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The Potential for House Building by Local Authorities – Can it be turned into bricks and mortar?

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The government's promises

In the 2007 Green Paper, *Homes for the Future: More Affordable, More Sustainable*, the government held out the promise of local authorities 'having a direct role' in building new housing. In October 2007, HouseMark published a briefing paper about what the Green Paper's promise meant and how it might be carried out. It explained the rules that affect new building by councils, and the changes which the government proposed to make. It gave some practical examples of how local authorities, either directly or in partnerships, might commission and build new housing.

Following further new government announcements, this revised version of the paper is being published, to give up-to-date guidance and review progress since mid-2007. In part, this is because the government has reiterated its promise. The Housing Minister, Margaret Beckett, was quoted (The Guardian, 7 January) as saying that she is creating '…a much more level playing field, and there is an opportunity now for local authorities to participate (in house building) – either in partnership with others or under their own steam'. Then the Prime Minister, Gordon Brown, said on 29 January that:

> *'…if local authorities can convince us that they can deliver quickly and cost effectively more of the housing that Britain needs, and if local authorities can build social housing in sustainable communities that meets the aspirations of the British people for the 21st century, then we will be prepared to give you our full backing and put aside any of the barriers that stand in the way of this happening. We will not allow old arguments and old ideologies to stop us getting on with the job.'*

Reversing the trend?

It is a long time since local authorities were volume house-builders. But surprisingly recently – up to 1990 – they were still building over 10,000 units per year. However, in the last twelve years direct output by councils has fallen to an average of just over 200 per year. Can this trend be reversed? In the last twelve months, starts by councils have totalled 280 units, so there is clearly still a long way to go.

Most commentators believe that councils can and will build more – but the expectation is that output might rise (across England) to 2-3,000 units, not to the levels of the 1980s. There is no indication of what levels of output by councils the government would *like* to see, but the government has now made proposals designed to 'boost this building rate by removing some of the financial barriers stopping councils from building new properties and increasing their housing stock'.[1] They have also suggested that some of the local authority partnerships (considered in this paper) will deliver thousands of new homes, at least a proportion of which will be for affordable renting.

Whether the trend towards councils building fewer and fewer homes will be reversed depends on several key factors. One is how much support for new investment is available and to what extent it is directed towards councils and their ALMOs (as well as housing associations and developers). Another is the changes in the HRA system and other rules, and how much difference they make. A third is the financial and investment models available, or which councils devise themselves. Finally, of course, progress depends on

[1] CLG press release *New Freedoms to Increase Council Building* (21 January, 2009).

whether councils make the most of the new opportunities that the Green Paper and subsequent decisions have created, and especially whether they make much more active use of their own land and/or are given the opportunity to also acquire or use land held by other public sector agencies.

This paper looks at all of these issues and explains what they mean for councils interested in 'reversing the trend'.

The Boost in Social Housing Investment

The Green Paper anticipated the last Comprehensive Spending Review in its announcement of extra investment in new affordable housing. Spending through the National Affordable Housing Programme (NAHP) rose to a total of £8bn over the three years 2008/09 – 2010/11, a 50 per cent increase on the previous three years.[2]

In the last few months, spending programmes have been revised again in response to the credit crunch and the fall in the housing market. First, in September, the government announced that it would bring forward £400m of spending on social housing, planned for 2010/11, in order to build an additional 5,500 social units over the period to April, 2010. It also announced that councils would be able to apply for this funding in the shape of social housing grant. Then, in December's Pre-Budget Report, the Chancellor brought forward a *further* £150m of social house investment from 2010/11, which is now also to be spent before April, 2010, and should provide a further 2,000 homes.

Will councils be in a position to take advantage of this rapid increase in funding, over so short a timescale? This question is made urgent because the recent announcements mean that a considerable increase in the funds available up to April, 2010 will be paid for by cuts to what was planned from April, 2010 onwards. Although it is possible that the next Spending Review will revise total spending upwards - this seems highly unlikely given the growing imbalances in the public finances.

[2] The details of the programme are still found on the Housing Corporation website at www.housingcorp.gov.uk/server/show/ConWebDoc.11921

What the Green Paper proposed on new social housing and how the proposals have been taken forward

Who would supply the new housing?

The Green Paper still expected the majority of new output to be through housing associations, with increased efficiency and further use of reserves helping to achieve the target levels. Without specifying what grant levels would apply, the government was originally aiming to reduce the share of new build costs met by social housing grant – which covered less than half the cost of a typical scheme. In the last year there has however been a general move towards increasing grant rates on the back of the recession in the market and the difficulties being experienced by a number of providers.

The Green Paper also promoted the role of private sector developers, whether using social housing grant or through PFI partnerships with local authorities. Housing associations were therefore still expected to be the main providers, private developers would continue to get social housing grant, and in an environment of intense pressure to get the maximum output from the extra funding, councils and their ALMOs would have to show that they could compete with both these other sectors.

