

HOUSING CORPORATION

GOOD PRACTICE GUIDE

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# LSVT Review

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# CONTENTS

## SECTION

1	EXECUTIVE SUMMARY	3
2	INTRODUCTION	7
3	THE TRANSFER VALUATION MODEL	13
4	STOCK TRANSFER ASSUMPTIONS	15
5	PROMISES MADE TO TENANTS	33
6	THE LESSONS TO BE LEARNED FOR FUTURE TRANSFERS	35

# 01 EXECUTIVE SUMMARY

## CONTEXT

- 1.1** In transferring its housing properties to a Registered Social Landlord (RSL), a local authority transfers all of the financial risk of managing and maintaining the stock for a capital receipt. An association has to ensure that its business plan has sufficient capacity to manage those risks as it will be funded solely by borrowings. A local authority needs to ensure that it receives “best value” for the stock having regard to the risks transferred.
- 1.2** Our review has assessed the extent to which the actual experience of associations has differed from the assumptions in their business plans and some of the reasons why these have occurred. Our findings can be used to inform discussions relating to future transfers on:
- setting the valuation price at transfer;
  - preparing association business plans; and
  - understanding risk areas within business plans from a regulatory perspective.

## FINANCIAL RISKS

- 1.3** Associations have to generate sufficient cash surpluses to repay loans over a thirty-year period. They also have other objectives to achieve, principally the improvement of the stock so that it meets, as a minimum, the Government’s Decent Homes Standards by 2010, and to increase the efficiency and effectiveness of services provided to tenants.
- 1.4** The six key areas of assumptions in an association’s business plan relate to:
- rental income;
  - stock numbers;
  - repairs and improvement costs;
  - management costs;
  - corporation tax; and
  - funding costs.

- 1.5** Each of these areas is subject to the risk that the original assumption in the business plan will vary with actual performance. Risk arises from changes in the operating environment, e.g. demographic and social and Government economic and fiscal policy. They also arise from the ability of an association to manage its finances efficiently and effectively.
- 1.6** Our review indicated that there are many assumptions where associations have little ability to influence outcomes, i.e. risks materialise from the external operating environment. A good example of this is the introduction of the Government’s rent influencing regime, in 2001. Other examples are; the introduction of the Government’s policy that social housing providers have to achieve the Decent Homes Standard by 2010, changes in interest rates and the increase in the attraction of right to buy (“RTB”) for tenants due to the buoyant housing market in the last few years.
- 1.7** These changes have a much more profound impact on the business plans of associations than factors over which they have more control such as; the numbers of staff employed and the prices paid for maintenance work. Where risks adversely impact on an association, their ability to manage them is often restricted to delaying or reducing repairs and improvement programmes which is not sustainable in the longer term.

## BASIS OF OUR FINDINGS

- 1.8** Our report is based on the detailed examination of the business plans and subsequent performance of a sample of eleven associations, which were formed in the period 1992 to 2001. We are very grateful and appreciative of their time and willingness to participate in our review.
- 1.9** It proved very challenging to make like for like comparisons of performance against the original plan. Associations do not stand still. Many have diversified their activities and some have joined other housing associations in group structures. Nevertheless, we have been able to distil themes from the comparisons we made, principally by

# 01 EXECUTIVE SUMMARY

comparing associations' current business plans projections with their original business plans.

- 1.10** The themes from our review are set out in the following paragraphs:

## BASIS OF OUR FINDINGS

- 1.11** Rental income is, in aggregate, forecast to be lower than anticipated. The range of variation between rental income in the original business plans and revised business plans in our sample is +6% to -41%. The principal reasons are; the effects of the Government's rent influencing regime, reduced stock numbers arising from RTB sales and lower than anticipated RPI increases applied to rental income, particularly for earlier transfers. Some housing associations have not been able to incorporate the full requirements of rent restructuring into their business plans due to the adverse impact on its ability to repay borrowings within a 30-year period.
- 1.12** Bad debts and voids rates have been higher than anticipated in the period after transfer but most associations expect that they can be reduced to the levels anticipated in their business plans in future. The range of variation between bad debts and voids in the original business plans and revised business plans in our sample is +62% to -7%. Possible reasons for the over-optimism in the early post transfer period are; the disruption to service caused by changes in staffing and/or systems and the effect of decanting tenants prior to demolition or for improvement works to take place.

## STOCK NUMBERS

- 1.13** Stock numbers have decreased more than anticipated in nearly every association due to higher than expected RTB sales. This is despite the fact that associations have developed more new properties than they anticipated. RTB sales are higher due to a number of reasons, principally speculation over property prices, lower interest rates, perceived threats by Government to reduce the attractiveness of right to buys and the prospect of purchasing an improved property.

- 1.14** Most association business plans assume that the impact of right to buys is neutral, the future rental income stream foregone is compensated for by lower management and maintenance costs and the capital receipt, even after sharing part of this capital receipt with the local authority.

- 1.15** Our review findings suggests that whilst this may be true with a relatively low level of right to buy sales, the incidence of right to buy sales on the scale which has been experienced will reduce the net income of the association as it needs to reduce its fixed and semi-fixed costs, which is more difficult to achieve, to compensate for lower rental income levels.

- 1.16** In an attempt to prevent stock numbers falling, associations, particularly earlier ones, have undertaken development programmes utilising the additional loan security generated from improving their property stock.

## REPAIRS AND IMPROVEMENTS COSTS

- 1.17** Repairs and improvement cost assumptions are in line with or lower than anticipated at transfer. The range of variation between repairs and improvements costs in the original business plans and revised business plans in our sample is -3% to -32%. Most associations have re-profiled their repairs costs after transfer to take account of changed stock numbers, improved knowledge of their stock, the need to meet the Decent Homes Standard or affordability issues. Some associations are critical of the variable quality of the stock condition survey data used to inform the original business plan assumptions.

- 1.18** Our review highlighted that there were a range of reasons for the lower than anticipated repairs and improvement costs assumptions being experienced, some relating to factors outside their control e.g. poor stock condition survey information or lower inflation and some due to improved procurement practices e.g. partnering deals with private contractors. It has not been possible to quantify the relative amount due to each of these factors, as information is not readily maintained by associations to enable such analysis.

# 01 EXECUTIVE SUMMARY

**1.19** The earlier transfers tend to show higher levels of § compliance with the Decent Homes Standard, reflecting the completion of their repairs programmes.

## MANAGEMENT COSTS

**1.20** Management costs have, in general, been higher than anticipated. The range of variation between management costs in the original business plans and revised business plans in our sample is 41% to -20%. The reasons identified are higher than anticipated salary cost and pensions increases, increased staff numbers in response to the desire to improve the service to tenants or the inability to reduce staffing levels as anticipated. In addition, management costs have not, in general, reduced in correlation with right to buy sales.

**1.21** Management costs as a percentage of rental income in the original business plans in our sample vary between 8% and 26%, with an average of approximately 20%. In the revised business plans the range is between 10% and 36%, with an average of approximately 22%.

## CORPORATION TAX

**1.22** For the non-charitable associations in our sample, none have yet paid any corporation tax, as was anticipated, because taxable surpluses only tend to arise in the latter years of the business plan. There are opportunities to avoid these future liabilities by joining a group, setting up a charitable subsidiary and using gift aid to mitigate tax liabilities, or changing to charitable status.

## FUNDING COSTS

**1.23** Interest rates are in line with or lower than anticipated. In aggregate, they are one third lower than expected. Associations have been fairly prudent in making interest rate assumptions in their original plans. Therefore, most associations have benefited from lower than anticipated interest rates almost immediately after transfer and from the sustained level of lower interest rates in the UK economy for the last few years.

**1.24** Associations have been active in managing the risks of interest rate rises by fixing interest rates on a good proportion of their borrowings, immediately after transfer, and refinancing loans to extend the loan period and take advantage of lower interest rates.

## OVERALL CONCLUSION ON ASSUMPTIONS

**1.25** Associations have managed to cope with lower rental income and higher management costs by reducing repairs and improvements and interest costs. Overall, though, they are generating lower amounts than they anticipated are needed to repay their borrowings. This position is still viable for many, as their funders have agreed to increase borrowings and extend the original borrowing period on the strength of future cash flows and the asset base.

## PROMISES TO TENANTS

**1.26** Our review also examined the extent to which there was evidence that promises to tenants were being met and how associations were using their financial resources. Again this aspect of the review proved challenging due to the variability of information available to provide a comprehensive picture and associations had not always made promises to tenants in a way which were sufficiently specific to allow measurement to take place.

**1.27** We found that where associations had made specific promises, we were able to see data confirming that the promise had been met or, in the case of recent transfers, was on course to be met.

## LESSONS FOR FUTURE TRANSFERS

**1.28** We have made a number of suggestions designed to assist; local authorities, associations, the Housing Corporation and the ODPM in discharging their respective responsibilities relating to the business plans of associations.

**1.29** In setting the transfer price, local authorities and associations should recognise that there are significant risks surrounding business plan assumptions over which associations appear to have little control. Accordingly, there is a need to ensure that sufficient capacity is built into business plans to manage these risks.

# 01 EXECUTIVE SUMMARY

- 1.30** In considering the assumptions for future stock transfer business plans, local authorities and associations should be aware of the experiences of the associations we reviewed, particularly in terms of the degree of variation which can occur in the key income and expenditure assumptions. Where the association has more control over its actual performance such as bad debts, voids and management costs, associations have tended to make overly optimistic assumptions.
- 1.31** Given the degree of risk that faces associations, it is unlikely that lenders will be willing to extend the 30 year loan period at the outset of the plan even though there is substantial potential for significant post transfer gains after the loan is repaid, as properties will continue to generate net income long after this period.
- 1.32** Lenders are, however, more willing to extend the loan period on the strength of the cash flows after 30 years, once the initial repairs programme is completed and the management of the association has demonstrated a good track record. This is helping associations to replenish some of the stock lost through right to buy sales.
- 1.33** Local Authorities are not obliged to recycle, into housing, right to buy sales receipts shared with them by the association, and associations have not been able to re-negotiate right to buy agreements even where the local authority has benefited from the windfall increase in house prices and higher than expected right to buy sales. There should be the opportunity for local authorities and associations to re-negotiate the terms of these agreements to take account of the financial circumstances of the association, post transfer.
- 1.34** We would suggest that associations seek to appoint, as a minimum, the Chief Executive and Finance Director of the association, prior to the transfer (i.e. immediately after the ballot) to provide more ownership of the business plan assumptions at senior management level. Ideally, the whole senior management team should be appointed prior to transfer.

