Appendix A

Somerset West and Taunton Council

HRA Forecast Update

Report version 2

7 January 2021

Contents

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1 | Executive Summary

1.1. We have produced an updated set of Baseline forecasts for the authority's housing revenue account. These forecasts reflect updated budget information provided by the council for its existing housing stock and services, plus its delivery plans.

1.2. Alongside the Baseline scenario we have explored the effects of extending the new build programme so that it delivers 1,000 units over the planning period. We have also provided a commentary on the effects of substantial additional spending pressures, such as the potential for a requirement to retrofit homes to a zero carbon standard.

1.3. The updated Baseline we have projected for the HRA shows the authority to be in a strong starting position. It is able to deliver a substantial medium term programme of new build schemes, using a combination of the available resources plus external borrowing, and repay most of the additional debt required by the end of the forecast period. Throughout the Baseline forecast the HRA is able to operate well within its means, with further headroom available should it need to respond to unexpected changes in circumstances. The authority's ability to deliver 1,000 new units within 30 years is also reasonable, though debt levels start to rise at the end of the forecast and so the authority should consider taking appropriate mitigating actions.

1.4. The introduction of substantial additional spending pressures (such as the delivery of a zero carbon retrofit programme) has the potential to present a more challenging situation. If such pressures are not accompanied by additional resources or compensating cost reductions there is potential for the HRA to be left with little or no "wriggle room". Under these circumstances the authority might need to reconsider and scale back its aspirations for delivering a long term development programme.

1.4.1. Sensitivity analysis shows that the HRA forecasts are very sensitive to changes in the levels of income generated and costs incurred. Relatively small changes in these assumptions can have a substantial long term impact on the financial capacity of the HRA. We therefore recommend that the authority routinely seeks to optimise income and minimise costs as part of its approach to maximising the long term financial capacity of the HRA.

2 | Methodology

2.1. We have prepared an updated set of Baseline 30 year HRA forecasts, using revised budgets provided by council officers and the Housing Finance Associates HRA business plan model.

2.2. In addition to the updated Baseline we have prepared a scenario that extends the new build programme to deliver 1,000 units over 30 years, in line with stated Council policy.

2.3. We have considered the impact of the Baseline and scenario on the following measures, when assessing its impact on affordability and financial sustainability:

- The minimum balance maintained by the HRA
- The level of the HRA capital financing requirement (HRA CFR), which measures HRA-related debt
- The ability to generate net income that is 125% or more of the cost of interest paid on HRA debt (interest cover). This measure is widely used by housing associations, and indicates the ability to pay for debt-related costs
- HRA debt as a proportion of HRA asset values (gearing)
- Unused borrowing capacity available to the authority (headroom)
- The ability to repay or reduce HRA debt

2.4. To provide further context we have also conducted a series of sensitivity tests on the updated Baseline position. These tests project the impact of:

- Keeping rents at 2020/21 levels in 2021/22 (a one year rent freeze)
- Interest rates on new loans increase by 1% (cost of borrowing rises)
- Costs increase by ½% more than expected from 2022/23 until 2026/27 (cost increases)

3 | Key assumptions

3.1. Source documents

3.1.1. The updated forecasts have been prepared with a 2020/21 price base using the following information:

- The revised 2020/21 HRA revenue budget and proposed budget for 2021/22 prepared for presentation to the Council in February 2021.
- A 10 year capital programme, provided by council officers
- The development programme, provided by council officers and reflected in the 10 year capital programme.
- Long term stock condition investment requirements, provided by council officers, which we have supplemented with a contingency of £2.000m pa from 2031/32. This contingency allows for potential weaknesses in the underlying stock condition data, which we understand is due to be refreshed.
- Inflation projections that reflect the statistics published in October 2020 by the Office for National Statistics (September Consumer Prices Index - CPI) and HM Land Registry (August House Price Index).
- Provision for a 1.5% rent increase in April 2021. This is the maximum rent increase permitted under the Rent Standard and reflects CPI +1%.

3.2. Development programme

3.2.1. The focus of the Baseline development programme has been narrowed so that it covers the provision of committed and likely schemes over the first 10 years of the forecast. As a result it excludes:

- The £1.900m provisional scheme at Oake
- Aspirations to provide any additional units

3.3. Capital financing and use of resources

3.3.1. We have modified the authority's approach to financing its capital programme to allow for the application of multiple resource streams, as follows:

- Major repairs reserve
- Hinckley Point C Fund
- Capital Grant
- S106 funding
- Retained 141 RTB receipts
- Revenue contributions
- Borrowing

3.3.2. Borrowing is the last resource stream that is available to finance the capital programme, and is only available for as long as the HRA is able to provide interest cover of at least 125%. If the authority is unable to provide this minimum level of interest cover, any unfinanced capital programme is automatically rescheduled to a later year with available headroom.

3.3.3. The revised forecasts allow for the authority to utilise HRA resources to help keep the use of borrowing to a minimum. The key assumptions here are

- Allowable Debt and LA Share receipts arising from right to buy sales are all set aside for debt repayment until all debts have been covered, and are then available to finance the HRA capital programme
- Any balance on the major repairs reserve is available to repay debt, as required
- Revenue balances above a minimum level of £2.000m (plus inflation) are available for debt repayment, as required

3.4. Debt and interest rates

3.4.1. Existing HRA-related loans are repaid using the available resources at their due date. If there are insufficient resources to repay a loan in full, the balance is refinanced with a new replacement loan.

3.4.2. The HRA attempts to repay any new loans as quickly as possible, whether the new loans are required to finance the capital programme or refinance existing debt. This allows the forecast to provide a clearer indication of the affordability of the authority's spending plans. This assumption is not intended to replace the financing decisions that the authority's Finance team will take (with appropriate treasury advice) when any borrowing is undertaken.

3.4.3. The interest rate assumed for new loans is 2.0% until 2024/25, rising to 2.5% from 2025/26.

3.5. Rents

3.5.1. Rents rise each April in line with the maximum level permitted by the Rent Standard, which is currently set at CPI+1% (based on CPI in September the previous September). We have assumed that CPI +1% rent increases will continue until 2024/25, which coincides with the end of the Government's stated five year policy. From 2025/26 the forecasts assume that rent increases reflect CPI.