Current market conditions have changed the context somewhat – however, local authorities who bid for grant are still entering a very competitive environment.

Access to social housing grant by local authorities

Although not new in itself, the Green Paper emphasised that ALMOs and other local authority special purpose vehicles (also now often known as local housing companies) would be eligible for social housing grant. By the end of 2008, just four local authority special purpose vehicles had pre-qualified for the National Affordable Housing Programme 2008/11. ALMOs have faired better: six have received allocations and one ALMO (Stockport Homes) has started on site (see below). A further 17 ALMOs have pre-qualified and are now able to bid for funds.

The government said that it would also look at the case for local authorities to get social housing grant directly, although it was concerned about the impact on public sector borrowing levels. (Although not mentioned, the reservation about public borrowing also applies to ALMOs and other local authority-owned companies. We explain this issue in the Appendix.)

Since the Green Paper, the government has reiterated the promise that social housing grant will be available to councils, but *has still not published details* (other than saying that only councils with existing housing stocks will be able to apply).

The Scope for New Build outside the HRA

The Green Paper clarified that it was possible for new build by ALMOs and local authority-owned companies to take place *outside* the HRA, to overcome the handicaps of having to pool rent income and receipts from sales. These changes were not strictly new, but made clear that development carried out at arms length from councils would not be caught by

three of the most restrictive rules that currently still apply to *direct* council building. This meant that:

- The rental income was usable to fund part of the costs of borrowing (and of managing and maintaining the properties) - it would not have to be pooled through the national HRA system.
- Any receipts from sales, if some of the properties were later sold, would return entirely to the council – they would not have to be pooled as with the majority of HRA receipts.
- The right to buy would not apply – any sales would be at the council's discretion.

These were significant – but as we shall discuss – not necessarily conclusive advantages.

The Scope for New Build within the HRA – and the latest proposals

The government said that it also wanted to allow councils to build themselves, *within* the HRA (not through an ALMO or local housing company), and have the same benefits of retaining rental income and receipts. However, at the time, the government clearly expected limited use to be made of these measures, saying it only wanted local authorities to build houses themselves if there was a clear value-for-money case compared with other options.

The government has now published details of how these measures could work.[3] The proposal is to change two of the current rules in their application to newly built (or newly acquired) housing. These are the rules relating to the inclusion of properties in the HRA subsidy system and to the pooling the receipts from sales under right to buy. The first change was made possible by the Housing and Regeneration Act 2008.[4] The second will be made by regulation.

The details are:

- Councils will be able to exclude newly built or newly acquired property from the HRA subsidy system. This would mean that rental income from the properties would be kept by the council, rather than being taken into account in its annual subsidy determination. The income would therefore be available to contribute to the costs of providing the properties.
- Councils would also be able to exclude properties covered by these agreements from the rules about pooling of right to buy receipts. (At present, authorities have to pool 75 per cent of the value of the receipts.)

Councils will have to *apply* for these exemptions. Applications can cover whole schemes or bundles of schemes. Any resulting agreement with CLG will have to ensure that schemes conform to all government policies regarding council housing, including rents and

[3] Changes to the Revenue and Capital Rules for New Council Housing: Consultation on excluding new council housing from Housing Revenue Account Subsidy and Pooling (January 2009) available at www.communities.gov.uk/publications/housing/capitalruleschanges

[4] Section 313 of the act inserted a new section 80B in the Local Government and Housing Act 1989, providing for agreements between the Secretary of State and a local authority which would exclude either a council's whole housing stock or specified properties (including future properties) from the operation of the HRA subsidy system.

allocations. Agreements will also be judged against their impact on public borrowing. The government will therefore use the agreements to secure continuing adherence to its policies.

The proposals are expected to be introduced later this year – subject to the consultation process, which closes on 17 April, 2009.

What will be the effect of the proposals?

The government assesses the likely additional income from retaining the rents to be about 28 per cent. If new homes were let at a typical current rent of say £65 per week, this would be extra income of about £18 over and above management and maintenance costs. The consultation paper is based on average guideline rents and average allowances (on existing stock). In practice the additional income will generally be much higher as new build properties tend to have higher rents and of course newer properties will require less maintenance or major repairs. However, councils will have to make their own calculations of expected income based on local circumstances and their particular new build proposals.

The point of removing the properties from the subsidy clawback calculation was to give councils an opportunity to compete on a similar basis to associations (subject to similar arrangements being introduced for grant), and use the surplus income from the higher rents which can be set for new properties because of their relatively higher capital values.

The rule change on capital receipts is a modest one, given that properties will still be subject to the right to buy. In the event of a discounted sale under right to buy, the council will be able to retain the whole of the capital receipt, but because of the discounts this may still not fully reimburse the council for the outstanding debt on the property. The government has yet to explain what would happen to any social housing grant received on the property sold – whether it would have to be repaid, or could be recycled into new affordable housing.

