Research into income and rents within the Housing Revenue Account

Local Government Association
Association of Retained Council Housing
National Federation of ALMOs

Final Report
October 2022
Updated December 2022

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Executive Summary

Introduction

Savills Affordable Housing Consultancy was jointly appointed by the Local Government Association (LGA), and its partners the Association of Retained Council Housing (ARCH) and the National Federation of ALMOs (NFA), to undertake research into various aspects of the policy, financial and technical operation of the Housing Revenue Account (HRA). This report addresses the work related to income and rents, carried out during the period from August-October 2022 when the Government's consultation on capping rent increases was in progress; it is based on the construction of a national HRA business plan model and taking into account the views and feedback from a series of participant local authorities.

Headline outputs

Rent increases

Prior to, and during, the consultation period, we were not aware of any local authority that was considering increasing rents by CPI+1% in April 2023 – this was confirmed when the September CPI rate was announced at 10.1%.

The majority of modelling for this research and analysis took place during the consultation period and helped to inform responses to the consultation. Our estimates of the net impact of capped rent increases for one or two years at 5% of less were that there would be significant savings required, over an extended period.

The differential impact of expenditure inflation allows us to estimate that the average "stand still" increase required for rents was between 7%-9% with an average of just over 8.2%.

This, combined, with pressures on costs within capital programmes, suggests that a 7% rent increase would fall short of covering increased inflationary expenditure pressures and that authorities will need to seek savings (or draw on reserves) to cover the deficits.

Our estimate of this requirement would be on average c5% of management and repairs costs (i.e. day to day revenue costs in the HRA).

Whilst the majority of authorities participating in this research and across the country had expressed a view around a 5% rent increase cap, the announcement of a 7% cap has been broadly welcomed as providing for more flexibility locally.

Whilst the feedback within this research has been that increases of 7% will be sought, it is possible that not all authorities will increase rents by this amount.

Catch up to formula rent

The long-term impact of a rent increase at 7% falling short of cost pressures is exacerbated if authorities are only allowed to charge formula rents upon relet. Our estimate of tenancy turnround is that c75% of tenancies churn over a 30 year period, hence catch-up to formula would be delayed well into the long term.

Conversely, the modelling of convergence or catch-up to formula rents over a set period (10 years) provided for in lower inflationary periods, could provide the opportunity to re-build resilience in HRAs and limit deficits to a short-medium term period, although our estimate of deficits over such a period are in excess of £3billion nationally and unlikely therefore to be able to be covered solely through drawing on reserves.

Service charges

Service charge increases are likely to be significant driven by higher communal energy, utilities and repair costs. Suggestions within the consultation paper on rent increases that authorities cap service charge increases at the same level risk the introduction of further rent pooling.

Our estimate is that capping service charge increases at 7% when cost drivers are significantly above that level might introduce cross-subsidy of service costs up to c14p per property per week across the entire stock.

Low income household arrears risk

For those households that pay some or all of their rent, focused on those on the lowest incomes and those just above the threshold for any housing benefit or Universal Credit support, there is a risk given the "cost of living crisis" that expenditure pressures for essentials such as food, transport and energy could lead to increased rent arrears. Lower income households tend to spend a higher proportion of their incomes on these essentials and these essentials are experiencing higher than CPI inflation (for example 14% for food in September 2022).

Our estimate is that there is a risk of additional arrears between one tenth and one fifth of average rents across the country. As gross rents are in the region of £7billion nationally, and the amount paid by households estimated at c35% of this amount (i.e. c£2.5billion), the risk of additional arrears should not be underestimated.

1. Introduction

1.1. Background

Savills Affordable Housing Consultancy was jointly appointed by the Local Government Association (LGA), and its partners the Association of Retained Council Housing (ARCH) and the National Federation of ALMOs (NFA), to undertake research into various aspects of the policy, financial and technical operation of the Housing Revenue Account (HRA).

There are three areas of research, each addressing a key area for review and exploration:

1. HRA Expenditure: incorporating a review of expenditure pressures affecting services provided to council housing within the HRA including: landlord services and housing management, building safety, net zero carbon and other pressures.
2. HRA income: incorporating a review of income pressures, possible alternative approaches to rent policy, future rent increase policy and all other areas of income.
3. Towards a more sustainable Right to Buy: not challenging the RTB policy itself but researching and exploring issues around sales volumes, the operation of discount levels, the recycling of RTB receipts – aimed to come up with some thoughts around future policy ideas to make the policy more sustainable for local authorities.

This report addresses the work related to income and rents.

The primary research and analysis work for this report was undertaken during the period from August-October 2022 which coincided with the Government engaging in a consultation on proposals to cap rent increases for social housing for 2023.24 and, potentially also, for 2024.25[1].

The final draft iteration of this report was utilised to inform the responses of the three trade bodies to the consultation.

The Government subsequently announced its rent policy determination for 2023.24 in its Autumn Statement made on 17th November 2022 – this was a cap on social housing rent increases of 7% for 2023.24 with exemptions for supported housing, and this has been reflected with updated narrative throughout this report where appropriate.

1.2. Overall methodology

The overall approach for this research and analysis was in two parts.

1. To construct a national financial model for the Housing Revenue Account (HRA) in England which enables a projection of income and costs in order to model the potential impact of a range of different approaches to rents and income policy going forward, and to highlight the overall financial position arising from income pressures being experienced by local authorities.

[1] *https://www.gov.uk/government/consultations/social-housing-rents-consultation*

2. To engage with a series of local authorities in order to gain feedback on local experiences; all partners were keen to ensure that a sample of local authorities were selected in order to test out a range of questions relating to income in the HRA. Details of the authorities that have been engaged as part of this research are set out below.

1.3. National financial model

We have consolidated information from the following sources to enable a national financial projection for the HRA covering 162 local authority HRAs launched from 2022.23, including:

- Actual HRA outturns reported for 2020.21
- Business plans known to us in respect of 2021.22
- Budgets set (public domain) for 2022.23.

We have cross-referenced these sources to data provided by authorities during the course of business plan support provided by Savills to our clients for c15-20% of the HRA sector.

The outputs are therefore based on what is essentially a “National HRA Business Plan”, focused on the income and expenditure cashflows for revenue in the HRA, and an overall benchmark assumption of core capital costs in the model.

We have necessarily had to make some assumptions around financial management and behaviour locally in order to make a national projection. There are two key points to note:

- The model assumes no draw on reserves in 2022.23 – whilst there is likely to be some increase or reduction in reserves arising from activity in 2021.22 and 2022.23, it is difficult to project – hence this is held at a balanced position so as not to distort projections.
- Levels of direct revenue financing of capital expenditure, and levels of debt repayment, vary widely between authorities; they can also vary significantly between financial years as programmes proceed – for ease of assumption, we have assumed that the 2022.23 assumption of these contributions is maintained throughout the projection, thereby allowing us to isolate the impact of rent increase and cost inflation variations

We have aimed to match and align forecast assumptions so that we can focus on the implications of variations in approaches to rent and income changes and increases.

Application of scenarios to financial model

We have applied varying rent increases under three broad “policy” approaches.

1. Allow actual and formula rents to increase CPI+1% all years – this allows the model to project the position based on the previously prevailing policy towards maximum rent increases and therefore show what the “real terms” expectation position would be
2. Cap rent increases for 2023.24 and 2024.25, permanently reducing formula rents; with a variation to apply a cap for 2023.24 only

3. Cap rent increases for 2023.24 and 2024.25, but allow catchup to formula rents over a set period, including over a number of years – with the number of years able to be varied according to different "catch up" scenarios.

The reference to "capping rent increases" captures both local authorities voluntarily restricting rent increases below CPI+1% and the government imposing a national cap – as the financial impacts are the same.