# 02 INTRODUCTION

## BACKGROUND

**2.1** In March 2003 the National Audit Office (NAO) published a report 'Improving social housing through transfer' which assessed whether large scale voluntary stock transfers have delivered the intended benefits to tenants, and examined the financial effects of transfers.

- 2.2** The NAO made a number of main findings on whether stock transfer is delivering improved services to tenants:
- £6.2 billion of private finance has been secured to fund future costs of renovations and long term improvement programmes.
  - RSLs have largely delivered the expected benefits to tenants of better quality social housing, better housing services and opportunities for tenant participation.
  - About 30% of the 82 RSLs surveyed were likely to meet the Decent Homes Standard within five years of transfer, and most should do so within ten years. However, 17% will fail to meet the standard within ten years.
  - The extent and cost of promises made to tenants varied. Promises are sometimes unclear, leaving tenants uncertain about what they can expect from transfer and hindering subsequent evaluation of RSL's performance.
  - Most RSLs have established sound finances after transfer. A small proportion have experienced financial difficulties and a very few have had to merge with other more viable RSLs to overcome significant financial problems.

**2.3** Their key findings on the financial effects of transfer can be summarised as:

- The terms on which a transfer is made to an association are intended to be cost neutral but this may not be achievable in practice. They found that the transfer valuation model uses a fixed time period of 30 years whereas property lives vary, and the discount rate used in the model has been higher than associations' cost of capital.
- In the NAO's view, the fixed parameters within the transfer valuation model mean that cost neutrality is unlikely to be achieved in practice, and may increase the taxpayers contribution beyond that intended to reflect the cost of bringing the properties up to an appropriate standard. Using data for eight case studies, they estimated that if the life of the properties had been assessed as 40 years the potential transfer value would have increased by £51 million, some 14% more than the actual transfer price. Similarly, they calculated that the potential transfer value of one of their case study transfers would have been 53% higher using the real cost of capital of the association.
- Post transfer events had an impact on the cost neutral position intended at transfer.
- The additional cost of transfer over local authority renovation has delivered non-quantifiable benefits such as earlier improvement of poor condition social housing, community regeneration and increased tenant participation, and achieved risk transfer, including the risks relating to income and cost, maintenance and risks arising from shortfalls in demand.

## 02 INTRODUCTION

### THE STOCK TRANSFER PROGRAMME

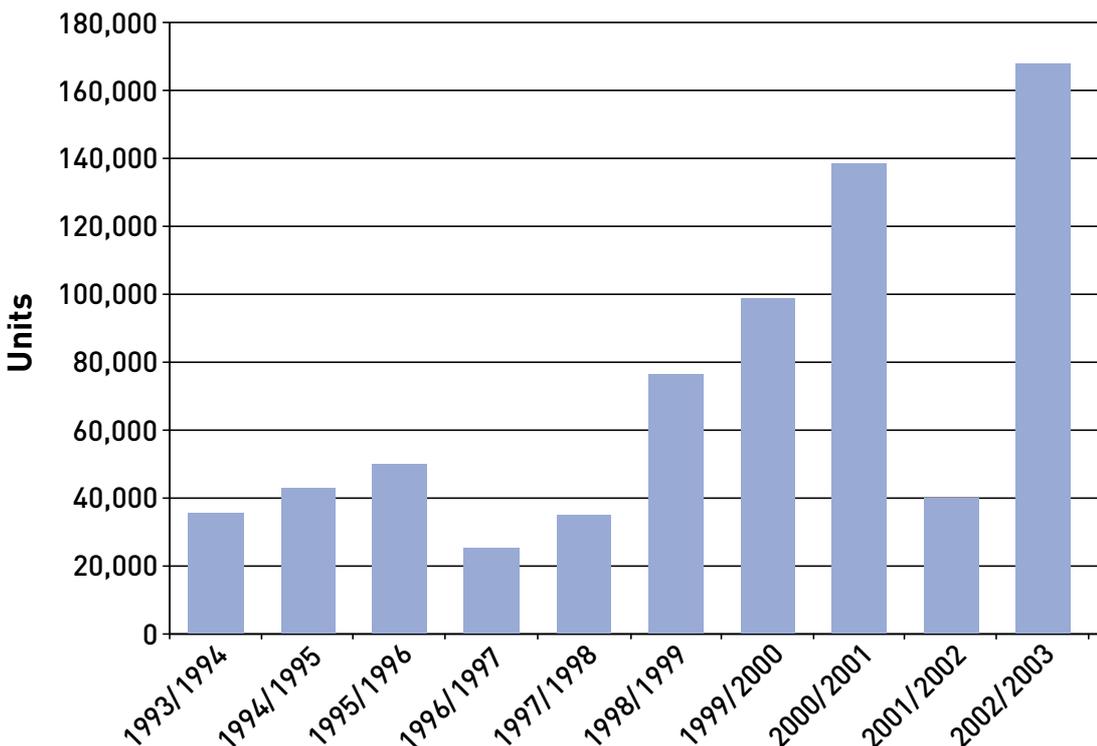
- 2.4** Since the stock transfer programme commenced in 1988, there have been 825,000 homes transferred to associations through LSVT, representing 18% of the 4.2 million homes owned by local authorities in 1988 (source: ODPM, NAO). In recent years, the number of properties transferred has increased (see **Diagram 2.4 below**).
- 2.5** On 5 May 2004, the ODPM announced that there were 58 new schemes on their ALMO, PFI and LSVT programmes. There are 37 LSVT schemes that will see the transfer of just under 115,000 homes from 18 local authorities.

### BUSINESS PLAN PREPARATION

- 2.6** When a local authority is appraising the options for the future of its housing stock, it will use the ODPM's Single Transfer Model to calculate the Tenanted Market Value (TMV) of the stock. In summary, this is a 30-year spreadsheet model that calculates the net present value of owning and managing the stock.
- 2.6** The Single Transfer Model, commonly referred to as the 'valuation' model, is the starting point of the stock transfer process and is the basis for determining the purchase price of the stock. The assumptions in this model are typically derived from historical local authority data, and from a detailed stock condition survey commissioned by the local authority.

DIAGRAM 2.4

**Total number of properties sold by local authorities to RSLs and housing associations**



SOURCE: ODPM

## 02 INTRODUCTION

- 2.8** This valuation model is then evolved into a 30-year cash flow model: the business plan. Indicative, and then final, funding terms are incorporated; corporation tax is included; where possible, development expenditure is included; other costs that the local authority is not willing to fund are added; plus any other amendments that the association wishes to make. This business plan must demonstrate to funders and the Housing Corporation that the association can repay its debt within a loan period, usually of 30 years. Refinements are made to the assumptions in the business plan to ensure repayment is achieved.
- 2.9** Once the business plan is prepared, an independent firm of consultants is engaged to review the business plan. This exercise draws the Board members' attention to those assumptions that are sensitive to the achievement of the plan and where risks may exist. Typically, the assumptions that receive the most debate are the subjective assumptions on real rates of increases in management and repairs costs.
- 2.10** After transfer, the association will prepare updates to the business plan, typically annually, to reflect actual results and changed forecasts for the future. The funders will use the revised plans to support their continued offering of the loan facility, alongside the use of covenants to monitor performance in specific areas.

### KEY ASSUMPTIONS IN THE BUSINESS PLAN

- 2.11** The key assumptions in the business plan models relate to those factors that determine how much income the association will receive and how this income is spent (**see table 2.11 overleaf**).

### OBJECTIVES OF THE REVIEW

- 2.12** The NAO report recommended that a review should be undertaken of a
- “sample of post transfer RSLs finances, to assess the extent to which transfer assumptions have proved realistic, and the transfer valuation robust, the lessons to be learned for transfer valuations in the future, and the implications for policy relating to post transfer gains and losses where these are significant”.

- 2.13** The Corporation required the review to achieve the following objectives:

- Investigate and comment upon the assumptions used by stock transfer associations in their business plans in the light of subsequent events.
- Assess the financial effects of any differences between the assumptions used in LSVT business plans and actual outcomes.
- Consider the promises made to tenants at the time of transfer and ascertain whether any changes to plans or variations to assumptions have had an impact upon the delivery of any of these, either financial or non-financial, in a beneficial or unfavourable way.
- Produce a report quantifying the effects of the above.

### SCOPE

- 2.14** Associations which agreed to participate in this study were selected to represent a cross section of LSVTs to date throughout the country: small and large, urban and rural, and early transfers through to those that transferred just a few years ago. Transfers that took place within the last two years were not selected because it was felt that it was too soon to be able to draw meaningful conclusions from their performance to date.
- 2.15** Eleven associations provided the required information. The key details of the sample associations are as follows (**see Table 2.15 page 11**).

TABLE 2.11

INCOME	EXPENDITURE
<p><b>Rental and service charge income:</b></p> <ul style="list-style-type: none"> <li>• Income per unit (latterly determined by rent restructuring guidelines)</li> <li>• Number of units</li> <li>• Real rate of inflation</li> <li>• Voids and bad debts</li> <li>• Any promises given to tenants</li> </ul>	<p><b>Repairs and maintenance costs:</b></p> <ul style="list-style-type: none"> <li>• Costs from the stock condition survey relating to catch-up repairs, improvements, cyclical works and responsive repairs.</li> <li>• Number of units</li> <li>• Real rate cost inflation</li> <li>• Any promises given to tenants</li> <li>• Costs of DLO (where applicable)</li> <li>• Repairs cost per unit</li> </ul>
<p><b>Income from right to buy/right to acquire sales:</b></p> <ul style="list-style-type: none"> <li>• Right to buy sharing agreement (which stipulates the net income foregone to be retained by the association)</li> <li>• Number of right to buy sales</li> <li>• Number of right to acquire sales</li> <li>• Split of sales by property type and year</li> <li>• Rate of re-letting properties with protected tenancies to new assured tenants (as this determines the number of tenants who will have the right to buy)</li> </ul>	<p><b>Management and administration costs:</b></p> <ul style="list-style-type: none"> <li>• Premises costs (incl new office accommodation)</li> <li>• Staff costs (incl pensions)</li> <li>• Overheads</li> <li>• Split of costs between variable and fixed</li> <li>• Number of units</li> <li>• Rate of corporation tax</li> </ul>
<p><b>Income from improvements (as previously included in some transfer business plans):</b></p> <ul style="list-style-type: none"> <li>• Number of properties being improved</li> <li>• Income per unit</li> <li>• Real rate of inflation</li> </ul>	<p><b>Developments:</b></p> <ul style="list-style-type: none"> <li>• Number and type of units to be developed</li> <li>• Income from new developments</li> <li>• Development cost per unit</li> </ul>
<p><b>Grant income:</b></p> <ul style="list-style-type: none"> <li>• Supporting People</li> <li>• Capital grants for new developments</li> </ul>	<p><b>Interest payable:</b></p> <ul style="list-style-type: none"> <li>• Variable and fixed rates and commitment fees</li> <li>• Purchase price of the stock</li> </ul>

