LAKES REGENERATION – CAPITAL BUDGET APPROVAL
13 July 2021 Cabinet

Annex A – Financial Summary

The financial modelling of the Lakes Regeneration, Phase A project has been undertaken in partnership with an expert external organisation together with cost consultants who have contributed to the development and challenge of assumptions.

The construction costs, including allowances for professional fees and a 7% contingency have been prepared in detail with professional advice from the technical cost consultants. The statutory costs and payments for disruption (including leasehold buy back) have been prepared by the Council based on current regulations with input from the property department. The costs are subject to surveys and technical reports for which cost allowances are included. Inflation has been allowed for in the cost estimates and is based on the HRA construction inflation assumptions and estimated start on site date.

Whilst some of the disruption payments might fall to revenue this substantially represents the capital budget and given the funding source remains the same for this element, this will only affect the accounting treatment of these costs.

Other Financial Implications

In addition to the capital costs of the scheme, there will be a wider impact to the Housing Revenue Account (HRA). This includes an assumption of £0.5m of Homes England Grant and additional revenues from new stock and incremental changes to the stock type of c.£0.4m per annum. The HRA will also need to fund the cost of borrowing and allowance for repayment of debt.

The development also includes two retail units and a Community Hub. The capital cost is currently estimated at £2.1m and is included within the total capital budget. Work is currently being undertaken to finalise the commercial income levels but this is projected to be c£0.070m per annum, with a projected payback of c50 years.

The overall impact on net operational cash flows (i.e. rents less housing management and reactive and routine maintenance costs) is positive but small under the base assumptions. This largely reflects the fact that only 16 new income generating homes are added to the rent roll. The revised mix includes some larger properties which has a further marginal increase in rental income. This does not allow for capital financing and repayment of debt.

The net new properties are assumed to be let on an affordable rent basis which results in higher per unit income than social housing. In practice (since there are currently 152 secured social rent tenancies to transfer with other units leased, void or on temporary lettings) there may be scope to increase the proportion of higher yielding affordable tenancies. If so, this would have a positive impact on the HRA over the longer term.

Value for Money

The nature of this scheme means that normal VFM assessment tools that we use are not appropriate to measure VFM of the project. We would normally use two metrics to assess VFM of new build developments and those would be payback period (the year in which all capital costs of the scheme are covered from revenues) and Net Present Value (the value of cashflows at a particular point in time).

Ultimately the financial payback involving such a wide brief is likely to be longer than a typical new housing development. This is due to many factors including the need to deliver a high proportion of the new homes at a social rent (given they are replacements and therefore minimal additional rental income will be received) and to high standards and sizes expected by both residents and MKC, particularly in relation to Plan:MK and the promises made by MKC at the time of the ballot (moving forward new council homes will be delivered at Nationally Described Space Standards and only larger to comply with planning policy).

Therefore, in the case of the Lakes Regeneration we need to consider VFM in the context of the alternative options. The three options we would have are;

1. Regeneration as proposed – full replacement of homes with some additional units as the site allows with wider estate improvements benefiting all residents, not just those in Serpentine Court
2. Ongoing planned maintenance
3. Do nothing, managed decline of the stock and residents moved into alternative stock

Option three is not a viable option. This will not address the quality of life issues for residents remaining in Serpentine Court and we have significant demand for affordable housing that this would lead to increasing cost pressures elsewhere, for example in homelessness. The cost of ongoing maintenance of the stock is only marginally less cost (c£6m) than full replacement which will also extend the useful life of the assets.

Whilst the overall cost of the scheme per unit / per tenant may be seen as high when compared to other new build schemes, the wider regeneration work will also benefit all residents on the Lakes with new purpose-built community and commercial facilities being provided alongside the improvements being made to the public realm. The

COVID-19 pandemic has highlighted the importance of access to good quality open space and local facilities and this project will deliver this. An overarching principle of regeneration includes levelling up the standard of homes and we aim to achieve decent homes standards for all of our tenants through our prioritisation of resources.

Employment and skills opportunities for local residents will also be provided, especially when MKC enters into contact for the construction phase of the project. With a new estate management and estate maintenance programme being created, MKC can expect to see savings made in relation to this and it is expected that we will see a reduction in crime and anti-social behaviour.