3.5.2. Existing properties are re-let at their formula rent, with an allowance for rent flexibility (as permitted under the Rent Standard). Rent flexibility for general needs properties is set at 5% above the formula rent, and for supported housing (i.e. sheltered and extra care) and additional 10% above the formula rent is allowed for rent flexibility. The re-let rate for existing homes is 7% for general needs and 10% for supported housing.

3.5.3. Rent loss as a result of voids reflects the budget for 2020/21 and 2021/22, and has then been assumed at 2% of gross rental income.

3.6. Stock movements

3.6.1. Right to buy sales are forecast to occur evenly throughout each year, as follows:

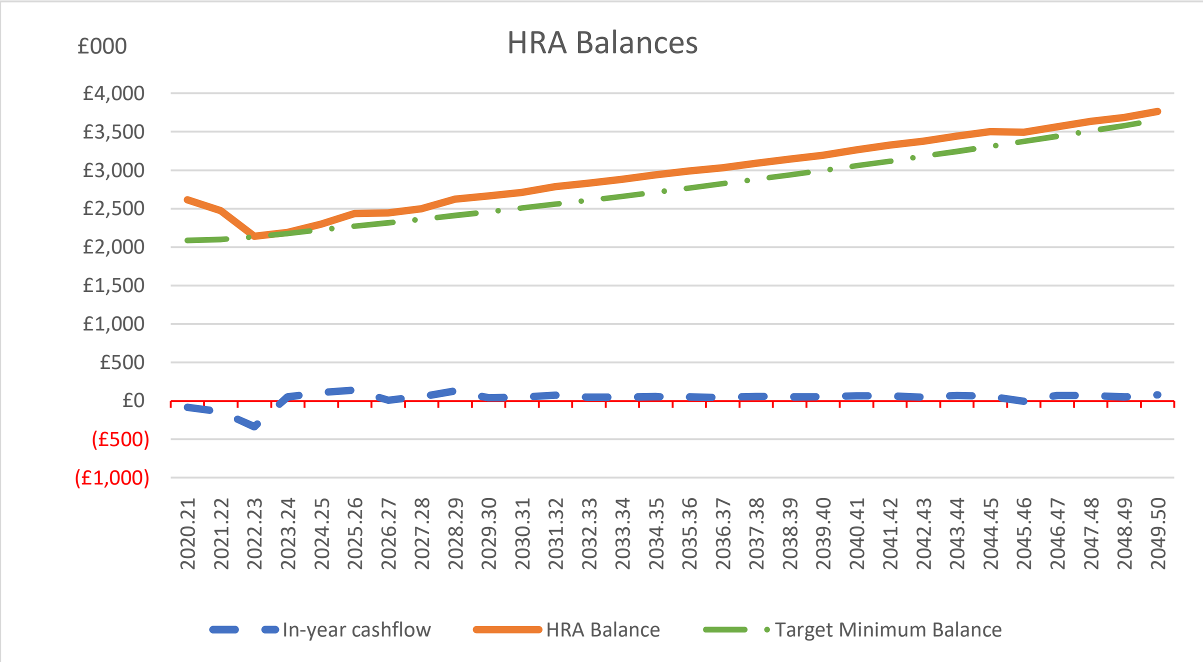
- 40 sales in 2020/21 and 2021/22
- 32 sales in 2022/23
- 28 sales in 2023/24
- 24 sales in 2024/25
- 20 sales a year from 2025/26 until 2027/28
- 18 sales a year from 2028/29 until 2030/31
- Thereafter reducing by 1 sale a year every three years

3.6.2. A total of 83 units marked for regeneration on the North Taunton Estate are currently in use, the remainder having already been vacated. The forecast removes these units from management in line with the profile provided by council officers.

4 | Baseline

4.1. Baseline – revenue position

4.1.1. The housing revenue account maintains a minimum balance of around £2.000m (plus inflation), as indicated below:

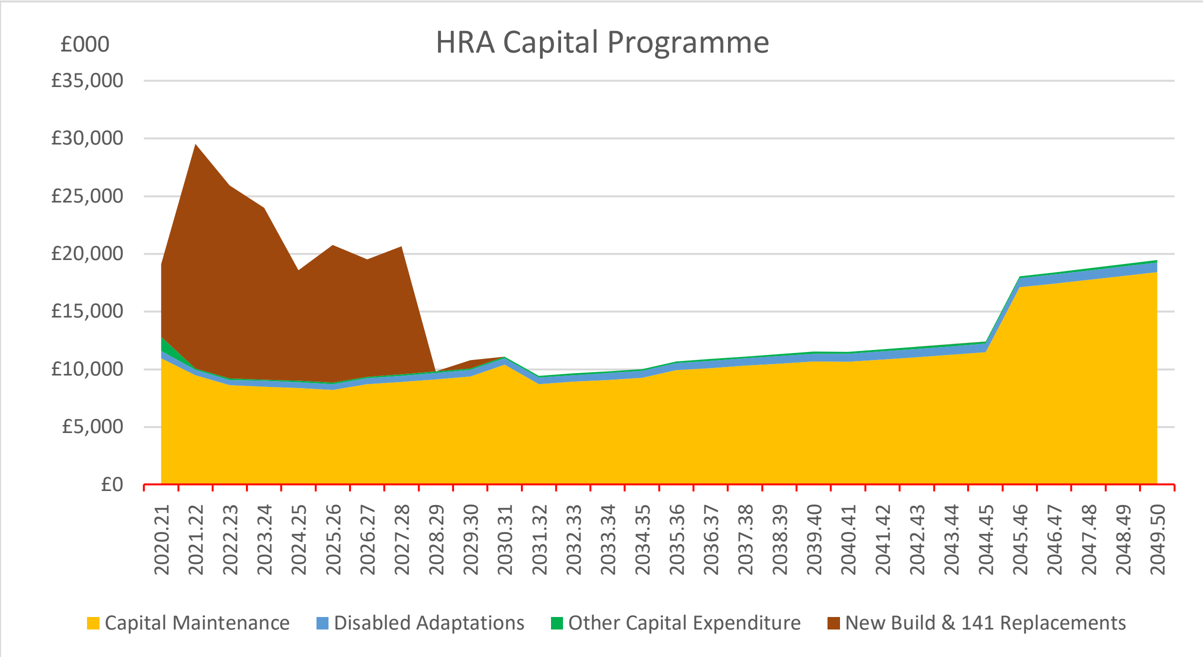


4.1.2. In this chart the orange line forecasts the accumulated balance at the end of each year and the blue line shows the in-year use or generation of balances.

