Economy and Enterprise Overview and Scrutiny Committee

28 September 2011

Stock Options Appraisal Project – Process and Resource Requirements

Report of Ian Thompson, Corporate Director, Regeneration and Economic Development
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Purpose of the Report

1 To advise Overview and Scrutiny Committee of potential options for the future financing, ownership and management of the council's housing stock; and to seek the Committee's views on their preferred option or mix of options.

Background

2 On the 29 June 2010 Durham County Council's Cabinet received a report entitled "Response to the Government's Proposals for the Dismantling of the Housing Revenue Account (HRA) Subsidy System". The report set out Durham County Council's response to the government's proposals to reform the existing HRA subsidy system and introduce a system of self financing from 1 April 2012. The government proposes to allow councils to leave the national housing subsidy system in return for a one off debt settlement. Once out of the system councils will be able to keep all of their rental income to subsidise improvements to their stock and housing regeneration programmes. The authority must also service the portion of debt allocated to them by the government but can not borrow privately above the debt cap.

3 Cabinet considered the viability of the government's reform proposals within the context of projected levels of investment required by the housing stock over the next thirty years. Cabinet concluded that to access the level of resources required to maintain the stock to the decent homes standard and to safeguard the improvement of neighbourhoods and services in the future, an appraisal of the options available for the financing; management and ownership of the housing stock must be undertaken.

4 This report sets out:

- The stock option appraisal's project objectives;
- The findings of a recently completed stock condition survey that provides an indication of the investment requirements of the housing stock;
- The process that has been followed to formulate potential options;
- Potential options for the future financing, ownership and management of the council's housing stock;
- Proposals for consultation with stakeholders including key questions for Overview and Scrutiny Committee;
- Conclusion; and
- Recommendations.

Stock Option Appraisal: Project Objectives

5 The stock option appraisal project began in October 2010. Consultation and partnership working with key stakeholders (including customers, staff, Councillors, Board members and other key partners) began immediately.

6 One of the first achievements of the project was the development of a set of eight objectives to guide the outcomes of the project. The objectives have been consulted on with customers to prioritise their importance. The objectives are (listed in priority order):

1. Bringing long term funding to support the improvement and repair of high quality, affordable homes;
2. Protecting tenant's rights;
3. Delivering a good return of new social housing;
4. Meeting regeneration needs;
5. Achieving comparable quality between council owned homes and those of housing associations
6. Improving communication between the owning organisation and customers;
7. Local presence and management of housing services; and
8. Strengthening customer involvement in services.

Stock Investment Requirements

7 Durham County Council is landlord for around 19,000 homes across County Durham. Around 13,000 of these units are managed by Arms Length Management Organisations (ALMOs) - organisations established by the local authority to manage and improve its housing stock to meet the decent homes standard.

This includes East Durham Homes (8500 homes) and Dale & Valley Homes (4300 homes). The remaining 6100 homes are managed by Durham City Homes, the council's in house management organisation.

8 Investment in the housing stock is the single largest area of expenditure in the council's HRA business plan and so accurate, up to date data on stock composition, condition and costs of renovation and improvement work is essential to complete an informed stock option appraisal.

9 In December 2010 the council appointed Savills Commercial Ltd to undertake a condition survey of a representative sample of the housing stock. Savills were also asked to provide the council with the necessary warranties in the event that a stock transfer is chosen as the preferred option.

