Council Housing Self Financing Regime and Options for Stock Investment

Pinsent Masons

The New Regime

Since the 1st April 2012 the HRA self financing regime has given local authorities the freedom to invest in their own stock from their own income. However, in return there has been an "allocation" of national housing debt between local authorities. If the value of an authority's stock (the stock is valued by reference to discounted cashflows from income and expenditure in relation to the stock) was lower than the amount of debt so supported through the HRA subsidy arrangements then the local authority paid the difference and if higher the Government paid the difference. The Secretary of State has made a number of Determinations under powers contained in the Localism Act 2011 to supplement the self financing regime. The most important of these are:

- The Housing Revenue Self Financing Determination 2012;
- The Settlement Payments Determination 2012; and
- Limits on Indebtedness Determination 2012.

Each authority will have an HRA business plan which will show the build up of income and expenditure within the stock including servicing any additional debt which may have been taken out by the authority. The ability to fund any investment will depend upon any excess capacity in the business plan. Furthermore in addition over the period of the business plan rents will increase (albeit in accordance with Government policy) and the "gap" between income and expenditure (including interest but not necessarily the repayment of principal) will increase thereby yielding a potential surplus cashflow which could be used to finance investment.

In principle there are basically 3 ways of deferring the cost through:

- borrowing;
- the grant of a lease; and
- a PPP structure.

Borrowing

The simplest way for a local authority to defer the capital cost of investment in its stock would ordinarily be through borrowing, probably from the PWLB, under the prudential borrowing regime. However, as a consequence of the Government's deficit reduction policy a cap has been imposed upon local authority borrowing within the HRA. Borrowing is defined as the HRA Capital Financing Requirement and is calculated by reference to the existing HRA accounting regime (the so called Item 8 debt and credit determination) as the CIPFA Prudential Code for Capital Finance is applied to it. A base amount of borrowing is assumed as the opening position on 1st April 2012 (calculated by reference to the Item 8 Determination) and to this is added any HRA capital expenditure financed by borrowing or credit arrangements in 2012-2013.

Lease

The second means of local authorities deferring the capital cost of investment in its stock is by way of a lease from a developer or investor. However, to be value for money, any lease will be long term and be subject to a rent which is fixed by reference to the capital cost of the investment plus a return. A lease with a rent which is fixed by reference to the cost of the asset is likely to be a finance lease and a liability in the HRA as being a credit arrangement. This would therefore once again take up headroom beneath the HRA borrowing cap.

The types of things which indirectly or in combination would result in a lease being a finance lease include ownership is transferred to the lessee at the end of the lease term, there is a "bargain purchase option", the lease term is for the majority of the leased asset's economic life, the present value of minimum lease payments equals substantially all the fair value of the leased asset and the leased asset is of a specialised nature that only the lessee could use it without major modifications.

PPP

The third means of local authorities deferring the capital cost of the investment in its stock is by way of a PPP. A PPP would need to be constructed in a way such that the cost of the PPP does not amount to borrowing or a credit arrangement within the HRA. Effectively this will mean that the risks in the asset do not lie with the local authority. Essentially there are two options a private finance contract or a residual value lease. They both largely amount to the same thing in substance with the key being the residual value risk lying with the developer/investor. This will probably mean the residual interest lies with the developer/investor unless an operating lease can be constructed with a purchase option with the risk remaining with the developer/investor.

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Private Finance Contract

One approach could be to construct a private finance contract. A private finance contract is very similar in risk profile to a PFI. The stock would be refurbished or redeveloped under a design, build, finance and operate/manage contract (all at the risk of the private sector).

Payment under the long term contract would be by way of a unitary charge over the length of the contract by reference to availability and to service KPIs. The stock will be on local authority owned land and as such tenants will be secure tenants. The private finance contract would be project financed ie financed by a financial institution from contract revenues. The risk for the availability of the stock will be passed to the contractor as would performance of the housing management and maintenance services.

However, whilst such a contract with sufficient risk transfer would be outside the definition of public sector debt, the UK Government having adopted the International Financial Reporting Standards from 2008-09 onwards would mean that the private finance contract would likely to be a service concession within the meaning of IFRIC 12 and the asset in the stock would belong to the local authority. As such the private finance contract will be a credit arrangement and will once again take up headroom.