4.1.3. The authority maintains the HRA Balance at the minimum level throughout the forecast. During this period any "excess" rents generated are made available to repay debt.

4.2. Baseline – capital programme

4.2.1. The next chart represents the Authority's Baseline ability to deliver its HRA capital programme within the available resources. This chart shows the capital expenditure required each year, identifying the main types of expenditure separately:

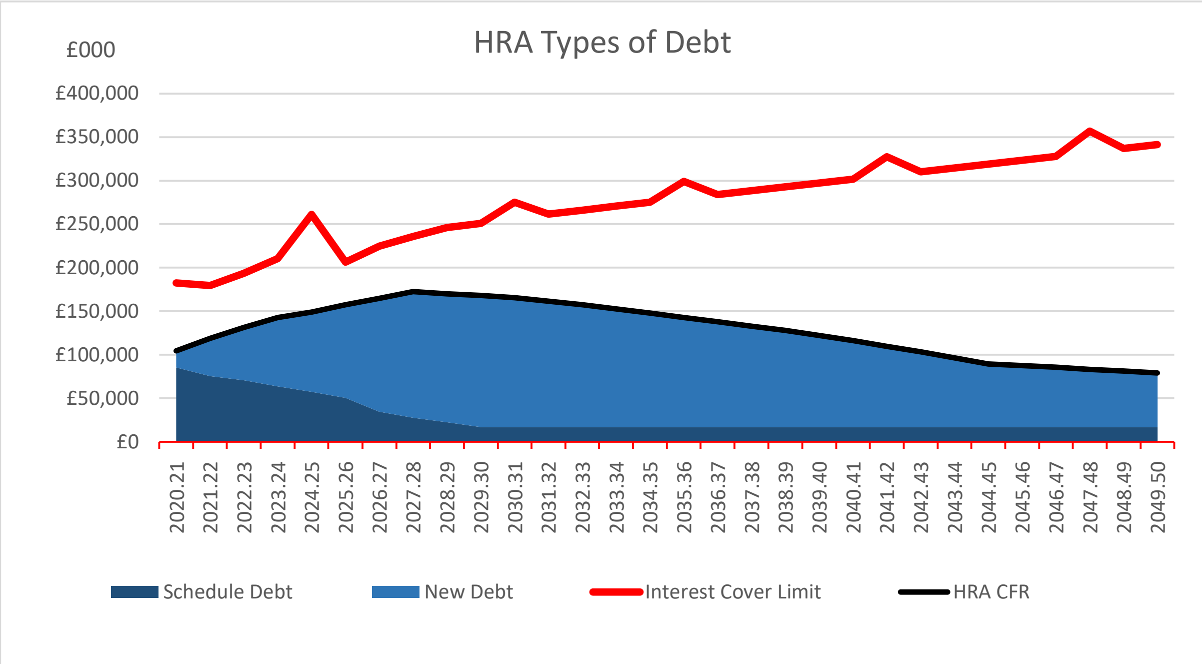


4.2.2. The baseline allows for new build and stock purchase projects that produce 374 new properties by 2027/28 (brown area), while continuing to maintain the existing stock (amber area). The investment requirement for the existing stock steps up significantly in the last five years of the forecast as a result of component replacements that are expected to become due.

4.2.3. The Authority can finance the capital programme fully from the resources that are at its disposal, with use of additional borrowing.

4.3. Baseline – debt

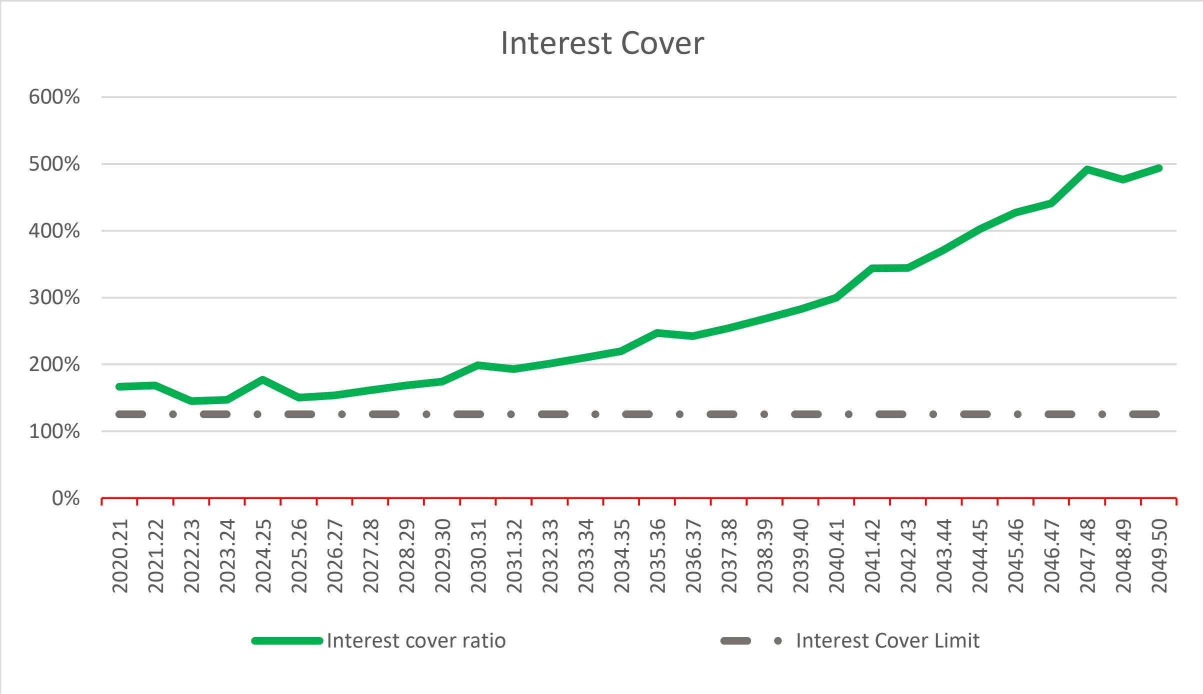
4.3.1. The next chart forecasts movements in the level of HRA debt (black line) during the planning period:



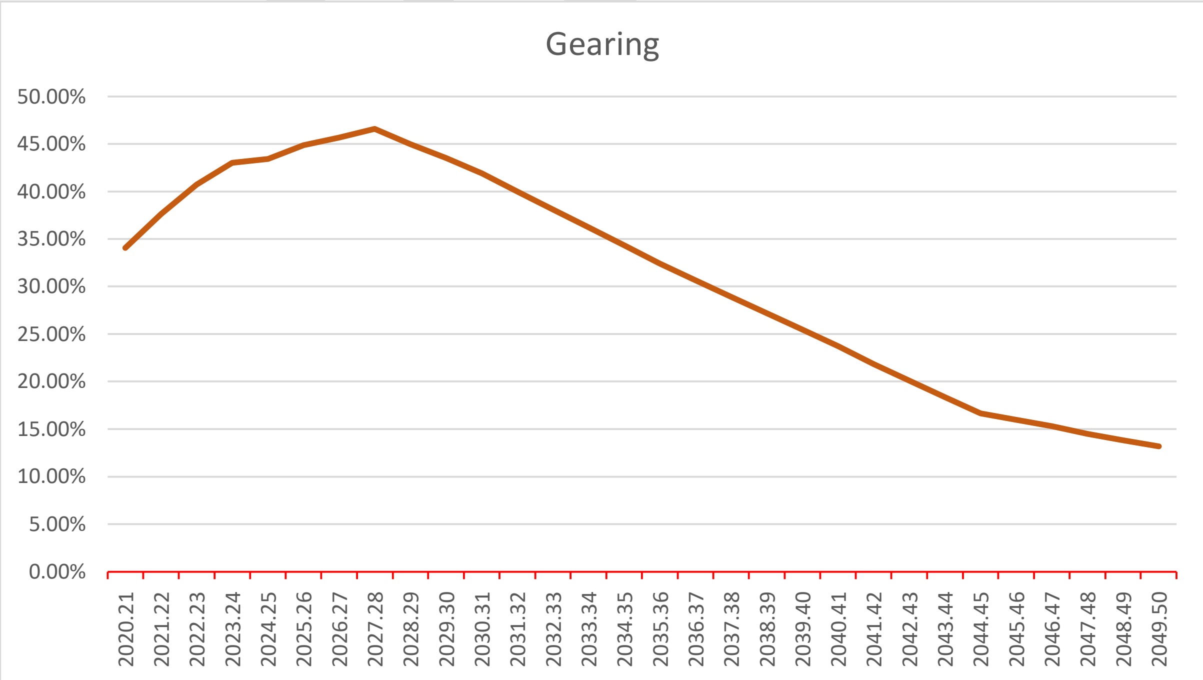
4.3.2. The dark blue area in this chart relates to existing loans. We have assumed that these loans will be repaid in line with the existing debt schedule, if the authority can afford to do so. The mid-blue area shows additional loans that the authority needs to undertake to pay for the capital programme or to refinance any loans that it cannot repay at their due date.

4.3.3. Peak debt of £172.633m is reached in 2027/28, after which the authority starts to reduce its HRA-related borrowing. Revenues are strong enough for the authority to repay most of its debt, with residual loans of £79.216m outstanding by the end of the period. It is noticeable that the rate of repayment slows over the last five years of the forecast, which coincides with an increase in the stock investment required.

4.3.4. The authority remains within any limit on HRA debt set by a minimum interest cover requirement of 125% (red line). The chart below provides further details and shows how the situation improves during the course of the forecast:



4.3.5. Gearing is a separate measure shows how much of the value of HRA assets is being used to cover HRA-related debt. The council has no local "rule" for the optimal gearing level. It is shown here because it indicates the level of HRA indebtedness, compared to the value of its housing assets. The Baseline shows peak gearing of 46.62% in 2027/28, reducing to 13.20% by the end of the forecast, as shown below:

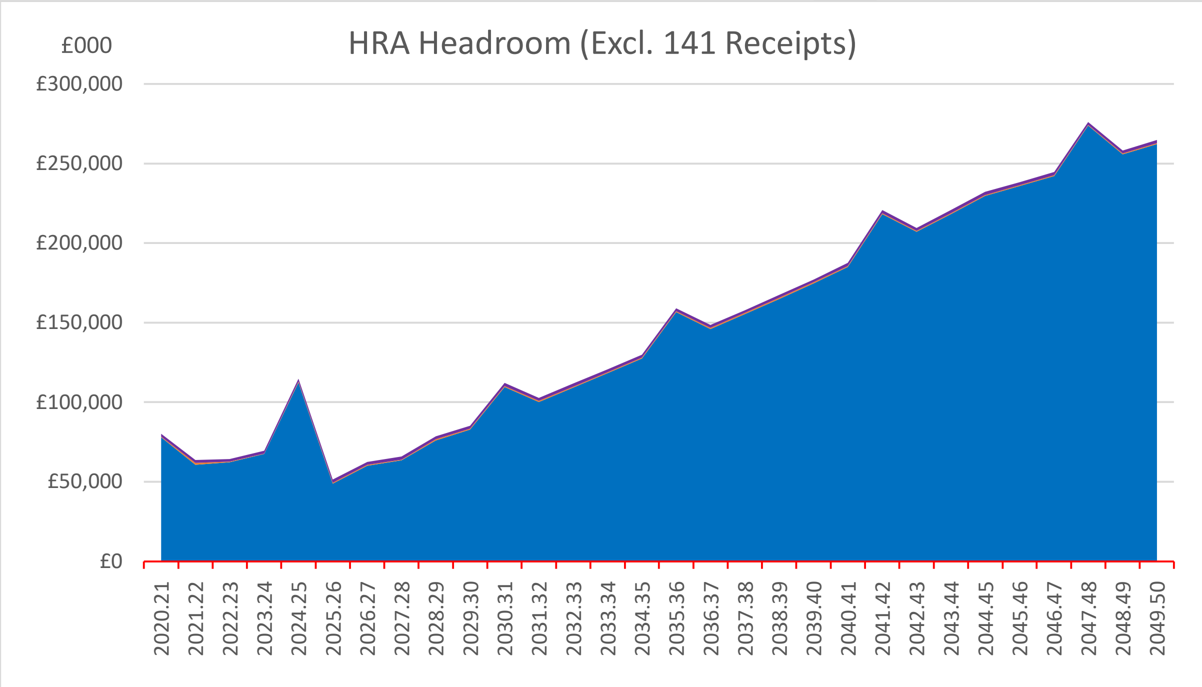


4.3.6. This is broadly equivalent to an owner occupier having a mortgage that comes to 46.62% of the value of their home.