When the government implements its plans to allow local authorities direct access to social housing grant, this will also be for social housing at 'affordable' rent levels, as set currently by its rent restructuring policy - and in future by any rents policy established by the Tenant Services Authority.

Longer-Term Plans for the HRA

As is well known, the government has also been conducting an overall review of council housing finance, due to report later this year. This has been carried out under independent chairmanship and has involved four 'workstreams' to which a number of practitioners and housing finance experts have contributed. If, as many commentators hope, this leads to moves towards the 'self-financing' of council housing, the full reforms are unlikely to take effect until April, 2010 (or, more likely, April 2011) even though in theory local authorities could already bid to leave the HRA system because of the recent legal changes explained earlier (see page 6 and footnote 4). The rest of this paper therefore concentrates on the immediate changes that apply, in the period before these medium-term plans might come to fruition.

Summary – New build and rule changes about rents and capital receipts

As a reminder, local authorities currently have to comply with government policy on affordable rents because it is (effectively) enforced by the annual HRA determination, which

gives councils only limited flexibility over rent levels. Councils also have to 'pool' their income from HRA rents and sales receipts in the following ways:

- *Rents* - pooling means that the government (in its annual HRA determination) makes an assumption about each authority's rent income and the expenditure it needs to make. In most cases, the calculation leads to the authority having an assumed 'surplus' from which it has to *pay* 'negative subsidy' to the government. In some cases, the local authority has an assumed 'deficit' and *receives* a subsidy payment ('positive subsidy'). In either case, the authority's income is highly dependent on each year's HRA determination.

- *Receipts* – Right to buy and other receipts from the sale of HRA property are subject to complex pooling arrangements, whereby in most cases the authority only retains 25% of the receipt and the rest is repaid to the government, although in return the government does pay back to the authority through the subsidy system the notional net loss of rent.

Figure 1 summarises the possible permutations following the recent proposals.

Figure 1: Recent government proposals about tenancies, rental income and pooling of rents and receipts

Type of housing	**Properties in the HRA - secure tenancies**		**Non-HRA properties owned by ALMOs or LHCs - assured tenancies**
	Under current HRA rules	**If recent proposals are implemented**	
New council housing (newly-built or acquired)	Rent levels strongly influenced by subsidy system; rents and receipts subject to pooling.	Rents would not be pooled; RTB receipts would not be pooled; rents would be limited by agreements between the LA and CLG.	Rents would not be pooled; receipts would not be pooled; rent levels would be determined by the landlord (unless the landlord applies for SHG in which case rents have to be affordable).
Existing council housing stock	Rent levels strongly influenced by subsidy system; rents and receipts subject to pooling.	Rent levels strongly influenced by subsidy system; rents and receipts subject to pooling.	

How can local authorities take advantage of the latest proposals - and build new houses themselves?

How can local authorities gain access to subsidy?

In effect, the only government subsidy available for new build is social housing grant, and (until new rules are issued) local authorities cannot yet access it directly. Authorities with ALMOs have a readily-available partner, eligible to bid for social housing grant if the housing service has either a 2* or 3* accreditation by the Audit Commission and the ALMO 'pre-qualifies' for the NAHP (see below).

Authorities without ALMOs will either have to await the rule change or create a special purpose vehicle, now often referred to as a local housing company (LHC). The LHC is then potentially eligible for social housing grant on a similar basis to an ALMO. They will need to weigh the costs and benefits of doing this – discussed later.

However, there are other ways in which local authorities can subsidise new build apart from (or in addition to) social housing grant:

- Subsidy can be obtained through 'planning gain', by a 'section 106' agreement with a developer under planning legislation. A local authority could take a commuted sum paid as a result of a s106 agreement, and use it to subsidise affordable housing built by the local authority, providing the original agreement doesn't prevent this. Of course, in current market conditions, councils are likely to find that new planning gain is in limited supply.

- Local authorities can also cross-subsidise developments themselves, from receipts obtained elsewhere (eg selling non-housing assets).

- Local authorities can borrow prudentially, if the borrowing costs can be supported from spare (or additional) income.

- Local authority land can be provided free or at low cost.

Islington London Borough has recently started a new build scheme of 14 units, subsidised through capital receipts from sale of commercial properties within the HRA, using council land, and *without* using social housing grant. Its ALMO will be involved in the scheme, but as housing manager rather than as a development partner.

However, access to social housing grant is potentially the most attractive form of subsidy and the following sections concentrate on this route, on the assumption that it will soon be open for local authorities to apply for grant in their own right, along with the possibility of applying through an ALMO or LHC.

How does the Homes and Communities Agency judge who will get social housing grant?