Application of expenditure inflation

The report on research into expenditure within the HRA covers the challenges arising from the current inflationary environment. However, in order to model the impact of rent increase policies on the HRA nationally, we have needed to adopt a series of assumptions around future inflation on costs in this element of the research.

The Consumer Price Index (CPI) inflation at September 2022 (which would otherwise apply to inform rent increases from April 2023) was 10.1%. Some costs are increasing below this level, some are increasing well above this level.

We are therefore recognising that inflation drivers are different for different cost components and that a "flat" inflation projection for costs is inappropriate, therefore we have applied the following:

- An assumption of the split in R&M costs between employees, materials and contractors
- An assumption of the split in management costs between employees, materials, contractors and utilities
- Differential inflationary increases which are then applied to each cost element.

Note on service charges

We have also applied the same income increase to service charges as for rent increases following overwhelming feedback from local authorities within this review and more widely that members are unlikely to want to pass on huge increases in service costs to tenants.

It is noted that any increase in service charges which does not fully recover increases in service costs will increase rent pooling (i.e. an element of cross-subsidisation of some service costs from mainstream rents) and in some cases may reintroduce rent pooling. We have addressed this element within the report below.

1.4. Engagement with local authorities

Basis of engagement

We invited up to 12 authorities to participate in the research through a high level engagement with relevant officers based around a summary questionnaire. All authorities were approached at the same time, and we were able to engage with a majority of those authorities approached. The authorities approached were selected to reflect a political, geographical, size, authority-type (district, unitary, metropolitan borough, London Borough).

An overall briefing was provided (see annex 1) and a schedule of questions were discussed(see annex 2).

The approaches were made on the basis that there was no additional work involved in authorities compiling or analysing data/information, there was an initial discussion / follow-up data review / follow-up discussion (as required) only, and that there was a key focus on rent income and rent policy, and on service charges.

Other areas of income appear to be less of a concern to authorities and therefore did not feature in the research.

A summary of the findings from the engagement part of this research is set out below. A schedule of those authorities engaged is also available upon request.

Backdrop to the current rent policy discussion

All authorities had/have rent increases in their HRA business plans at or below CPI+1% according to previous forecasts – i.e. at a maximum of 3% based on CPI assumptions of 2%, occasionally 3.5% based on assumptions of CPI at 2.5%.

All authorities therefore recognised there will be more income in their business plans than previously forecast – the key factor is the extent to which expenditure inflation is higher than in the business plan and outweighs additional income received.

Service charge de-pooling appears to be generally patchy outside London – and likely to be increased as a result of the current cost of living crisis as members determine not to pass on very large increases in service costs to tenants who pay service charges.

1.5. Additional analysis

As a result of discussions which took place during the course of the research, we have also undertaken a high level analysis of the possible impact on low income households which pay some or all of their rents (i.e. those that are not on full housing benefit or receive the full housing element of Universal Credit). This was felt to be an area of investigation worthy of further work given inflationary pressures around the cost of living generally, and in particular the impact that these pressures are having on low income households.

2. National financial model: baseline assumptions

2.1. Core assumptions applying to the modelling

In additional to the overarching assumption around no use of reserves referenced above, the following have been adopted as key core assumptions in the model.

Capital investment in the stock

This commence in the model at the rate set out in 2022.23.

We have applied construction inflation assumptions to capital works – this is has a knock-on impact into depreciation and the transfer to the Major Repairs Reserve; we have also applied a proportionate increase in investment need arising from standard life cycle repairs needs and compared these to forecast levels of depreciation – in order to determine any additional borrowing requirements arising from capital expenditure pressures – this is estimated at c£150m pa.

In order to isolate the rent increase impact, we have not assumed any large increase in those costs arising from (for example) building safety, energy efficiency and initial work towards net zero carbon targets; however, we have modelled these as a scenario within the report.

Other relevant assumptions

Right to Buy sales are assumed at 0.45%pa of the stock, gradually declining over time in line with the majority of HRA business plan assumptions being made by local authorities.

We have assumed no new build development or additional acquisitions as this complicates the rent modelling.

We have modelled interest rates at a consolidated weighted average increase from 3.84% to just over 4% over the period to 2028; this reflects both the increase in PWLB rates compared to the current weighted average interest rate for the HRA nationally, but that any change in interest rates would be subject to a “marginal increase” given the volume of fixed debt within the HRA nationally.

Note re differential future inflation

We have also aligned longer-term income and cost inflation.

If future rent policy allows rents to increase CPI+1% from 2025, so do repairs and maintenance and management costs; if future rent policy to increase rents is at CPI-only from 2025, CPI-only applies to these costs.

We regard this as a fundamental principle of future projections as this controls for any inadvertent modelling of real growth or reduction in forecast net operating income.

It is noted that the Government did not make any announcement in the Autumn Statement towards future rent policy beyond 2025, and has committed to consult widely on this during 2023. At this stage therefore our projections make the assumption of “no change” in policy and model CPI+1% rent and cost increases throughout all years from 2023.

2.2. Cost and income inflationary drivers

These have been derived from business plans and information derived through the course of the research as an average set of factors and drivers that apply to HRAs.

Application of range of inflationary criteria differentiated between expenditure type

Table 2.1: split of operating costs by different expenditure elements

Driver	Repairs & maintenance	Management
Employee/pay	25%	65%
Contractor	50%	15%
Supplies/materials	25%	10%
Utilities		10%

The table highlights an overall average applied to operating cost elements. Some local authorities have direct labour organisations and would therefore have a higher proportion of repairs costs which are driven by employee costs. Conversely, many local authorities have only a very limited amount of direct labour committed to repairs services.

Similarly at least some repairs and maintenance costs will be driven by utility and energy costs, though we estimate that the overwhelming majority of authorities account for the "management of the repairs service" as management costs rather than as repairs and maintenance costs.

The table highlights our estimate of the broad average across all HRAs.

Application of inflation based on blend of local experiences, national forecasts, published indices

Table 2.2: inflationary assumptions applying to different expenditure elements

	2022.23 *	***2023.24***	***2024.25***	***2025.26***	***2026.27***	***2027.28***
General CPI		***10.00%***	***6.00%***	***4.00%***	*2.00%*	*2.00%*
*Pay award ***	***5.00%***	***6.00%***	***4.50%***	*3.00%*	*3.00%*	*3.00%*
Contractors	***8.00%***	***10.00%***	***7.00%***	***4.00%***	*3.00%*	*3.00%*
Supplies/materials	***8.00%***	***10.00%***	***7.00%***	***4.00%***	*3.00%*	*3.00%*
Utilities costs	***30%***	***100%***	***50%***	***5%***	*3%*	*3%*
Construction	***7.00%***	***10.00%***	***10.00%***	***5.00%***	*3.00%*	*3.00%*
Real rents from 2025				*1.00%*	*1.00%*	*1.00%*

** Note that inflationary drivers affecting 2022.23 are necessary to apply to a revised operating cost base from 2023 – as inflation has been higher in 2022.23 than was provided for in HRA business plans*

*** Note that pay award inflation estimates represent an estimated conversion into %age pay increase applying to local authorities – this is different given the pay base for each authority*

These values have been derived from a range of sources and were correct at the time the projections were made. The sources included: construction industry indices (BCIS-all in and BCIS-maintenance), general CPI and inflationary forecasts produced by HM Treasury, the assumptions being utilised to inform valuations of social housing stock for security purposes for private lenders into the housing association sector., as well as a range of direct feedback from authorities engaged for this research.

Highlighted in bold are inflationary drivers which are above the long-term OBR forecast.

It must be noted that experiences vary widely – in particular for energy and utility cost inflation as authorities are re-negotiating their supply contracts.

Additional note

As a result of the revision to national economic forecasts within the Autumn Statement, the forecast level of CPI inflation for September 2023 (therefore applying to 2024.25 rent increases) is higher than assumed within this analysis (c9%). If this is the case, it is possible that the Government might consult again on capping rent increases for 2024.25.