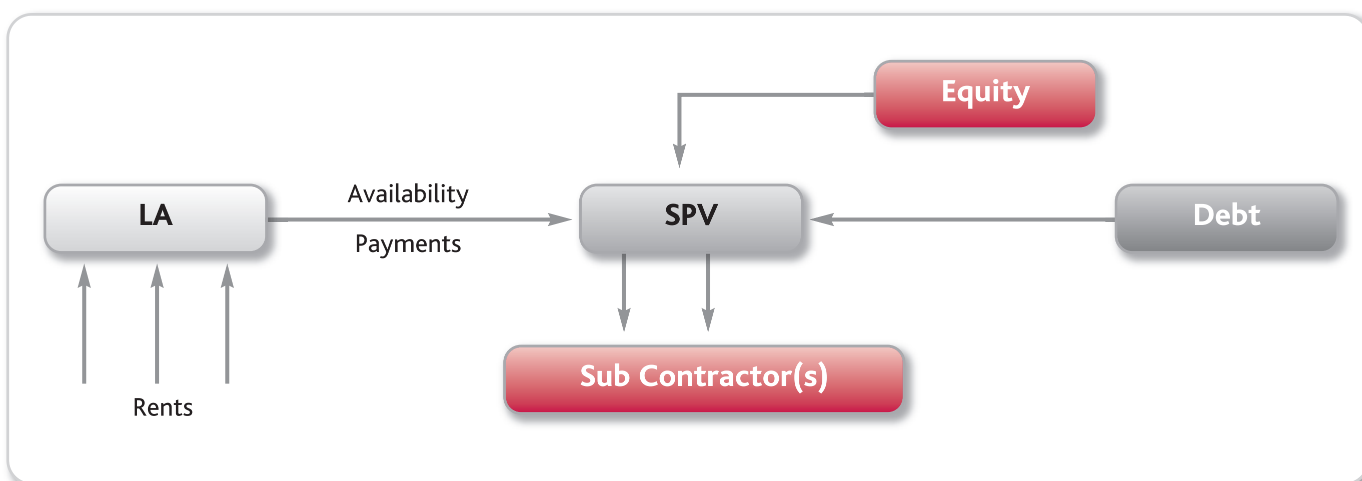
The issue therefore for a PPP is how the stock can be accounted for by the operator rather than the local authority. IFRIC 12 on service concessions is the international accounting guidance for operators rather than the public sector. IFRIC 12 states that it is control that determines accounting treatment by the operator. If the grantor of the services concession, in this case the local authority, controls the asset then the asset is not an asset of the operator and the asset becomes or remains an asset of the grantor (or local authority).
A service concession is where:

- the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price; and

- the grantor controls through beneficial entitlement or otherwise – any significant residual interest in the infrastructure at the end of the term of the arrangement.

Whilst the first condition is likely to apply to a private finance contract it could be possible to structure the commercial arrangements such that the second condition did not apply. To do so would mean that the residual interest in the stock could not pass to the local authority at the end of the contract or otherwise the risk in the residual interest would remain with the operator. In practical terms for a private finance contract this would mean transferring the freehold of the dwellings to the operator at the end of the contract with a pricing arrangement which would leave the risk with the operator. There will clearly be a need either to gain vacant possession at this time or a consent for disposal. See below for a structure diagram for a Private Finance Contract.

Private Finance Contract



Residual Value Lease

An alternative but similar approach would be to structure the arrangements via a lease in much the same way as NHS LIFT (with a transfer or more likely lease of the HRA land into the operator for best consideration whether rent or premium). The developer/investor would acquire the land and construct the new stock and then lease it to the Council for a sufficiently long period first to be affordable and secondly to qualify for treatment within the HRA. As to the latter, the HRA (Exclusion of Leases) Direction 1997 excludes from the HRA leases of up to 10 years for the purpose of housing homeless households.

