Main Findings

- Output capacity depends on the future levels of key local and national variables, as well as the risk management strategies of landlords (and particularly in the RSL sector) lenders. Actual output can fall short of capacity due to these differing from their modelled levels, or due to social landlords having priorities other than new build (although SHQS commitments are modelled).

- On the basis of reasonable assumptions about these variables, it is estimated that, at a grant rate of 25%, Scottish LAs have the capacity to construct 2,484 houses annually over the next 20 years. The real terms annual cost of such a programme in terms of government grant would be £78M (equivalent to £32K per unit).

- The above capacity estimate assumes a sector-wide annual rent uplift of RPI+1%. If, instead, currently 'low rent' authorities chose to raise rents by RPI+2% for a run of years, average annual capacity would rise by 27% – though at increased cost in overall government grant. A sector-wide policy of raising rents by RPI+2% p.a. would more than double municipal housebuilding capacity.

- In line with assertions by some councils, this central housebuilding capacity estimate incorporates future management cost increases held to inflation-only. If, instead, management costs continue to rise 2% ahead of inflation, projected construction capacity is cut by 40%.

- Assuming a reduction in the grant rate to 50% and factoring in other reasonable assumptions, estimated annual RSL housebuilding capacity over the next 20 years would be 3,894 homes, costing £286M p.a. in government grant. This compares with the Scottish Government’s current ‘RSL core programme’ of about 3,600 homes at £290M p.a. in government grant.

- Halving the assumed RSL grant rate (to 25%) would reduce housebuilding capacity by only 27%. Such a grant rate would be similar to that currently in force for LAs and, at this level, would imply a similar housebuilding capacity for each of the two sectors (around 2,500 homes p.a.).

- In terms of government grant, the annual cost of a programme predicated on a standard 25% grant rate would be approximately £200M – around two-thirds of the Scottish Government’s current total budget for LA housebuilding grant and the RSL core programme.

- More effective use of landuse planning powers could substantially reduce affordable housing development costs. If sites were routinely secured at nil cost, it is estimated that national social housebuilding capacity would be boosted by some 14%. Routinely securing cross-subsidy from private housebuilding would increase national social housebuilding capacity by 43%.

- If a substantial proportion of homes secured through the planning system were for low cost home ownership rather than for social rent, the resulting units would be substantially higher.
Research objectives and methods

As commissioned from Heriot-Watt University, the main aims of the research were to:

1. Assess the financial capacity of both LAs and RSLs to build or support the provision of new affordable homes through exploiting under-utilised borrowing capacity, and other assets.

2. Provide examples of good practice in collaboration on development services between RSLs and LAs.

3. Consider the implications of the above for funding options for new affordable housing, including proposals for a single funding stream.

Undertaken May-August 2010, the research involved three principal strands:

(i). Contacts with government policy makers, industry stakeholders and RSL lenders.

(ii). Modelling social landlords’ financial capacity to contribute to housebuilding over the next 25 years.

(iii). Qualitative case study work mainly focused on six social landlords – three LAs and three RSLs.

Qualitative research evidence

Given its requirement for cross-subsidy by the entire tenant population, new council housebuilding is already placing upward pressure on LA rent levels. Among LAs charging rents at the lower end of the national rent distribution there is increased awareness that a strategy of converging rents with the national average could provide additional headroom to expand housebuilding. However, it is much harder to justify to tenants rent increases for this purpose than to fund improvements to existing properties. Higher rents also evoke concerns about affordability and benefit dependency.

The historic trend for management costs to rise at rates well above inflation has limited the scope for housing investment. Most case study landlords, nevertheless, believed it realistic to project future management costs rising at slower rates than in the past. There could be scope for management efficiency savings via new forms of inter-organisational collaboration or, as seen by lenders, through further RSL sector consolidation to be achieved with regulatory encouragement.

Availability of conventional loan finance for RSL investment remains fairly good, with loan conditions and security requirements also remaining little changed on pre-credit crunch norms. However, margins have increased substantially and loan terms much shorter than the traditional 20-30 years have become standard. Bond financing is attracting wide-spread interest among RSLs looking to access such funding via consortia arrangements. The substitution of private finance by council loans (the ‘East Lothian model’) is seen as attractive by some RSLs elsewhere in Scotland.