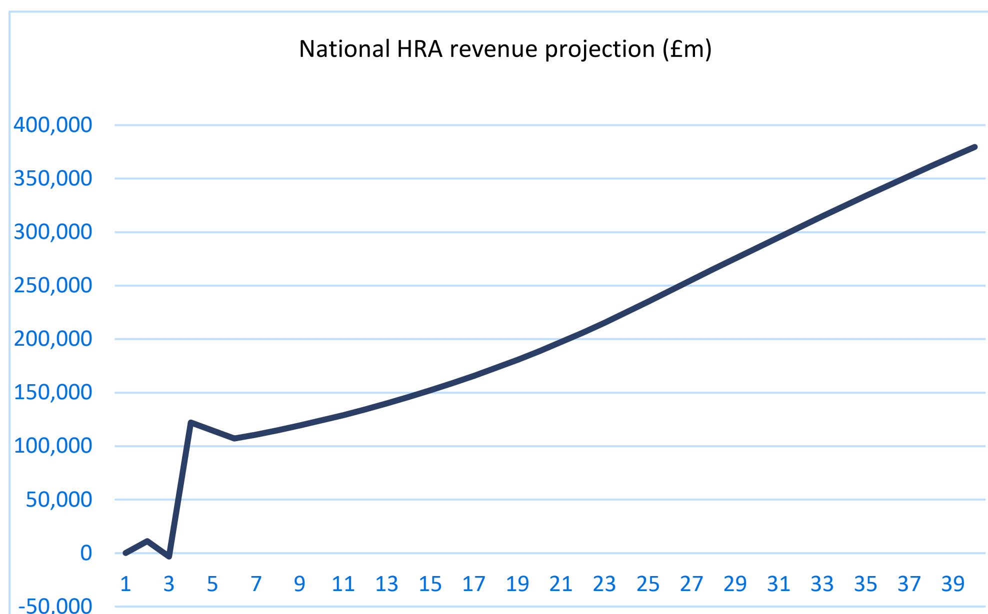
3. Projections of rent increase levels

3.1. Introduction

The following sections set out a summary of the various projection scenarios based on a range of alternative rent increase policies. For each, there is a chart setting out the national forecast of net rent income (surplus or deficit on the HRA) together with a summary of the net impact and confirmation of what increases in rents this would represent over time.

3.2. Projection scenarios: baseline projection with CPI+1% rent increases

Chart 3.1: baseline projection with CPI+1% rent increases all years



The chart highlights that:

- In the first year or two, there are potential pressures on revenue arising even when rents are increased at the full CPI+1% - this is because of the inflationary drivers in the HRA
- Beyond the first 2-3 years, however, the projection is for a gradually increasing relative annual surplus – which is entirely in line with expectations as we have aligned income and expenditure inflation for all future years of the projection
- This “steady state” projection offers the basis for comparison when rent increases are varied under alternative scenarios below.

The key points from this projection are as follows.

Rent increases would be as follows:

- April 2023 11.0%
- April 2024 7.0%
- April 2025 5.0%
- April 2026+ 3.0%

As we are applying very high inflation to elements of capital costs, this is driving higher depreciation requirements (to the Major Repairs Reserve).

In the short-term, therefore, there may well be a requirement to draw on reserves to meet these inflationary pressures – even when rents are increased at the full CPI+1%.

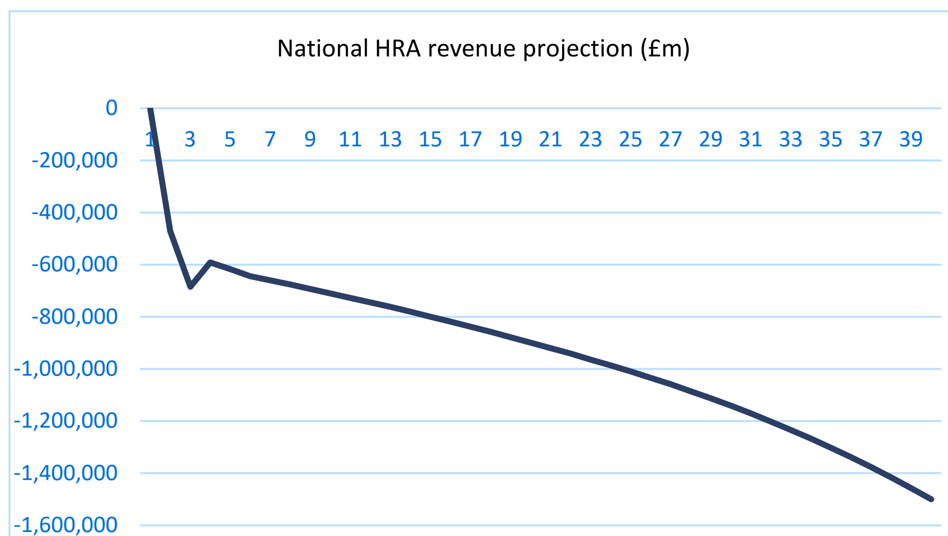
The projection returns to a stable position for all future years.

The projection shows that there may be limited capacity for additional investment to be financed via borrowing (i.e. increasing surpluses could be used to finance increased debt) to cover additional capital expenditure pressures - but that this is not extensive.

Clearly, if rent policy were to be reduced to CPI only, there is the potential for future lower surpluses – from what is already a relatively tight position based on CPI+1% rent increases.

3.3. Rent increases capped at 5% for 2 years – with no catch-up to formula rents

Chart 3.2: baseline projection with rent increases caped at 5% for 2023.24 and 2024.25 – no catch-up



The chart highlights that:

- In the first year or two, there is a risk of large deficits as rent increases do not keep up with cost inflationary pressures
- Beyond the first 2-3 years, the position is unable to be recovered as rents do not thereafter catch up with the cost pressures that have become part of the expenditure in the first 2-3 years
- This longer-term projection is therefore for increasing deficits: operating margins decline from 18% now to zero over the projection term.

The key points from this projection are as follows.

Rent increases would be follows:

- April 2023 5.0%
- April 2024 5.0%
- April 2025 5.0%
- April 2026+ 3.0%

The projection implies deep deficits in the first 2 years – which would need to be addressed by making substantial additional savings.

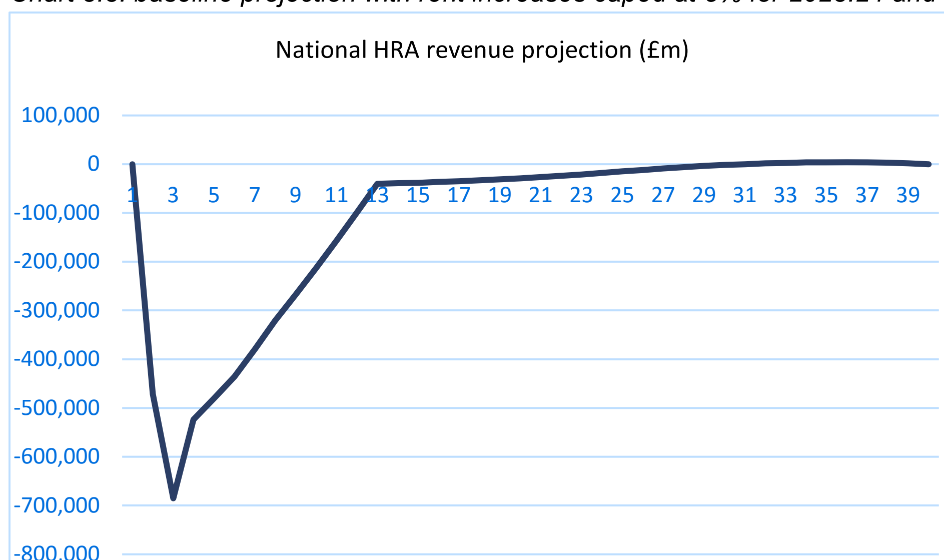
Our estimate of the cumulative loss of resources are as follows (to the nearest £10m):

- 2 years -> £1.16bn
- 5 years -> £3.36bn
- 40 years -> £45bn

These losses represent c6-8% of all operating costs (including major repairs) or c9-11% of management and maintenance costs (excluding major repairs).

