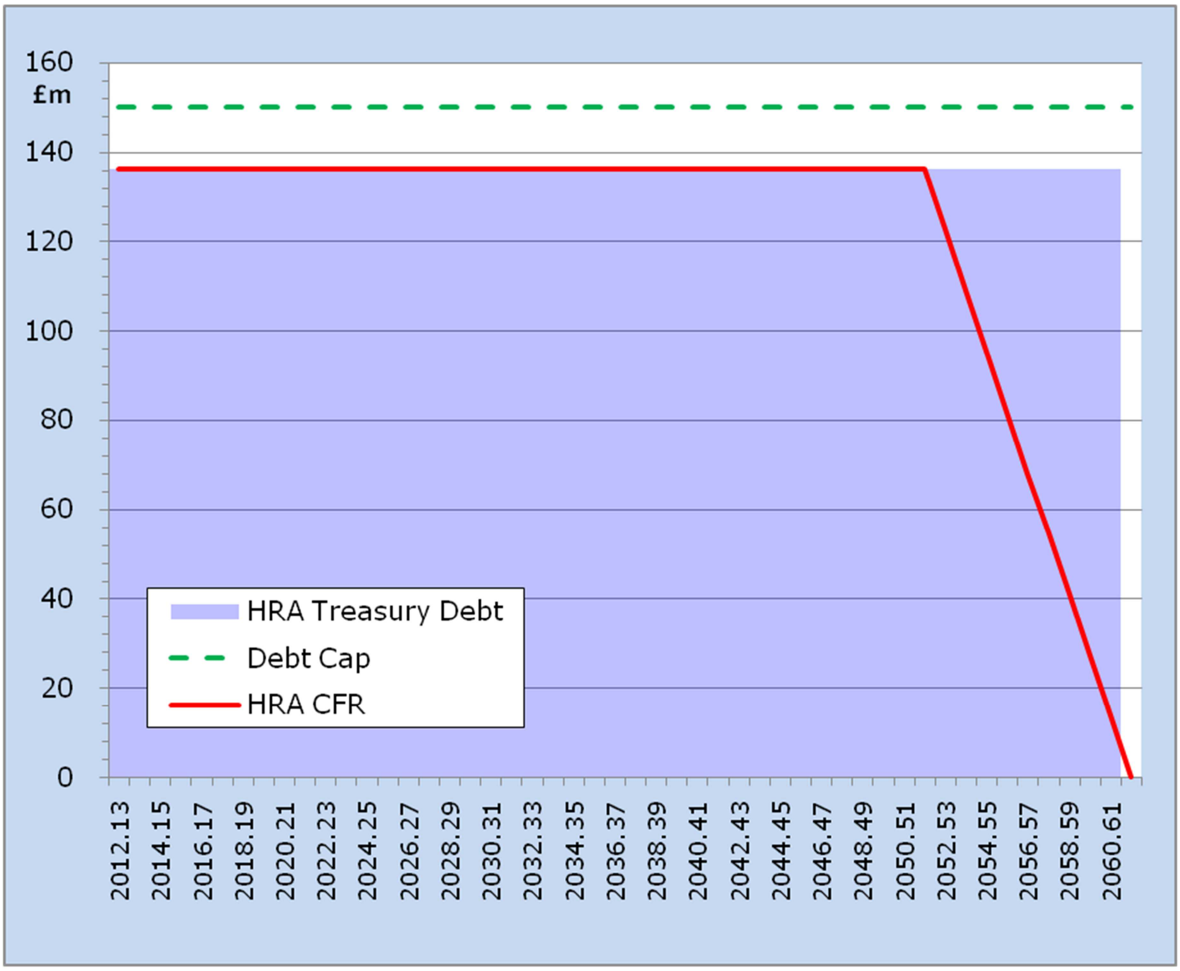
APPENDIX 3

BRIEFING NOTE TO HRA SELF FINANCING BOARD RE SELF FINANCING DEBT STRATEGIES

This briefing note updates the version previously presented to the Board in December 2011 and reflects various changes since then such as refinements to the Business Plan, discussions with Sector and increased aspirations for New Build. The previous note discussed options for taking one 30 year loan, repayment of debt at various stages throughout the life of the Business Plan and repayment of debt at various stages over 25 and 30 years. In order to meet the new build aspirations within the latest Business Plan it has been necessary to expand the life of the Business Plan from 30 to 50 years with a consequent revision of the debt options to allow for this. Three options have been identified for consideration, two of which allow for new build of approximately 1,400 properties over the life of the Business Plan and the third allows for new build of just under 1,200 properties and these are discussed in the following paragraphs.