The refurbishment and 60-year cost for retaining Serpentine Court was assessed as £53.5m in 2017 which in Q1 2021 prices equates to c.£59.8m. The upfront cost represents some £31m compared to £45m for Phase A housing with ongoing high costs of major repairs. In addition, at the end of the 60 years (or perhaps sooner) the existing Serpentine Court would require replacement at the same cost as Phase A whereas the new build would potentially have perhaps 40 years remaining life. Whilst this assumes a 60 year life, in reality the life of the asset is considered to be much shorter even with substantial investment given its current condition, age and structure.

Comparison of costs (£m)	**Refurb of Existing SC**		**Phase A New Housing**
Price Base Date	**2017**	**2021**	**2021**
*Refurbishment/**New Build	*27.7	*31.0	**45.9
Ongoing Major Repairs	*25.8*	*28.8*	*20.0*
Total (2021 Prices)	**53.5**	**59.8**	65.9

Even on this conservative basis the total cost is only about 10% higher than the riskier retention option without the benefits of opening the gateway to Phase B development (for which a business case is being prepared) and the welfare benefits to existing residents. Taking account of the lower ongoing risk of the new build solution, this is supportive of the financial case for Phase A compared to do minimum on a housing only basis, irrespective of social and strategic considerations. The non-housing elements have other supporting rationales.

Homes England Grant

At the current time we are only able to assume a prudent level of Homes England Grant. Following discussions with Homes England we are unable to provide figures until we submit a grant funding bid. However, conversations are ongoing over the number of properties that may attract grant, due to the government's desire to only provide funding on nett new homes and not replacement homes. The Council believes that as it is providing new homes, grant should be available for all units. However, until we have concluded the application process with Homes England we cannot be certain and have therefore made a prudent assumption within the budget of £504k[1].

The current revised Phase A also allows for the new commercial units to be delivered within the HRA. Further work will be undertaken to explore the benefits of these being delivered within the general fund, but ultimately this would not reduce the overall funding required for the delivery of the scheme, just the funding source.

With the delivery of new council homes there remains a risk of losing these new homes over time through the right to buy process. Whilst we are unable to remove this risk it is believed to be low due to a number of factors. MKC will receive a level of protection against it costs for the loss of any homes through the RTB cost floor calculation. Section 131 of the Housing Act 1985 (the cost floor) limits the Right to Buy discount to ensure that the purchase price of the property does not fall below what has been spent on building, buying, repairing or maintaining it over a certain period of time (relevant expenditure). We also apply for a pooling exemption on all newly built / acquired properties – this increases the flexibility on use of the receipt and on timescales meaning we have longer to spend and we can also use for repayment of debt or wider regeneration costs. In addition to the above risk mitigation on 141 receipts, we also include an adjustment in the overall HRABPM to allow for this risk and ensure we are not over-committing resources.

Borrowing

The cost of the scheme will be met through HRA borrowing and is within the available headroom in the HRA. On the total capital cost of £61.150m (capital costs of £61.650m less £0.500m Homes England Grant) and at a current interest rate planning assumption of 2.5% the interest cost is c.£1.5m per annum. This will be reduced by annual revenue of c.£0.4m once the scheme is complete but as this does not cover the total cost, debt increases into the future and there is no payback point. However, this is to be expected given there will be no increase in rent for the replacement units (other than marginally through the revised mix of property sizes and small number of new units).

The debt service deficit may be to an extent be offset by net income from Phase B which includes market receipts (either capital or market rent) and might be expected to attract grant. This will be confirmed in the Phase B business case analysis.

[1] 2021 prices indexed in model with timing aligned to construction programme.

Impact on HRA Business Plan Model (HRABPM)

Summary Impact

The financial impact of the Lakes Regeneration (Phase A) has been incorporated into the HRA Business Plan Model, our 30-year forecast projection of the HRA.

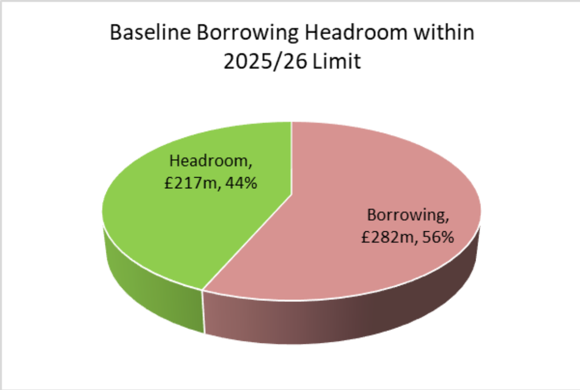
No other amendments or updates to the HRA BPM have been included at this time in order to give an accurate comparison to the previously reported baseline. The HRA BPM will be brought back for approval alongside the rest of the draft budget, to Cabinet in December 2021 incorporating Lakes into the baseline HRA budget, alongside any other updates to the plan.