TABLE 2.15

AUTHORITY	DATE OF TRANSFER	ASSOCIATION	GROSS TRANSFER PRICE £M	NUMBER OF DWELLINGS	PRICE PER DWELLING £
LB Bromley	06/04/1992	Broomleigh (now part of Affinity)	117.60	12,393	9,489
Wycharon DC	03/10/1994	Evesham & Pershore	42.90	4,020	10,678
Rushmoor BC	13/11/1995	Rushmoor (now part of Pavillion)	65.1	5,102	12,800
Walsall MBC	26/03/1996	Beechdale Community	3.80	1,485	2,525
South Oxfordshire DC	07/07/1997	South Oxfordshire HA (now soha housing)	68.33	5,018	13,618
LB Bexley	09/02/1998	London & Quadrant	34.99	4,097	8,540
East Lindsey DC	01/03/1999	East Lindsey Partnership Housing (now Linx)	45.0	5,102	8,820
West Lindsey DC	18/10/1999	West Links Housing (now ACIS)	30.7	3,929	7,814
Burnley BC	08/03/2000	Burnley and Padham Community Housing	22.41	5,330	4,205
Coventry CC	22/09/2000	Whitefriars Homes North & Whitefriars Homes South	49.50	20,125	2,460
Calderdale MBC	06/03/2001	Pennine Housing 2000	36.00	12,759	2,825

Source: ODPM

## 02 INTRODUCTION

### DEFINITIONS

**2.16** A stock transfer business plan is typically a narrative document appended with outputs from a financial model. It is common practice for the financial model to also be referred to as a 'business plan'. In this report, all references to 'business plan' relate to the detailed spreadsheet financial model that supports the narrative 'corporate' plan.

### APPROACH

**2.17** For each association in the sample, we compared the original stock transfer business plan with the current business plan to highlight the differences and similarities. We also plotted actual results against the original business plan to assess the level of correlation between what was envisaged at transfer and what actually happened.

**2.18** To understand the reasons between the variances, we met with key finance people from a number of the associations. It was important that we met with people who had been with the association since transfer, or shortly after, had a deep understanding of the business plan, and could provide the explanations we required. We also asked for their views on how well the stock transfer process worked for them, and what they would do differently if they were to repeat the process.

**2.19** We obtained copies of tenants' consultation documents to understand the promises made to tenants. We then reviewed newsletters, annual reports and internal information to assess whether these promises had been met.

**2.20** We concluded our review by comparing our findings from each association to see what trends, if any, emerged. We assessed whether the factors that had impacted upon the association since transfer were within their influence and whether they could have been or should have been foreseen at transfer.

### LIMITATIONS IN OUR REVIEW

**2.21** One of our aims for this study was to compare the assumptions in the valuations with those in the business plans. Unfortunately, the valuation models are owned by the local authorities and not all the associations had copies. Where we were provided with valuation models, they were in paper form and we were therefore unable to determine the formulae and assumptions.

**2.22** Another limitation of our review was the evolution of time between the transfer and today. We were reliant on staff continuity and recollection to explain what was intended by the detail of business plans prepared over ten years ago.

**2.23** In all cases, the way the association presents its actual and forecast information today differs from the formats used when their original business plans were prepared. We found it difficult to review repairs and maintenance expenditure as associations have reclassified their costs (by category and in respect of management of the works) both in their business plans and financial statements. It was particularly difficult to track actual costs in early years when some items were expensed and others capitalised into the cost of housing properties. Consequently, our analysis of repairs and maintenance works is not as extensive as we would have liked. In our opinion, a consistent approach should be taken to the classification of repairs management costs in the preparation of business plans and financial statements.

**2.24** The presentation of information in financial statements has changed since 1992, as a result of presentational changes from the Accounting Determinations and policy changes brought in by SORPs and accounting standards. Comparing financial statements prepared in 2001 with business plans prepared over 5 years earlier is problematic as some of the information is not completely comparable.

### STRUCTURE OF OUR REPORT

**2.25** Our report is structured as follows:

- The transfer valuation model.
- Stock transfer assumptions.
- Promises made to tenants.
- The lessons to be learned for future transfers.

**2.26** We also include an appendix for each association highlighting key points from the review of their data.

# 03 THE TRANSFER VALUATION MODEL

## BACKGROUND

**3.1** As referred to in Section 2, each local authority considering stock transfer must prepare a valuation of its housing stock, using the outputs from its stock condition survey. The method for valuing the stock is prescribed by the ODPM (and its predecessors) in the Housing Transfer Manual.

## THE EVOLUTION OF THE SINGLE TRANSFER MODEL

**3.2** Valuations prepared in the early 1990s are not comparable with valuations prepared today. The first transfer in our sample occurred in April 1992. Back then, the model did not have to deal with rent restructuring or Decent Homes, and Section 54 grant was available to offset corporation tax liabilities. The required discount rate at that time was 8%.

**3.3** During the years that have followed, the price that LSVTs have had to pay for their stock has been affected by a number of factors:

- Rent restructuring. Early transfers assumed that rents would rise at RPI plus 2%, then latterly RPI plus 1% and plus   %. Moving to target rents has had mixed effects but has limited rent increases, post-target, to RPI plus   %.
- Decent Homes. Valuations must reflect the expenditure needed to meet the Decent Homes Standard.
- Changing discount rates.

**3.4** The Housing Transfer Manual for the 2003 programme addressed some of the issues in the NAO report. Key changes from the 2002 manual are:

- “The 12,000-dwelling guideline on the number of dwellings that can be transferred to a single landlord has been removed.”
- “Confirmation that the sale price for the transferred stock incorporates any non-rental income such as that from shops and garages, sales of vacant land. A clear policy and contractual arrangements for the use of Right to Buy receipts.”

- “We have stated that we would be willing to consider alternatives to the 30-year income and expenditure assumptions in the single transfer model, and different discount rates from the current 6-8% range, but only where these demonstrate value for money in comparison.”

**3.5** This last point is arguably the most significant change to the single transfer model in a number of years. The Manual justifies the use of 30 years by noting that it is a sensible timescale that is acceptable to potential funders, but that the ODPM would consider argued cases for valuations over periods longer, or shorter, than 30 years. It infers that if funders were happy with a different timescale, and if value for money was demonstrated, there would be no further objections from the ODPM. Using a period of less than 30 years would decrease the value of the stock, and hence the price paid by the association (and vice versa).

## SINGLE TRANSFER MODEL

**3.6** The single transfer model is constructed as follows:

- A Cost Generation Model is used to detail the repair and improvement works needed to bring the properties to the Decent Homes Standard. It allows these costs to be charted over a 30-year period.
- These figures flow into the Pricing Model, which calculates the property valuation over 30 years using a discount rate of between 6% and 8%. This is called the Tenanted Market Value (TMV).

**3.7** There is clearly an understanding, even expectation, that the assumptions in the valuation will be different to those in the transfer business plan. For example, there are a number of prescribed elements in the pricing model that the association may wish to amend in its business plan. Also, the association may wish to disaggregate assumptions in the business plan to provide more detailed projections than is required in the pricing model.

## 03 THE TRANSFER VALUATION MODEL

### PRESCRIBED ELEMENTS OF THE PRICING MODEL

- 3.7** The pricing model offers the local authority flexibility in how it calculates the income and expenditure to be input in the model, and in some areas offers flexibility on what types of income and expenditure these might be. There are, however, certain areas where flexibility is not permitted:
- The model must reflect the costs of Decent Homes compliance.
  - The rent model must be included.
  - RTBs must be included unless cost neutral (this is inherently flawed because whilst RTBs may be cost neutral they are not cash flow neutral)
  - The NPV must be calculated over 30 years (unless value for money is demonstrated by using a shorter or longer period).
  - The discount rate must be 6 to 8% (unless value for money is demonstrated by using a different rate).
  - Service costs should equate to service charge income.

### CONCLUSION

- 3.9** The pricing model is not intended to be prepared to the level of detail required for the business plan, and the local authority is offered flexibility in how it incorporates income and expenditure into the model, subject to the prescribed elements noted above. The business plan should be regarded as the definitive forecast of the income and expenditure to be derived from owning and managing the stock, not the pricing model.

# 04 STOCK TRANSFER ASSUMPTIONS

## INTRODUCTION

- 4.1** The income and expenditure streams of each association will be affected by a number of factors; some that the association is able to influence, some that it can only partially influence, and others that are beyond its control. In assessing whether the single transfer model is an appropriate way to calculate the value of the transferring stock and whether any lessons can be learned for future transfers, we first examine the level of influence the association has over the key assumptions in the valuation and business plan financial model.
- 4.2** We then summarise the trends from our comparison of the associations' actual results and revised business plans against the original transfer business plan. Where applicable, we outline the key reasons behind the variances from the original business plan, and conclude by offering our thoughts on what can be learned for future transfers.

- 4.3** Our work covers the six main areas of the business plan:
- (i) Rents.
  - (ii) Stock numbers.
  - (iii) Repairs and improvements.
  - (iv) Management costs.
  - (v) Corporation tax.
  - (vi) Funding.

## RENTS

### Key assumptions affecting rental income

- 4.4** The rental income of each association is affected by the following assumptions set out in **Table 4.4 (overleaf)**.
- 4.5** In summary, there are very few areas where the association can influence its rental income.