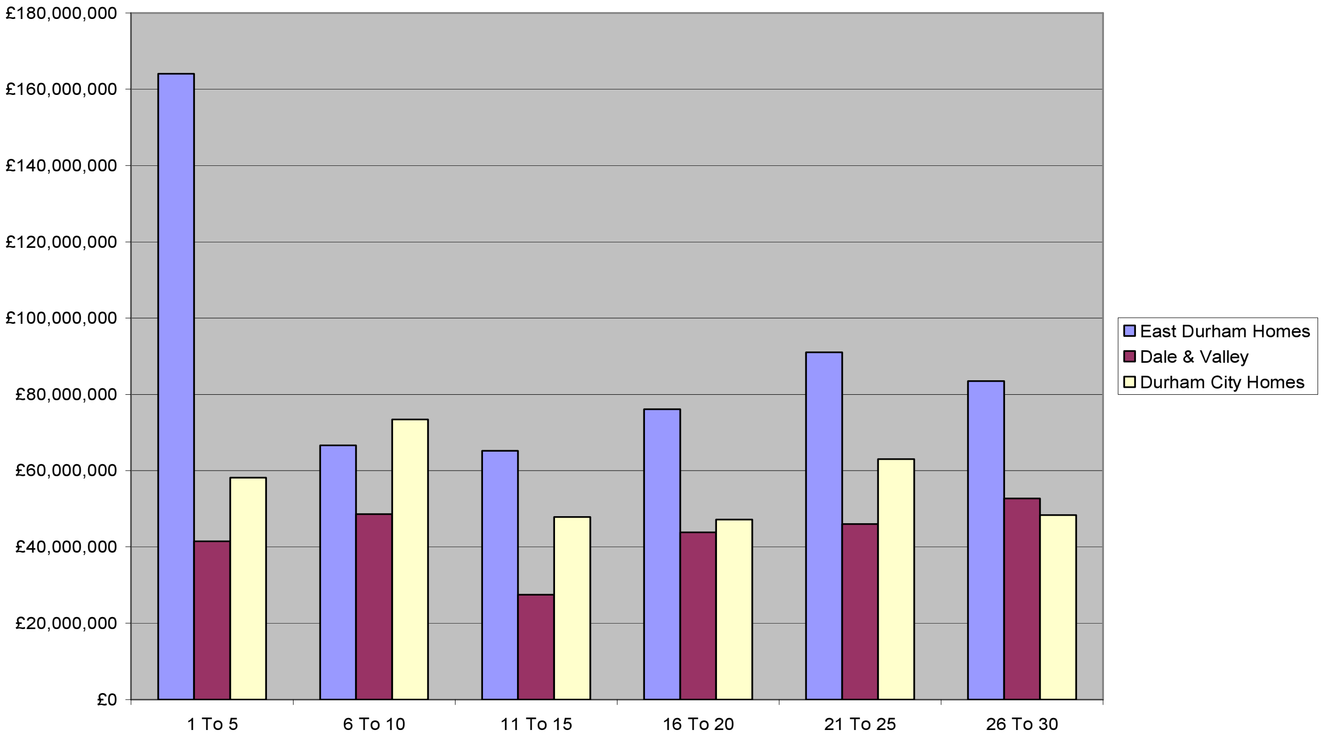
10 Savills validated the stock information already held by East Durham Homes. The council and East Durham Homes judged that because East Durham Homes already holds a substantial amount of stock condition data it was not value for money to produce new survey data for East Durham Homes.

11 The collation of stock condition data and the development of a set of investment profiles were completed at the end of March 2011. Investment profiles include elements of work that are in addition to the decent homes programme. The profiles also refer to work that the council must undertake to keep homes in a good and sustainable condition.

12 The stock condition survey found that the council's housing stock requires around £797M of investment over the next thirty years. This is roughly equivalent to £40,000 per property.

13 In January 2011 the council was awarded almost £70M of backlog funding to invest in the completion of the decent homes programme in East Durham and in Wear Valley. The stock condition survey found that once this funding is invested the need for renewals and maintenance becomes broadly consistent across the three provider areas. This is represented in the following chart:

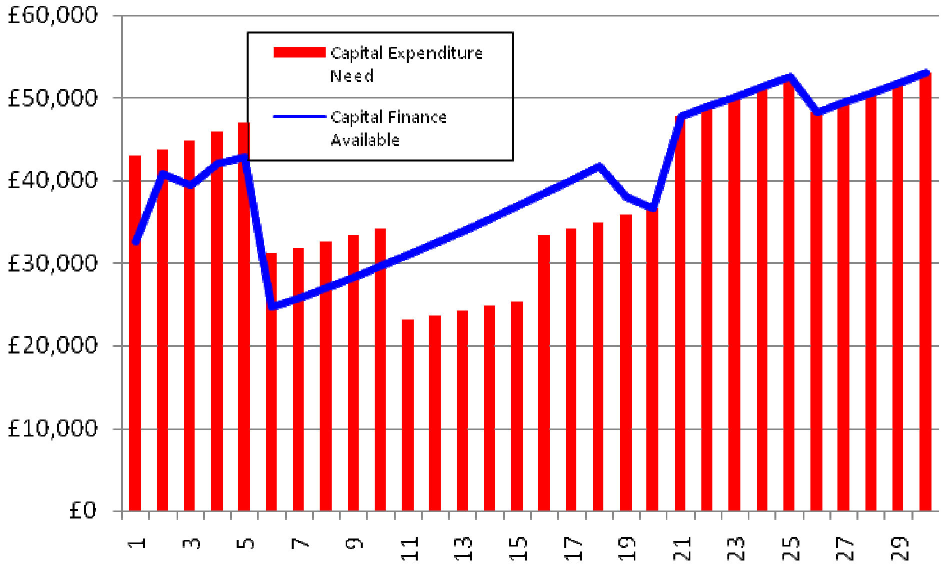
Figure 1: Investment Needs – Thirty Year Profile



14 The profile shows that the need for investment arises at different times in the thirty year business plan for each provider. For East Durham Homes, the most pressure to spend is within the first five years of the thirty year business plan. For Dale & Valley Homes and Durham City Homes the most pressure to invest arises between years six and ten of the business plan. This is because some of the components in homes will reach the end of their lifecycle and require replacement or significant maintenance.

15 In summary up to £388M of investment is required by the council's housing stock in the first ten years of the thirty year business plan. Analysis of the council's income and allowances indicate that only £333M is available to the authority over the same period. This leaves a shortfall of £55M rising to £63M with inflation. This is represented in the following chart:

Figure 2: Durham County Council HRA Income and Capital Expenditure Projections



19. The council must now understand how and where it can access the necessary resources to deliver its business plan or to supplement it. This requires analysis of the council's rental income, examination of spending on management and the exploration of capital investment in sustainable housing stock.

Financial Analysis and Potential Options

20. In April 2011 the council appointed Consult CIH and their partners Savills to provide specialist financial advice to assist in finalising a thirty year business plan. The business plan will set out how the council can afford to service the debt allocated to it by the government and continue to support the management and improvements of its homes.

21. In formulating the business plan Consult CIH and Savills have considered:

- The budget for 2011/12 complete with management efficiencies of £1.5M and £3M factored in over years two and three in the business plan (respectively);
- The latest stock condition survey outputs;
- The latest self financing debt settlement (£216M);
- The availability of £70M of backlog funding available to the authority to bring homes up to the decent homes standard.

22. Comparisons have also been made on costs between the provider organisations and with other ALMOs and authorities. The council and its providers plan to work together to further analyse management costs and to identify efficiencies that could be achieved if the number and shape of the provider organisations is reduced or altered.

23. Consult CIH have advised the council that it can deal with the shortfall in its business plan in a variety of ways. If the council retains ownership of the stock then it must accept that its ability to borrow to supplement its business plan is severely restricted. Therefore the council must seriously consider the ways that it can enable borrowing above the debt cap imposed by the government to invest in its housing stock and bridge the distance between its investment requirements and available resources.

24. The council could consider the deferral of some improvement works to its homes until year eleven of the business plan. Year eleven marks the beginning of a period when the pressures on the business plan are not so great.