The lease could be for serviced accommodation rather like the Lease Plus in NHS LIFT. In which case, as in the private finance contract, the payment of the rent could be by reference to availability and KPI's. The lease would not have to be a finance lease (see section on

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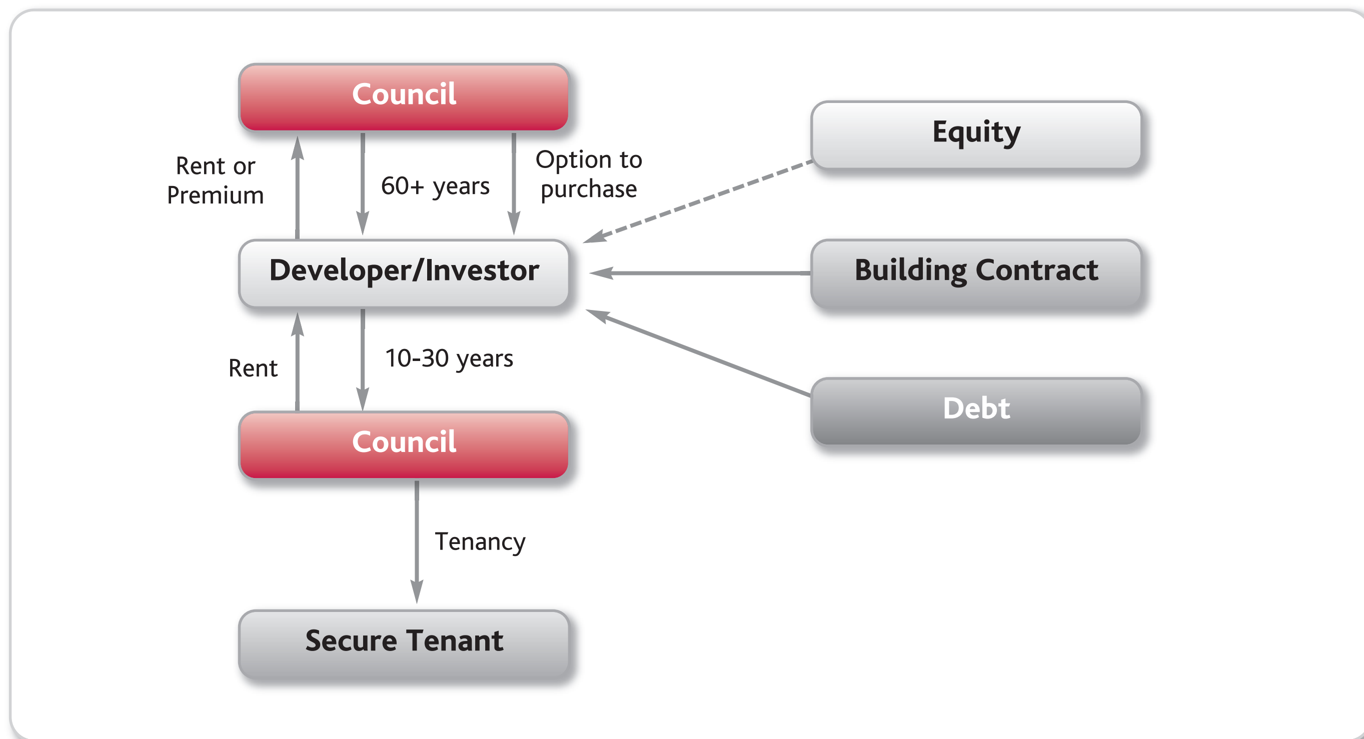
leases above) and to determine this, the principles of IAS 17 would need to be applied. The local authority would be the immediate landlord of the tenants and therefore be secure tenants. For there to be an operating lease in favour of the local authority risk in the value of the reversion would need to be with the developer/investor. If the stock is not transferred to the developer/investor at the end of the lease then any option in favour of the local authority to acquire the reversion would need to be at a price at the risk of the developer/investor and accounting advice would be required to ensure that it is not a finance lease under IAS17.

Residual Value Lease Model



Special Purpose Vehicle

In the ordinary course the operator would need to be independent of the local authority. The local authority establishing a special purpose vehicle would take the borrowing on acquisition of the stock outside of the HRA. The local authority would transfer the land into the SPV, although such (unless vacant) would need to be at market value. However, the current CLG General Consent for the Disposal of Housing Land (The General Housing Consents 2012: Section 32 of the Housing Act 1985) requires a ministerial consent for the disposal of a dwelling (but not vacant land) where:

- the disposal would result in the tenant of the local authority becoming a tenant of a private landlord; or
- the disposal is to a body in which the local authority owns an interest except where the local authority has no housing revenue account or if it has, the first 5 disposals in a financial year).