While new LA housebuilding schemes have so far mainly involved council-owned land, the availability of sites in housing department ownership (and thus potentially available for development at nil cost) is very limited in some areas. There are frustrations at the reluctance of some other public sector landowners to contemplate site disposals. In certain areas, housebuilding programmes will soon become dependent on site acquisition which could, in turn, call for the effective use of landuse planning powers. As yet, however, experience in affordable housing procurement via such powers has been decidedly mixed.

The need to invest in infrastructure (e.g. water and sewerage) is another barrier to affordable housing development, as it means that larger, developer-led schemes can be taken forward only as a large-scale ‘package’. Without a strong market where there is confidence that hundreds of properties could be sold within a short period, developers are believed unlikely to contemplate funding the infrastructure usually required for large schemes to proceed.

Modelling social landlords’ future housebuilding capacity

The modelling was set up to project annual output of new homes for 5-year periods between 2014 and 2034/35. For each scenario a 20-year average value was also generated. Scenario-specific grant expenditure and grant rate projections were also produced.

Modelling was based on a set of standard assumptions (see Table 1), with ‘high’ and ‘low’ variants on each variable. The modelling also took account of geographical variations in the incidence of housing need, enabling the calculation of future housebuilding capacity on a ‘need-constrained’ basis.
Table 1 – Central assumptions on key variables

<table>
<thead>
<tr>
<th>Factor</th>
<th>LA</th>
<th>RSL</th>
</tr>
</thead>
<tbody>
<tr>
<td>RPI (% p.a.)</td>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Interest rate %</td>
<td>5.5</td>
<td>5.5</td>
</tr>
<tr>
<td>Management cost per unit (real % increase p.a.)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Maintenance cost per unit (real % increase p.a.)</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Real unit new build dev'ment cost (year 1) £k</td>
<td>120</td>
<td>120</td>
</tr>
<tr>
<td>Real unit new build dev'ment cost increase p.a. %</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Annual real rent increase %</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Grant rate %</td>
<td>25.0</td>
<td>50.0</td>
</tr>
<tr>
<td>Rent ‘premium’ - newly built homes (%)</td>
<td>20.0</td>
<td>0</td>
</tr>
</tbody>
</table>

As far as possible, modelling utilised common assumptions for LAs and RSLs (see Table 1). However, it was necessary to allow for differences in the financial frameworks of the two sectors. While the traditional RSL approach accounts for new build costs entirely at scheme level, the framework for new grant-funded council housebuilding incorporates substantial cross-subsidy from the main body of council stock. It is mainly this difference which underlies the much lower grant rate recently achieved for LA housebuilding, where grant typically accounts for about 25% of total scheme costs as compared with the RSL historic norm of around 60%. Central projections for RSLs also assumed a national budget of £270M – similar to the 2010/11 ‘RSL core programme’ Affordable Housing Investment Programme budget (£290M).

The base data for LAs was the Housing Revenue Account (HRA) 5-year financial projection returns submitted to the Scottish Government in 2009. RSL modelling drew on data from RSLs’ published accounts for 2008/09, as well as 5-year financial projection returns submitted by RSLs to the Scottish Housing Regulator (SHR) in 2009.

Modelling results: LAs

Our central projection for LA housebuilding estimates the sector’s new build capacity as amounting to 2,484 units p.a. over the period 2014-2035. This projected level of output would be about half of the average level of social sector starts achieved by RSLs annually in the six years to 2009. The cost to the government in grant to support this programme would be about £78M p.a. at today’s prices. The assumed grant rate of 25% would mean average grant per unit of £32K (2010 prices).

This central projection is based on a council contribution to scheme costs funded equally by direct revenue funding (‘CFCR’) and prudential borrowing supported by the LA-wide rent base. While the ‘high borrowing’ scenario (75% of the HRA contribution financed by loan finance) increases average annual capacity only by a small margin, it also permits a significantly more front-loaded investment profile. Under the ‘need constrained’ scenario (no build by ‘zero housing need’ LAs) the average annual output capacity is reduced by 20% on our central projection.

Results from various other scenarios are detailed in the full report. Of particular interest is the importance of management costs – real unit costs rising by 2% p.a. would cut capacity by nearly 40% to 1,505 units p.a. The SHQS expenditure 33% above its central projection value would cut capacity by 29%. On rents, substituting RPI+2% would raise annual capacity by 120% to over 5,000, while inflation-only increases would cut capacity by 65%.