25. Deferral of works across all three areas is a possibility if they are carefully planned and prioritised in a detailed asset management strategy. However, Consult CIH has advised the council to be cautious when deferring works as it can mean departures from industry standards. Deferral can also lead to component failure, high maintenance costs and reductions in customer satisfaction. Deferral of works would also prevent the council from clearing the £216M of debt it has been allocated by the government. The council would remain in nearly £100M of debt at the end of the thirty year period if it was to choose to defer works.

26. The council is clear that it wishes to implement a stable, affordable business plan that enables investment and the repayment of debt. Consult CIH has advised that in order to do this the authority must make efficiency savings no matter which option for the future financing, management and ownership of the stock it selects.

27. Efficiency savings must equate to £2M and must be sustained each year. £2M of efficiencies must also be in addition to the £3M of efficiency savings already identified in the council's Medium Term Financial Plan. A significant amount of efficiencies may be found in undertaking some degrees of change within the council's existing housing management arrangements. Efficiencies will be subject to further discussions between the council and its provider organisations.

Potential Options and Associated Models

28. In order to deal with the shortfall in investment, meet customer priority objectives and develop an affordable and sustainable thirty year business plan, Consult CIH have modelled a number of potential options for the future financing, ownership and management of the council's housing stock. The models are:

29. **Stock Retention**: The Council could retain ownership of the housing stock. Potential models include the achievement of efficiencies by reabsorbing the housing service back into the authority to create a large housing department. Another model includes the reorganisation of existing arrangements to make the required efficiencies to reinvest into the business plan. This may involve the creation of a single Arms Length Management Organisation (ALMO) or a combination of ALMOs.

30. A number of caveats accompany the stock retention option. The council would not be able to borrow above its debt cap and would struggle in the long term to meet the business plan deficit. This would mean the delivery of a basic business plan and may mean that the authority is left servicing debt at the end of the thirty year period. If the authority is to choose to reabsorb housing services into its structure the approval of customers will be required through a test of opinion. It is unlikely that customers of Dale & Valley Homes and East Durham Homes would agree to a return of housing services to the council.

31. **Large Scale Voluntary Transfer (LSVT):** LSVT is a term used to describe the transfer of the whole or a substantial part of a council's housing stock to a new or existing social landlord (also known as a Registered Provider – RP). The key features of an LSVT are:

    - Transferring tenants are offered benefits such as stock investment programmes and rights as "assured tenants";
    - The transfer takes place on the basis of a price (based on the Tenanted Market Value – TMV) offered to the authority for the stock. TMV is calculated by assuming affordable rent levels and good standards of maintenance and forecasting income and expenditure over thirty years. The forecast surplus for the period is used as a basis for calculating the capital value[1] .
    - Transfers enable increased investment in improvements to the housing stock and to living environments without calling on public sector housing budgets or putting pressure on the public sector borrowing requirement.

32. Consult CIH has advised the council that the LSVT of the whole stock to a Registered Provider is unlikely. This is because the total stock TMV is valued at £5.6M. If the council was to try to transfer its stock using this valuation (on the basis of the other stock transfers that have taken place in the County) it would require the government to "write off" almost all of the £216M it has allocated in debt to the authority. It is unlikely that the government would support such a proposal.

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[1] The council is paid the TMV for the housing stock by the RP and usually uses the proceeds to repay HRA debt. Sometimes the TMV is lower than the level of debt the council has. This situation is often referred to as "overhanging debt" and in these circumstances the council tends to ask the government to fund the difference.

33. The valuation of Durham City stock is positive because of high decency levels and good rent levels. This could make Durham City Homes stock eligible for a partial stock transfer. Dale & Valley Homes' stock is also positively valued (albeit significantly lower than Durham City Homes' stock). Therefore Dale & Valley Homes could also qualify for a partial stock transfer or a joint transfer with Durham City Homes.

34. The removal of Durham City Homes and Dale & Valley Homes from the council's portfolio of housing services will reduce the overall debt, but the authority may be left servicing substantial debt with a low level of rental income and high levels of investment need. The council is committed to ensuring that all of its stock receives the investment if requires and will not take a decision that favours one part of the stock over another. Therefore the council would favour an option or mix of options that provide a solution for the "whole stock" and enables investment to be made when required in all areas.