4.3.7. The Baseline position generates sufficient resources for the Authority to be able to repay any additional debt required to deliver the capital programme within a comfortable timeframe, while remaining above the limit set for providing interest cover and maintaining a good level of gearing. This represents an affordable and sustainable situation.

4.4. Baseline – headroom

4.4.1. Financial headroom available to the authority fluctuates during the course of the forecasts, as indicated by the chart below:



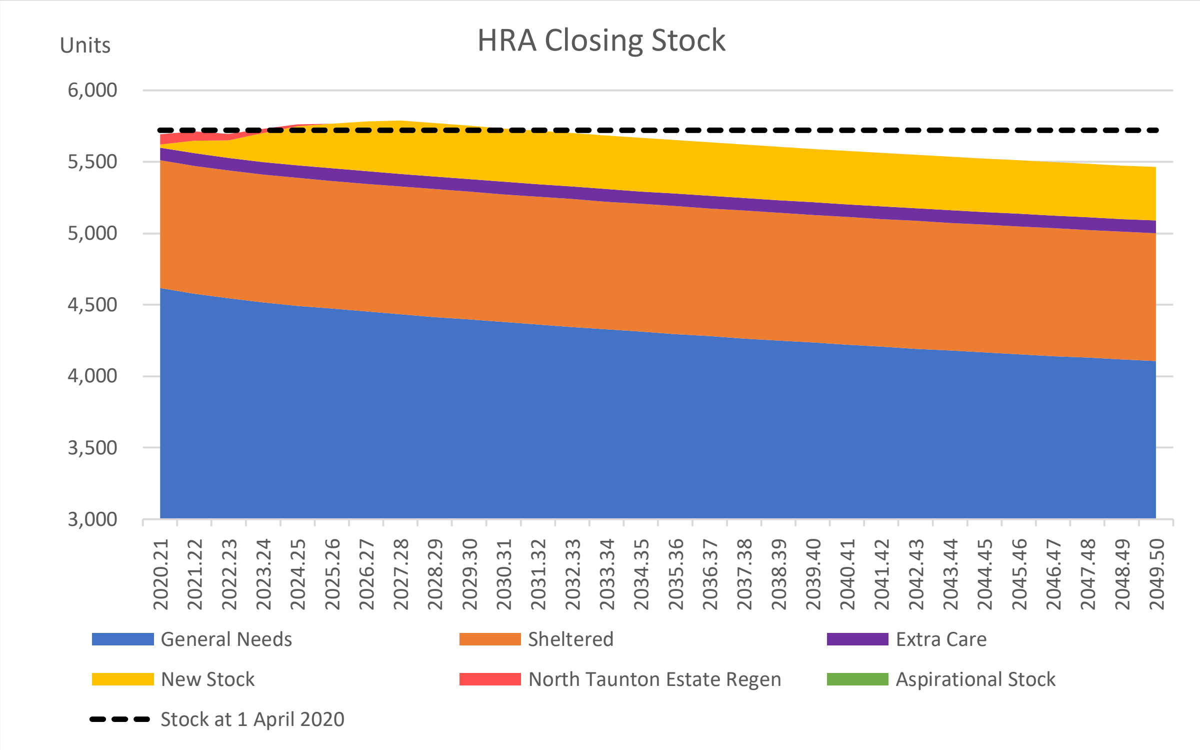
4.4.2. The blue area in this chart represents the gap between the HRA CFR (HRA-related debt) and the interest cover limit shown on the debt chart. Other resources that are generated by the HRA are fully utilised.

4.4.3. At its lowest point the headroom chart shows the additional borrowing that the HRA could draw upon, if necessary, without exceeding its locally set interest cover limit. This borrowing headroom is £48.882m in 2025/26. The reduction in headroom that occurs in that year coincides with an increase in the interest rate assumed for new borrowing (which reduces interest cover performance), and comes two years before the end of the development programme. There are occasional peaks in the projected headroom for an individual year, which coincide with years where there are 53 rent weeks. In these years the Authority generates slightly more rental income, which causes a small blip in its interest cover performance.

4.4.4. The Baseline leaves the authority with a reasonable level of spare borrowing capacity, which would be available for use in response to emerging circumstances.

4.5. Baseline – stock

4.5.1. The final chart shows the movement in stock numbers, taking into account the expected new units and the effects of continuing RTB sales:



4.5.2. This chart projects an initial period of growth in stock numbers, while the programme is delivered, reaching a peak of 5,834 units at the end of 2027/28. From 2028/29 the number of homes declines each year from continuing right to buy sales, with the number of dwellings staying at or above current levels (shown by the black dashed line) until 2033/34. By the end of the 30 year forecast the stock drops to 5,515 units.

4.6. Baseline – summary

4.6.1. The baseline presents a comfortable starting position, in which the authority is able to deliver a substantial medium term development programme, while maintaining its existing stock and repaying any debt required to finance the capital programme.

4.6.2. There may be scope for the authority to improve on this position by adopting an active approach to managing its costs, while optimising its potential for generating income.

5 | Delivery of 1,000 units

5.1. Delivery of 1,000 units – assumptions

5.1.1. This scenario allows for extension of the programme for delivering new units so that 1,000 additional homes are provided over 30 years.

5.1.2. The units have been added in line with details provided by council officers. They include the existing £1.900m provisional scheme at Oake, plus an allowance for further notional projects. The additional new projects are delivered between 2024/25 and 2049/50.

5.1.3. The Delivery of £1,000 Units scenario adds a further 626 units to those delivered under the Baseline. Of these, 169 would be let at social rent with the remaining 457 at an affordable rent.