TABLE 4.4

ASSUMPTION	DEGREE OF INFLUENCE BY ASSOCIATION
Retail price inflation.	No influence. This is a standard assumption across all business plan models.
Starting rents for tenants transferring over from the local authority.	No influence. This is determined by the local authority before transfer.
Target rents for transferring and assured tenants.	The target rent figure is calculated based on local earnings and local property prices compared to national, of which the association has no control. However the association is able to use a 5% tolerance above or below this figure as it sees fit.
Rate of convergence with target rents.	Whilst the association has very little control over the target rent figure, it is able to determine how it moves from current rents to target i.e. as quickly as possible (subject to limits), or evenly over the convergence period. The method chosen will affect rental income over the convergence period.
Number of properties upon which a rent is received.	Almost no influence – see section on stock numbers below.
Long term real rate of rent increases.	Prior to the introduction of the current and previous rent regimes, the association would have had some control over the long-term rate included in the business plan. Now, rent rises are restricted to RPI plus _%.
Rental income from improvements.	Prior to transfer, the local authority transfer team would have decided whether tenants were to be charged for improvements to their homes. The association would have to uphold any guarantees given to tenants in this respect. For any new improvements, the association is able to determine what level of charge can be levied subject to the constraints of rent restructuring and promises made to tenants.
Rate of bad debts.	Whilst the association can take measures to improve credit control, there is an element of this assumption that is beyond its control. The assumption in business plans is usually informed by the local authority's historical bad debt rate.
Rate of voids.	The influence that the association has over the rate of voids depends on the reason why the tenant has left. The association will have no influence if the tenant wants to leave the property due to moving out of the area or because the size of type of property is no longer appropriate. However, it does have the power to ensure its properties are attractive to live in and that it delivers its services properly, plus it is able to control how quickly properties are re-let. Also, the association's demolition programmes will shape the pattern of voids. The assumption in business plans is usually informed by the local authority's historical void rate, as amended for the effect of any catch up repair and demolition programmes that require tenants to be decanted.

# 04 STOCK TRANSFER ASSUMPTIONS

## Overview of review of rent assumptions

**4.6** We compared actual rental income to date and revised future rental income with the original business plan for each association. With the exception of one association, all currently forecast future rental income to be lower than in the original business plan. The main reasons for this absolute loss in rental income are rent restructuring and right to buy sales (see Diagram 4.6 below).

## Rent restructuring

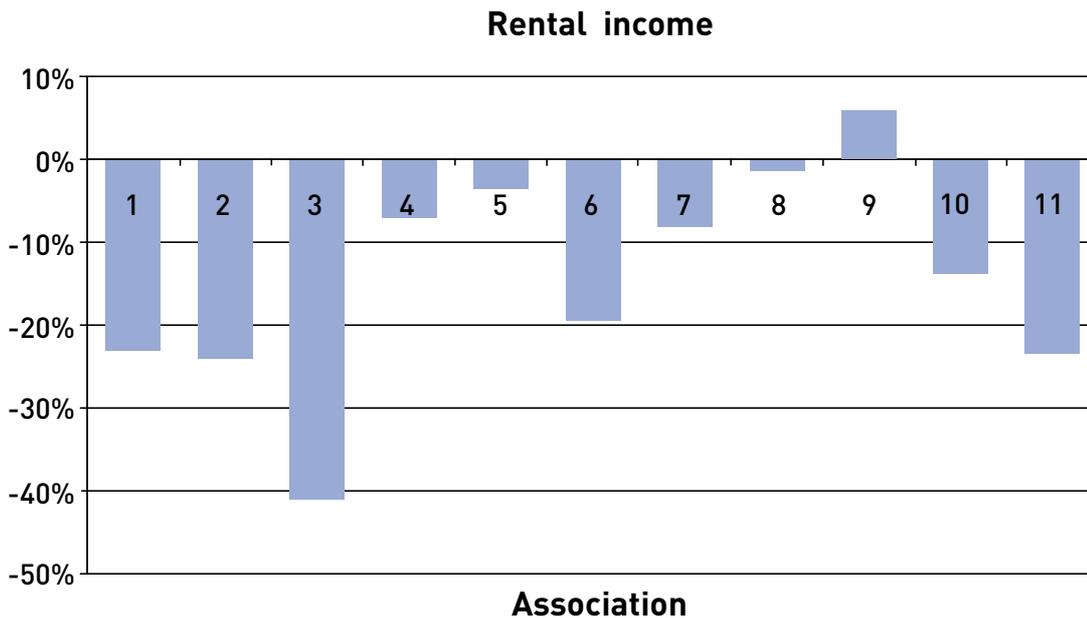
**4.7** Early transfers assumed a higher level of rent increases than is now possible under rent restructuring. However, the effect of rent restructuring will depend on whether the association's rents were above target rents or below. Where rents were below target, rent restructuring will increase absolute rents charged. Where rents were above target, rent restructuring will decrease

absolute rents charged. Clearly the cap on the level of rent increases applied to absolute rents at RPI plus % will cause plans prepared using RPI plus 1% or RPI plus 2% to experience a reduction in their long-term rental stream.

**4.8** Some associations are not yet able to incorporate rent restructuring into their business plans as the adverse effect would push their loan repayment beyond the required 30 years.

**4.9** There is clearly a disparity between those transfers that took place before rent restructuring was introduced and those that took place after. One of the associations commented that their valuation of £36 million would have been negative if rent restructuring had been incorporated.

DIAGRAM 4.6



## 04 STOCK TRANSFER ASSUMPTIONS

### Voids and bad debts

- 4.10 Transfer business plans tend to assume that voids and bad debts will continue at a rate similar to that experienced by the local authority.
- 4.11 In some cases, the plans assumed that the long-term rate would fall. In the majority of cases, voids and bad debts were higher in the first few years after transfer than forecast, but the associations have generally managed to bring them back in line with the business plan.
- 4.12 Where demolitions are planned, especially of high rise flats, voids will rise as tenants are decanted.
- 4.13 Associations appear to underestimate voids and bad debts figures that are experienced immediately after transfer. Possible reasons are that they fail to recognise the disruption caused by recruitment of new staff and implementation of new systems that can be exacerbated by decanting of tenants prior to demolition of properties.

### Conclusion

- 4.14 Rent restructuring has reduced the rents per unit received by the sample of associations, with the exception of one association for whom rent restructuring has increased rents per unit. Combined with the experience of stock numbers, referred to in the next section, the associations in our sample are set to receive a future rental income stream that is generally below that forecast at transfer. Even those associations with an active

development programme are struggling to reinstate rental income to that forecast at transfer and rental income figures used to calculate the purchase price of the stock.

### STOCK NUMBERS

#### Key assumptions affecting stock numbers

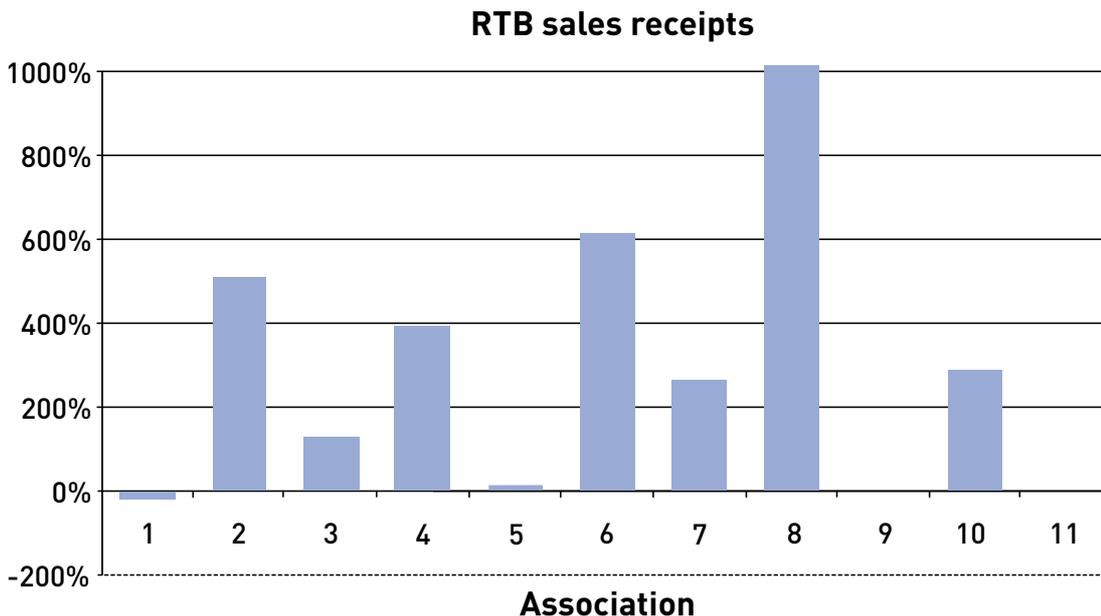
- 4.15 The stock numbers of each association are affected by the assumptions set out in **Table 4.15 (overleaf)**.
- 4.16 In summary, the only assumption that the association can influence is the number of new developments, which is dependent on the availability of funding and suitable sites.
- 4.17 We compared actual to date and revised stock number movements with the original business plan for each association. The main factor determining stock number movements is right to buy sales. All associations have experienced higher right to buy sales since transfer than forecast in the original business plan. If we look at the period from now until the end of the original 30 year period, we can see that increased right to buy sales are forecast to continue **(see Diagram 4.17 p20)**.
- 4.18 Associations 9 and 11 included no income from right to buy sales in their original business plans, but have now included it in their revised business plans. Association 8 is forecasting a 30-fold increase in income from right to buy sales. We have capped this line in the chart above as it distorts the scale.

TABLE 4.15

ASSUMPTION	DEGREE OF INFLUENCE BY ASSOCIATION
Number of right to buy/right to acquire sales.	<p>Virtually no influence, although the number is restricted as only protected tenants have the right to buy. Arguably, as properties become improved the tenants may be more likely to exercise their right to buy, but as the association is required to improve the stock to meet its promises and Decent Homes the effect is beyond their control.</p> <p>At transfer, the business plan will include an estimate of the likely number of sales, as forecast by independent surveyors. This is assessed for reasonableness by comparing with the local authority's historical sales numbers, the buoyancy of the local housing market and with the total number of protected tenants.</p> <p>Right to acquire will depend upon the amount of eligible new stock developed.</p>
Timing of right to buy sales.	No influence. The assumed timing of sales in the transfer business plan will be informed both by the independent surveyors and the local authority's past experience.
Net income foregone retained by the association from each property sale, per the right to buy sharing agreement.	The sharing agreement is fixed at transfer using a calculation of the net income foregone prepared using the business plan at that time. The association is unable to influence this figure after transfer.
Number of new developments.	The association is able to decide if it wishes to undertake new developments, subject to having grant funding, land, loan capacity/asset cover sufficient to allow it to happen..

