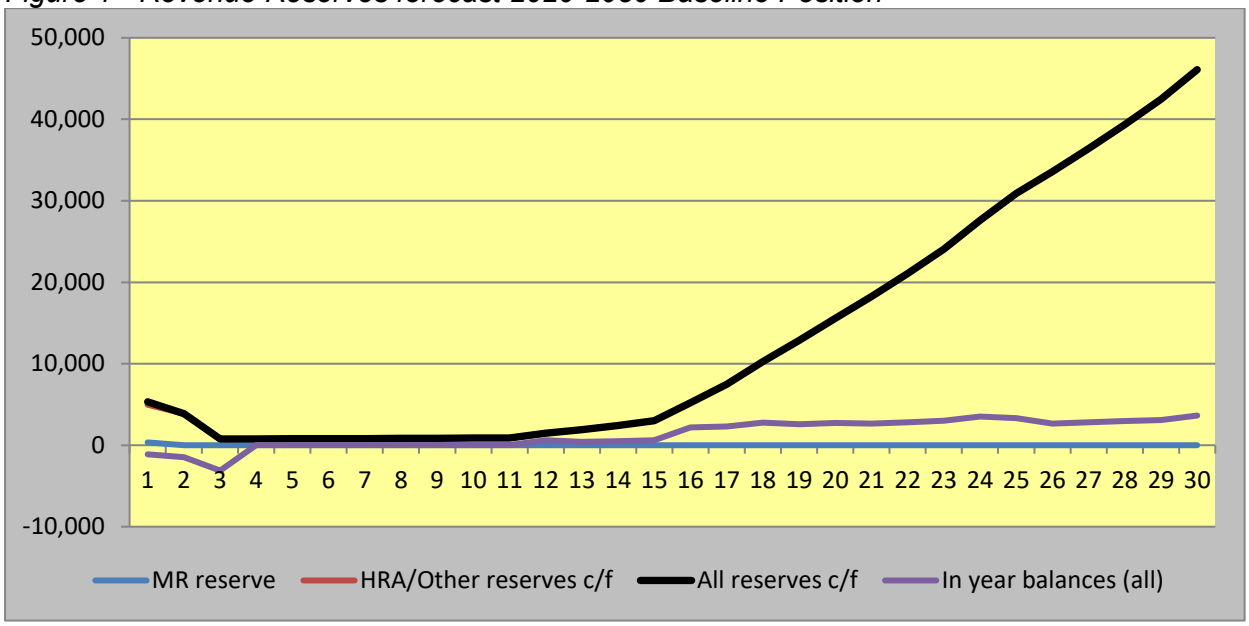
In summary, the assumptions made within the business plan are prudent without being excessively restrictive.

The Baseline Summary Outputs

The charts below summarise the forecast:

- Revenue reserves forecast over 30 years
- Capital programme forecast over 30 years
- HRA Debt forecast over 30 years.

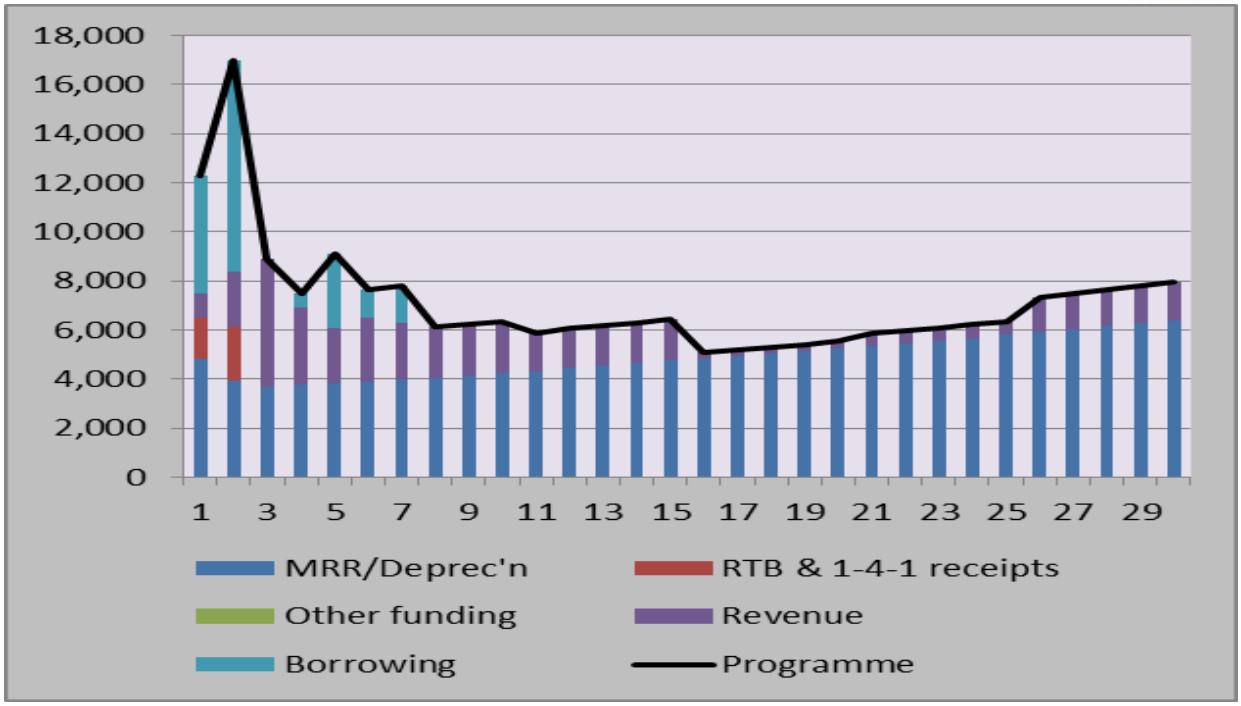
Figure 1 - Revenue Reserves forecast 2020-2050 Baseline Position