The Homes and Communities Agency (HCA) took over responsibility for the National Affordable Housing Programme (NAHP) and for approving applications for social housing grant, when it replaced the Housing Corporation in December 2008. Social housing grant is only available through the NAHP, so it is vital that local authorities, ALMOs or LHCs interested in bidding for it are familiar with the NAHP *Prospectus*.[5] For bodies that have not yet 'pre-qualified' for the programme, they should be ready to enter the next pre-qualification round when it is announced. (More detailed guidance on entering the HCA's programme cannot be given here, and local authorities should consult the appropriate regional office.)

The NAHP *Prospectus* sets out four criteria for gaining access to social housing grant in competition with other bidders:

- *value* – in terms of total public subsidy per home and per person housed (total public subsidy is social housing grant plus any other public subsidy – see below)
- *quality* – judged using the Corporation's Design and Quality Standards, and rewarding quality above the minimum standards set for all projects
- *deliverability* – with particular concern for planning status
- *policy fit* – judged by fit with national, regional and local strategies.

Value and quality are judged through the 'grant index' – a detailed tool described on pp53-55 of the *Prospectus.*

The ranking of these criteria has not been fully identified and may vary according to the scheme.

It is important to note that it is unlikely that large numbers of local authorities will receive social housing grant in the near future, if the experience of ALMOs is a reliable guide. The availability of social housing grant to ALMOs was announced at a HouseMark event in March 2007. Since then, of the 23 ALMOs that pre-qualified for grant, six have received an allocation of which one has a scheme on site. More will no doubt follow, but the success ratio for the 69 current ALMOs is not likely to be large. Furthermore, while the 'window' for applications is currently wider because of the bringing forward of capital funding in response to the credit crunch, after April 2010 it is set to get much narrower as the amount of social housing grant available is sharply cut (assuming present spending plans are maintained).

It is therefore worth authorities investigating as quickly as possible the opportunities available to them to build new houses, particularly on their own land, even though details on accessing grant funding have yet to be produced.

How will local authorities determine their rent levels in bidding for social housing grant?

If local authorities (and ALMOs or LHCs) are to compete they will need to make similar assumptions on rents and costs as the housing associations who are also bidding for social

[5] www.housingcorp.gov.uk/server/show/ConWebDoc.11921

housing grant. Associations tend to base their feasibility exercises on the marginal costs of the new scheme and set rents at 'target' levels under the government's rent policy – and will often use the full 5% discretion (for general needs) and 10% (for supported housing). Even then they may significantly subsidise a scheme from their surpluses or reserves – an option not currently open to local authorities

The rent levels for new build will need to be carefully assessed as part of the feasibility modelling for each scheme, and while these still need to be set in line with the government rent restructuring rules they are likely to be considerably higher than existing rents – especially where the authority is many years away from convergence of its rents (with housing associations' local rent levels).

On high-density flatted schemes the authority will also need to consider its position on recovering service costs. This may mean a change in local policy on service charges.

How can local authorities demonstrate value for money?

So how can councils compete with associations and with private developers? The *Prospectus* makes clear that ALMOs are likely to receive a poor value assessment due to the classification of their borrowing as part of the 'total public subsidy' mentioned above. However, the Housing Corporation also said that it would ensure equal treatment of all bidders across 'the set of criteria as a whole'. This means that a local authority bidding for social housing grant must be able to put a winning case in terms of one of the three other criteria in the *Prospectus.* So far, the HCA is operating to the same criteria. It remains to be seen whether borrowing by councils for housing purposes will be dealt with differently from other borrowing by the Treasury.

Land is the key factor because it is such an important component of the cost of development. If the local authority can provide cheap or free land, it will reduce the amount of social housing grant required for a given scheme. In theory, by putting in cheap or free land, a local authority is simply making another form of public subsidy. This is true, but the government is clearly also interested in the cost in money terms – getting the maximum number of units from the £8bn funding it is making available.

Access to land can be a determining factor for another reason. Whether the development can go ahead *at all* depends on land being available. In some areas, local authorities may have access to significant land assets in a situation where land overall is in very short supply (or values are prohibitively high). Making their land available may then be crucial in allowing the government to deliver its affordable housing programme in the localities where housing pressure is greatest.

There are several ways in which these advantages of access to land might apply:

- If local authorities are able to show that they have land which is only accessible if they develop it themselves (or are partners in its development), this may be decisive in itself. This could be the case where releasing the land means reconfiguring an estate, for example, and residents would insist on the authority having a decisive role and/or they would want to remain secure tenants of the authority. Estate redevelopments have often been delayed or foundered because of the need to also dispose of the land to an association (and in some cases a private developer as well).

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- If the authority is willing to make the land available free of charge (or at lower than normal cost), this may be decisive in bringing down the amount of social housing grant needed per unit, or reduce the market price of low cost home ownership units. The authority may be able to justify this if it can show significant community benefit from doing so.