## 04 STOCK TRANSFER ASSUMPTIONS

DIAGRAM 4.17



### Right to buy sales

**4.19** For ten of the associations, actual income from right to buy sales to date has exceeded that included in the original business plan, which is forecast to continue. Reasons cited include:

- Improved properties are more attractive to buy.
- Some business plans incorporated only 50% of forecast property sales to be 'prudent'. RTB sharing agreements are designed so that the effects of RTB sales are theoretically cost neutral, but the sale accelerates the cash benefit of holding the property to the year of sale rather than being spread over 30 years. More sales in earlier years equates to more cash and less borrowings, so it has been commonplace to assume less sales so that the association has more headroom in the funding.
- The capping of the discount available to tenants, and the speculation that the ODPM would remove the right to buy, increased applications for right to buy.

- Lower interest rates have made it easier for tenants to afford a mortgage. The differential between mortgage payments and paying rent has narrowed.
- Speculation that house prices will continue to rise and therefore an individual's wealth would increase.

**4.20** Most transfer business plans assume that an element of management costs is variable, so as properties are lost through right to buy there will be a reduction in overheads. However, when sales occur faster than anticipated, the association will need to cut its variable costs faster than anticipated. Often, associations underestimate the number of right to buy sales in their business plans so that the positive cash effect of a property sale is not overestimated. If the association underestimates that number of right to buy sales in its business plan it is underestimating the reduction required in variable management costs.

**4.21** Most of the associations have been able to start development programmes to replace the stock lost through right to buy. One of the associations received development land at transfer so has been able to achieve this and more. Another of the early transfers has implemented an impressive development programme but is yet to reinstate the numbers lost through right to buy.

## 04 STOCK TRANSFER ASSUMPTIONS

### Right to buy sharing agreements

- 4.22** Right to buy sharing agreements differ in their sophistication, but are designed to pass the risk of losing money through fluctuations in property prices back to the local authority. We noted the following shortcomings relating to RTB sharing agreements:
- Some agreements incorporate a combined net income foregone to apply to both flats and houses. More houses tend to be bought than flats, so in these cases associations are able to keep less money than they would if flats and houses were dealt with separately.
  - One association noted that they found it difficult to reconcile the net income foregone figures to the costs in the business plan as one was finalised before the other.
  - The net income foregone figures are finalised at transfer. Any amendments to assumptions after that date because of external or internal factors are not reflected. In particular, variable cost changes are not reflected.
  - When improved properties are sold, the association loses the benefit of the money spent on improvements.
  - Local authorities are able to use their discretion in drafting the agreements. The ODPM requires there to be a contractual relationship to govern how the proceeds are shared, but it does not specify how the proceeds must be shared. The use of discretion allows some associations to share more of the risk and more of the proceeds than others.

### New developments

- 4.23** In most cases, the transfer business plans assumed no development programme. The trend has been for associations to implement a development programme as soon as they can after transfer to replace properties lost through right to buy. The scale of this depends on how well they improve their position in relation to their business plan and how much additional funding they can attract.
- 4.24** The revised business plans of the earlier transfers assume rolling five-year development programmes. The main reasons we noted for current forecast peak debt figures being higher than forecast at transfer is due to drawing additional facilities to fund developments.

### Conclusion

- 4.25** Associations are unable to control the pace and number of properties lost through right to buy. Business plans should reflect a realistic estimate of what properties will be sold and when, so that management can plan for cost reductions and future developments.
- 4.26** RTB sharing agreements are the only detailed long term agreements that the association has with the local authority that affect business plan assumptions. We recommend that the practice of having net income foregone figures fixed at transfer be reviewed to ensure that both the association and the local authority can share the risks and rewards more equitably.

### REPAIRS AND IMPROVEMENT COSTS

#### Key assumptions affecting repairs and maintenance

- 4.27** The repairs and improvement costs of each association are affected by the following assumptions set out in **Table 4.27 (overleaf)**.
- 4.28** In summary, the association is able to influence the timing of catch-up and major repairs if it does not delay compliance with the Decent Homes Standard, but it is unlikely that the association can influence the timing of responsive repairs. The association has influence over the rates it pays for all categories of repairs by virtue of the specification of materials used and the method of procurement.

TABLE 4.27

ASSUMPTION	DEGREE OF INFLUENCE BY ASSOCIATION
Retail price inflation.	No influence. This is a standard assumption across all business plan models.
Stock condition survey input information.	<p>The stock condition survey commissioned prior to transfer is prepared to the brief of the local authority. The association is able to rephrase the works and ultimately can commission another stock condition survey if it disagrees with the outputs, but is nonetheless required to do those works that are necessary to meet the Decent Homes Standard.</p> <p>The costs incurred post transfer for each association will depend on whether unit costs are in line with the stock condition survey, and whether the actual numbers of repairs done are in line with the plan. The association may well spend the exact amount of money in the plan, but it may be that it has done more works for less money, or even less works for more money. Consequently, drawing any meaningful conclusions from comparing actual spend against budget in this area has its limitations.</p>
Real rate of increases in repairs and maintenance costs.	The association's influence over cost inflation depends on the demand for contractors' services in the area and the association's ability to negotiate favourable rates, perhaps through partnering arrangements. When transfer business plans are prepared, the real rate of increase used is usually based on the transfer team's estimate of what the increase in building and repairs costs is likely to be. It is rarely derived from historical data from the local authority.
Rate of Value Added Tax.	This is largely outside the influence of the association. Those associations that have their own Direct Labour Organisation will pay less VAT in total on their repairs, but the existence of a DLO depends on the arrangements made at transfer.
Stock numbers.	The number of responsive repairs will be determined by the number of properties (largely outside the control of the association) and the overall state of repair of properties. Those properties that are more run-down and have yet to be improved could arguably incur more responsive repairs. This is somewhat within the influence of the association as they determine the timing of the improvement programme, but ultimately the improvements have to be carried out within the parameters of the business plan, giving the association less influence.

# 04 STOCK TRANSFER ASSUMPTIONS

## Overview of review of assumptions

**4.29** As noted in section 2, we experienced difficulties reviewing repairs and maintenance costs because of classification differences. In all cases in this sample, repairs and maintenance costs were either in line with or below that envisaged at transfer. In addition, forecast spend between now and the end of the original 30 year period is less than forecast at transfer: It is not clear whether this is because of an acceleration of works or because the costs in the original business plan overestimated the likely amount payable (see Diagram 4.29 below).

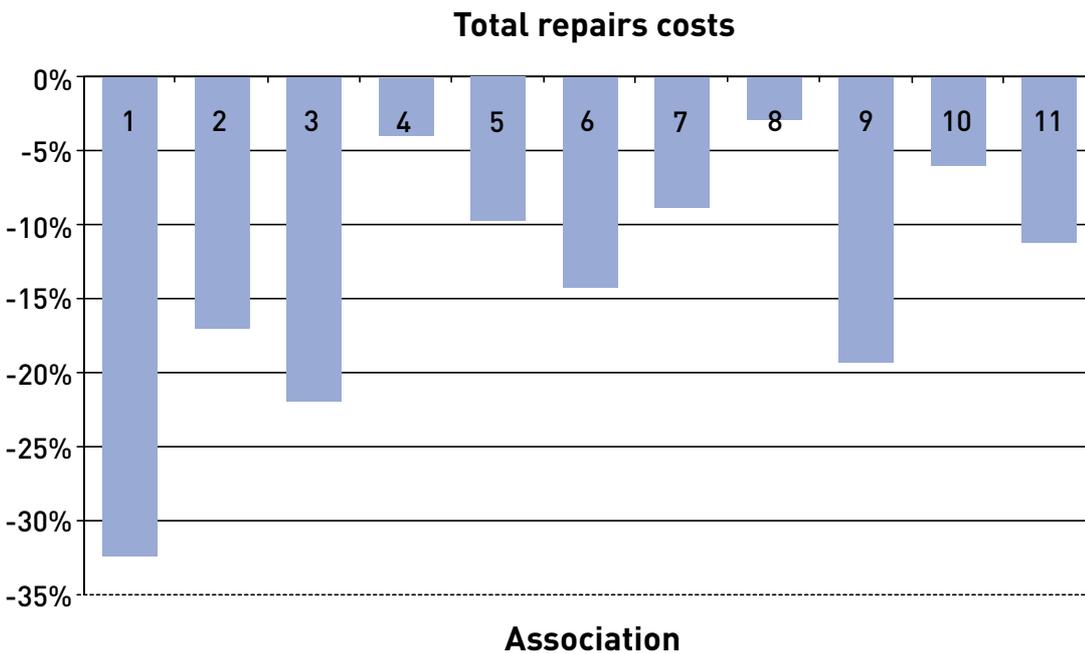
## Decent Homes

**4.30** The Decent Homes Standard (Decent Homes) appears to have affected the timing of repairs work more than the actual total repairs costs. Most associations re-profiled their repairs and improvements work after transfer, and the introduction of Decent Homes has required a further reassessment for those who transferred prior to its introduction.

**4.31** The Housing Corporation Performance Indicator data for 2003 shows the sample associations' compliance with Decent Homes as at 31 March 2003 (see Diagram 4.31 overleaf).