The main outputs from the revenue forecast are as follows.

1. There is a call on revenue reserves in the very early years - this is to assist the financing of the stock investment in existing stock and backlog of £8.4million. The HRA does not go below the pre-set minimum balance of £0.750million (inflated on an annual basis) in any year of the plan. The overall trajectory of revenue reserves is however upwards towards the end of the 30-year term. Revenue reserves are part-called on to repay loans through the MRP mechanism, but this could be revisited to increase the level of debt repaid thus reducing revenue balances but also the level of debt at the end of the plan.
2. The Major Repairs Reserve is fully utilised in the early years of the plan to assist in the funding of the Codeman in-year works and backlog repairs; thereafter the trajectory (blue line) is upwards suggesting that long-term investment costs are able to be covered more than fully until later in the plan.
3. The overall level of reserves (black line) is positive at the end of term highlighting that the plan generates sufficient revenue to meet all its obligations (but could not fully repay the full value of the HRA debt outstanding if the council so wished).

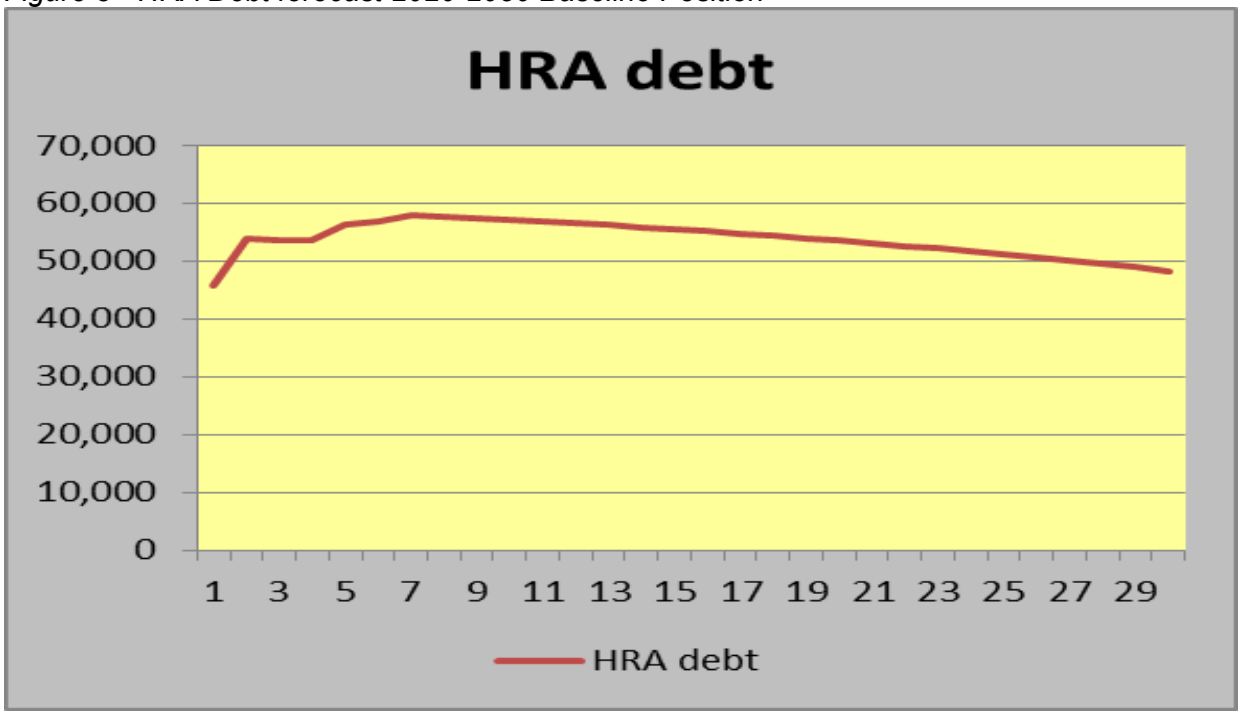
Figure 2 - Capital expenditure and financing forecast 2020-2050 Baseline Position



The capital forecast is fully financed as follows.