35. Consult CIH has advised that even a partial transfer of the stock may still require a significant level of debt write off at a time when the government's position and policy on stock transfer is sketchy. The government have stated that they will consider transfer proposals after they have applied a rigorous value for money assessment. Councils are also expected to provide significant financial support for transfer proposals.

36. On this basis Consult CIH have modelled **an unconventional stock transfer** as a potential option for the authority. This would require the transfer of the housing stock to a charitable organisation (likely to be one or all three of the existing providers) that is one third owned by the council and two thirds owned by tenants and the local community – a CoCo.

37. A CoCo is not a conventional stock transfer because it retains a financial relationship with the council. It would do this through a covenant to service the council's HRA debt, which would remain with the council after transfer. The CoCo would covenant to meet the council's interest and repayment obligations on its HRA loans (most of which are likely to be from the Public Works Loan Board).

38. A CoCo has several advantages compared with conventional stock transfer or with taking the management service back in house.

- The CoCo can take advantage of the council's borrowing rates, enabling it to raise additional finance in a more cost effective way;
- Unlike council borrowing all CoCo borrowing is off balance sheet, so it is not subject to the public sector borrowing restrictions imposed by the treasury under the self financing settlement; and
- The council's retention of HRA debt and its covenant with the CoCo would mean the council keeping a form of pecuniary interest in the stock. This may provide a degree of comfort to the council and its customers.

39. The landlord would change from the council to the CoCo (as with a conventional LSVT) so a tenant ballot would be required to demonstrate tenant support.

40. The new landlord could be one or all three of the existing providers. Most of the staff required to run the housing service provided by the CoCo would have already transferred from the council to its ALMOs when they were set up. There would be a few staff (mostly working for Durham City Homes) that would transfer from the council under the new model.

41. There are some clear advantages in transferring the stock to a CoCo for the council and its customers. The model works financially for each of the council's housing management areas. Borrowing would be enabled and so investment could be made when required. Efficiencies would still be required, but could be achieved to produce even greater benefits to the business plan.

42. The council must also be mindful of the risks associated with the CoCo model. The government's approach to the whole concept of stock transfer is uncertain and proposals to transfer to a CoCo could be refused. The CoCo model is completely new, with its finer details only being refined by its creators (the National Federation of ALMOs) in June 2011. The model has never been implemented any where else.

43. The CoCo would be required to pay VAT and would require the government to account for this in its debt settlement, adjusting it accordingly (reducing it from £216M to £150M). The model is also reliant on the government's agreement to providing a fifteen year VAT shelter. The COCO would also incur slightly higher costs of borrowing, but only on borrowing above the local authority's debt cap.

Potential Options and Associated Models

44. The council is committed to ensuring that the identification of potential options and models is as transparent as possible. To achieve transparency the council decided to undertake a stakeholder jury session to provide an opportunity for stakeholders to weigh up the advantages and disadvantages of each option; discuss potential risks; and agree the most appropriate options to go forward for full consultation.

45. The stakeholder jury session went ahead on Friday 24 June 2011. The session was facilitated by Engage Associates (Independent Tenant Adviser). The session was attended by the projects Stakeholder Steering Group, which includes three Councillors (Cllr Robson, Cllr Napier and Cllr Foster); ten customers from each of the council's housing management areas; and three staff members from each of the provider organisations.

46. The stakeholder jury were provided with expert advice on the most financially viable options and the affect each option could have on the long term business plan. The stakeholder jury also received presentations from Dale & Valley Homes, Durham City Homes, East Durham Homes and Durham County Council on their preferred options. The stakeholder jury used this information to score options against the project's key objectives.