- The authority could make land available on any individual site for private market sale. The scale of this would depend on the size of the site. This would provide some additional cross subsidy and would go towards meeting government targets on more mixed communities. The viability of this approach will need to be carefully considered in terms of any potential changes in the property market as well as the tax position which might apply to any new vehicle set up to deliver market sale housing.

- If an authority is one owner in a multi-landlord estate – perhaps managing the property through its ALMO – then new development might be combined with rationalisation of stock ownership or management, demonstrating efficiency gains overall.

In many cases there will be a clear efficiency gain if the council/ALMO remain land owners and landlords, compared to the typical current model where housing associations might purchase council land in order to undertake grant-funded development. The subsequent management arrangements could certainly be more efficient as the ALMO, rather than one or more associations, would be the landlord of both the existing estate and infill developments within it. If some of the development was for low cost home ownership, there would be further efficiency benefits from having unified freehold ownership and estate management in the hands of the ALMO.

Figure 2 gives some ideas for potential development opportunities involving council-owned land. It is worth noting that only the local council is likely to know about and be in a position to appraise opportunities of these kinds: the government can only guess at the scale of new development land they might make available. It would be a valuable exercise (if an authority has not already done it) to carry out such an appraisal.

Figure 2: Possible local authority development opportunities

- Land-locked land behind houses in existing estates
- Obsolete lock-up garages
- Poorly-designed amenity areas or estates with large gardens
- Unsuitable blocks of housing where replacements could be made on site while still releasing other land
- Redevelopment of HRA-owned shops that are no longer viable
- Low demand units (eg sheltered schemes) which could be replaced by more popular units meeting wider demands

When assessing ALMO and local authority bids for social housing grant, the treatment of land and public borrowing will be critical to the overall assessment of the value for money represented by the scheme.

As noted above, councils are not able to cross-subsidise schemes from balance sheet equity as council accounting rules do not work in this way. But councils do have land which can be provided as 'equity' and this would in theory enable them to compete on a similar basis to associations. When housing associations subsidise schemes from their balance sheets, it is not regarded as public subsidy. However, it is still not clear how free or cheap land provided by councils will be assessed when calculating grant entitlement / public subsidy.

Councils therefore will need to liaise closely with the HCA to ensure that their bids are sufficiently competitive after taking account of all the criteria.

Figure 3 provides an illustration of this point. As on most housing association new build schemes the typical feasibility assessment will show an initial loss in year one, even after a contribution from reserves, but over the longer term this should be offset by increased rental growth.

Local authorities are unable to contribute reserves in the same way but can offer free land. If social housing grant is not reduced to reflect the free land, the scheme will show a similar revenue position to a typical housing association in the first year. However, if the land value has to be deducted from the grant the initial revenue position would suggest that the scheme makes a loss in the longer term.

The authority will also need to consider whether the standard assumptions on management costs (see illustration below) are sufficient to cover contributions to overheads – especially where it is setting up a new vehicle.

On any scheme it will be necessary to carefully set out the parameters and risks which could affect that scheme's feasibility and agree what impact this has on the wider business plan.

Figure 3: Comparison of Treatment of Land / HA Equity for Year One of a Scheme

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		Housing Assoc Where Land Has to be Acquired £	Local Authority If Grant Isn't Reduced For Free Land £	Local Authority If Grant Is Reduced For Free Land £
Land		30,000	0	0
Construction Costs		120,000	120,000	120,000
Total Capital Cost		150,000	120,000	120,000
Grant	44%	66,000	66,000	36,000
Contribution from Landlord		30,000	0	0
Net Capital Cost / Loan		54,000	54,000	84,000
Rent	90	4,680	4,680	4,680
Voids	4%	-187	-187	-187
Management		-500	-500	-500
Maintenance		-500	-500	-500
Major Repairs Provision		-400	-400	-400
Interest on Borrowing	6%	-3,240	-3,240	-5,040
Net Revenue Impact - year 1		-147	-147	-1,947

Or is it better to form partnerships – and what form should they take?

Some councils may decide to enter partnership arrangements which combine the advantages enjoyed by the different types of partner, and demonstrate greater value against the four criteria discussed above, than the partners could achieve acting on their own. The two main types of partnership which have emerged for new build are to develop the established ALMO model or to create a new special purpose vehicle, now normally known as a local housing company (LHC), which is only part-owned by the local authority. A further type of partnership – PFI – is considered in the following section.

Partnerships with ALMOs

The most basic partnership would be between the local authority and the ALMO which it has set up and which it owns. Two possibilities are these:

- *The local authority contributes the land, and the ALMO undertakes the development.* An example is the partnership between Hounslow LB and Hounslow Homes, its ALMO, which is being given high value land for development. Sale of some of the homes built will fund the building of rented units, which, as they will be owned by the ALMO, will be let at affordable rents but under assured tenancies with no right to buy. Roughly one house for sale will be needed for every house built for rent. Hounslow LB will have 100% nomination rights. The proportion of social to private sale will vary in practice in other authorities, according to the location and type of scheme.