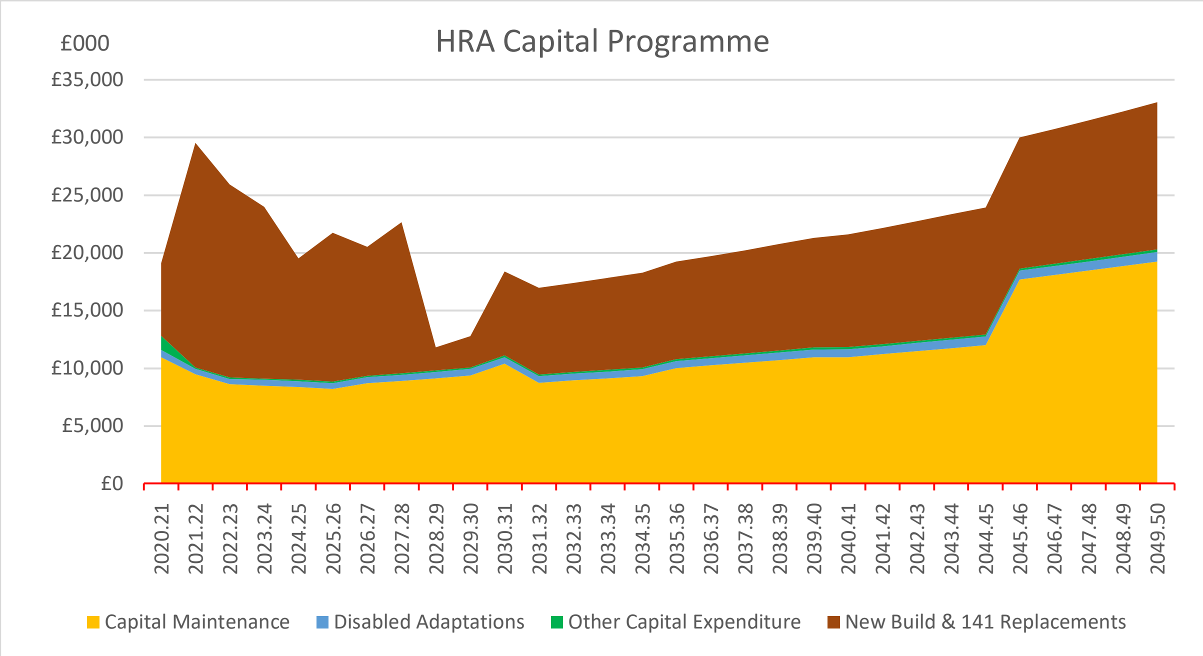
5.1.4. All other assumptions remain as for the Baseline position.

5.2. Delivery of 1,000 units – revenue position

5.2.1. The revenue position under this scenario does not change substantially from the Baseline. The HRA maintains the minimum level of balances and uses any sums above that level to repay debt or finance the capital programme.

5.3. Delivery of 1,000 units – capital programme

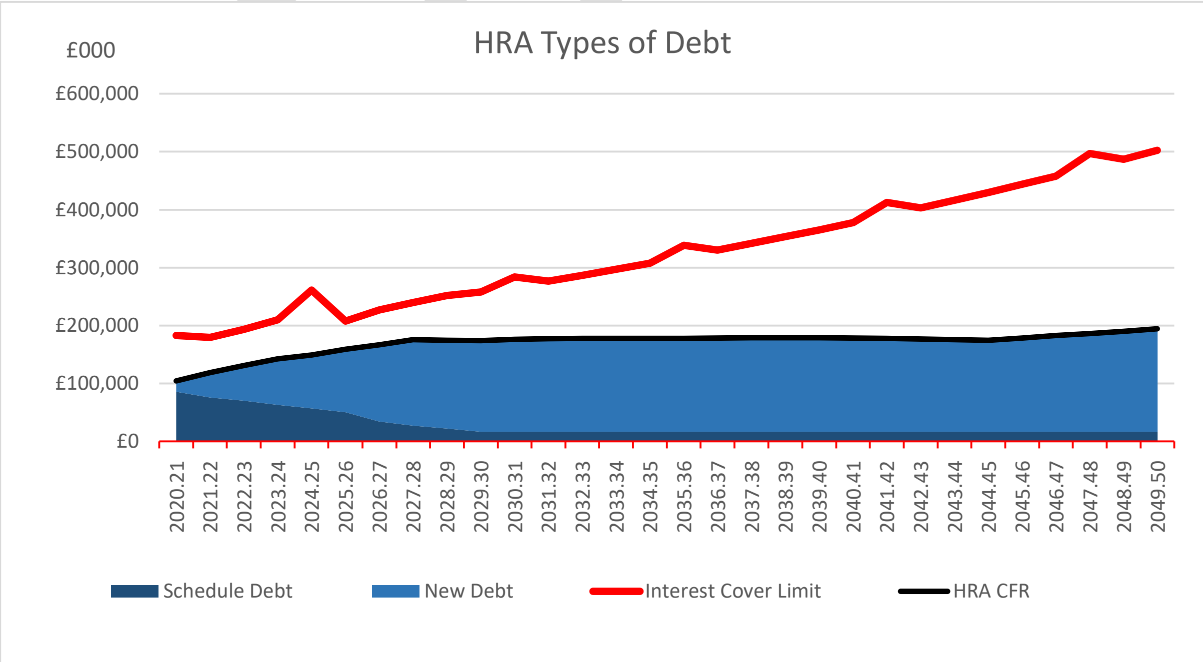
5.3.1. Extending the programme of adding new units through new build and acquisition schemes increases the scale of the capital programme throughout the period, as reflected in the chart below:



5.3.2. This scenario adds to the expenditure on New Build and 141 Replacements, which is shown by the brown area.

5.4. Delivery of 1,000 units – debt and headroom

5.4.1. Peak debt rises to £194.402m in 2049/50, as shown below:



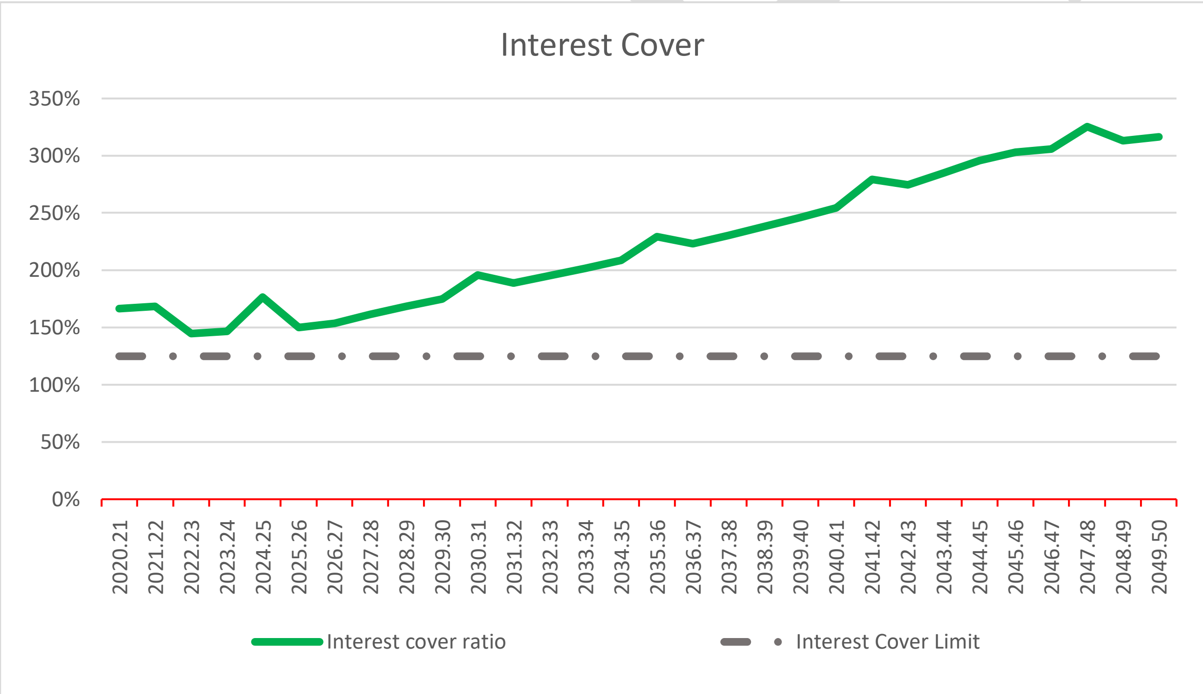
5.4.2. The authority reaches an initial debt peak of £175.883m in 2027/28, which coincides with the end of the initial phase of development. It broadly maintains debt at around this level until 2045/46. The requirement for additional investment in the stock then forces the authority to take out additional loans, bringing debt up to its peak level of £194.402m by the end of the 30 year forecast. This remains above the £107.982m in HRA-related debt that was held at the start of 2020/21.

5.4.3. Borrowing headroom reduces slightly to £48.720m in 2025/26. This leaves the HRA with a reasonable level of spare capacity for responding to most emerging risks and pressures.

5.5. Delivery of 1,000 units – affordability

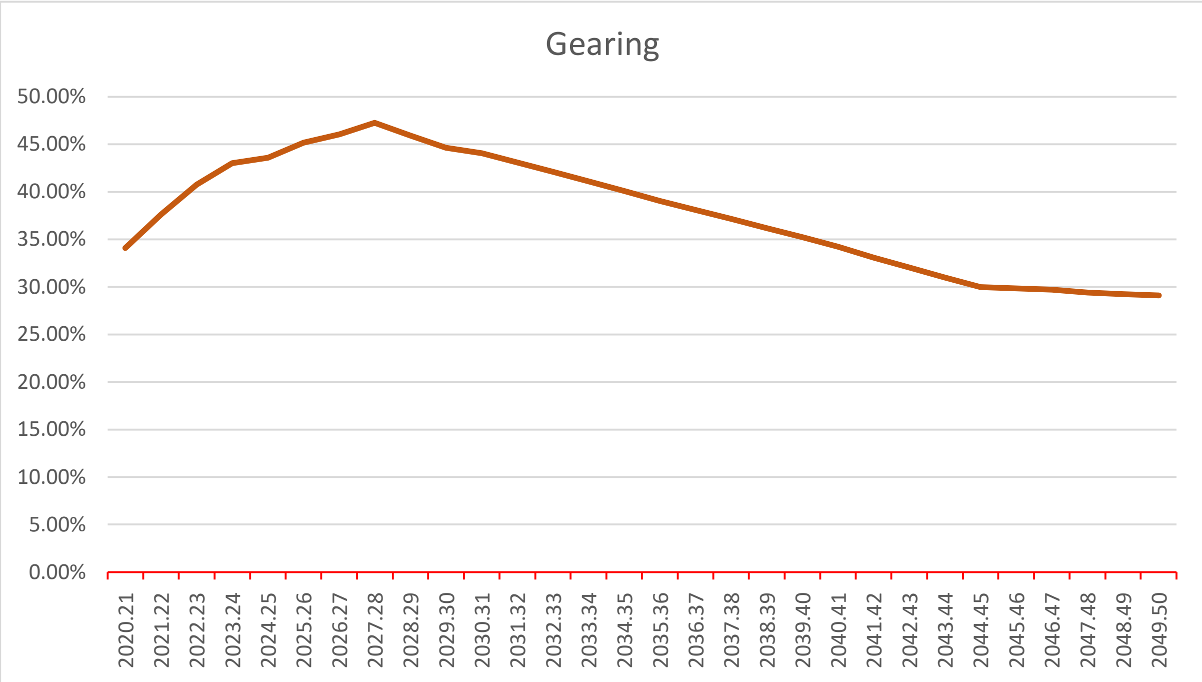
5.5.1. Under this scenario the authority depends much more on borrowing to deliver the new homes required. While this generates additional rental income, it takes the authority longer to reduce its overall debt.

5.5.2. The higher debt levels mean that interest cover takes longer to rise significantly above the 125% minimum level for the first part of the plan:



5.5.3. The level of interest cover provided is lower than under the Baseline, but follows a reassuring trajectory.

5.5.4. By increasing the number of units during the forecast the value of assets that the authority owns also increases. This has the following effect on gearing:



5.5.5. Gearing peaks at 47.27% in 2027/28, reducing to 29.09% at the end of 2049/50. At its peak level the "mortgage" per property is slightly higher than the forecast suggested for the Baseline. By the end of the forecast the figure is substantially higher than under the baseline, due to the authority's continued reliance on debt finance to deliver the 1,000 unit programme and stock investment.