Modelling results: RSLs

Our central projection for RSL output capacity is an average of 3,894 units p.a. during the projection period. This is just above recent activity levels: the comparable RSL ‘core programme’ output for the current year is around 3,600 homes. There is also some mismatch between the geographies of capacity and need.

Sensitivity analyses for RSL new build outputs generate findings similar to those for LAs, albeit more modest in many instances. For example, introducing an initial ‘rent shift’ via increases at RPI+3% for years 1-5 would push up average annual capacity by 15%. Under a ‘need-constrained’ scenario (see above) output would be curtailed by some 575 units p.a. (or 15% of the central projection value).

Combining a number of potentially negative factors within a single scenario (rising management costs, higher interest rates, smaller HAG budget, higher newbuild costs) would reduce average annual capacity by 53% to only 1,835 units p.a. A scenario combining positive factors (higher rents, larger HAG budget, lower newbuild costs) could see output rising by 105% to 7,995 units.

Under a scenario incorporating an identical 25% grant rate for the two sub-sectors, we project that output capacity for LAs and RSLs would be similar (2,484 units p.a. and 2,850 units p.a. respectively). A scenario based on a common grant rate of 35% (and assuming approximately the current national AHIP budget excluding topsliced elements) could generate annual national output around 6,300.

Generating affordable housing through the Planning system

Landuse Planning Agreements (often using ‘section 75 powers’) can play a key role in affordable housing procurement, either as (a) a simple lever to facilitate site provision, (b) a means of reducing procurement costs via the
acquisition of sites at below market value, or (c) a form of cross-subsidy where an element of affordable housing build costs is financed within the scheme. Assertive use of the power (as in (b) or (c)) is justifiable as a means of compensating for the problem of housing affordability which stems in part from the restriction in general land and housing supply which the broader planning system creates. However, while the use of s.75 powers in this way has gained a broad legitimacy in England, this is, as yet, less true in Scotland.

It is clear from the modelling for both LA and RSL sectors that output capacity is sensibly related to net procurement costs. Moving from option (a) to option (b) (land transferred at zero price) would increase output capacity by 14%, while fully exploiting the scope for cross-subsidy (option (c)) could increase the figure by 43%. If a significant proportion of affordable housing delivered via s.75 were intermediate tenure (requiring lower unit subsidy), capacity would be correspondingly greater.

Conclusions, limitations and implications

Summing the output numbers from our central projections, it appears that (in the absence of need-constraint) LAs and RSLs have the capacity to develop some 6,400 homes p.a. over the period to 2034. But, at around £360M p.a., the associated grant cost would be slightly above the 2010/11 Scottish Government social housebuilding budget (including both core and topsliced elements) – some £340M.

At an annual average of 3,894, projected capacity of the RSL sector in the 25 years 2011-2035 would be only slightly greater than the current ‘core programme’ RSL output of around 3,600. This could be read as suggesting that the scale of currently un-utilised RSL housebuilding capacity is modest. Conversely, the recent LA housebuilding programme appears to be unlocking capacity for activity on a significant scale, which could continue well into the future.

It is important to note the inbuilt modelling assumption that all social landlords both utilise to the full their financial capacity and prioritise new housebuilding. In the modelled system output is driven by the ability to service debt and, in the case of RSLs, to maintain acceptable values on most financial stress ratios. This is our interpretation of modelling financial capacity. If in some LAs and RSLs senior managers and/or governing bodies opt not to use all of their financial capacity in this way, due to being more risk averse than we have assumed or because of other priorities (but note that SHQS commitments have been included), actual takeup would fall short of modelled capacity. It should also be emphasized that the projections cited here assume neither an increased rate of rent rises, nor the more effective use of landuse planning powers to secure effective cross-subsidy from private housebuilding, than in the past.

Numerous policy implications follow from our research. In particular, most or all developing RSLs may need to emulate LAs by adopting as standard the ‘cross-subsidy’ funding model whereby development is partly funded by rental income from the rest of the landlord’s stock. This has implications for rent levels which point towards the need for a national rent policy to provide benchmarks against which landlords’ development business plans could be judged. Potentially, this opens up an important role for the SHR in relation to both LAs and RSLs.

Similarly, confirmation of an ongoing role for LA housebuilding will call for new municipal obligations, including the development of robust HRA business plans and associated submission of statistical returns. The Scottish Government should also require to be convinced that new housebuilding does not provide an unnecessary managerial distraction (as well as a competing funding requirement) for any social landlord still facing major challenges in delivering its SHQS programme.