The latter condition in particular will encompass any SPV in which the local authority has an interest. The rationale for this consent requirement is to ensure that the viability of the HRA business (and the controls on housing borrowing) is not compromised by moving assets out of the HRA whilst retaining arm's length ownership. An SPV involving the transfer of dwellings would therefore be very difficult to structure with this consent requirement.

Joint Venture

A final option is a joint venture. This has similar characteristics of both the SPV and Residual Value Lease Model. This option is wider and takes in the whole of the development including any potential development for sale. The principal characteristics are as follows.

The local authority procures a joint venture partner. The local authority will need to decide its procurement strategy and there may be a preference to appoint an investor as a partner with a subsequent EU procurement for a developer/contractor. The local authority's contribution to the joint venture will be its land and the private sector partner will match the local authority's land value with cash. The finance model will determine the level of local authority equity as opposed to guaranteed land value at the time of the respective contributions. With assets the joint venture vehicle will be able to raise further finance to fund the construction works or the can be funded by and at the risk of a developer depending upon the risk profile which the local authority is comfortable with.

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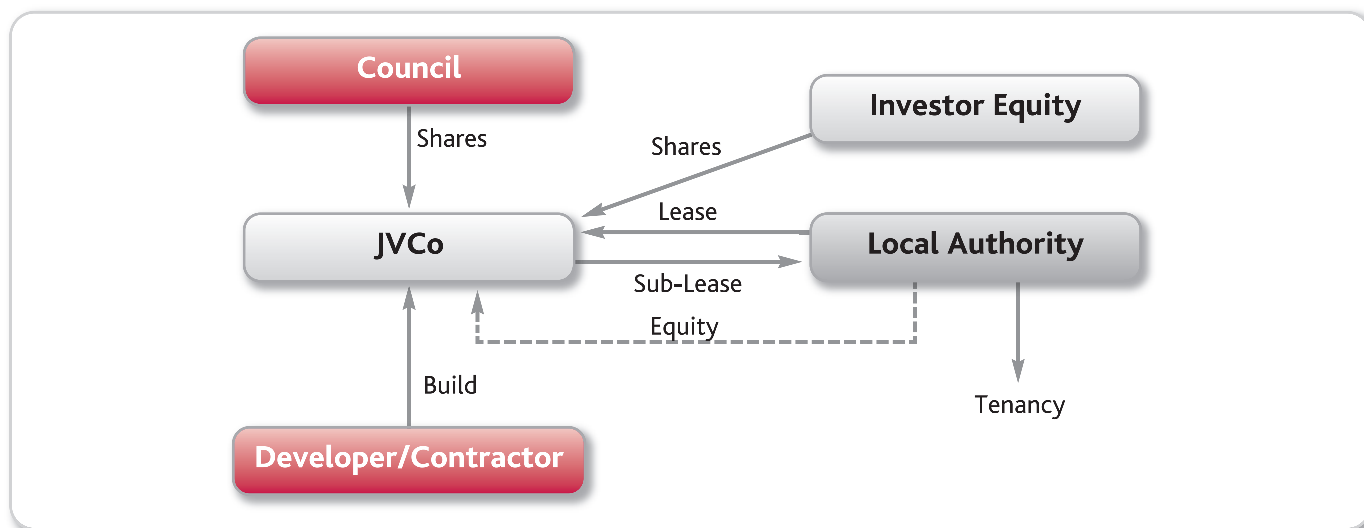
The local authority will need to transfer the land (unless vacant) into the joint venture vehicle at market value. Market value can include deferred payment for the land. As the local authority will have an interest in the joint venture vehicle, a ministerial consent will be required for the land disposal which includes dwellings under the CLG General Consent for the Disposal of Housing Land. However, as a bona fide joint venture there would seem on the face more justification for this structure than a single standalone SPV. The development JV will be outside the HRA.

The local authority will still take a lease of the stock. The lease will need to be an operating lease rather than a finance lease as per the residual value lease option, although in this case the risk will be shared. The local authority will account for its interest in the joint venture vehicle as a joint venture.

This model clearly increases the financial risk for the local authority but would reduce the overall cost of the scheme. However, it will need to be modelled financially to ensure it is viable and affordable.

Joint Venture Model



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