47. The stakeholder jury found that the council's long term aim should be the transfer of the housing stock to enable borrowing abilities to ensure that funding is obtained to continue to invest in homes, neighbourhoods and services (customer's first priority objective). The stakeholder jury recommended that the council go out to full consultation on a proposal to transfer the housing stock. The stakeholder jury also identified five potential models to implement the transfer option. These models are represented in the table set out at Figure 3.

Figure 3: Potential Models for Full Consultation

	EDH	DCH	DVH	Comments
1	CoCo	CoCo		Debt write down £66m - £2m efficiencies needed – could be a Group (synergy)
2	CoCo	ALMO		Debt write down £48m - £1m efficiencies CoCo/£1-2m HRA
3	CoCo	LSVT	CoCo	Debt write down £66m – receipt £50m - £2m efficiencies needed in CoCo's and Council
4	CoCo	LSVT	LSVT	Debt write down £66m – receipt £64m - £2m efficiencies needed in CoCo and Council
5	CoCo	LSVT		Debt write down £66m – receipt £64m - £2m efficiencies needed in CoCo and Council

Full consultation will be undertaken on the proposal to transfer housing stock and on the five potential models of implementation.

48. The stakeholder jury also recommended that the council begin discussions with the government immediately to determine the likelihood of agreement to the council's proposal to transfer the housing stock.

49. The stakeholder jury took account of the risk that the government could refuse the council's proposal on a basis of value for money, or could ask that transfer be postponed until the new system of self financing is embedded.

To mitigate against this risk and to ensure that the council makes the necessary efficiencies to deliver its business plan in the long term stakeholders have requested that the consultation process also includes discussions on potential efficiency savings, proactive asset management and the reorganisation of existing housing management arrangements.

Consultation

50. Full consultation on options and potential models (and their various combinations) began at the end of June 2011. Consultation for customers is being led by Engage Associates. Consultation with other key stakeholders is being led by the council's Stock Option Appraisal Team. Consultation activities include public events, focus groups, freephone numbers, briefing sessions, seminars, newsletters and e communication.

51. During consultation all stakeholders are provided with the reasons for the stock option appraisal; the financial issues the council faces and an explanation of potential options and models. Stakeholders are asked the following questions:

- What are your thoughts and feelings about the proposal to transfer the stock?
    - What concerns do you have?
    - What's good about the proposal?
    - What's bad about the proposal?

- What are your thoughts on the proposal models?
    - What do you think about the combinations?
    - Which model do you prefer and why?
    - What concerns do you have?

- If the transfer proposal is not accepted by the government what do you think could be done to make the business plan more affordable?
    - What efficiencies do you think could be made in existing housing management arrangements?
    - What changes do you think could be made?
    - What affect do you think efficiencies and changes could have on existing housing management providers?
    - How do you feel about this?

52. The consultation process will continue until the end of September 2011. The findings of the option appraisal and outcomes of consultation will be included in a final report to the council in December 2011.

Conclusion

53. Council owned housing stock requires significant investment over the next thirty years. This is particularly acute in the first ten years of the business plan due to a specific need to invest in properties in the East Durham area and arising need in the Wear Valley and Durham City area from year six of the business plan.

54. The council will need to invest £388M in its homes in the first ten years of the business plan, but the resources available to the council total £333M – a shortfall of £55M rising to £63M with inflation.

55. Consult CIH have identified two headline options for the council to consider that will address the shortfall and enable investment into the housing stock. The options are:

    - Stock retention; and
    - Stock transfer.

56. Retention of the housing stock would not allow the council to borrow above the debt cap imposed by the government. Retention would also require the council to make significant efficiency savings to ensure that a basic business plan can be delivered.

57. Transfer of the housing stock would enable the council to borrow above the debt cap and ensure that funding is available to invest in the stock when it is required. Transfer is the preferred option of stakeholders and the council's provider organisations.

58. The transfer proposal carries some risk in that government policy on transfer is uncertain; ballots may be required; unconventional stock transfer models (CoCo) have not been implemented before; and concessions are required from the government in terms of reductions in the debt settlement, the write off of some of the debt and a VAT shelter.