1. The total programme over 30 years is £197.2million (at outturn prices - which is £153.8million at today's prices), excluding the £17.7million budgeted for development and acquisition programme.
2. Between years 1 and 7 borrowing is required to cover the backlog of investment in the stock identified in section 7 above and development phase 4.

Figure 3 - HRA Debt forecast 2020-2050 Baseline Position



In summary, the debt forecast highlights the following.

1. Following a short to medium period in which borrowing is drawn to assist in financing the stock investment programme, loan repayments are scheduled based on the annuity calculations.
2. There are alternative approaches to the repayment of loan balances based on the treasury management position for the council. An alternative plan, such as increasing the annuity payments would affect the level of reserves, debt and funding/investment profile within the plan.
3. However, the plan provides for the repayment of c£12.8million of debt balances, set against borrowing of £19.7million during the term which is in addition to the generation of c£44million of revenue reserves. Taken together, this presents a positive position in that 92% of debt balances can potentially be covered (or repaid) over the duration of the plan, allowing for the HRA minimum balance requirement.

Impact of Growth to the Plan

Officers wish to assess the impact to the baseline position of a net growth of 1% of stock over a 10-year period.

This is results in a total of 253 units delivered from 2022.23 to 2030.31, in addition to the 28 properties within phase 4 and 26 properties acquired in Inghram Road, with expenditure split 50:50 where appropriate over the prior and year of delivery. The key assumptions are as follows:

Year	Scheme	Properties	Cost
2022.23 - 2030.31	Unidentified Sites	253	£63.25m*

*Note * Inflation excluded*

Subsidy by way of 1-4-1 receipts, assumed at 30% of development cost.
New Borrowing based on an adjusted interest rate of 2%
Rents: Based at affordable rent levels.
Operational Costs (per unit): Management £0, Service Costs £473 (flats only), Repairs £680 and Life-Cycle Costs £1,000 (year 11 onwards)

The key impacts are as follows:

Figure 4 - Revenue Reserves forecast 2020-2050 1% Net Growth in Properties (11 Years)

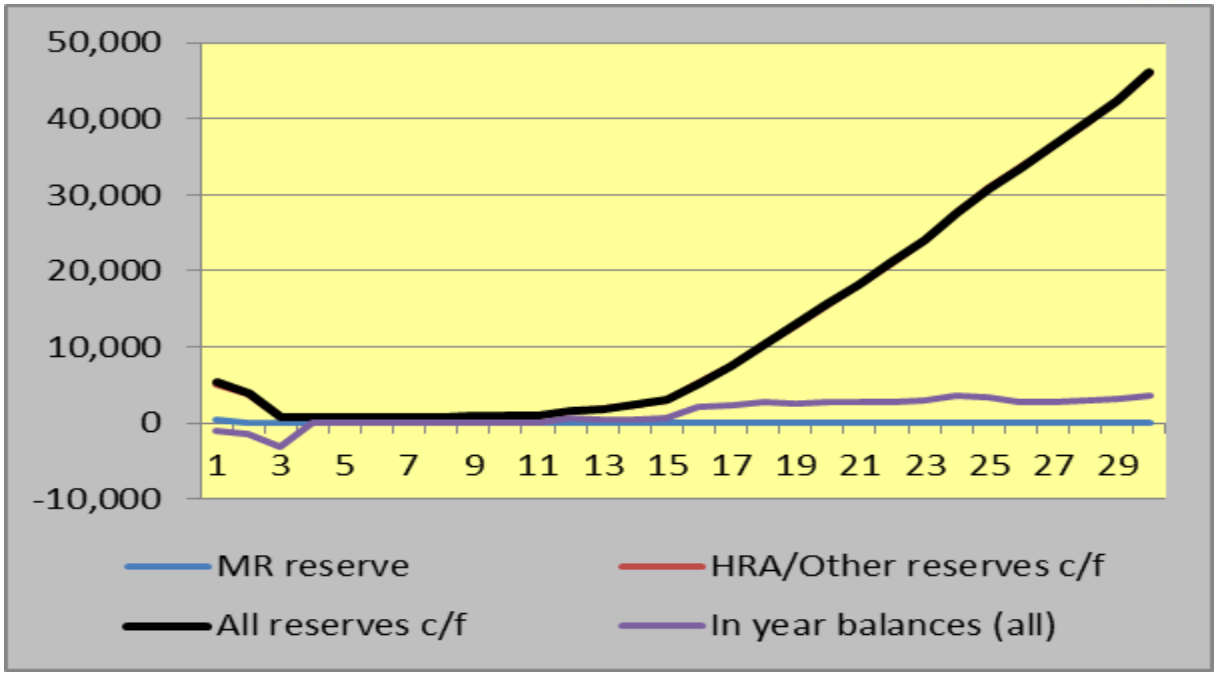


Figure 5 - HRA Debt forecast 2020-2050 1% Net Growth in Properties (11 Years)

In summary, HRA reserves balances increase on account of the net rental income and lower overall interest costs by £1.7million (£46.1million to £44.4million). However, the additional borrowing required increases the closing debt by £17.9million to £65.9million. The debt reduction in the above chart has replaced the annuity repayment mechanism with a straight 2% MRP approach.