3.4. Rent increases capped at 5% for 2 years – with catch-up to formula rents over 10 years

Chart 3.3: baseline projection with rent increases caped at 5% for 2023.24 and 2024.25 – with catch-up 10 years



The chart highlights that:

- In the first year or two, there is a risk of large deficits as rent increases do not keep up with cost inflationary pressures
- Beyond the first 2-3 years, the position is able to be recovered as rents are gradually allowed to be increased back up to the original path of CPI+1%
- If “catch up” is over 10 years, the projection position is to return to “balance”.

The key points from this projection are as follows.:

Rent increases would be follows:

- April 2023 5.0%
- April 2024 5.0%
- April 2025-29 4.1% average
- April 2030-34 3.6% average
- April 2035+ 3.0%

The projection implies deep deficits in the first 2 years – which would need to be addressed by making substantial additional savings or dipping into reserves

Our estimate of the cumulative loss of resources are as follows (to the nearest £10m):

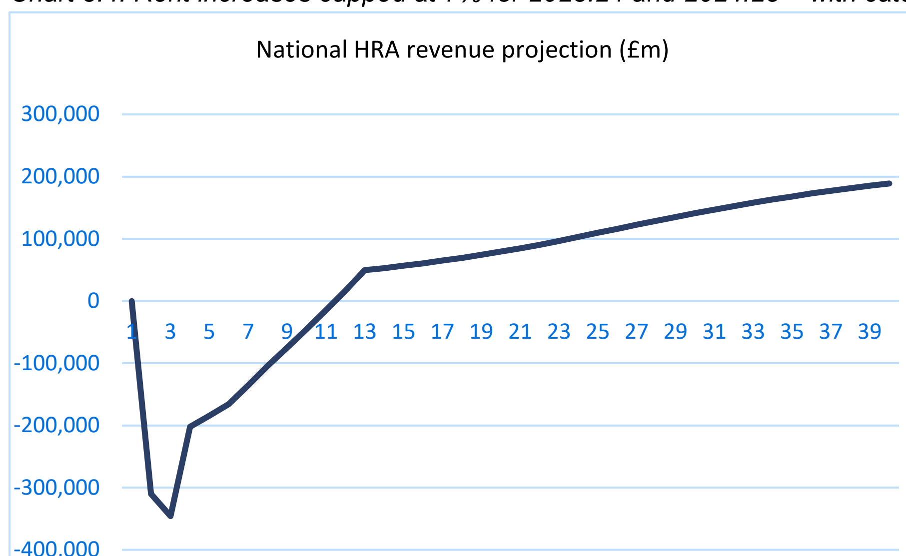
- **2 years -> £1.16bn**
- **5 years -> £2.95bn**
- **40 years -> £12bn**

These losses represent c5-7% of all operating costs (including major repairs) or c8-10% of management and maintenance costs in the first 2-3 years

Our estimate of the reserves position is c£3.8billion – hence it is unlikely that reserves would be able to cover these deficits in full during the catch-up period.

3.5. Rent increases capped at 7% for 2 years – with catch-up to formula rents over 10 years

Chart 3.4: Rent increases capped at 7% for 2023.24 and 2024.25 – with catch-up 10 years



The chart highlights that:

- In the first year or two, there is a risk of deficits as rent increases do not keep up with cost inflationary pressures
- Beyond the first 2-3 years, the position is able to be recovered as rents are allowed to be increased back up to the original path of CPI+1% (over 10 years in this scenario)

Clearly, if "catch up" were to be modelled over 5 years, the projected position is to return to "balance" over a shorter period of time.

The ley points from this projection are as follows.

Rent increases would be follows:

- April 2023 7.0%
- April 2024 7.0%
- April 2025-29 3.8% average
- April 2030-34 3.3% average
- April 2035+ 3.0%

The projection implies deep deficits in the first 2 years – which would need to be addressed by making substantial additional savings or dipping into reserves

Our estimate of the cumulative loss of resources are as follows (to the nearest £10m):

- **2 years -> £0.66bn**
- **5 years -> £1.56bn**
- **40 years -> £6-7bn**

These losses represent c3-4% of all operating costs (including major repairs) or c4-6% of management and maintenance costs in the first 2-3 years

Our estimate of the reserves position is c£3billion – which means that it is unlikely that reserves would be able to cover these deficits in full, albeit that this is a less challenging position than with 5% rent increases.

3.6. Capped rent increases for 2 years – with catch-up to formula rents via relets only

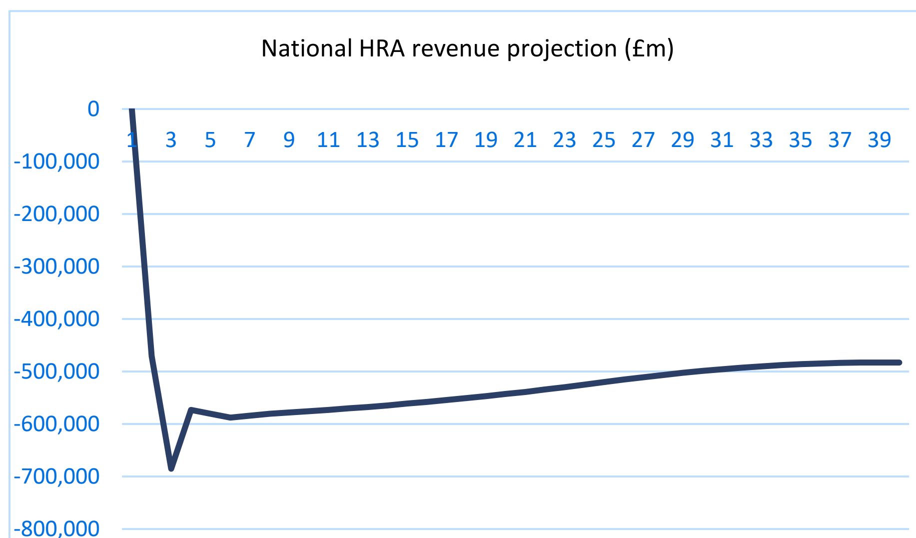
The Government's consultation paper proposed capping rent increases with authorities able to relet vacant and newly built properties at formula rent, with the formula rent having increased by the full CPI+1% in the background.

We therefore modelled the impact of reletting at formula to test the extent to which this might allow short-term deficits to be recovered from gradually increasing rents over time.

In so doing, we made an assumption that all authorities would relet at target, although feedback from this research suggests that this might not always be the case at all authorities for all properties. We also made an assumption of the average level of tenancy turnover.

It is acknowledged that there would be an impact of new build properties being developed and rents set formula rents which would add net operating income into the HRA – though this would also depend on the basis for financing of these new build properties. We felt that the impact was likely to be marginal, and in any case, the potential for deficits in the first few years following a cap on rent increases would may well lead to a reduction in new build programmes in the HRA (see also expenditure research).

Chart 3.5: Rent increases capped at 5% for 2023.24 and 2024.25 – with catch-up via relets only



The chart highlights that:

- In the first year or two, there is a risk of large deficits as rent increases do not keep up with cost inflationary pressures
- If rents are able to relet at "formula" which has been increased the full CPI+1% in 2022-2024, this would help to stem a move into further deficit
- However, not all stock would turnover in 30 years - our estimate of relets is that c75% of the stock would relet over a 30 year period – and therefore there would not be any "recovery" to formula sufficient to return HRAs to surplus.