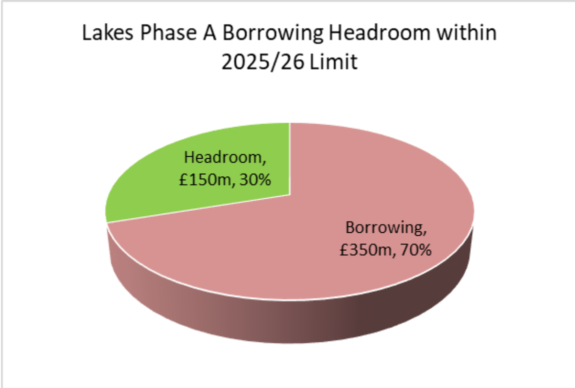
The updates to the HRA BPM have been made on prudent basis, including provision for additional Right to Buy (RTB) sales, and do not include any potential benefit from gradual conversion (through re-letting) of replacement stock from current actual rents to formula rents based partly on higher property values.

There are differences in the individual scheme cashflows and the output of the HRABPM which is due to differences in sensitivities within the plan, for example, the scheme cashflows model costs monthly but the business plan picks up only the annual sum so this may also lead to differences in inflation and borrowing assumptions, but this is not material and if anything, will be more prudent in the HRABPM. The HRABPM is refreshed on actual costs and income as part of the annual rolling refresh so these will become aligned.

The overall impact on the 30 year HRABPM of Lakes Phase A regeneration is £118m. The HRABPM reflects the impact of all aspects of the scheme; the initial capital investment, interest costs and repayment of borrowing and the revenue implications of the scheme (changes in rent income and ongoing management and maintenance costs). Debt outstanding at the end of the BPM period, is £14m.

The additional borrowing required to deliver Lakes Phase A is £67.38m and this can be financed within the borrowing headroom. This will impact on the overall borrowing position of the HRA (and the headroom below the borrowing cap of £500m agreed by Cabinet) reducing headroom by 14% as shown:

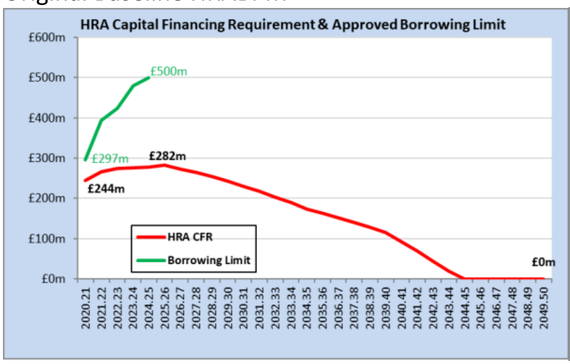




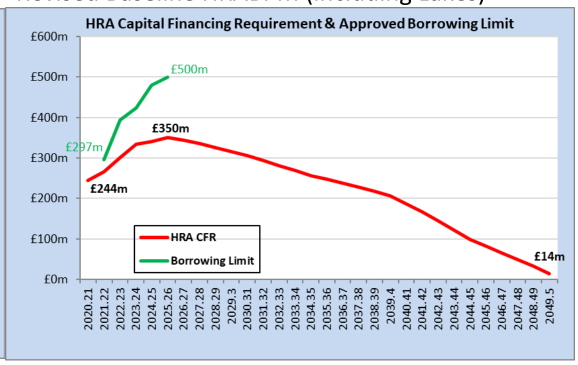
Any changes to the baseline HRABPM will impact the borrowing cap calculation, which is driven by the annual operating surpluses in the HRA as this is determined by how much debt servicing costs the HRA can afford to repay each year. Therefore, as we add new schemes into the BPM, the headroom calculation will change. Whether this changes positively or negatively will be driven by the net cashflows of the scheme. The debt cap and associated headroom are set for the MTFP period but reviewed as part of the rolling refresh of the business plan.