5.6. Delivery of 1,000 units – summary

5.6.1. Under this scenario there is a significant long term rise in the number of units produced, which requires the authority to rely more heavily on borrowing to deliver its plans. However, as the new units produced generate additional rental income for the HRA, the authority is able to keep its overall level of borrowing within manageable levels. The slight increase in borrowing at the end of the forecast is an area of potential concern, for which the authority may need to consider taking mitigating action.

5.6.2. The Delivery of 1,000 Units scenario leaves the authority with a reasonable level of financial "wriggle room", but it reduces the capacity of the HRA to use borrowing to respond to a significant expenditure pressure that competes with the delivery of new homes, or to any potential unforeseen shocks.

5.6.3. Under this scenario the authority should remain flexible in its approach, so that it is able to adjust its spending plans in response to changes in circumstances. It should also explore options for making additional resources available, while maximising income and bearing down on its operational costs.

6 | Impact of additional spending pressures

6.1. Context

6.1.1. There is potential for the authority to incur substantial additional costs to cover further expenditure pressures, such as retrofit works to both the existing stock and some new units as part of delivering a carbon neutral housing stock.

6.1.2. While the updated Baseline contains an additional contingency for works to the housing stock from 2031/32, this is unlikely to be sufficient to cover the cost of a substantial pressure, such as retrofitting all homes to a zero carbon standard.

6.2. Potential impact of additional pressures

6.2.1. Any additional pressures that cause the scale of investment required to increase significantly would mean that the authority quickly utilises all the headroom identified under the updated Baseline. This could reduce the available headroom to zero, leaving the authority with much less “wriggle room” and much higher debt levels.

6.2.2. It is therefore possible that the requirement to meet substantial new pressures could reduce the capacity of the HRA for delivering additional homes after the medium term programme included in the Baseline, as well as its ability to respond to other emerging risks and situations. As a result, if the authority needs to respond to other pressure it may also need to adjust its aspirations for continuing to provide more new homes over the long term, unless the HRA is able to access substantial additional resources or find compensating cost reductions.

7 | Sensitivity testing

7.1. Approach to sensitivity testing

7.1.1. We have conducted a series of tests that show the effects of a one year rent freeze, and increase in the cost of new borrowing and general increases in cost. This allows the authority to consider the potential effects of changing circumstances and helps to illustrate the consequences of different actions.

7.1.2. For each sensitivity we have assessed their impact against the following key metrics:

- Peak debt (amount and year)
- Debt at the end of the forecast
- Borrowing headroom (amount and year)

7.1.3. Taken together, these metrics help to show how each sensitivity impacts on the affordability of the authority's updated Baseline. The table below summarises the effects of each sensitivity on these key metrics:

Scenario/ Sensitivity	Peak debt		Terminal debt		Minimum headroom	
	Year	£000	Year	£000	Year	£000
Baseline	2027.28	£172,633	2049.50	£79,216	2025.26	£48,882
Rent Freeze	2027.28	£174,458	2049.50	£87,338	2025.26	£38,778
Cost of Borrowing Rises	2029.30	£178,017	2049.50	£130,825	2025.26	£0
Cost Increases	2027.28	£174,988	2049.50	£104,350	2025.26	£33,923

7.1.4. The paragraphs below describe the causes of these effects.

7.2. One year rent freeze

7.2.1. Freezing rents at 2020/21 levels for 2021/22 reduces the rental income generated in 2020/21, compared with the Baseline projections. However, since rent increases in are based on rents in the previous year, any rent freeze then has an ongoing impact on the levels of income generated from existing tenancies in both the year of the rent freeze and in future years.

7.2.2. As a consequence of freezing rents the authority is less able to repay debt, and so it has to borrow more for a longer period. This means that peak debt goes up by £1.825m and debt at the end of the forecast increases by £8.122m.

7.2.3. If the authority generates lower levels of income it also has less money available to provide interest cover for its loans. This means that the amount of borrowing it can afford also drops, and so we see the authority's borrowing headroom reduce by £10.104m. This represents a substantial reduction in the financial "wriggle room" that the authority can access when responding to emerging risks and opportunities.

7.3. Cost of borrowing rises

7.3.1. Of the three sensitivities, a 1% increase in the cost of new borrowing has the most significant impact. The high level of borrowing required by the authority to deliver its Baseline capital programme means that any rise in borrowing costs requires any new loans to be repaid over a longer period.

7.3.2. This causes the authority to use more of its rent income to pay for the higher interest charges and so there is less available to repay debt. As a result the HRA has to borrow more for a longer period. Compared with the Baseline, peak debt is reached two years later (in 2029/30) and goes up by £5.384m. Debt at the end of the forecast is substantially higher, increasing by £51.609m.

7.3.3. If the authority incurs higher borrowing costs this reduces the level of interest cover, and so the amount of borrowing it can afford also drops. Under this sensitivity the authority uses up all its borrowing headroom by 2022/23. This would require it to take compensating action to ensure that borrowing levels remain within the limits set.

7.4. Cost increases

7.4.1. Allowing for costs to rise by an additional ½% a year for five years also has a strong negative impact on the health of the HRA. Under this sensitivity the authority generates the same level of rent as under the Baseline, but pays more to deliver services, investment and new homes.

7.4.2. This means that the HRA has less income available to repay debt and so borrows for a longer period. The cost increases we have modelled also increase the cost base for subsequent years, and have a greater impact as the forecast progresses. Peak debt is £2.354m higher than under the Baseline in 2027/28, and debt retained after 30 years is £25.134m higher.

7.4.3. Headroom also reduces, and is £14.959m lower than the Baseline in 2025/26.

7.5. Summary

7.5.1. As we have shown, the HRA forecasts are very sensitive to changes in the levels of income generated and costs incurred. Relatively small changes in these assumptions can have a substantial long term impact on the financial capacity of the HRA.

7.5.2. We recommend that the authority routinely seeks to optimise income and minimise costs as part of its approach to maximising the long term financial capacity of the HRA.