REPORT TITLE: HOUSING REVENUE ACCOUNT RISK & VIABILITY

5 MARCH 2020

REPORT OF CABINET MEMBER: CLLR LEARNEY - CABINET MEMBER FOR HOUSING AND ASSET MANAGEMENT

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WARD(S): ALL

PURPOSE

To outline the current New Build development viability assumptions and the impact of current and emerging risks and opportunities on future assumptions. The paper identifies a number of issues to consider when assessing New Build schemes, including benchmarking construction costs. The paper also recommends that the existing 35 year scheme payback test is retained to achieve value for money and enable external funding to be applied for when required.

RECOMMENDATIONS:

1. That the Committee recommends retaining the existing New Build viability tests, including the scheme payback test of 35 years.

2. That the Committee members raise any other comments about the New Build viability tests in preparation for the forthcoming New Build Development Strategy paper.

IMPLICATIONS:

1. COUNCIL PLAN OUTCOME

1.1 The Council Plan 2020 – 2025 includes the priority “Homes for All” focusing on providing more affordable homes for young people and families in the Winchester district and making homes more energy efficient.

2. FINANCIAL IMPLICATIONS

2.1 The level of new homes delivery is dependent on a number of factors, including available funding, rental income levels and the requirement to keep a minimum housing revenue reserve balance of approximately £1.1m. The minimum reserve balance is included within our HRA agreement with MHCLG and can increase by RPI each year. The minimum reserve balance is in place to give some liquidity protection for the HRA. A breach of the minimum reserve balance could lead to an audit qualification in the Council financial statements.

2.2 In October 2018, the Ministry of Housing, Communities & Local Government (MHCLG) lifted the debt cap placed on all local authority housing revenue accounts. This allows unrestricted borrowing from the Public Works Loan Board (PWLB), or alternative sources of borrowing, to the extent that the housing revenue account business plan can afford to pay annual interest costs.

2.3 Increases in rental income are governed by the rent standard 2020 – 2025 issued by MHCLG. Annual increases for social and affordable rent properties are CPI + 1% for the next 5 years from 2020/21 and CPI flat annually thereafter. Rent levels, plus associated service charges, must not exceed local housing allowance (LHA) rates, to ensure the combined weekly charge can be covered by housing benefit and universal credit where applicable.

2.4 The housing revenue account business plan needs to consider long term operational and major repair commitments before assessing the available financial capacity to development additional new build properties.

3. LEGAL AND PROCUREMENT IMPLICATIONS

3.1 The construction element and associated professional costs for all new build developments are subject to the Public Contracts Regulations 2015 (PCR2015) and the Council’s Contract Procedure Rules.

4. WORKFORCE IMPLICATIONS

4.1 The New Build team must be sufficiently resourced to ensure properties can be delivered on time and to the appropriate standard.

5. PROPERTY AND ASSET IMPLICATIONS

5.1 New Build properties must be built to decent homes standard and designed to a high quality.

5.2 Changes to the decent homes standards, specifically relating to fire safety, are likely to be recommended once the final report from the Hackitt review into the Grenfell disaster is published later this year.

5.3 The Council, as a key priority in the Council Plan 2020 – 2025, will consider a number of Carbon Neutrality measures to improve the energy efficiency of existing and new properties. This could potentially result in an increased initial capital outlay to replace and procure more efficient heating systems, with the potential benefit of reduced annual maintenance costs and cheaper energy running costs for residents.

6. CONSULTATION AND COMMUNICATION

6.1 The Council Plan 2020 – 2025 outlines the strategies of reaching Carbon Neutrality in the district by 2030 and the need to build more affordable homes.

6.2 Local residents are consulted on all prospective new build developments that are likely to be seriously considered.

7. ENVIRONMENTAL CONSIDERATIONS

7.1 The New Build team will need to consider Nitrate Neutrality & Carbon Neutral measures on all new developments.

8. EQUALITY IMPACT ASSESSMENT

8.1 None required.

9. DATA PROTECTION IMPACT ASSESSMENT

9.1 None required.

10. RISK MANAGEMENT

10.1 The key risks impact on new build developments are identified below:

Risk	**Mitigation**	**Opportunities**
Property *Inadequate review of land & site issues, potentially leading to ongoing drainage and service issues.*	Site & environmental surveys are carried out prior to the development to assess risk & identify required mitigations.	Ongoing maintenance costs will be kept to a minimum and the life of the property will be maximised.