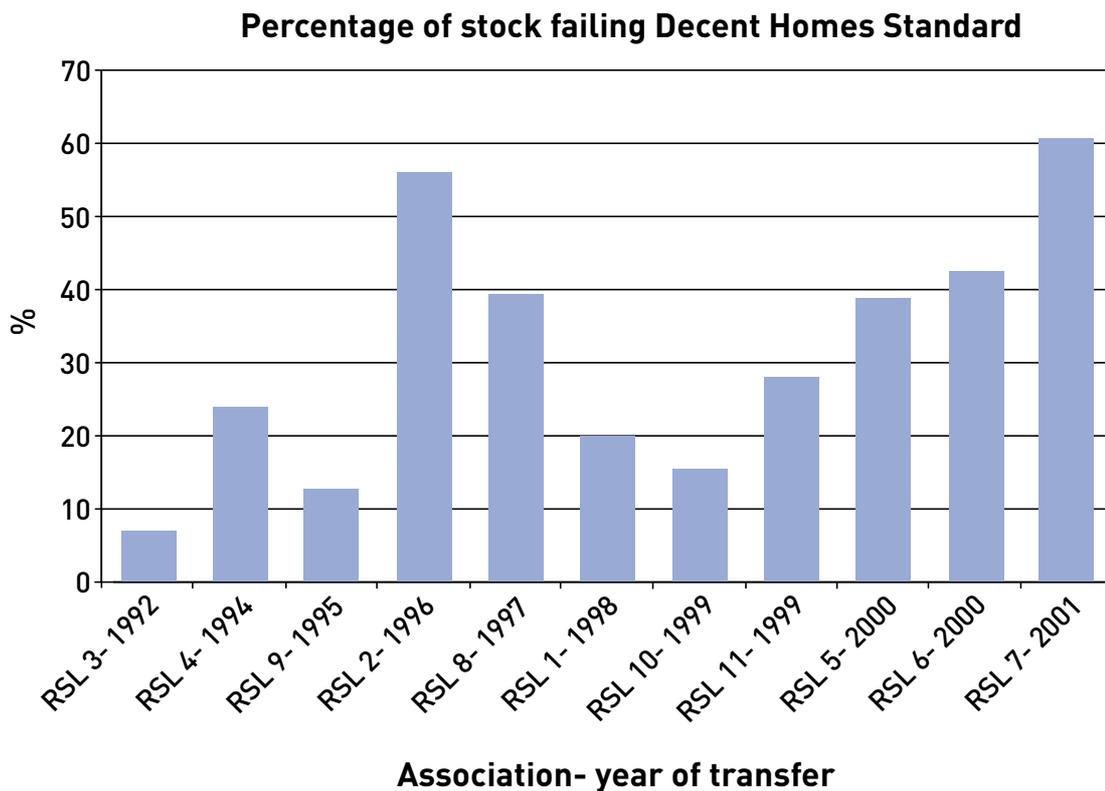
**4.32** There appears to be a trend of later transfers requiring more works to be done to meet the Decent Homes Standard than the earlier transfers. Associations 2 and 7 have a comparatively high amount of work to do to meet Decent Homes Standard compared with the rest of the sample.

DIAGRAM 4.29



## 04 STOCK TRANSFER ASSUMPTIONS

DIAGRAM 4.31



### Building cost inflation

- 4.33** Some business plans assumed a higher long-term level of building cost inflation than others. It is not clear whether changes in absolute levels of expenditure have resulted from differing cost inflation, re-profiling of expenditure, different unit costs, or a combination.
- 4.34** Building cost inflation has been higher in some areas than others. Most associations would like to take account of a higher level of inflation in future projections but are restricted by what the plan and the ODPM will allow.
- 4.35** Some associations have been able to negotiate very favourable contracts that have transferred the risk of rising people costs to the contractor.

### Stock condition survey

- 4.36** A number of associations commented on the variable quality of the original stock condition survey used in the Cost Generation Model. In many cases the timing and scope of work had to be changed beyond that included. For example:
- The stock condition survey is undertaken to enable a valuation to be placed on the housing stock. Its purpose is not to drive the repairs undertaken by the association.
  - Stock condition surveys use a sample approach which, by its nature, is not always representative of the whole stock.
  - The surveyor is engaged by the local authority during the option appraisal stage. By the time transfer takes place the figures are often out of date. They are prepared to the terms of reference of the local authority and often the association is unaware of the brief given to the surveyors. Some associations commissioned a new stock condition survey shortly after transfer.

## 04 STOCK TRANSFER ASSUMPTIONS

- Often the stock condition survey quantifies the minimum level of expenditure needed to rectify a problem. In some cases associations chose a better, but more expensive, solution for their tenants. i.e. demolition and rebuild versus repair.
- The surveyor may have assumed life cycles for cyclical works that are inappropriate. One association commented that, as they have replaced wooden windows with UPVC double glazing, the life of the windows is extended beyond that assumed at transfer.

**4.37** When we charted the repairs and improvements costs of the associations, it was clear to see the profile of costs in the early years when the catch-up programme and repairs promises to tenants were undertaken.

**4.38** We also noted a stepped increase in costs in the last ten years of the plan. One explanation for this is life cycles – some of the major repairs done after transfer will have lives of 20 or 25 years before they need to be replaced again. Another explanation offered by one of the associations was that works were pushed into the later years of the plan because the valuation, and hence the amount received by the local authority for the stock, would be higher the further costs were forecast into the future. This is an area of commercial tension between the local authority maximising its receipt and the association paying a transfer price that reflects the reality of the works to be done.

### Conclusion

- 4.39** Repair and maintenance costs are, on average, forecast to be lower than in the original business plans. Actual costs tend to be variable when compared to plans.
- 4.40** We are unable to quantify the difference effects which cause lower than expected repairs costs, as they represent a combination of factors such as:
- Lower inflation.
  - Better procurement.
  - Less work done.
  - Delaying/re-profiling work.
  - Variable quality of stock condition information.

### CONCLUSION

#### Key assumptions affecting management costs

- 4.41** The management costs of each association are affected by the following assumptions set out in **Table 4.41 (overleaf)**.
- 4.42** In summary, the association has significant influence on the level of management costs incurred.

TABLE 4.41

ASSUMPTION	DEGREE OF INFLUENCE BY ASSOCIATION
Retail price inflation.	No influence. This is a standard assumption across all business plan models.
Real rate of increase in management costs.	One of the largest elements of management costs is likely to be staff costs. Whilst starting salaries are usually governed by the TUPE arrangements for those staff that are transferring from the local authority, the association does have influence over what it pays its staff, to the extent that it does not depart from market rates such that staff may leave and it cannot recruit replacements.
	In some cases business plans assumed a real rate of decrease in management costs in some years to reflect anticipated efficiency savings. The assumptions in transfer business plans in this respect are usually formulated by the transfer team, and the association is required to operate within them. However, the association has influence over numbers of staff employed, quality of service offered and the mix of senior/junior staff.
Split of management costs between variable and fixed.	The association has only limited influence. The transfer business plan will assume a split between those costs that theoretically vary with stock numbers and those that are fixed. The association is able to manage its costs within reason, however when stock numbers reduce rapidly through higher than expected right to buy sales, associations can find that marginal cost savings cannot be achieved even if stock numbers reduce further.
Initial management cost budget.	The transfer business plan will include a management cost budget derived from the local authority's housing management department budget. Whilst the association has to manage its costs within the parameters determined at transfer, the association does have a high level of influence over its management costs. This is with the exception of cost changes that are imposed by external factors i.e. changing national insurance rates, increased pension contributions and VAT legislation.
Changing stock numbers.	As described above, the association's variable management costs will be affected by changing stock numbers, and this is largely outside the influence of the association.

# 04 STOCK TRANSFER ASSUMPTIONS

## Overview of review of assumptions

**4.43** We compared actual to date and forecast management costs with the original business plan for each association. In most cases management costs represent a greater proportion of rental receipts than they did at transfer. Namely, management costs have not been reduced to match reductions in rental income.

**4.44** If we look at the amount forecast to be spent on management costs between now and the end of the original 30 year period compared to the original business plan, we can see that the majority forecast an absolute increase in management costs (see **Diagram 4.44 below**).

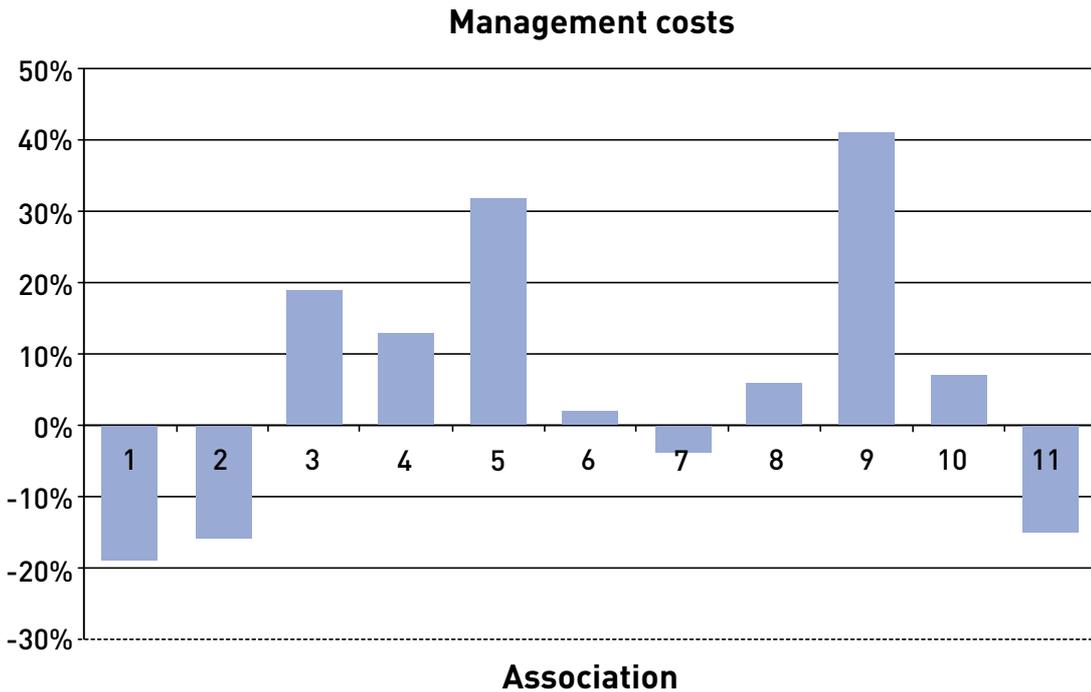
**4.45** However, there are trends in the detail of the management costs, and we explore them below.

## Control over management costs

**4.46** In all associations we noted differences between the level of management costs forecast at transfer, actual expenditure and revised forecasts:

- Management costs tend to be re-categorised following transfer and it is difficult to track actual against planned. For example, repairs management costs are included as either repairs costs or management costs. Our analysis was skewed where associations changed presentation.
- One association commented that the management cost budget in the business plan represented the local authority's equivalent housing management budget. No allowance was made for those areas where the association would not be able to reclaim input VAT.

DIAGRAM 4.44



## 04 STOCK TRANSFER ASSUMPTIONS

- Another association commented that their management costs are higher than envisaged at transfer because of a conscious decision to give tenants a better service. IT was an area of significant additional expenditure.
- Some transfer business plans assumed a long-term absolute reduction in management expenditure, perhaps to reflect efficiency gains or the end of the catch-up repair programme. In reality this does not appear to happen because the associations expand their service delivery into other areas, perhaps new developments.

### Rising insurance premiums

- 4.47** Insurance premiums have increased in recent years and are, in the majority of cases, higher than forecast in the original valuations and business plans.

### Pension schemes

- 4.48** Staff transferring from the local authority to the association are usually members of the local authority defined benefit pension scheme. In recent years, actuarial deficits in these schemes have caused the employer contributions to increase. The more recent transfers tend to have warranties from the local authority in respect of past pension deficits, however earlier transfers have met this cost themselves.