- *The ALMO obtains social housing grant and the local authority provides the remainder of the finance needed.* Stockport Homes has become the first ALMO to receive social housing grant, for a 17-unit affordable rented development. The council is providing further subsidy in the form of free land, and prudential borrowing from its General Fund. The resulting homes will be owned and managed by the ALMO and let in the normal way, although the tenancies will be assured and there is no right to buy. A similar, much larger scheme is planned by Westminster LB and its ALMO Citywest Homes.

Straightforward partnerships which only involve the council's own ALMO can be viable in areas with high land values where there is sufficient subsidy in the sales of some of the homes or through a s106 arrangement. Alternatively, they may be viable with social housing grant if the council can subsidise the remaining costs of the scheme. In many cases, however, a wider partnership may be required, involving a housing association or developer.

In some cases, councils and ALMOs might consider creating a subsidiary of the ALMO to own the properties, with management being the responsibility of the ALMO itself. The subsidiary might then itself be a joint venture vehicle with a housing association or developer.

Should the authority set up a Local Housing Company?

If an authority does not have an ALMO it may want to consider the costs and benefits of setting up a local authority special purpose vehicle, now often called a local housing company (LHC) to undertake development (see figure 4).

Figure 4: Costs and benefits of setting up a special purpose vehicle

Costs	Benefits
• Set up costs - legal fees, staff time etc • Governance arrangements – not under the direct control of the LA and therefore has potential for conflicts • No track record (unlike an established ALMO) • Potential extra tax payments • Risks associated with sale of properties.	• Potential access to social housing grant (provided there is a registered provider to manage the houses) • Clearly separate development arm • Operates outside the HRA and properties not subject to secure tenancies • A potential source of rented housing with no direct financial input from the LA • LA can retain freehold title to land

The model which several councils are adopting for a LHC is one in which the council has no more than a 50 per cent share, with the other main interest being a private sector body such as a housing association or developer. Four LHCs have now been established, in Barking & Dagenham, Newcastle-upon-Tyne, Nottingham and Manchester. The local authority contributes land, while the HA or private sector partner supplies development expertise. As it is a joint venture, risks and profits are shared. The outputs are likely to include housing for outright sale, shared ownership properties and affordable rented homes. The rented homes might be passed back to an ALMO to own and manage on assured tenancies, as in the examples above relating to new build via ALMOs.

In the Nottingham LHC, the plan is to sell half the homes outright, and a quarter on a shared ownership basis, with one quarter being rented through the ALMO, Nottingham City Homes. Barking and Dagenham are undertaking a 500 home development through an LHC on the Lintons Estate, half of which will be rented or shared ownership. Barking and Dagenham with developer First Base have pre-qualified for the NAHP.

In total, CLG believed the first four LHCs could deliver 10,000 homes – only a proportion of which will be for affordable rent – but that of course was before the recent market downturn.

When looking at the delivery vehicle it will be important to ensure that the business plan model is based on a set of realistic assumptions for ongoing management and maintenance costs and provisions for future major repairs. In particular the management costs need to reflect a contribution towards overheads – especially if the vehicle is new as it is likely to

have a high level of fixed costs, including set up costs. There will therefore be less scope to operate on the marginal cost basis on which many associations currently base their feasibility assessments.

When looking at setting up a new vehicle the authority should also consider the tax issues, especially if the vehicle is being used to undertake either open market or shared ownership sales. It will also need to take advice on the VAT position of any new vehicle as this may no longer be recoverable.

The authority should also take account of the number of new units which might be deliverable on their own land. It may not be worthwhile incurring the costs of setting up a new vehicle unless there is capacity to build at least 500 units.

Other partnership models

Some local authorities are looking at a **variant of the LHC model** which would involve establishing a Local Asset-Backed Vehicle (LABV) which will receive council-owned assets to undertake wider regeneration. Like an LHC, the LABV will be a special purpose company with the local authority as one partner alongside a private sector company as the other. The private partner may be an equity company, which would provide a loan against the value of land contributed by the council. The value of the LABV will be the amount at which the council land is valued plus the amount of loan from the private sector partner. The LABV can then enter into a number of project agreements with a range of different organisations. The first local authority LABV is in Croydon, where it will undertake redevelopment of town centre sites, including commercial development as well as housing.

Some councils are also looking at partnerships with housing associations which are based on more than just providing free or low-cost land and receiving nomination rights. For example, Wandsworth Council has a partnership with Notting Hill Housing Trust in which the council will build new housing on infill sites in estates (using the kinds of opportunity mentioned in figure 2), and then sell them to NHHT, who will be able to claim grant for the development. Under the agreement, NHHT remain the owners, but the properties will be managed by the council as part of its normal service on the estates concerned. The council therefore has the advantage of using NHHT's development expertise and its ability to access grant, but controls the new housing directly itself rather than only having nominations.