New Properties are not constructed to the required standard leading to ongoing maintenance and habitation issues.	Properties are designed to a high standard in line with decent homes standard	New properties are energy efficient, cheap to maintain and cheap for residents to run.
Community Support *Local issues are not considered on a New Development leading to potential management and maintenance issues,*	Residents are consulted on New Developments to ensure local issues are considered in the design and construction of new properties.	New properties are designed taking into consideration local factors creating sustainable communities.
Timescales *New Developments are not completed on time leading to delays in handover to new residents and potential cost overruns.*	New Developments are closely managed by the New Build team throughout the construction phase.	Well managed New Developments ensure fewer issues at hand over and ensure properties are constructed to a high standard.
Project capacity *Delivery of a New Development is compromised due to a lack of resource and other delivery priorities*	Sufficient resources are made available to support the New Build programme.	The New Build programme is delivered in line with target providing a steady stream of available properties for new residents.
Financial / VfM *Changes in the economy and lending market leading to increases in interest rates.* *Increases in the cost of construction, resulting from inflation factors and other market issues.* *Unplanned cost increases arising on a new development during the build phase and the 12 month defects period.*	Where loan finance is required any borrowing should be on fixed rate terms to lock in interest rates. Revise business plan projections and change financial viability assumptions for new development schemes Include a contractor retention in the build contract assessed on the level of risk and include contingencies in financial viabilities to potentially cover any overspends.	Ensure other funding sources are utilised to keep borrowing costs to a minimum. Optimise economies of scale by focusing on medium/larger developments and by using standard house types. Holding a contractor retention during and after the completion phase of a development maintains the relationship until the defects period is complete.
Legal *Insufficient protection*	Build contracts include	

against contractor default & negligence.	clauses to protect the Council and clear exit strategies are identified in the case of default.	
Innovation *New properties have limited digital & WIFI capability potentially creating communication difficulties for residents.*	New properties are designed to cater for residents living requirements both currently and into the future.	Residents can make use of digital solutions to keep running costs low. Other solutions may provide the Council with improved data on energy efficiency.
Reputation *Insufficient project control and consultation leading to negative publicity*	Good project control and regular communication with key stakeholders including contractors and residents	If issues arise on a development, potential solutions can be agreed with the support of stakeholders.
Other		

11. SUPPORTING INFORMATION:

11.1 Background

11.2 The Council launched its new build programme in April 2012 with an initial target to develop 300 homes over a 10 year period. Funding for the programme was identified within the HRA Business Plan to be supplemented by any additional Homes England grant or developer contributions from S106 sites.

11.3 In October 2018 the Government lifted the HRA debt cap which previously limited the amount of money Council's could borrow to develop new housing. The Council took the opportunity to review its new homes target and increased the figure to 1,000 homes by 2025. To date the Council has completed 213 new homes and has a further 121 under construction. Approximately, a further 400 homes have been identified for development.

11.4 When the programme commenced in 2012 the national economic context was that we were coming to the end of a major downturn in construction due to the financial crisis of 2008/9. This meant that the Council's early new build schemes comfortably met viability assumptions, this quickly changed and build prices have risen steadily since 2015 (between 8-10% pa). During this period rents for existing Council properties have been reduced at 1% pa and limited for new builds.

11.5 New Build Viability Assumptions

11.6 The initial key development scheme assumption criteria were agreed in 2012/13 when the New Build development programme commenced and were modified following a review by the Informal Policy Group in 2015, see CAB2701 (HSG) Rents.

A summary of the key assumption criteria are as follows:

Achieve a positive Net Present Value (NPV) on all schemes.
Achieve payback on all schemes by year 35.
Total scheme cost to be less than the combined market value for all properties developed on a scheme.
Rent levels to not exceed local housing allowance (LHA) and affordable rents to be set at a guideline of 70% of market rent.

11.7 Since 2015 the assumption criteria have been modified further to reflect annual changes in CPI, changes to the MHCLG rent standard, current interest rate assumptions and a new interest cover assumption.

11.8 The current list of development appraisal assumption criteria are as follows:

Core Assumptions	**Criteria**
Social rent	Based on the target social rent
Affordable rent	70% of market rent level as a target with the option of being no greater than LHA maximum for each housing type.
Shared ownership rent	2.75% of remaining equity owned by the Council
Loan Interest/ Cost of Capital	Appropriate interest rate as agreed by S151 officer based on PWLB fixed rates plus margin; currently 3.30%
Interest Cover	Net operating income to be a minimum of 105% of the annual interest cost
Annual Maintenance	£469 per property
Total scheme cost as a % of combined property market value	Maximum of 95%
Management Costs	Assumed to be zero, as covered by existing housing management resource.

Major works	Equivalent to 0.8% of the development scheme works cost
Major works deferral point	Assumed to commence from Year 6.
Voids & Bad Debts	Combined 2% of annual rental income
Inflationary Assumptions	**Criteria**
Social & Affordable Rent Increases (set in line with the MHCLG Rent Standard)	CPI + 1% (2020/21 – 2025/26) CPI flat thereafter
Baseline CPI	2.00%
Annual Maintenance	2.50% (0.50% above CPI)
Management Costs	2.50% (0.50% above CPI)
Major Repairs	2.50% (0.50% above CPI)

11.9 <u>Development scheme cost criteria</u>

11.10 The New Build team are currently compiling a series of cost benchmark levels to be used as a guideline for future appraisals. These include build cost assumptions, based on cost per square metre, and baseline levels for all professional costs, including design, valuation and planning fees.