### Conclusion

- 4.49** This is an area of the business that the association is most able to influence. However, there is a trend of management costs being higher in absolute terms than forecast at transfer, and also, associations are not reducing management costs in line with decreases in rental income. In addition, operating expenditure has been affected by some significant issues, over recent years, that are less easy to control e.g. pensions and insurance costs.
- 4.50** The business plans assumed that long-term efficiency savings would mean that management costs would utilise a decreasing proportion of rental income over time. Those associations that transferred over five years ago have demonstrated that cost savings have not been made, especially when the association may want to expand and improve the services it offers.

### Corporation tax

- 4.51** In the past ten years the effect of corporation tax on associations has changed. Section 54 grant is no longer available to offset corporation tax liabilities, and the rules on classifying a repair as either capital or revenue have changed.
- 4.52** In response to this potential cost, some of the associations sampled have obtained charitable status, others have formed group structures allowing them to gift aid surpluses to a charitable group member. Some of the more recent transfers have yet to put tax mitigation plans in place as it is a number of years before they will make surpluses, although the tax cost is included in the business plan.
- 4.53** In our opinion, corporation tax is a cost that associations are able to mitigate. Associations should be required to show mitigation arrangements in their business plans to enable the cost of corporation tax to be eliminated.

### FUNDING

#### Key assumptions affecting interest costs

- 4.54** The interest paid by each association is affected by the following assumptions set out in **Table 4.54 (overleaf)**.
- 4.55** In summary, an association has little influence over interest rates and margins, but by adopting an active treasury management strategy there is scope for an association to manage its interest costs within these external parameters.

TABLE 4.54

ASSUMPTION	DEGREE OF INFLUENCE BY ASSOCIATION
Retail price inflation.	No influence. This is a standard assumption across all business plan models.
Interest rates and margins.	The association has no influence over the interest rates being offered by lenders, but it does have the ability to manage its finances to ensure it secures the most advantageous rates at all times.
	Transfer business plans tend to assume as high a variable interest rate as is possible whilst ensuring that the funding repays in 30 years. As the interest rates in business plans represent the association's cost of capital i.e. an allowance for risk plus the likely interest cost payable, it is expected that the rate in the business plan will exceed the expected amount payable.
Split of debt between fixed and floating interest rates.	The association is able to influence its treasury management strategy.
Length of facility.	Business plans are required to demonstrate that the debt can be repaid within 30 years, but the association is not restricted from negotiating longer terms.

## 04 STOCK TRANSFER ASSUMPTIONS

### Overview of review of assumptions

**4.56** We compared actual interest costs with the original business plan, and the revised business plan with the original business plan for each association. Long-term interest rates are forecast to be lower than at transfer.

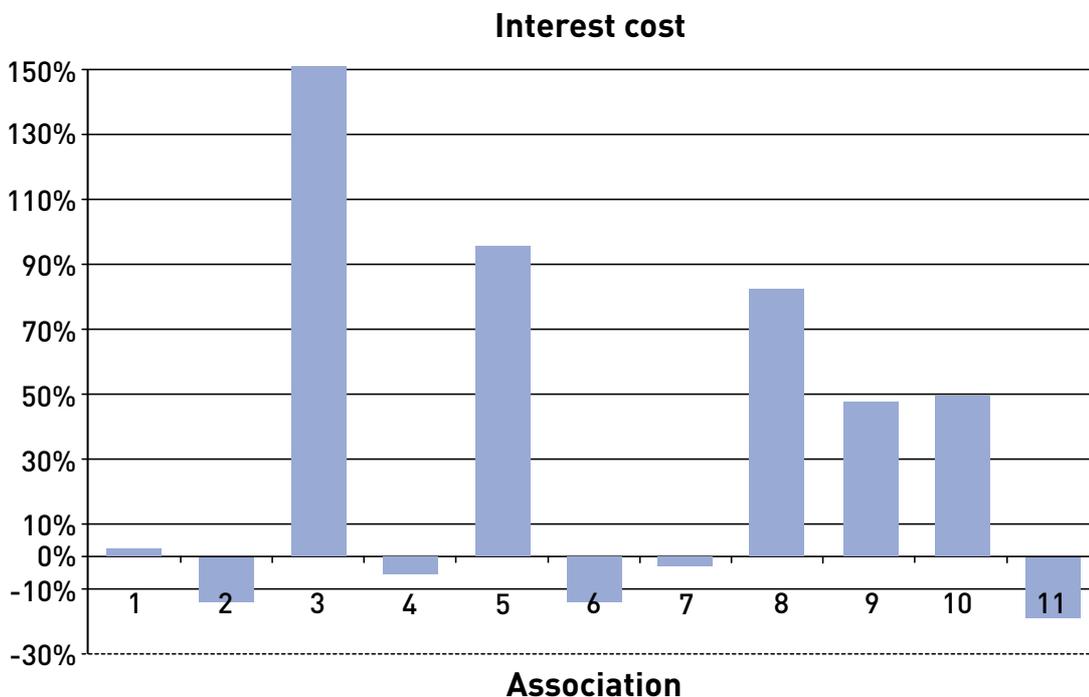
**4.57** However, because of increasing debt to fund new developments and to replace properties lost through right to buy, the actual amount of interest forecast to be paid in the future is higher in some cases than forecast at transfer. The following chart shows the percentage increase or decrease in interest costs from the original business plan for the period between now and the end of the original 30 year period (see Diagram 4.57 below).

**4.58** Every association in the sample has benefited by interest rates being lower than assumed in their transfer business plans, although some only marginally so. Some of the earlier transfers assumed long-term interest rates of over 10%, and they have been able to achieve significant savings. Recent transfers are assuming long-term rates as low as 7%, but with fixings available at below 6% even they are also making savings.

**4.59** Most of the associations fixed a significant tranche of their funding at transfer. Fixed interest rates have reduced over the past ten years reflecting the reduction in LIBOR. The savings that associations could have achieved from the reduction in LIBOR have been restricted to the floating-rate element of their funding package – typically 20% to 35% of the total.

**4.60** Some associations have demonstrated more active treasury management policies than others. One of the associations reviewed refinanced twice in the first four years after transfer to ensure they had the most advantageous funding terms.

DIAGRAM 4.57



## 04 STOCK TRANSFER ASSUMPTIONS

### Conclusion

**4.61** Associations have held interest rates lower or in line with their original business plans despite the increase in loan debt they have incurred. Active treasury management has delivered reduced interest costs.

### SUMMARY OF REVIEW OF STOCK TRANSFER ASSUMPTIONS

**4.62** It is clear from the trends in income and expenditure that some themes can be observed from how associations have performed since transfer.

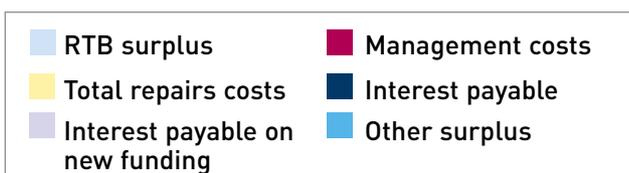
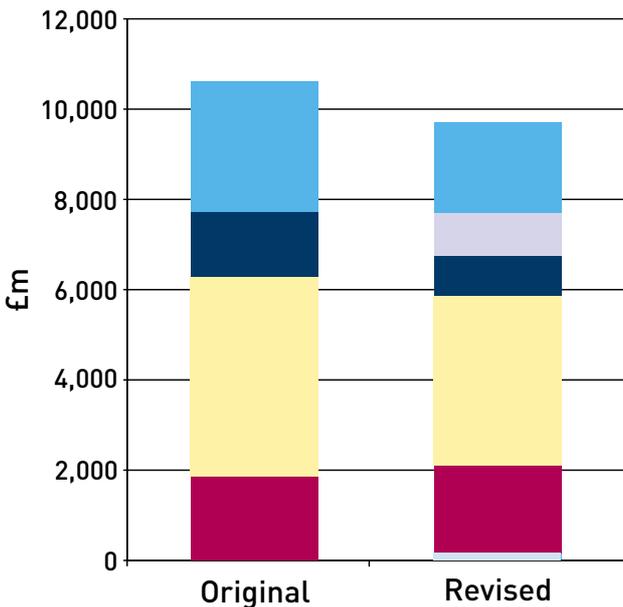
**4.63** We have aggregated the figures for income and expenditure for the original and revised business plans of the sample associations to assess the scale of variation occurring. The results are shown in the following chart (**Diagram 4.63**), which shows total income and how it is spent. Figures for individual associations are included in the appendices.

**4.64** The chart above shows that there is a 16.3% reduction in the level of total income between the original and revised business plans. The pattern of spending has also changed. Despite the reduction in income, management costs are higher than anticipated. Associations are anticipating lower spending on repair costs and interest costs for existing loans. Part of the reduced income has been committed to borrowings for new developments and there is a lower surplus than anticipated available for the repayment of loans.

**4.65** We have also examined the aggregate variation in the pattern of how rental income is spent in percentage terms. The results are set out in the **Diagram 4.65 overleaf** and the pattern of spending mirrors the position shown by the total aggregation of the business plans, although clearly these are relative levels of spend as the aggregate totals are different.

DIAGRAM 4.63

### Total income (£) and how it is spent

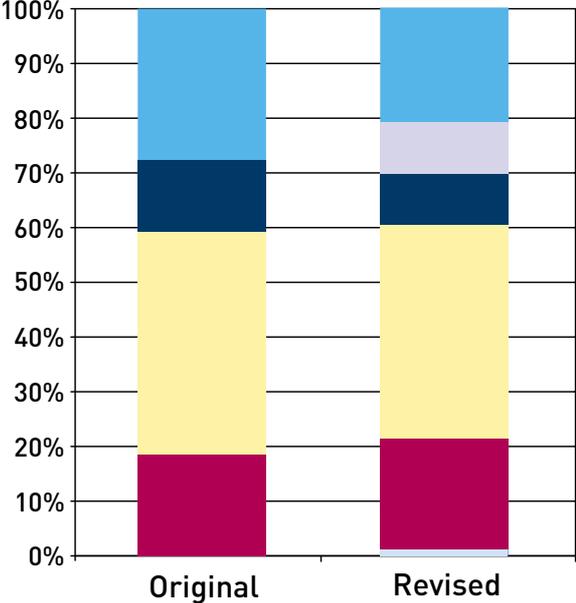


	Original £'000	Revised £'000
RTB surplus	38	139
Management costs	1,860	1,948
Total repairs costs	4,449	3,822
Interest payable	1,392	958
Interest payable on new funding	-	876
Other surplus	2,885	2,902
	<b>10,623</b>	<b>9,769</b>

# 04 STOCK TRANSFER ASSUMPTIONS

DIAGRAM 4.65

Use of rental income in percentage terms



# 05 PROMISES MADE TO TENANTS

## INTRODUCTION

- 5.1** We asked the associations in our sample to provide us with details of promises made to tenants, and to give us information to show how these promises have been met.
- 5.2** Typically the tenants' promises are delivered over a five-year period. Some of the associations in the sample have passed the end of their five-year period, but others are still in the process of delivering their promises.