The following tables demonstrate the HRA capital financing requirement and comparison to borrowing limits in the baseline HRABPM (without Lakes) and with it included (revised baseline).

Original Baseline HRABPM



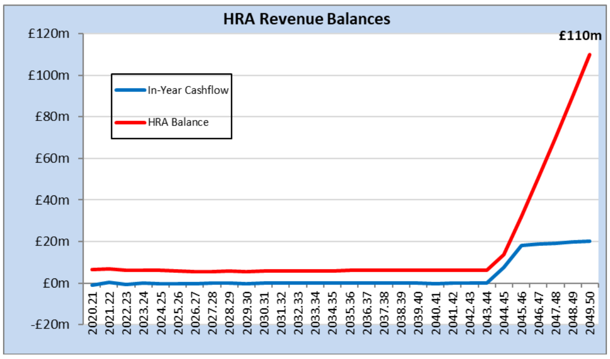
Revised Baseline HRABPM (including Lakes)

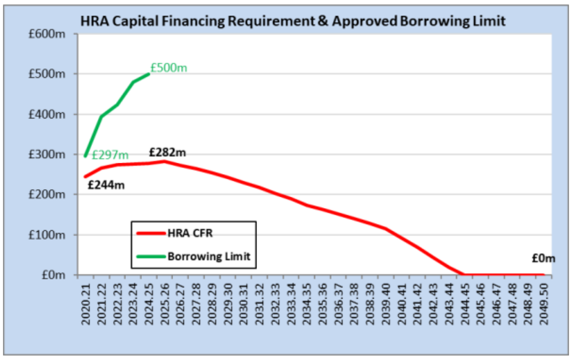


Detailed HRA Business Plan Update Steps (over 30 years)

The following information describes in detail the steps undertaken to update the HRABPM for the Lakes Phase A scheme.

The HRA BPM considered at Cabinet on 2 February 2021, was based only on committed capital plans and revenue budgets and this showed a surplus of £110m over the 30-year period, after paying off borrowing:





Detailed HRABPM Adjustments

The HRA BPM has been updated in three stages to incorporate the Lakes Phase A impact:

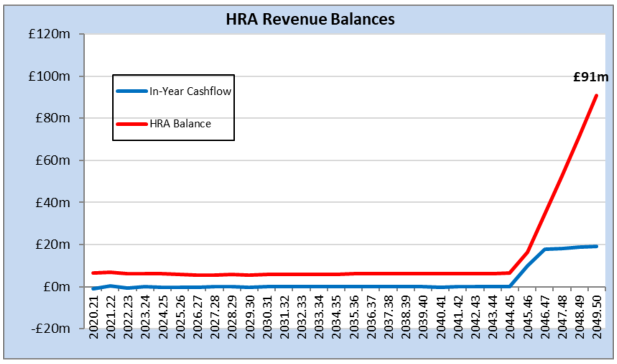
1. To show the impact of the demolition of Serpentine Court
2. To show the impact of new stock (186 social rent and 16 affordable rent) as modelled by Local Partnerships
3. To show the impact of optimising HRA borrowing as set out in the updated Treasury Management Strategy

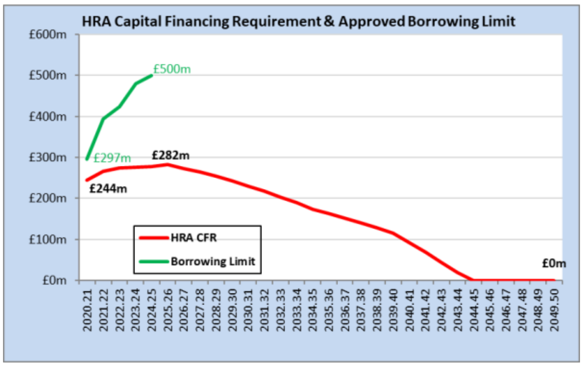
Demolition of Serpentine Court

The impact of the demolition of the existing 199 properties at Serpentine court on the HRA BPM can be summarised as:

Item	Change £m
Reduction in rent income	37.66
Increase in interest costs *(less income available to pay down debt)*	5.25
Reduction in revenue costs (Management & Maintenance)	(9.30)
Reduction in capital costs (Planned Maintenance)	(14.23)
Net Change in HRA BPM	**19.37**