Therefore, there is an overall combined negative net impact of £16.2million to the plan when combining both the revenue and debt position.

Impact of De-Carbonising the Stock to the Plan

The recent Social Housing White Paper reiterated the focus on climate change and along with the Council declaring a climate emergency we have modelled the potential impact for improving the energy efficiency of the current stock.

Drawing upon our national modelling for the Local Government Association we have assumed an average cost of £20,000 per property based on a programme spread over a 10-year period commencing 2022.23.

We have assumed no form of Government subsidy for these works.

Figure 6 - Revenue Reserves forecast 2020-2050 with Energy Efficiency Works

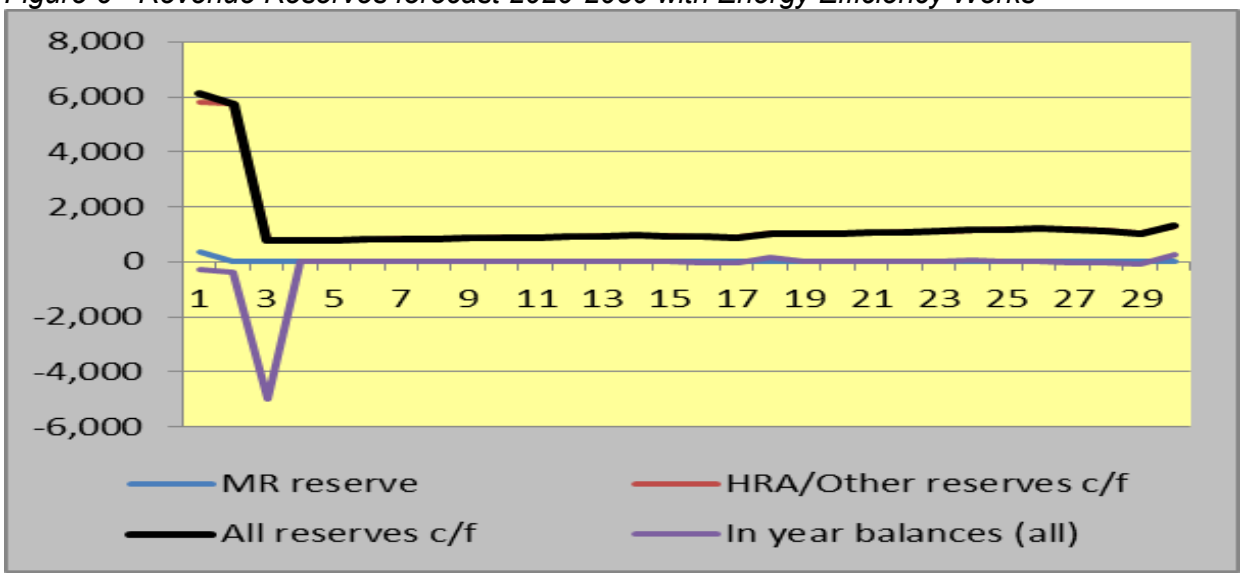
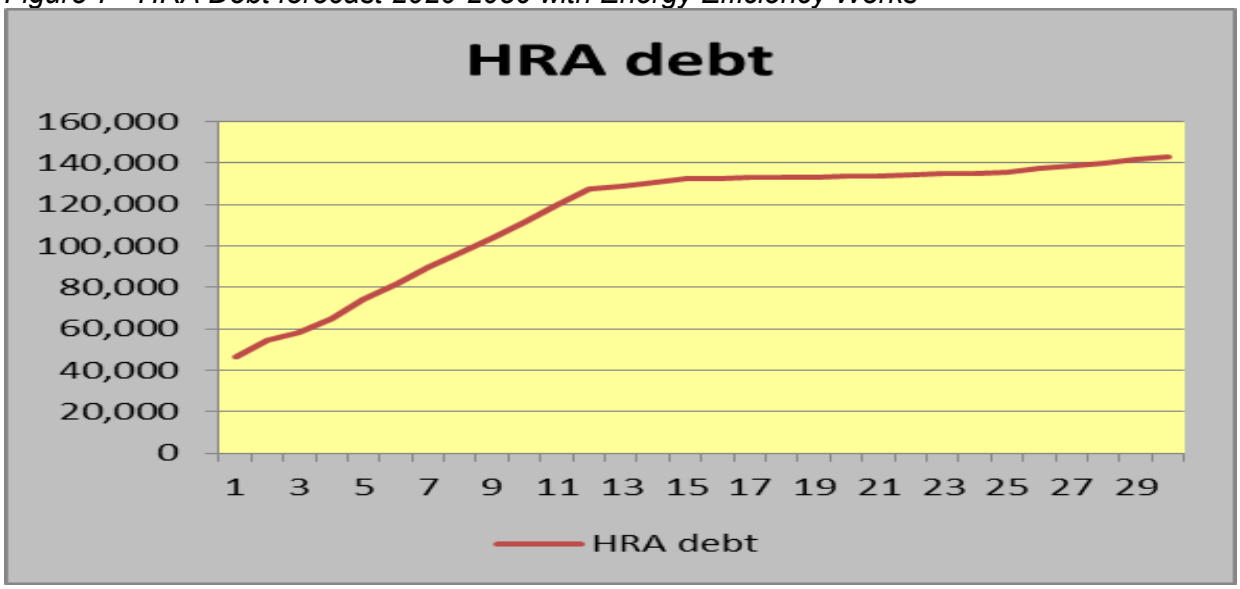