59. The council will consult on the transfer proposal and possible models for implementation throughout the summer 2011. The council will also begin negotiations with the government on the possibility of stock transfer and (in recognition of the possibility of the government's refusal) the council will also consult on possible efficiency savings and the affect these may have on its housing management arrangements.

Recommendations

That the Economy and Enterprise Overview and Scrutiny Committee:

1. Note the reasons for the Stock Option Appraisal and the findings of the stock condition survey and financial analysis;

2. Discuss the potential options and:

    i. Provide a view on the council's proposal to transfer the housing stock in the long term;
    ii. Comment on the proposed combinations of models for implementation;
    iii. Provide answers to the questions set out at point 51 of this report.

Background Papers

Cabinet report dated 29 June 2010
CMT Report dated 22 December 2010

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Appendix 1: Implications

Finance

In April 2012 Durham County Council will be allocated a £216m debt settlement by the government I order to implement a system of self financing for council housing. From that point the council must use its own income from rents to invest in improving and maintaining its homes. Council owned housing in County Durham requires over £1bn of investment over the next thirty years. £388m is required in the first ten years of the business plan, but only £333m is available to the authority. The council must determine the most appropriate options for dealing with the shortfall in resources and in reducing its debt to ensure a sustainable future for council housing.

Staffing

Staff are a key stakeholder in the stock option appraisal process. This includes staff working for the council and for its two housing service providers, Dale & Valley Homes and East Durham Homes.

Risk

There are a number of risks associated with each of the options available to the council. These include:

Stock Retention: The council may be able to make efficiencies to balance the business plan in the short term, but this would only deliver a basic business plan. Borrowing would not be enabled and the council could not invest in all of its stock as need arises. The council would also be left with debt at the end of thirty years and it is unlikely that customers of Dale & Valley Homes and East Durham Homes would agree to a shift of housing services back into the authority.

Large Scale Voluntary Transfer: The LSVT of the council's housing stock is not a suitable option for all of the stock. Partial transfers could leave the authority servicing substantial debt with low levels of income and high levels of investment need. An **unconventional stock transfer** could enable access to additional borrowing to invest in the stock as need arises. However, the CoCo option is untested and all LSVT proposals require some financial support from the government (even if it is the form of VAT concessions or reductions in debt); government policy on stock transfer is also unclear.

Equality and Diversity

One of the appraisal's key objectives is to address inequity in the quality of the housing services and neighbourhoods currently provided by the council. The project also aims to provide all individuals and organisations with an interest in the future of the council's housing stock with the best opportunities to contribute to the stock option appraisal process, if they wish to do so. This will be accomplished through the implementation of a communication and consultation strategy and a tenant empowerment statement.

The council will use these strategies to address potential barriers to involvement in the project and in improving housing services by providing a variety of involvement mechanisms and a selection of communication methods to suit a variety of needs and requirements.

Accommodation

None

Crime and Disorder

A reduction in crime and disorder is reflected in the option appraisal's objectives. This ensures that potential options consider the reduction of ASB and the designing out of crime in homes and neighbourhoods.

Human Rights

None

Consultation

The option appraisal and the council's decision on the future financing, ownership and management if its housing stock will be fully informed by consultation with customers, staff, councillors, board members and other key partners. The council has developed a detailed communication and consultation strategy and consultation programme for each stakeholder group.

Procurement

Specialist financial (Consult CIH) and legal (Trowers and Hamlins) advisers and an independent tenant advisor (Engage Associates) have been procured to support the formulation of potential options and the delivery of the project.

Disability Discrimination Act

None

Legal Implications

The council currently has legally binding 'Management Agreements' with Dale & Valley Homes and East Durham Homes for the provision of housing services to its customers. Depending on the option that the council ultimately selects, these management agreements may be subject to change or redevelopment. There are also significant legal implications if the council selects the transfer of its housing stock. Trowers and Hamlins, the leading legal consultants in this area of work have been engaged by the council.