The HRA BPM position is then a surplus of £91m over the 30-year period, after paying off borrowing, an adverse change of £19m:





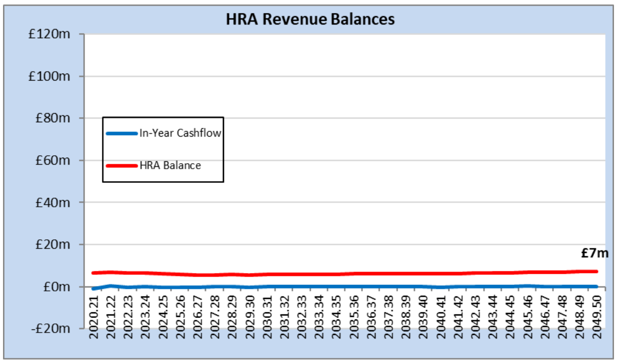
Construction of Lakes Phase A

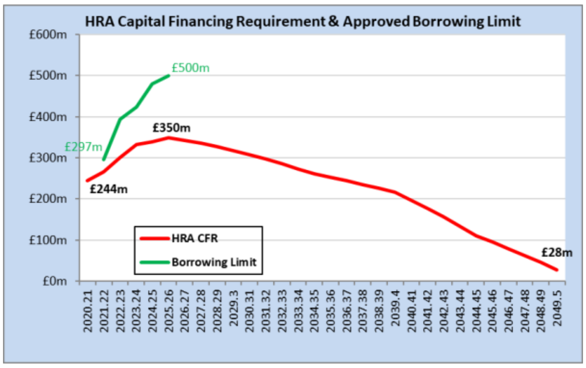
The further impact of the construction of 202 units of stock and associated non-stock investment (wider regeneration and public realm) on the HRA BPM can be summarised as:

Item	Change £m
Investment in Lakes Phase A*	64.51
Increase in Rent income	(30.19)
Increase in interest costs and VRP	65.47
Increase in Revenue costs (Management & Maintenance)	5.90
Increase in Capital costs (Planned Maintenance)	6.51
Net Change in HRA BPM	**112.19**

** This differs to the capital budget summarised earlier in the report due to the differences described in the summary, namely that the HRABPM cannot accommodate detailed cashflows but only annual adjustments and the inflationary impact of those sensitivities also varies when built into the overall model which then applies core assumptions on elements such as borrowing and inflation.*

The HRA BPM position is then a revenue balance of £7.17m (the prudent minimum) at the end of the 30-year period, with outstanding debt of £27.83m.



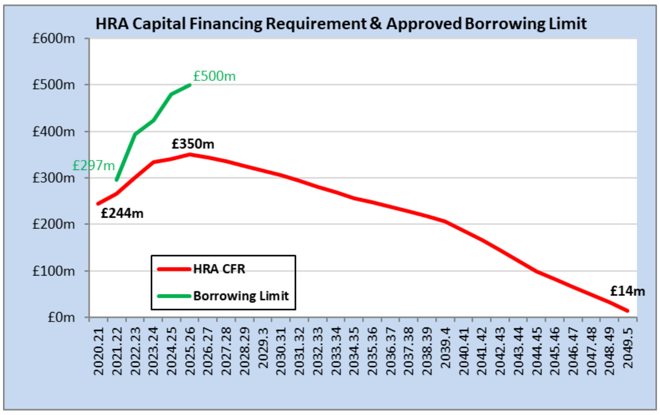


Optimising HRA Borrowing

The Treasury Management Strategy allows the HRA to borrow internally at fixed rates, which is funded as part of the council's overall internal and external borrowing as set

out in the strategy. This allows the HRA to secure its funding at current low interest rates rather than at future dates when interest rates are expected to have risen.
To optimise the HRA's borrowing, while providing some margin for slippage in capital expenditure to avoid or minimise over-funding, would mean additional internal loans which would optimise the borrowing approach in the HRA.

The financial impact of this debt optimisation would be to save £13.59m in borrowing costs, and reduce the debt outstanding at Year 30 to £14.24m:



It is therefore proposed that the cost of this scheme will be met through internal borrowing/lending between the GF and HRA and this will formalised in the detailed borrowing strategy being presented to Cabinet in September 2021.