Figure 7 - HRA Debt forecast 2020-2050 with Energy Efficiency Works



The inclusion of these works has a significant impact to the plan. We have modelled that no MRP is made to reduce debt in order to maximise the revenue position. In addition, we have followed the same principles in the stock growth scenario where new borrowing is factored in at 2%.

Debt balances increase on account on meeting the costs of energy efficiency but also maintaining the capital programme for existing stock.

In order to mitigate this it is possible that some form of subsidy may be made available and that the Council could consider reducing its investment of all priority categories for existing stock as per section 7. Furthermore, more modelling could be undertaken in terms of the interest rate for borrowing.

Capacity Analysis

The HRA debt cap represented an artificial constraint on borrowing set outside the HRA and linked to future income and cost assumptions which were made in 2012. The housing and financial policy environment has moved on considerably since then, however the only change in the debt cap that has been implemented was for a small minority of authorities that opted to bid for an increase in 2014.15.

The proposition within this analysis is that, whilst there is theoretically now no limit to borrowing within the HRA, the existing asset and operating base generates a net income stream that does offer a logical limit on sustainable borrowing levels. In setting out its investment strategy, the council therefore needs to consider how it will take decisions on whether to invest, how to fund, the extent of new borrowing, and determine a framework within which decisions will be taken for the business plan overall, within the medium term financial strategy and within successive budget rounds.

This report applies some metrics developed in the light of the experience of 40 years' of successful private finance of housing associations, during which associations have developed hundreds of thousands of new affordable homes, without a single association ever going into default with any of its lenders.

This is not the only approach that can be utilised, for example the council will have an established approach to the setting of Prudential Indicators in the General Fund which it might wish to consider in the HRA context. However, as will be seen, looking at tried and tested principles from a privately financed sector in the HRA context provides a powerful and persuasive evidence base for a significant increase in funding for new HRA developments. Housing associations have traditionally been funded from long-term bank lending from the High Street banks and Building Societies. There is over £55billion of debt on HA balance sheets. Bank lending has been built on lending covenants which have become established in the marketplace and associated with the delivery of cheap debt. Whilst local authority borrowing is not directly secured on its asset base, the covenant approach provides a key insight into the viability and sustainability of borrowing as viewed by private lenders.

We have identified three covenants/ratios or metrics which we consider potentially relevant in the HRA context, set out below.

Interest Cover Ratio (ICR)

This is the ratio of operating surplus divided by interest costs, and represents the cover that the HRA has against its interest cost liabilities in any year; the ICR is set to a minimum which provides comfort that if there were a sudden drop in income or increase in operating costs, there would be sufficient headroom to continue to cover debt interest. For housing associations, the usual definition of operating surplus is EBITDA (Earnings before Interest, Tax, Depreciation and Appropriations). The average ICR for the HA sector in 2018.19 was around 1.8; typical lending covenants vary between 1.10 and 1.50 depending on the size and nature of the HA, with 1.25 being a typical expectation.

For the HRA, this is best defined as:

- Turnover (dwelling rents, other rents, service charges, contributions)
- Less
- Operating Costs (general management, special management, other management, repairs & maintenance, major repairs)

For housing associations, depreciation is not a cash transaction. In the HRA, because of the treatment of depreciation as a cash transfer to the MRR plus or minus an adjustment to reflect actual transfers to MRR, it is essential to include the net amount transferred to MRR in the calculation. This represents the revenue expenditure on major repairs made legitimately as part of operating costs. Notwithstanding that these are subsequently treated as part of the capital programme, they are funded from revenue and property an operating cost. Whilst transfers to the MRR may not be spent in-year, our experience is that the majority of balances carried in the MRR tend to be from expenditure slippage.