The key points from this projection are as follows.

Rent increases would be follows:

- April 2023 5.0%
- April 2024 5.0%
- April 2025-29 5.2% average (includes some relet impact on the average increase)
- April 2030-34 3.2%
- April 2035+ 3.2%

The projection implies deep deficits in the first 2 years – which would need to be addressed by making substantial additional savings.

Our estimate of the cumulative loss of resources are as follows

- **2 years -> £1.16bn**
- **5 years -> £3.25bn**
- **40 years -> £29bn**

These losses represent c6-8% of all operating costs (including major repairs) or c8-10% of management and maintenance costs in the first 2-3 years – any savings or budget cuts made in the first two year would not be able to be recovered.

Modelling a **3% cap** increases 5-year deficits to £4.7billion – 14% savings on management and maintenance budgets.

Modelling a **7% cap** reduces 5-year deficits to c£1.7bn – representing 5% savings on management and maintenance budgets.

3.7. Capped rent increases for 1 year (2023.24 only) – with catch-up to formula rents via relets only

We carried out a series or projections based on a proposal to cap rent increases for one year only for 2023.24. these were based on capping rent increases at 5% or 7% with catch-up to formula rents set at 10 years, or catch-up to formula rents based on relets only.

These projections are based on a one year cap for 2023.24 and then a CPI+1% rent increase in 2024/25 – hence we have modelled the "catch up" to formula starting at 2025 (year 3) as the rent increase for 2024/25 would already be high / unaffordable at CPI+1% given that our CPI assumption is 6%.

The charts showing these projections are set out below.

Chart 3.6a: Rent increase capped 5% for one year, catch-up relets only

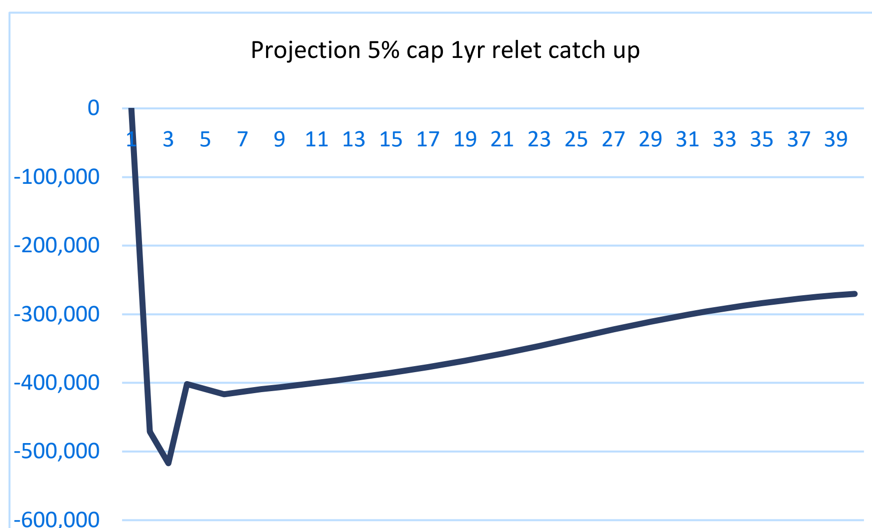


Chart 3.6b: Rent increase capped 5% for one year, catch-up over 10 years

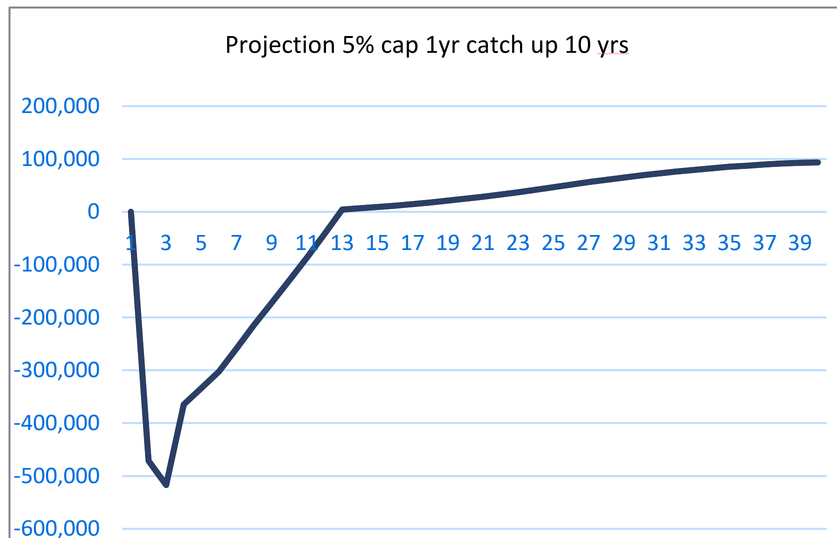


Chart 3.6c: Rent increase capped 7% for one year, catch-up relets only

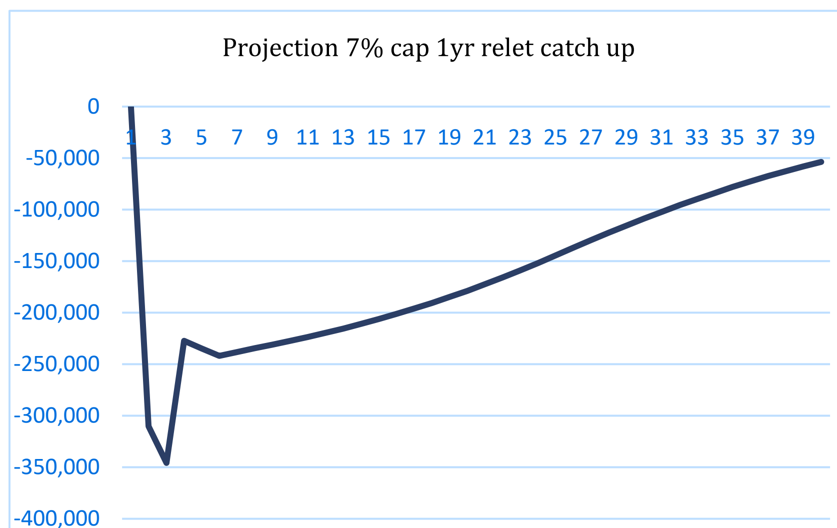
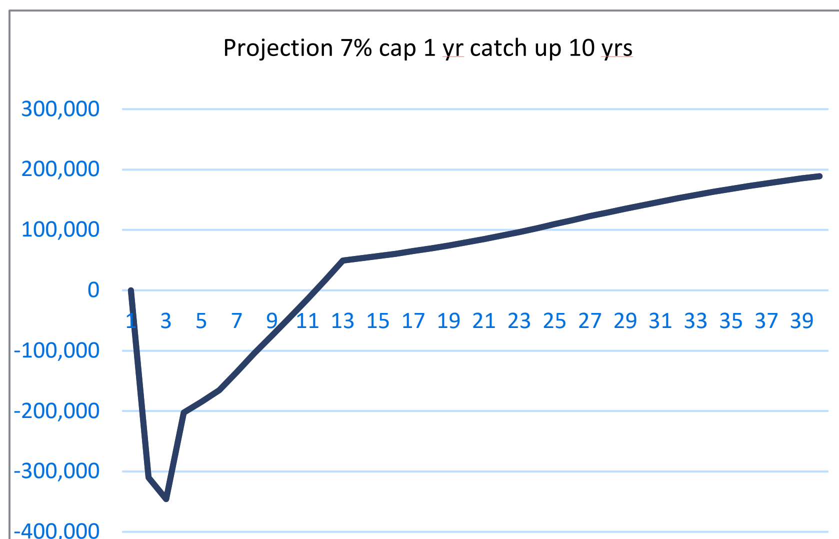


Chart 3.6d: Rent increase capped 7% for one year, catch-up over 10 years



The key points from these projections are as follows.

