The Importance of cost, and value in social housing finance

This exploratory piece by Bill Truin, a director at i.s.4, was originally written for CIPFA Housing Network, and was published on their website in January 2013. It looks at why it is we still seem to be in a bit of a muddle when it comes to sorting out the difference between 'costs' and 'value'. Needless to say an important (if not business critical) distinction in the world of social housing! **Using illustrations from the aborted West Coast Rail franchise exercise, to the recent concerns from the HCA on the excessive use of RPI based finance**, Bill's timely piece reminds us all to pay attention to what really matters.

Hi, let me introduce myself; Bill Truin. I've now been in housing finance longer than I care to think about; in fact I can remember the days of 90% grant….just. So what have I been doing? Well up until about two years ago I was Head of Finance at a large RSL group, since then I've joined the ranks of the consultants. I thought it was about time that I got out and about a bit, you know, see the world etc.!

So, where do we start? Well, how about the West Coast Main Line franchise? What's that got to do with housing?

Two aspects, firstly one of my regular "offices" is coach "E" of "Penny the Pendolino", yes, Virgin Trains really have named one of their trains "Penny the Pendolino"! Glad to see there is at least one company with a corporate sense of humour! Taking a slight diversion, I work regularly in Scotland, so does that mean if they vote for independence, I can say I provide an international consultancy service? Just another thought!

Sorry, back to the WCML franchise; the second aspect is that it was a process that involved financial modelling in a long term inflationary environment. Sound familiar? Also, as it transpires, it illustrates the importance of being able to differentiate between cost and value.

So let's see what we can learn from the West Coast debacle.

Whether we like it or not, inflation is important, especially to long term asset owning, debt funded businesses. One of the main reasons housing associations are viewed by politicians as wealthy organisations is because of 20 plus years of inflation which has increased the value of the asset whilst reducing the relative size of the debt. So the public capital subsidy ends up in assets and reserves, not cash backed, but nonetheless valuable collateral for future borrowing. No wonder DLCG is always working on ways of getting HAs to work with less grant, it is the only way of getting the value of the public contribution back into housing investment, rather than provide large comfortable cushions to sit on. Now with HRA self-financing local authorities can use their housing stock not just to provide homes but also to create value for investment in homes in the future. And it's not just homes, it is investment in the local economy, the construction industry and the national economy…another small contribution to growth, but every little helps.

Okay, the WCML model was different from a housing model in that it was trying to estimate the size of an obligation, in housing we are looking at the potential value of an asset, but the lesson is still the same; don't underestimate the importance of inflation.

Then there is the other side of the coin, the tenant, especially those not on housing benefit: inflation may be good news for asset value, but it isn't good news for tenants on fixed incomes. Also, it might just be about to get worse for every tenant (not just those that decide to put up with the cost of the "Bedroom Tax") as Benefits as a whole move to CPI. One of my colleagues was doing some research on Welfare Reform for a client recently, estimating the potential cost to tenants and the consequential loss of spending power. We were all expecting the biggest impact to come through the reduction in actual benefit, however, in fact the biggest reduction in income would come about if rents remained linked to RPI while benefits moved to CPI - the potential cost to the tenant made everything else look like the Petty Cash (relatively speaking)! So, the tenants need rents to move to C.P.I. a.s.a.p. (nothing like back to back acronyms!) …easy? Not quite, what then happens to social housing providers' ability to invest? Ah, let's get the capital grant levels back up again? No wonder trends in funding social housing seems to go round in ten yearly political circles!

Now let's consider the other aspect of this exercise; value verses cost. Would you recognise value, if it bit you in the bum? It's not that easy, but in social housing we can actually measure it by using the net present value of net rental stream. May be the Department of Transport should have had a discounted cashflow model for their business plan, assuming they remembered inflation! The lesson to learn is that we always need to understand that cutting costs may actually impact on long term value, and to help us understand the risks and relationships involved in cost cutting decisions we can use some basic risk management techniques. Conversely, remember that spending doesn't necessarily result in generating value, either.

A quick bit of analysis of the WCML situation, based on publicly available information, goes a bit like this:

- In order to save costs a significant number of very experienced and senior railway industry specialists were allowed to leave the Department of Transport and there was also a clamp down on using consultants
- In order to extract more value from the business model, in the form of larger payments from the company operating the franchise, the bidding process was changed.

So far so good, we've reduced the administrative cost base and increased the potential financial return on the business model.