The above definition of ICR works in the HRA context as it determines the revenue surplus before interest, appropriations, and other "below the line" adjustments.

Loan to Value (LTV)

This is an essential tool for private lenders where debt is secured against properties, hence theoretically against their value. The basis for valuation in HAs has been Existing Use Value (Social Housing) - EUV(SH) - for decades with many HAs and lenders now adopting Market Value Subject to Tenancy as a valuation. Typical covenants prescribe 65-70% maximum LTV.

For the HRA, borrowing is not directly secured against the properties. In addition, the EUV(SH) calculation prescribed by government is not cashflow based, but is based on vacant possession values discounted by a regional factor periodically published by the government.

LTV is best defined in the HRA context as Outstanding Debt / Fixed Asset Value. Debt is defined as the HRACFR as this is the amount that must be financed with interest payments in the HRA. Asset values include all assets, dwellings and non-dwellings, as all assets are included in the generation of net income cashflows in the HRA.

Whilst the LTV definition works for the HRA to an extent, the absence of a clear relationship between net rental income and asset values means that the ratio tends to deliver a "low" result, compared to HAs.

Gearing

The gearing ratio aims to capture the extent to which assets are financed through debt. HAs are evolving their practice alongside lenders with many beginning to focus on historic cost of assets as opposed to updated valuations. A higher-geared HA will have a higher proportion of funding of asset acquisition and development through debt (compared to reserves, grant or other resources). Banks see that as essential in ensuring that HAs are not "over-stretched" on their borrowing commitments. Gearing is set to a maximum, with 70% being typical.

There are obvious challenges in the HRA context in considering the use of historic costs for asset acquisition/development and also the extent to which assets have been financed from reserves or capital receipts over many decades. We have therefore proposed a "proxy" for gearing which aims to capture some sense of the development of reserves alongside asset value to provide an extra sense around capacity.

Gearing-proxy is defined in the HRA context as: Debt / (HRA Reserve + Major Repairs Reserve + any other Reserves not earmarked for specific purposes + Fixed Asset Valuations).

This results in a lower %age than LTV but the movement over time captures the growth in reserves and may offer more of a complete picture than LTV.

Others

There are other covenants and ratios that are utilised in the HA context, including in particular Asset Cover (broadly, the inverse of LTV). Lenders and HAs are tending to move away from this towards gearing as a key measure.

Another measure we have used for this analysis is the ratio of Debt to Turnover. This measure the level of turnover in relation to debt, which differs slightly from the ration used for assessing debtor balances against turnover. As a proxy we have suggested a ratio of 5:0, so that turnover can cover the level of debt outstanding by 5 times.

Using the Metrics

The application of each metric to the cashflows and balance sheet within the business plan will result a maximum constraint on borrowing.

In the HRA context, the projected constraint on borrowing will operate separately because of lack of direct dependency between net income streams and asset values and the level of debt. We would expect to see quite different results from each, and the extent to which the measures vary will offer additional insight into the viability and sustainability of new investment within the business plan.

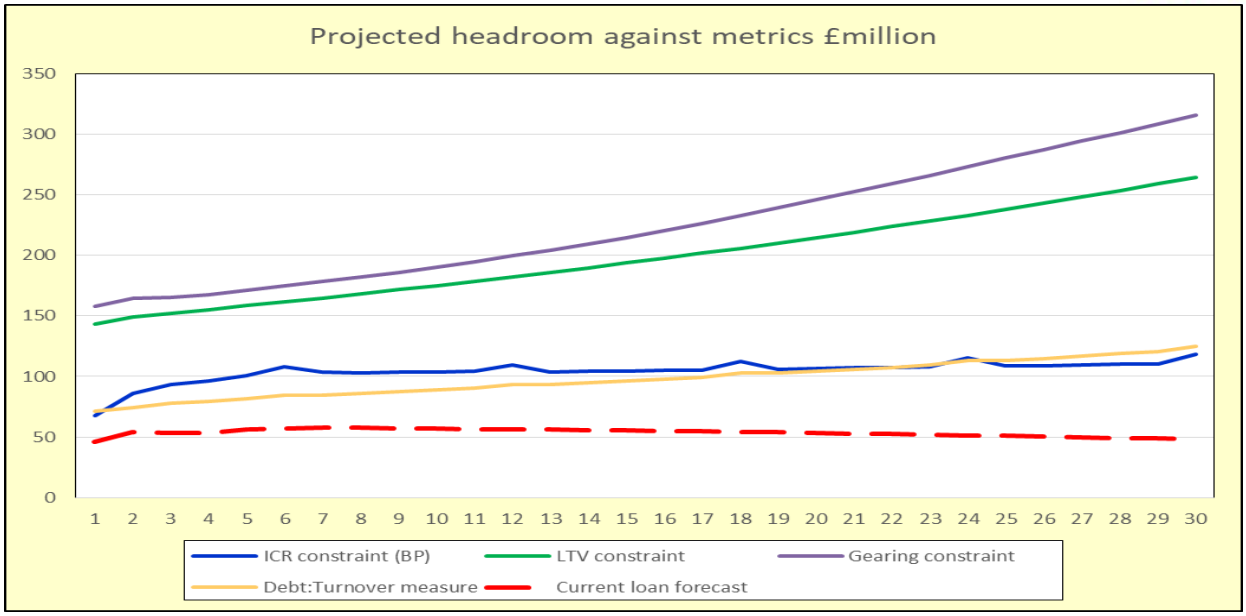
The maximum capacity will result from the lowest outcome from each of the four metrics and each will change over time. A forecast for all four illustrates potential capacity frameworks for Medway, however we have proposed that the key focus might be on the Interest Cover Ratio as this provides the most straightforwardly interpreted and practical measure.