<u>*One year cap, reletting at target*</u>

With a one-year cap at either 5% or 7%, allowing reletting at target to catch up only, neither projection returns to a balanced HRA position over 40 years.

The projected net deficits from these are:

	5%	7%
• 1 year ->	£482m	£321m
• 2 years ->	£995m	£664m
• 5 years ->	£2.56n	£1.71bn
• 40 years ->	£22n	£15bn

<u>*One year cap, catch-up to formula rent over 10 years*</u>

With a one-year cap at either 5% or 7%, allowing catch up over 10 years, both projections return to a balanced HRA position at the period when catch up is achieved.

The projected net deficits from these are:

	5%	7%
• 1 year ->	£482m	£321m
• 2 years ->	£995m	£664m
• 5 years ->	£2.34bn	£1.56bn
• 40 years ->	£9bn	£6bn

The impact of a one year cap is therefore likely to be significant for local authorities in the short-medium term irrespective of whether there may be a further cap on rent increases in 2024.25.

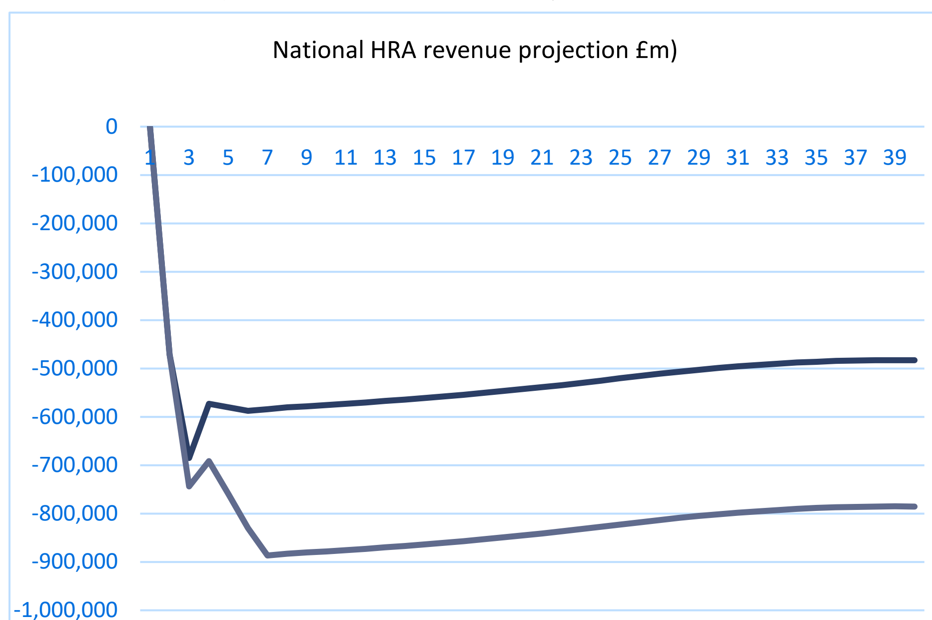
3.8. Scenario with additional capital expenditure

Whilst our research into the potential costs of additional capital requirements for the HRA stock is contained in detail in the accompanying report into HRA expenditure, we have applied an overarching estimate of additional capital expenditure into the net income projections set out above.

The chart below covers a high-level estimate for the first two of these to be invested in the period to 2028 based on the following.

The chart shows the revenue impact of borrowing to achieve additional £5k/unit across all units in non-revenue generating capital investment (fire, building safety etc) – a total estimate of c£7.5billion. This is an illustration of a programme of 5 years, part-financed through revenue, but mostly financed through additional borrowing (c85% of the additional programme financed through borrowing with no additional revenue).

Chart 3.7: Capping rent increases at 5% for 2 year, catch up via relets, with additional capital requirements



If it is assumed that capital investment in the stock over and above replacement life cycle works (building safety, fire safety, commencing net zero programmes) is able to be financed via borrowing (i.e. that there is sufficient headroom below sensible borrowing capacity limits), the implications for revenue over time given the capping of rent increases would be to further increase revenue deficits by c300m in the first few years (based on 5% cap applying for 2 years);

Additional capital support would therefore be required in order to achieve these essential programmes of work without further requiring revenue savings to balance the HRA.

3.9. Implications for service charges

Introduction

We have carried out modelling in relation to the potential limiting of service charge increases to those applied to rent increases, as envisaged in the Government's consultation paper. It should be noted that service charges are not covered by the Government's Rent Standard and therefore any position taken by the Government would be advisory only.

It is important to recognise that best practice for service charges suggests that all service costs relating to those elements of services received by certain groups of tenants only should be recovered separately from those service users and not financed from general rents. The principle is generally that charges are levied on the basis of a budgeted estimate during a financial year, then adjusted in the following financial year, the adjustment being made to the next years' budget.

These charges are generally taken to apply to households in flats and in sheltered/supported housing and cover those services which are related to communal areas: lighting, heating, grounds maintenance, concierge, caretaking etc.[2]

Historically, many local authorities have carried an additional cost in their HRAs relating to service costs unrecovered by service charges. This is known as "rent pooling" – where some element of rents charged across all properties (i.e. houses) subsidise these charges for people in flats and sheltered housing.

The Government's consultation paper was not clear whether any catch up might apply (via relets for example), hence we have assumed 5% cap for 2 years with no catch up for modelling purposes.

Estimating service cost increases

Our estimate of management costs that are linked to service costs hence service charges is 5%. This has also been tested through engagement with local authorities within this analysis.

We note that rent pooling remains in place in many authorities and whilst it is difficult to estimate the total amount, our sense is that it is unlikely to be very large in cash terms – this is because the amount of costs relating to these services is relatively low, and any under-recovery likely therefore to be well below the total cost.

As set out above, the experience of local authorities on cost areas which form the basis of service charges (especially utility costs). Because a higher proportion of service costs are linked to repairs and utilities than is the case for the general management of the stock, our estimate if the potential increase in service costs is:

- 54% in 2023.24
- 28% in 2024.25.

This is based on the following estimated breakdown of service costs by components.

- Service employee costs 25.0%
- Service contractor costs 12.5%

[2] *Service costs and charges relating to Special Services (formerly Supervision & Management Special) in HRA reporting*

- Service materials costs 12.5%
- Service utilities costs 50.0%

It should be noted that the table above represents an average position but that experiences of cost increase drivers are varying widely nationally. In one authority we heard of energy cost increases of over 400%. In others we heard that current contracts were being honoured for another year despite the increase in energy costs.

Follow up work with a small number of authorities engaged in this research suggests that service charge increases are likely to be very large in some cases[3].

Impact on rent pooling

Utilising the above estimates and applying a specimen cap on service charge increases for 2 years, our estimate of the additional rent pooling as a result of limiting service charge increases are as follows:

5% cap 2 years

Rent and service charge cap of 5% for 2 years, estimate of unrecovered service costs £16m in the first year – the equivalent of 20p on all rents across the entire stock.

The estimated level of service costs not recovered via service charges – up to c12%.

7% cap 1 years

Rent and service charge cap of 7% for 1 year, estimate of unrecovered service costs £12m in the first year – the equivalent of 15p on all rents across the entire stock.

The estimated level of service costs not recovered via service charges – up to c9-10%.

Summary: update note

It will be noted that the implications remain significant if the approach to cap service charges were to be adopted by local authorities.

We have engaged with a small number of participant authorities since the announcement of the consultation outcome and there would appear to be a clearer sense of the need to ensure that costs are recovered in order to minimise the impact on service delivery. Our sense is therefore that many authorities will seek to recover service cost increases through increased service charges – albeit that this may vary the degree of rent pooling in a limited way.