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Is PFI an option?

The Private Finance Initiative (PFI) is a further route to deliver new or refurbished affordable housing, although local authorities have in the past been dissuaded by the lengthy procurement period and the relatively high set up costs. To date there are 11 signed non-HRA contracts focussing on new build, with a further four in procurement and three at outline business case stage. Some of the HRA PFI projects also have new build elements.

The advantage of PFI, from a government perspective, is that (as with housing associations) the borrowing is undertaken by the contractor not by the local authority, and so does not count against public borrowing targets. The authority is of course committed to future payments to the contractor, supported by PFI credits paid by government.

From a local authority perspective, an advantage of PFI is that payment is performance-related, unlike one-off social housing grant, and is effectively paid as a revenue subsidy rather than an upfront capital grant. This gives the local authority more control over ongoing performance (eg in ensuring that the property is maintained in good repair) than by simply having nomination rights on HA property.

CLG announced in 2008 that PFI credits of up £1.875bn would be made available for a new PFI round, and bids were encouraged for larger schemes worth over £100m, particularly ones involving some form of regeneration. The bids are currently being reviewed by CLG, but it has already been announced that the PFI round has been considerably over-subscribed (assuming all schemes are able to proceed). An additional element of uncertainty for these bids is the changed housing market context, which is likely to affect those schemes dependent in part on private sales. Schemes may also be jeopardised if changed market conditions make the borrowing on the part of the private contractor too expensive.

Housing PFI partnerships for non-HRA new build

Most new build PFI schemes so far have been non-HRA projects, involving a housing association developing units to the local authority's requirements, and receiving 100% local authority nominations, but with the rental income going to the association, which remains the owner of the properties. There is no right to buy.

These schemes have offered little advantage over social housing grant schemes yet have been more complex, and so not many have gone ahead.

Housing PFI partnerships for HRA new build

In some instances PFI-funded regeneration of local authority estates is incorporating a new build element to reconfigure the stock profile of these areas. In these cases, the new units (like the refurbished ones) remain local authority-owned, but with a long-term (typically 25 years) contract for their management by an outside company. Rents are at affordable levels.

PFI-funded regeneration can therefore provide new council housing, which will eventually return to the council's mainstream stock. As with non-HRA schemes, subsidy is through on-going PFI credits, but in this case added to normal HRA subsidy. The amount of PFI

credit needed will be higher than a non-HRA scheme as the rent surpluses are recouped by government through the subsidy system.

PFI-funded regeneration is probably the preferred form of PFI where the council wants to own the new build units, but is content that it will not initially be managing the housing. Following the approaches used in PFI schemes in the national health service, it would be possible for local authorities (or their ALMOs) to manage the stock either (a) by allowing management to be excluded from the PFI contract, or (b) putting management in the PFI contract, but encouraging ALMOs to join private consortia bidding for the stock.

Further Developments

At various points in this paper, mention has been made of detailed rule changes which are expected but which have not yet been announced. These may be crucial to the practicability of new build schemes for councils, particularly those through the HRA or requiring social housing grant. Local authorities considering building new housing will need to stay informed of developments, by reading *HouseMark News*, maintaining contact with their Government Office and, if planning to enter the National Affordable Housing Programme, the regional office of the Homes and Communities Agency.

Appendix

Local authorities, housing associations and borrowing rules

What are the advantages that housing associations have compared with local authorities?

As well as not being restricted by the national arrangements to pool rents and capital receipts, as described earlier, housing associations enjoy several other advantages compared with local authorities. For example:

Ability to borrow privately
In addition to the restrictions of the HRA system, local authorities have an automatic handicap compared with housing associations: any borrowing to meet the substantial part of scheme costs that is not covered by social housing grant is considered to be public borrowing. Despite the other changes in the Green Paper, even councils' prudential borrowing (and borrowing by ALMOs) remains on the public sector balance sheet (see explanation below).

Use of surpluses and reserves
Another serious handicap is that associations can and do use their reserves (and surplus rental income) to cross-subsidise new developments, and indeed the government is encouraging them to do so. The HRA system effectively prevents local authorities from building up reserves and surpluses in the same way. Local authorities are also not able to carry forward negative HRA balances – compared with LSVTs for example - and therefore have to meet any initial revenue losses on new build from existing revenue resources.

Development expertise
Many associations and developers also have lengthy experience of procuring and carrying out new developments, and may well have considerable financial expertise in this area, as well as having their own development staff. Most local authorities have lost the expertise they once had in this field.

And what advantages do local authorities have?