Debt Strategy 1 – Borrow one 50 year Fixed Interest Maturity Loan

The graph below illustrates this strategy:-

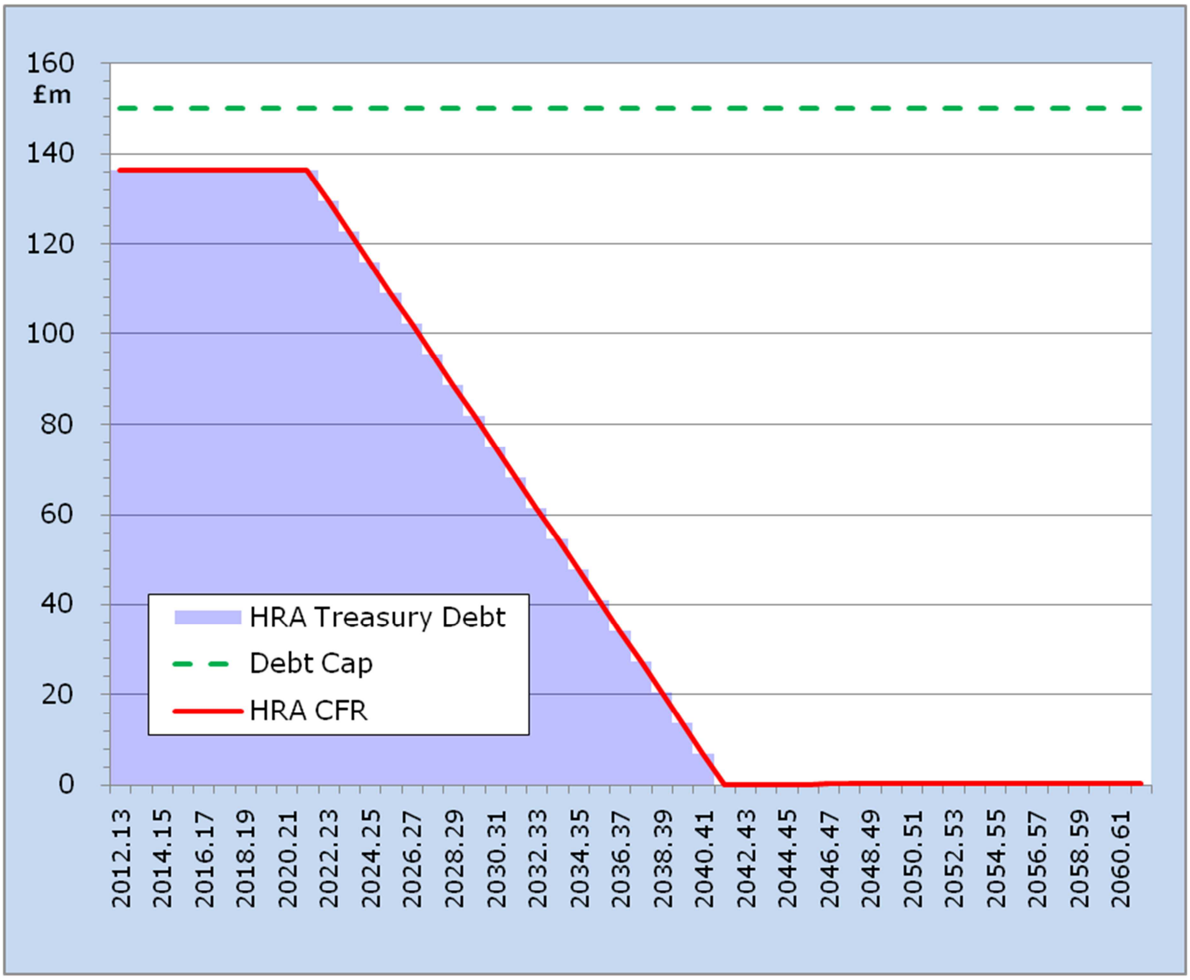


This option is essentially option 1 from the previous note but expanded to 50 years. One single loan for the full Self Financing payment of £136.157m would be taken to be repaid in year 50 and provision for repayment of this debt would commence in year 41 thus allowing the surpluses in earlier years to be devoted to financing new build of approximately 1,410 properties. Based on current expectations, the 50 year loan could be secured at approximately`3.20% and this will be fixed for the 50 years. However, no further borrowing, other than the headroom, could be taken before the loan matures in year 50. From a Treasury point of view, there may be a significant re-financing risk should it be necessary to re-finance the loan or part of the loan on maturity due to not being able, for any reason, to provide for full repayment as expected over years 41 to 50. The Business Plan does not envisage this situation but it nevertheless remains as a risk. It is also not good practice to have such a large amount of borrowing maturing in any one year. Significant counterparty credit, interest rate and maturity risk will also exist as the funds set aside from year 41 onwards for debt redemption will be invested until required for repayment of the debt in year 50.