[3] *It is important to distinguish between service charges being made for communal services, and those charges made for use of energy through such schemes as district heating; the latter are domestic energy costs and should be compared to national domestic energy costs increases – it is acknowledged that these are likely to be very large increases for many households in such schemes.*

3.10. Summary of scenarios

We have noted that the scenario set our at chart 3.6c above – 7% rent increase cap for one year allowing relet at formula rents - is the one which most closely relates to the outcomes of the Government consultation exercise.

This does not represent the precise outcome of the consultation as the Government has announced the potential to exempt some specialist and supported housing from the rent cap. If local authorities were to exercise flexibility in applying rent increases at the full CPI+1% to these properties, the net deficits projected above would be reduced.

Conversely, feedback from local authorities received during the course of this research tends to suggest that members may be unwilling to apply higher rent increases to supported housing tenants.

For completeness, the summary outputs from this scenario are: projected cumulative net deficits as follows:

	7%
• **1 year ->**	**£321m**
• **2 years ->**	**£664m**
• **5 years ->**	**£1.71bn**
• **40 years ->**	**£15bn**

The Government has also committed to consulting on whether to allow an element of catch-up to formula rents for existing tenants following the current period of inflationary pressure. The implications of allowing convergence to formula rents (modelled here over 10 years, but could be a different period) would be to reduce these projected long-term deficits considerably, although it is noted that the real benefit of allowing such a policy (and authorities being willing to apply future rent increases in this way) would be felt after 5 years.

4. Commentary on engagement with local authorities

4.1. Introduction

We have set out below a summary commentary of the engagement with local authorities for this element of the research.

Where necessary, individual feedback has been anonymised and/or collated into an overall view.

It should be noted that the feedback set out below was very broadly consistent in many themes, although also acknowledged that the majority of the feedback was received during the consultation period on rent caps, and that therefore we expect authorities to have been very much minded to emphasise key elements such as the importance of balancing rent and service charge increases with the need to maintain service delivery.

4.2. Key themes

Distance between target/formula rents and actual rents across the stock

Generally, the feedback is that local authorities are close to the original target rent convergence but there is no authority that is exactly "at formula" in the 2022.23 financial year.

However, in a significant minority of cases, there are authorities that are well behind formula rents as a result of rent increases lower than CPI+1% since 2020 – and as a legacy of policy before 2015.16.

The effect of capping rents is therefore to widen the gap between actual and formula rents – and extending the overall catch-up period well into the future unless there is specific action and policy to "catch up".

Relet of properties at target rent

All but two of the ten authorities that have been engaged have a policy of reletting at target rent.

In one case, the policy of reletting at target is under review given the political balance within the authority.

Policy towards rent increases since 2020?

Around three-quarters of the authorities that have been engaged have increased at CPI+1% in 2021 and 2022.

Of the other quarter, increases have either been at a fixed lower rate or rents frozen – though none have frozen or increased rents at reduced rates in all years.

These outcomes from the "sample" are consistent with other research undertaken into rent increase policy at local authority level (Inside Housing, Savills internal HRA User Group).

Member appetite to put rents up CPI+1% next April given that September CPI is likely to be 10%

No authority that has been engaged has said that members would have gone with CPI+1% with CPI at c10%.

In a number of cases, there is likely to be appetite to locally cap rents at a lower level in the case when rents are capped nationally.

For example, at the time of the engagement, we did not find an authority that would likely expect members to go with 7% if that were the national cap outcome.

Subsequent to this feedback, we engaged with a number of the participants following the consultation outcome. The picture was once again mixed, though we did find a majority were, in the light of budgeting now taking place and cost pressures being significant, more willing to present to members an increase of 7% for April 2023.

In one case, however, the response was a clear and definitive.. “members will not go with 7%” and we might therefore expect that a minority (perhaps a significant minority) of authorities would be in this position.

Government potential to cap rent increases In April 2023 and April 2024 – modelling such a cap, and impact caps could have at different levels have on your HRA

All local authorities engaged had rent increases in MTFS/business plans at CPI or CPI+1% - typically 2.0%-3.0%.

The modelling of the loss of rent income has not tended to feature as no authority believes that members would ever have increased rents at CPI+1% (10%-11%).

Debate around whether rents from 2025 onwards should be able to “catch up” with CPI+1%

General feedback is that this is likely to depend on future levels of CPI, and that a specific policy towards “re-convergence” would not necessarily affect future decisions on rent increases – as these increases would be above CPI+1%.

We note that this is In potential contrast to much of the housing association sector where there is reported appetite to “re-converge” over a period should the government allow this to happen.

However, it is clear that authorities will want to retain as much flexibility as possible on the future capability to converge with formula rents. Put another way, whilst members may not necessarily want to apply above inflation increases, even in periods of lower inflation, authorities wish to retain the flexibility to do so, so as to maximise visibility around future decision-making.

Modelling to work out what minimum rent increases need to be next April to cover cost inflation pressures?

The spread of “minimum rent increase to stand still in budget terms” next year at the time of engagement was between 7-9% - this has latterly been affected by significant increases in pay award modelling (which are yet to be agreed for 2023+) and utility cost increases (where costs are unlikely to be passed on to service charge payers).

As above, our modelling suggests that capping the increase at 7% would still result in budget losses – there are differential impacts between HRAs and housing associations in this regard (with the latter potentially taking a lower margin and cutting back on capital expenditure, rather than reducing revenue expenditure to maintain margins).

Extent of de-pooled service charges from rents across all relevant properties

Experience varies considerably around the country – this appears to depend (as expected) on level/number of leaseholders and appetite from members to recover costs in the light of the level of social rents.

Our estimate of the level of de-pooling of rents focuses on: London – up to 100%; other large cities in metropolitan areas – between 80-100%; smaller districts and unitary authorities – very variable depending on geography.

In one case, a sample authority has undertaken no de-pooling for tenants at all over any period, and it is considered that this will continue to be the position going forward.

Communal costs and potential to pass onto tenants and leaseholders; given the massive increases in (for example) utility costs, member appetite to pass on such increases as increased service charges

At the time of our engagement, at no authority was there felt to be any appetite from members to pass on significant levels of service charge increase to tenants living in flats.

Conversely, in the two London boroughs in this part of the research, this line was moderated by the fact that leaseholders would be receiving these increases and therefore tenants are likely to have to be affected (this appears due to the relatively low level of (rents + service charges) compared to other tenures in London).

There was a clear line emerging that if tenants are due to receive higher housing costs relating to energy bills, that any help from government should be made available to them (or the authority).

Arrears: what has been the experience of arrears been during and since the pandemic

The majority experience appears to have been related to uncertainty and unpredictability around rents and arrears, as opposed to any trend for arrears to increase as a result of the pandemic.

Authorities are much more concerned about the impact of the cost of living crisis on the ability (appetite) to pay rent in the future. We followed up with a number of authorities and have estimated that there are additions to assumptions around arrears being added into HRA business plans as a result of the cost of living crisis affecting the ability of households to pay their rent.

All authorities are therefore keeping under review the extent to which their provision for bad debt write-offs may need to increase as a result of cost of living pressures. See below for our summary analysis of the possible impact.

Behaviour change as a result of the roll out of Universal Credit – any increased provisions as a result

Until the recent inflationary pressures, there was a majority impact on arrears that authorities were projecting – with an increase in provisions over the first 3-5 years, then reduced to a long-term stable level of write-offs in line with previous experience; this is reflective of the move to payment of benefits direct to tenants in the early period, with the potential to switchback to landlord payment direct should arrears arise during the short-medium term period.

All authorities that have been engaged said that they are taking advantage of “switchback” to direct payment, and noted that DWP have been positive (i.e. not the barrier that they used to be) in this respect.

Any other issues or experiences around income, income collection or income policy that you would like to flag?

There were minor impacts noted relating to those authorities where non-domestic rates are still payable in the HRA – and that rents in the market for non-dwellings are unable to keep up – most non-dwelling rents are being modelled at CPI increases with increased void rates keeping actual income receipt to the previously budgeted amounts.