We have taken the outputs from all three of the scenarios derived from the HRA Business Plan model and analysed these for the four metrics.

We have set minimum metrics as follows:

ICR	@ minimum 1.25
LTV	@ maximum 65%
Gearing-proxy	@ maximum 70%
Debt:Turnover	@ maximum 5:0

*Figure 8 - HRA Projected Headroom Using Assumed Metrics with the **Baseline** Position*

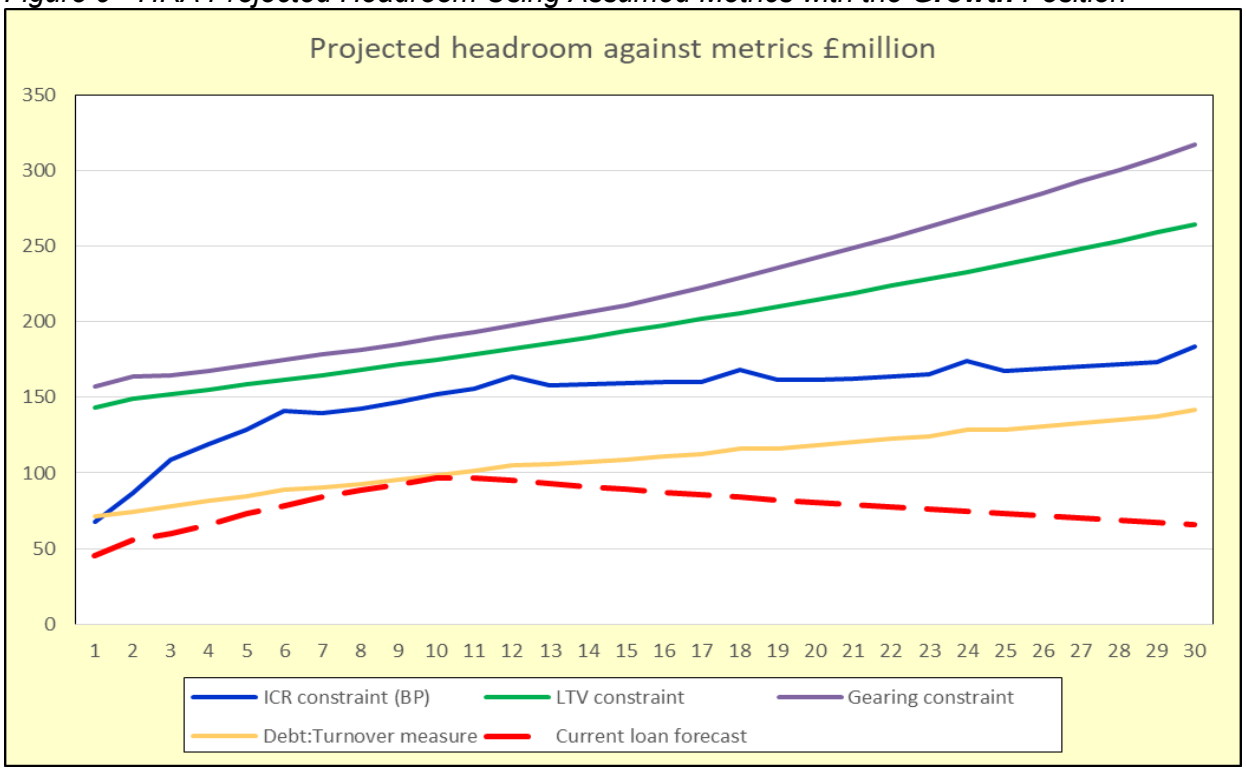


The red (dashed) line shows the projected loan balances without the inclusion of the 253 units, nor energy efficiency works.

This is set against the suggested borrowing headroom from the 4 metrics identified and minimum factors modelled.