Debt Strategy 2 – Borrow Maturity Loans with Different Maturities

This was the previously preferred option and provides for equal repayments of debt between years 11 and 30.

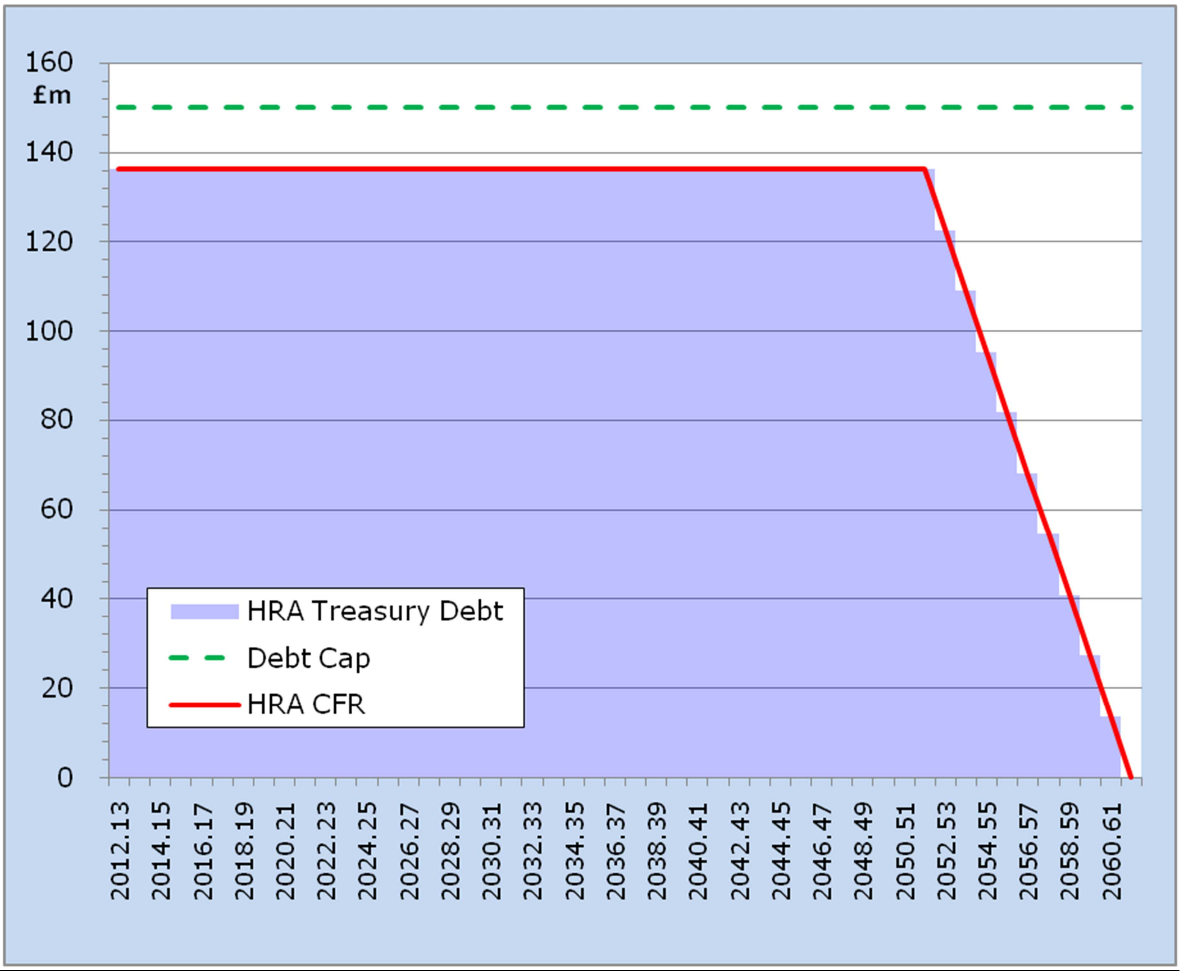
The graph below illustrates this strategy with all debt repaid by year 30:-



This option would deliver the cheapest fixed rate PWLB funding in terms of annual cost but there would be no capacity for new build during the years 11 to 30 as surpluses during those years would be dedicated to debt repayment and the total number of properties that could be built would be around 1,200.