- So now let's conduct the new and more complex bidding process using less experienced staff.

Result; it is discovered that there is a fundamental error in the financial model. Now errors in financial models are not unusual, let's face it some of them are so complex, if there isn't an error somewhere I'd be surprised, but this one has left inflation out of a calculation to estimate a future obligation that is key to determining the bidders commitment to stick with the contract for the whole period of the franchise.

Process abandoned, £40m to repay to bidders, plus potential legal action, plus delayed investment and more resources needed to pick up the pieces and re-run the process.

From that I can only conclude that cutting those costs was not done in a way that understood the concepts of value and risk management.

I think I should also say that if the cash isn't available you can't spend it, but at least understand the potential consequences of not spending.

Moving on there are two themes I want to explore, in a little more detail here, firstly the issue of resources and secondly, the issue of RPI.

In the current economic climate there is constant pressure to reduce costs, and if you are using a debt funded business model, there should always have been that pressure. However, you can't just carry on doing what you do and cut costs, the reality is that either you stop doing some things or you do the same things (or even more things) but do them differently.

So what does a typical public organisation do to deliver its cuts and meet the demands of government policy? In a recent budget document I noted that the savings were to come from the process of deleting vacant posts, no matter how essential they were to service delivery – with an implicit assumption in the plan that everything was going to carry on as before. Now I might be drawing the wrong conclusion, it might be that the document didn't demonstrate very well what the actual strategy was going to be in practical terms, but it didn't have a very good feel about it. Surely the approach should have been to set out the service delivery objectives, then the delivery methodology followed by the resources needed. Effectively start with a clean sheet of paper, and always consider the prime importance of 'value' not just service costs.

This has been illustrated to me recently by some advice we've given another organisation. They have been dependent on support from their sponsors through "start-up" but wished to be independent. We were asked to advise them on "how" they could achieve this, as financial sustainability was the core challenge. The main issues were that they needed to break the link between growth in customer numbers and operating costs. The only way to do this was to provide the service in a different way – with the easy answer being "more IT", and the more complex, challenging answer being to ask the organisation to create fundamental cultural changes in the way it delivered its services. We also advised them to review their processes through "customer service eyes" and not as just an administration matter, thus helping managers and staff to concentrate on what was really important to their business.

The other thoughts that come to mind in this sort of situation are; firstly it is always easy to cut low level admin staff costs, only to replace these with senior staff doing admin, but not the job they are paid to do! Secondly, if you're making a saving on budget, make sure you understand why, otherwise you might make the wrong decision when it comes to using that saving.

Right, let's move on, or back, (whichever way you look at it) to RPI. RPI seems to be in the headlines, not just in transport, but also in housing. The Homes and Communities Agency has expressed concern over the excessive use of RPI based instruments as part of the funding mix for RSLs. Actually, I think they are absolutely correct. RPI based financial instruments are very complex, especially when it comes to modelling how they behave and the risks they present. I ought to know, I've been asked to do a Brixx model for a client on an RPI leaseback business model….ahhh! Okay, RPI based instruments have a role in managing RPI risk, but RPI comes in many forms, you don't

always get that “back to back” movement between profit before interest and RPI based finance charges. But what really worries me is that I’m not convinced that organisations really understand that some types of RPI funding actually are taking away the rewards of ownership, the growth in future investment capacity, leaving behind all the risks of ownership. That doesn’t sound like a good deal, even if you do get your sticky paws on loads of dosh NOW.

To really understand the risks/rewards of RPI finance you need to understand what drives financial capacity, or to put it another way, future expected profit.

Finally, let’s round off with that other big risk on the horizon, what happens if you sign up to RPI based funding, only to find the income stream is now CPI based? I have read one treasury consultant’s view that says the difference between the two is just a timing difference. From some work a colleague of mind has done recently, the difference is permanent and widening.

Okay, so how do we minimise the chances of eroding value and increase the opportunities of generating value? Well, firstly, value management is everybody’s responsibility, and that is everyone acting together, not as just a collection of individuals. Just because value is measured in money terms doesn’t mean to say it is only the preserve of the finance department! Note to the accountants; don’t keep information to yourselves…share it! Then ensure everyone understands the whole business, especially the relationships inherent in the business between customers, services and assets, and how they are reflected in value. Remember to define what you mean by value, it is actually relatively easy with social housing. Understand and quantify the downside risks…how much will it cost if the decision goes pear-shaped! If in doubt model it and run a risk workshop.

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January 2013

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