Local authorities *do* have advantages compared with housing associations and developers, which can offset the handicaps just mentioned. They include:

Lower borrowing costs
Their borrowing, although counting as public sector, is potentially cheaper because of their financial strength, their status as part of government and ability to borrow at low interest rates through the Public Works Loans Board (PWLB), and to pool their borrowing costs across the local authority. This is a significant advantage at present as borrowing margins in the housing association sector are much higher than in the local authority sector.

Control of land

Most significantly, they control large amounts of housing land, some of which they might be able to release. Although downplayed in the Green Paper, it is clear that access to council-owned land is a major attraction to the government of giving councils a bigger role. Land availability is one of the key factors which determine whether a scheme is 'deliverable' (one of the four criteria by which bids will be judged). However, free or subsidised land also counts as 'other public subsidy' in assessing the value demonstrated by the scheme.

Existing management service
Local authorities (or their ALMOs) already provide good housing services in their capacity as landlords, and these services can readily be extended to any new properties built. It also improves the authority's overall economies of scale and helps combat the impact of property lost through the right to buy and other sales.

What different rules apply to local authority borrowing (and borrowing by ALMOs and local authority-owned companies)?

There have been several references in this paper to public sector borrowing and to prudential borrowing. How do they relate to investment in new social rented homes, in a project eligible for social housing grant? At present, a typical house costs about £150,000 to build, and the grant required might be £66,000. The remaining £84,000 has to be borrowed, and the costs of borrowing met from rents.

In the case of a *housing association or developer*, the borrowing comes from the private market (eg a bank or building society) at the rates which the market offers, which will depend in part on the financial status of the association or developer. From the government's viewpoint, although it may be concerned about the impact of borrowing costs on rent levels (and therefore wants to get associations to subsidise schemes from any surpluses they have), it is not overly concerned about the amount they borrow as it is not on the public sector balance sheet.

If a *local authority* were to build the same properties at the same cost and with the same grant, it too would have to borrow £84,000. It would probably borrow from the PWLB, at much better rates than a housing association, because of its status as part of government and because its borrowing is pooled across the whole of the local authority. But the borrowing is on the public sector balance sheet - even if it is an ALMO which does the borrowing (because the ALMO is local authority-owned). This concerns the government because although it has recently abandoned its targets for public sector debt, it is clearly likely to be worried about levels of debt growing even higher. Large amounts of extra borrowing for council house building might therefore be a problem.

Local authorities might counter this argument by saying that their borrowing is now governed by rules that it must be 'prudential', and that they would have no intention of breaking these rules. This is true, and it means that the government is likely to be less worried than it might have been that authorities would overreach themselves. However, it doesn't alter the overall point, which is that borrowing might be prudential for the authority but the cumulative total still adds to the government's total debt. That is one of its main concerns.

What are the prospects for changes in the rules?

If the current CLG and Treasury review of council housing finance leads to self-financing HRAs, then local authorities will be able to retain all their rental income (not just the rents on new houses) and will be able to afford more prudential borrowing (although any transition seems certain to include restraints on the amount of borrowing). This borrowing would still count towards public borrowing targets. The outcome of the review will be known later this year, but it is not clear whether it will address the issue of how borrowing is accounted for.

If there were changes in the arrangements about borrowing, they might apply either to separate companies like ALMOs, or (more ambitiously) to local authorities themselves. There are two main possibilities, neither at present 'on the table' as far as the government is concerned:

1. HouseMark (with the CIH and National Federation of ALMOs - NFA) made the case for taking **ALMO borrowing** out of the public sector – in our 2005 report *ALMOs – A New Future for Council Housing*. If the government did accept this argument, it would be likely to mean ALMOs having to become non-local authority owned companies, probably by having a majority of tenants on the board and the local authority retaining a minority interest (but still owning the housing stock, as before). The report showed how this could be done in ways that would take any new borrowing by such an ALMO off the public sector balance sheet, and the ALMO put in a similar position to a housing association. This could be done within *current* rules about public sector borrowing. The NFA has taken forward this work and is publishing further proposals in the first half of 2009.

2. CIH and others have also argued that **direct borrowing by a council** for housing investment should be accounted for differently from general government borrowing, as it is a trading activity and accounting rules would support its different treatment. This is because the assets create an income which helps to pay the costs of the debt. It is unclear whether recent promises by the Prime Minister to 'put aside any of the barriers' to council house building might include such a reform.[6] It would mean *new* rules about borrowing, but they would bring Britain into line with the conventions followed in other EU countries.

Until major reform takes place, the rules are clear: direct borrowing by a local authority or ALMO counts as public borrowing. Current indications are that the HCA will be counting this borrowing as a different form of 'public subsidy' when assessing the local authority/ALMO bids, thus making them less un-competitive. However, the latest indications are that the Treasury will be looking at the aggregate level of public borrowing used to support the ALMO/local authority new build programme. It is not yet clear whether there will be any overall cap on this borrowing.

[6] Speech by the Prime Minister to the New Local Government Network, 29 January 2009.

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