Debt Strategy 3 – Repay debt between years 41 and 50.

The graph overleaf illustrates this strategy:-



Again, in order to provide the maximum resources for new build of around 1,440 properties throughout the life of the Business Plan this option does not include any provision of debt repayment until year 41 with the actual debt being paid off during the years 41 to 50. The current working hypothesis is for equal amounts of debt to be paid off each year. It also allows for fresh borrowing (excluding the headroom) from year 41 if required. From a Treasury debt maturity profile point of view it is better than the single 50 year loan option as it exposes the Council to less risk as the repayments are spread over 10 years rather than in one single year. Also, this debt strategy minimises counterparty credit, interest rate and maturity risk as large investment balances are not building up due to the surpluses being regularly used to repay debt and pre year 41 financing new build. In terms of annual interest costs there is little difference between this option and option 1 as the expected interest rates for loans with yearly maturities of between 41 and 50 years are virtually the same as that for a single 50 year loan.

Variable Rate Debt

Any PWLB variable rate debt taken out to finance the Self Financing debt settlement would have to be repaid by year 10 and this would impact on the Business Plan's new build aspirations from year 6 as funds would have to be diverted away from new build to provide for debt repayment . It could be converted into fixed rate borrowing but this would be at higher interest rates than those obtainable for the March 2012 Self Financing debt settlement and this would be counterproductive in that it would cost the Business Plan extra borrowing interest. For these two reasons, the taking of variable rate debt is considered not to be an option.

Internal Borrowing

Discussions have taken place over whether it would be possible to part fund the debt settlement from either GF or HRA balances or a combination of both. However, from the GF point of view the amount that could be utilised was relatively small e.g. £5m and was available for only a few years before needing to be repaid to the GF and replaced by borrowing in the HRA which would have been at a much higher interest rate than that levied by the GF. In addition if the borrowing were not to be replaced then this would have an impact on the new build aspirations in the early years of the Business Plan. It was also felt that it would not be fair to charge the HRA an interest rate greater than the PWLB variable rate which it could obtain for itself when making the Self Financing debt settlement. Whilst the HRA has balances of its own that it could contribute to the Self Financing settlement for the same reasons as outlined for the GF, particularly in respect of providing resources for any potential capital expenditure on projects outside of the Business Plan e.g. solar panels it was felt not to be practicable for these balances to be utilised.

Headroom

The final determination indicates that the self financing settlement will be £136.157m within a "debt cap" of £149.998m. The difference of £13.84m represents the "headroom" or additional borrowing that the Council can incur during the lifetime of the Business Plan and is effectively the HRA Subsidy Capital Financing Requirement (CFR). Consideration has been given to taking this debt alongside the Self Financing debt on the 28th March but this has been discounted on the grounds that a) there is no immediate need for this borrowing, the new build aspirations being financed from within the Business Plan b) there will be a "cost of carry" i.e. the difference between the interest paid and what interest can be earned on it c) until utilised there would be increased Counterparty credit, interest rate and maturity risk as the £13.8m would be invested and d) in order to avoid being declared "Ultra Vires" the borrowing would have to be utilised within 18 months of it being taken out and as already mentioned there is no immediate need for it.

Summary

Debt Strategy 1 provides certainty over debt servicing payments but lacks flexibility and there is no prospect of fresh borrowing other than the headroom. In addition, due to the large investment balances building up there are significant Treasury Management risks

Debt Strategy 2 repays the debt by year 30 and allows for fresh borrowing but there will be no opportunity for new build between years 11 and 30 as surpluses are used to repay debt. It also builds the least amount of new properties.

Debt Strategy 3 allows for new build throughout the life of the Business Plan, as does option 1 but in terms of Treasury Management is the strategy with the minimum amount of risk and is therefore the recommended strategy that should be followed when finalising the borrowing.

Naturally, this is an evolving subject and over the years the Business Plan will need to meet changing circumstances such as slippage in revenue and capital spend and changes in income levels both of which will have an effect on the debt strategy causing this in turn to be kept under review and amended where possible.

Finance
02 December 2016