## APPROACH TO OUR WORK

- 5.3** Tenants promises are usually outlined in the offer documents that are sent out to tenants before the ballot. In addition, promises can be outlined in other documents sent to tenants before transfer.
- 5.4** We reviewed the offer documents to understand the promises that have been made. In most cases these covered the following areas:
- Rent guarantees
  - Improvements to properties
  - The right to buy the property
  - Service improvements
- 5.5** We then reviewed annual reports and internal documents to understand how the promises had been met. For the earlier transfers it was difficult to obtain data to support how the promises had been met. We had to rely on the annual reports of the associations that communicated high-level details on compliance with promises.
- 5.6** For the more recent transfers we reviewed how the association is progressing in meeting its promises.

## REVIEW OF PROMISES

- 5.7** In the appendices to this report we have detailed the promises made by each association and, where available, information on how these promises have been or are being met.

## RENT GUARANTEES

- 5.8** Most associations gave their tenants guarantees on the maximum levels of rent increases during the first five years following transfer. In addition, some gave maximum increases after this period. Clearly, rent increases after the promise period are now governed by rent restructuring, which in all cases requires lower maximum increases than included in the promises.
- 5.9** For the sample we reviewed, each association appeared to meet its promise on maximum rent increases.

## IMPROVEMENTS TO PROPERTIES

- 5.10** The promises made to tenants on improvements are variable in the level of detail provided. Some promises were not specific. Others offered very specific commitments such as "x properties to have double-glazing". Based on the evidence provided to us it is clear that promises have been met, or are in the course of being met for the latter transfers.

## RIGHT TO BUY

- 5.11** Transferring tenants are told that they are being given the right to buy, but this is a statutory right which must be passed to them. Our analysis showed that associations experienced far higher numbers of right to buys than the local authorities experienced pre transfer. This reinforces the importance of the development programmes that the associations have been able to start. Whilst associations have been able to undertake stock replacement they, on average, have not yet been able to replace all the stock lost.

## 05 PROMISES MADE TO TENANTS

### SERVICE IMPROVEMENTS

**5.12** There have been intangible promises made to tenants regarding service improvements. There is no reliable data on the extent to which tenants feel that services have improved between the pre and post transfer position. Tenant satisfaction data is available in some cases but there is no conclusive relationship between tenant satisfaction and management costs. This may be an area that the Housing Corporation might wish to include in the Audit Commission inspections of associations' housing management services.

### CONCLUSION

**5.13** There is evidence that tenants promises have been and are being met, but imprecise promises and the lack of detailed performance monitoring information means that we cannot conclude on the extent of achievement of the full range of promises made.

# 06 THE LESSONS TO BE LEARNED FOR FUTURE TRANSFERS

## BUSINESS PLAN PREPARATION

**6.1** It was apparent, when meeting senior staff from the associations, that many of the associations would have prepared their business plans differently, and negotiated different valuations, if they had the benefit of hindsight. Consultants are a necessity when valuations and business plans are being prepared, but they do not always have the experience of having had to 'live' one of their plans. New stock transfer teams would be wise to obtain the counsel of experienced transfer Finance Directors who could share their experiences.

## BUSINESS PLAN ASSUMPTIONS

**6.2** Our review indicated that there are many assumptions in business plans where associations have little ability to influence outcomes, i.e. risks materialise from the external operating environment. A good example of this is the introduction of the Government's rent influencing regime, in 2001. Other examples are; the introduction of the Government's policy that social housing providers have to achieve the Decent Homes Standard by 2010, changes in interest rates and the increase in the attraction of RTB for tenants due to the buoyant housing market in the last few years.

**6.3** These changes have a much more profound impact on the business plans of associations than factors over which they have more control such as; the numbers of staff employed and the prices paid for maintenance work. Where risks adversely impact on an association, their ability to manage them is often restricted to delaying or reducing repairs and improvement programmes which is not sustainable in the longer term.

**6.4** We noted the following observations from our review of business plan assumptions:

- Rental income is, in aggregate, forecast to be lower than anticipated. The principal reasons are; the effects of the Government's rent influencing regime, reduced stock numbers arising from Right to Buy sales and lower than anticipated RPI increases applied to rental income, particularly for earlier transfers.

- Bad debts and voids rates have been higher than anticipated in the period after transfer but most associations expect that they can be reduced to the levels anticipated in their business plans in future. Possible reasons for the over-optimism in the early post transfer period are; the disruption to service caused by changes in staffing and/or systems and the effect of decanting tenants prior to demolition or for improvement works to take place.
- Stock numbers have decreased more than anticipated in nearly every association due to higher than expected right to buy sales. This is despite the fact that associations have developed more new properties than they anticipated. Right to buy sales are higher due to a number of reasons, principally speculation over property prices, lower interest rates, perceived threats by Government to reduce the attractiveness of right to buys and the prospect of purchasing an improved property.
- Most association business plans assume that the impact of right to buys is neutral, the future rental income stream foregone is compensated for by lower management and maintenance costs and the capital receipt, even after sharing part of this capital receipt with the local authority. Our review findings suggests that whilst this may be true with a relatively low level of right to buy sales, the incidence of right to buy sales on the scale which has been experienced will reduce the net income of the association as it needs to reduce its fixed and semi-fixed costs, which is more difficult to achieve, to compensate for lower rental income levels.
- Repairs and improvement cost assumptions are in line with or lower than anticipated at transfer. Most associations have re-profiled their repairs costs after transfer to take account of changed stock numbers, improved knowledge of their stock, the need to meet the Decent Homes Standard or affordability issues. Some associations are critical of the variable quality of the stock condition survey data used to inform the original business plan assumptions. Our review highlighted that there were a range of reasons for the lower than anticipated repairs and improvement costs, some relating to factors outside their control e.g. poor stock condition survey information or lower inflation and some due to improved procurement practices e.g. partnering deals with private contractors.

## 06 THE LESSONS TO BE LEARNED FOR FUTURE TRANSFERS

- Management costs have, in general, been higher than anticipated. The reasons identified are higher than anticipated salary cost and pensions increases, increased staff numbers in response to the desire to improve the service to tenants or the inability to reduce staffing levels as anticipated. In addition, management costs have not, in general, reduced in correlation with right to buy sales. Management costs as a percentage of rental income in the original business plans in our sample vary between 8% and 26%, with an average of approximately 20%. In the revised business plans the range is between 10% and 36%, with an average of approximately 22%.
- For the non-charitable associations in our sample, none have yet paid any corporation tax, as was anticipated, because taxable surpluses only tend to arise in the latter years of the business plan. There are opportunities to avoid these future liabilities by joining a group, setting up a charitable subsidiary and using gift aid to mitigate tax liabilities, or changing to charitable status.
- Interest rate assumptions are in line with or lower than anticipated. In aggregate, they are one third lower than expected. Associations have been fairly prudent in making interest rate assumptions in their original plans. Therefore, most associations have benefited from lower than anticipated interest rates almost immediately after transfer and from the sustained level of lower interest rates in the UK economy for the last few years.

### OWNERSHIP OF THE PLAN

- 6.5** It is vital that the senior executive team owns the business plan. In many cases the Chief Executive and Finance Director are recruited after the valuation has been agreed and the business plan prepared. Their role is to deliver a 30-year business plan that they have played largely no part in creating.
- 6.6** Paragraph 12.6 of the 2003 manual states that 'whilst it can be difficult to recruit a Financial Director in advance of a ballot result, the shadow RSL should consider what steps it can take to cover this post if it is not occupied full time.'
- 6.7** In our opinion as a minimum the Chief Executive and Financial Director should be appointed immediately after the ballot to ensure that they have a role in the creation of the business plan.
- 6.8** The 2004 supplement to the Housing Transfer Manual indicates that the Corporation expects all association chief executive jobs to be advertised externally.

### RTB SHARING AGREEMENTS

- 6.9** In section 4 we listed a number of shortcomings in right to buy sharing agreements. In recent years, property prices have risen and associations are seeing the effects of this appreciation in the value of their stock passed back to the local authority.
- 6.10** In our view, sharing agreements are very important as they mitigate against the risk of fluctuating property prices. But the simple way they are structured at present does not recompense the association when larger than average or improved properties are sold.
- 6.11** Two of the associations reviewed have attempted to renegotiate their RTB sharing agreements post transfer. One tried to buy out the agreement by paying the local authority the net present value of what their clawback would be. The two parties could not agree on a price: the local authority wanted its receipts to inflate at house price inflation, whereas the association inflated the receipts using the rate of inflation stipulated in the sharing agreement i.e. RPI. Clearly they were some way apart, and a compromise was not agreed.

## BUSINESS PLANNING PERIOD

- 6.12** The ODPM is willing to consider alternatives to the 30-year single transfer model and different discount rates from the current 6% to 8% range, but only where the local authority could demonstrate 'value for money in comparison'. It is not clear whether this is value for money for the local authority or for those in need of affordable housing.
- 6.13** There is no doubt that associations have the potential to generate gains after the loans are repaid at the end of the business plan period, because the properties often have lives well in excess of 30 years. Funders appear willing to re-finance loans and extend borrowings on the strength of an association's cash flow and asset base, although it is likely that they look to assess the track record of management prior to further lending.
- 6.14** Given the degree of variation in assumptions we have observed it is not clear to us whether or not lenders would be willing to provide loans for a period in excess of 30 years at the outset of the new association. The Housing Corporation might wish to discuss this issue further with lenders.
- 6.15** The business plans are artificial in that they include no development programme, or only a five-year programme. In reality most associations operate a continual development programme. They are constrained by what grant they can attract and what their asset cover ratio will let them borrow, but most have the support of their funders to increase their debt and repay over a longer period. At each business plan revision they tend to rebase and demonstrate that they can repay their current commitments within 30 years from the date of revision, not transfer.