Using the lowest borrowing constraint (debt:turnover) the minimum borrowing headroom is potentially £24million in year 3, and then continually increases.

*Figure 9 - HRA Projected Headroom Using Assumed Metrics with the **Growth** Position*



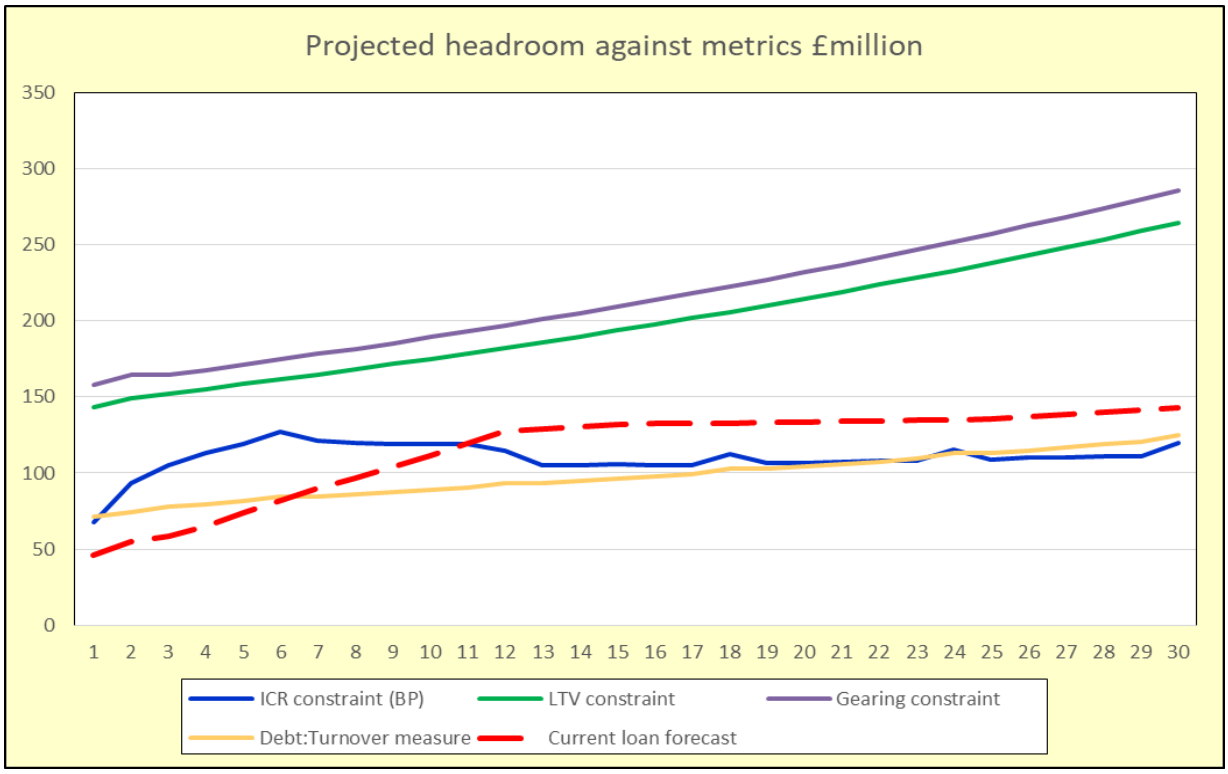
This graph represents the impact of the addition of 253 homes delivering the growth strategy.

The debt levels increase as demonstrated by the red line and virtually all borrowing headroom is utilised if using the debt:turnover metric.

Given that the model reflects the changes in debt levels, interest charges and net rental income there will be differing impacts on each of the suggested borrowing limits.

The baseline graph above shows lower borrowing limits than this with growth but the fact that the borrowing undertaken comes with an income stream to support the borrowing is reflected in the increase in limits.

*Figure 10 - HRA Projected Headroom Using Assumed Metrics with the **Energy Efficiency** Position*



This chart shows the impact of energy efficiency works to the borrowing limits.

Unsurprisingly, given that the borrowing required is not supported with additional income the suggested borrowing limits are exceeded for two of the metrics in the medium to longer-term.

Overall Summary

The briefing has covered the up to date position for the HRA business plan based on latest forecast, assumptions and stock investments needs.

It progresses to show the impact of delivering an additional 253 properties over a 11 year period on an assumed set of assumptions to both the forecast revenue and debt position.

Finally we have provided our opinion as to whether the additional borrowing is deemed sustainable and prudent in terms of a series of suggested metrics. It is important to note that these are suggested and would require reviewing by the council's finance team and in conjunction with Medway's overall borrowing prudential indicators.

Further consideration should be given to impact to the above modelling in respect of the councils aspirations in terms of becoming carbon neutral and the energy efficiency measures and associated investment required within the HRAs existing stock.

Simon Smith
January 2021