11.11 All development appraisals include a contingency of 5% on build costs and associated professional fees.

11.12 <u>Development scheme funding</u>

11.13 A number of funding sources are available, including Right to Buy sales income, Homes England grant, property sales income, S106 receipts and loan funding.

11.14 Under Right to Buy 1-4-1 MHCLG funding allocation rules, 1-4-1 receipts can only be allocated against social rent & affordable schemes. It is also currently not possible to claim Homes England grant on a scheme where 1-4-1 receipts have been allocated. MHCLG issued on consultation on the use of 1-4-1 receipts in August 2018, highlighting a number of potential reforms. These included having the flexibility to use 1-4-1 receipts in conjunction with Homes England grant and other forms of funding and the potential to allocate 1-4-1 receipts against shared ownership schemes. The Council responded to the consultation, supporting the proposals and suggesting further flexibility on the 3 year time limit on the use of 1-4-1 receipts. MHCLG has not yet responded on the consultation outcome.

11.15 Issues to consider

11.16 It would be possible to extend the scheme payback year beyond 35 years, given that it is possible to obtain fixed rate PWLB loans for a period of 50 years and the average lifespan of a property is 60 years.

11.17 If the payback period is increased beyond 35 years, it could have an impact on the HRA revenue position, as in the early years following a new development, annual costs including loan interest and maintenance costs could exceed rental income. This period could be extended if the development cost takes longer to payback. It would be useful to build in an additional viability test on development schemes to measure the first year when revenue is greater than cost.

11.18 There is a risk that by extending the payback period, it could make a poor scheme look viable, as the viability tests potentially become easier to pass. Conversely, by having the payback period too short, a potentially viable scheme may appear unviable.

11.19 Most recent new build schemes have achieved a 35 year payback or better. The suite of viability test encourage project managers to make development schemes cost effective by looking at alternative options. There should be some scope however to support a scheme that does not meet the viability tests where there is a specific priority or Council strategy. An option could be to seek an average 35 year payback across the development programme to cater for schemes that have a longer payback period.

11.20 What level of gearing is acceptable? Gearing is the relationship between property value and the balance of outstanding loans. As at 31 March 2019, the HRA had a housing property market value of approximately £1,277m, with outstanding loans of £157m, giving a gearing percentage of approximately 12%. This is a very comfortable position and it does give some scope to increase the level of borrowing if required. Across the housing sector, gearing levels of up to 50% are not uncommon, although commercial lenders generally place restrictions on the level of gearing to guard against the risk of loan recovery in the event of a property market downturn.

11.21 Build costs are likely to increase as a result of changes in decent homes standards resulting from the Hackitt review into Fire Safety and from Carbon and Nitrate Neutrality measures. MHCLG have not identified specific capital funding for any of these measures but as it could reduce social housing delivery nationally, it is possible that future grant funding could be made available.

11.22 The Council is exploring alternative property construction methods including Passivhaus that will potentially increase build costs in the short term but could reduce ongoing energy maintenance costs

11.23 The New Build team has made use of existing land to develop new properties, including garage sites and the regeneration of existing housing schemes. There are remedial and opportunity costs associated with developing these sites but no land acquisition cost

11.24 The New Build development programme needs to have the flexibility to deliver different sized schemes across the district. As there are economies of scale with larger schemes, small sites may be more expensive to develop, making them financial unviable.

11.25 Social rent is a more affordable option for tenants, but due to the rent level being lower than affordable rent, development schemes have only been financial viable with Homes England grant or other forms of subsidy.

11.26 Rental income is governed by the MHCLG rent standard, with the need to keep rents below LHA levels. Under the latest standard, rents can be increased by CPI + 1% for the next 5 years and by CPI flat thereafter. The LHA cap is also likely to increase from April 2020, potentially allowing rent levels on new affordable rent properties to be increased.

12. <u>Summary</u>

The development of new homes by the Council will face a number of challenges as it strives to meet the 1,000 home target. Development is becoming more complex and costly to reflect current and emerging issues such as,

12.1 Net zero carbon targets

12.2 Nitrates issues

12.3 Build cost inflation (materials and labour)

12.4 Increasing borrowing costs

12.5 Lack of development land

12.6 Changing demand

12.7 Government rent or Universal credit restrictions

12.8 The Council will be reviewing its Housing Development Strategy in June 2020 to address the challenges and opportunities listed above.

13. OTHER OPTIONS CONSIDERED AND REJECTED

13.1 The various options are detailed in the paper and none have been rejected at this stage.

BACKGROUND DOCUMENTS:-

Previous Committee Reports:-

CAB2602 (HSG) Housing Development Strategy 2014/15 – 2018/19

CAB2701 (HSG) Rents - Informal Policy Group Report

CAB3216 HRA Budget Options 2020 – 2021

CAB3214 HRA Budget 2020 - 2021

Other Background Documents:-

None.

APPENDICES:

None.