5. Household income and arrears risk

5.1. Introduction

We have modelled the possible impact on household budgets for low income households to test the risk of households going into rent arrears as a result of switching spending to other household priorities. We have:

- Utilised a combination of household income spread (from ONS 2020) and household spending composition by quintile (per JRF 2020)
- Analysed the average spending patterns for two household income levels (both implying partial as opposed to full benefit)
- Carried out an analysis based on 2020 patterns uplifted for inflation since (to 2022) and forecast inflation on different components (to 2024)
- Made assumptions around energy cost capping per the announcement on 8th September 2022 - i.e. 2 years from now
- Derived an estimate of level of rent at risk on the basis of increased costs for other essentials not covered by increased income (i.e. pay) or benefit increases.

5.2. Household exemplars and assumptions

We have modelled for two household income exemplars

- £18,000 household income -> take home pay £16,180 -> £311/week – mid-point for lowest quintile.
- £35,000 household income -> take home pay £28,195 -> £542/week – at or just above benefit threshold.

We have projected inflation drivers for expenditure components, taking these over two x two year periods (2 years to 2022 then 2 years to 2024):

	2020/22	2022/24
• Food & drink	10%	10%
• Transport	10%	5%
• Comms/culture	5%	7%
• Goods/services	3%	10%

It should be noted that the components modelled above might be seen to be an understatement of possible inflationary drivers for some elements. For example, food inflation was 14% at September 2022 within the general CPI level of 10.1%.

The Energy Cap announced by the Government in September has been applied with the full £650 rebate (including an estimate of water costs within utilities).

Finally, rent increases have been applied at 5.6% to 2022 and 10% (representing c4.1% in 2022 and c5-7% in 2023) to 2024.

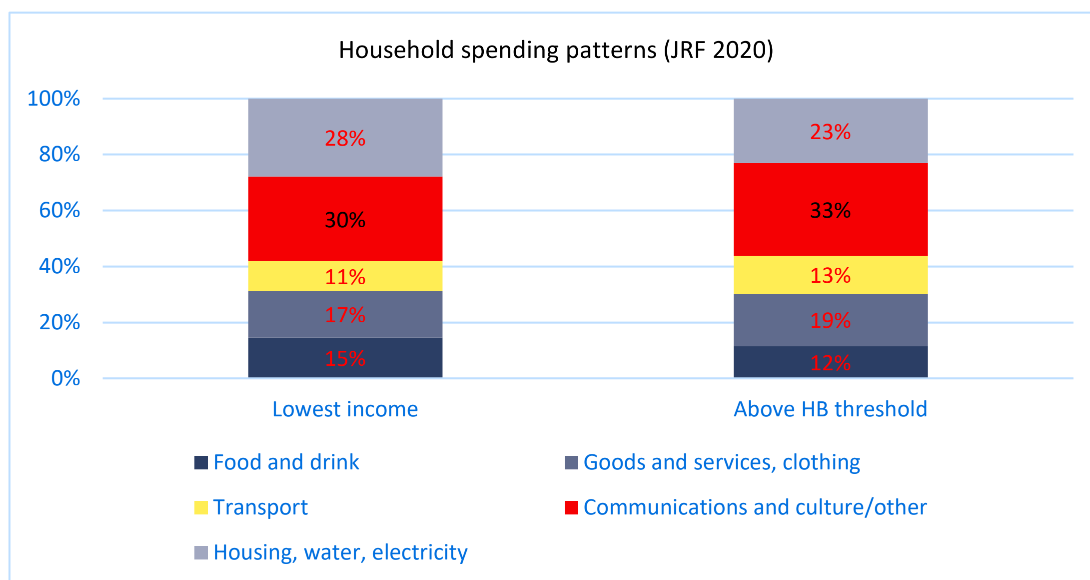
Incomes are assumed to increase 5-6% in line with wage growth in the economy (announced in the Autumn Statement).

It is also assumed that there might be a reduction in "discretionary" spend of c10%, reflecting that household may respond in part to these pressure by cutting recreational and other related activities.

5.3. Outputs

Household spending patterns per the JRF analysis in 2020 were as follows.

Chart 5.1: components of household spend by income bracket (JRF 2020)



Applying the differential impacts of these cost components combined with incomes increasing lower than inflation and house befit elements increasing with inflation allows us to derive an estimated amount of "cost pressure" where future costs would be higher than future income. This additional cost pressure for household has then been applied to average rents to derive a "percentage of rents at risk of arrears" should households continue to spend at current rates.

In fact, we note that these pressures on households have already been the case during the period 2020-2022 and are likely to be exacerbated in 2022-2024.

The charts below highlight the outputs.

Chart 5.2a: lowest quintile income households: risk of arrears (as %age of rent)

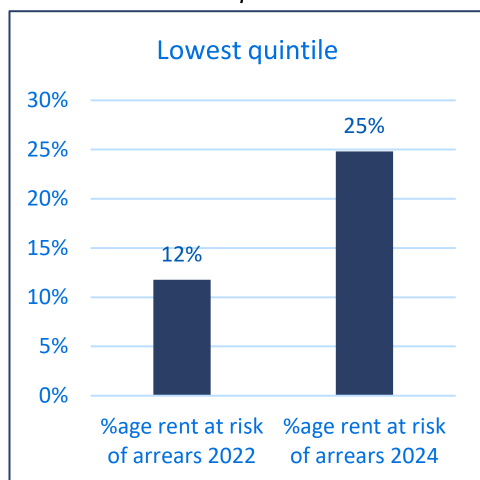
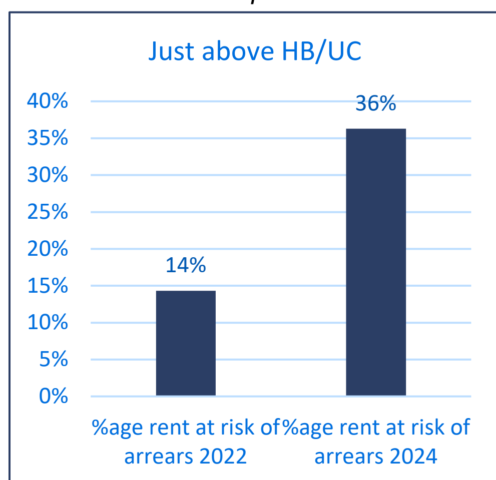


Chart 5.2b: second quintile income households (just above UC.HB threshold): risk of arrears (as %age of rent)



5.4. Summary

The above analysis highlights our estimate that cost of living pressures will apply to lower income households in council housing where at least some element of the rent is required to be paid over and above housing benefit or receipt of the housing element of Universal Credit, and that these pressures could put pressure on the ability to pay rent with a “risk of additional” arrears between one tenth and one fifth of average rents across the country.

As gross rents are in the region of £7billion nationally, and the amount paid by households estimated at c35% of this amount (i.e. c£2.5billion), the risk of additional arrears should not be underestimated and local authorities will need to be focused on ensuring that they work closely with tenants and residents to minimise this impact on their HRA going forward.

6. Potential mitigations

6.1. Introduction

During the course of this research, we have worked with officers from the LGA, ARCH, the NFA and participant authorities to identify potential areas to mitigate the impacts of lower increases in income compared to increases in costs.

We have identified the following key areas for consideration from a policy perspective. Some of these have been addressed through the various government announcements made during the autumn of 2022.

Temporary revenue support

One off grants paid to HRAs as revenue support to cover spikes in inflation – there are precedents with Covid grants paid to LAs to support increases in costs or loss of income; need to determine impact on utility costs – ongoing announcements on government support for business and enterprises towards utility cost increases would be welcomed.

Capital grant support

Specifically for local authorities, pressures on financing additional fire/building safety costs should be considered in the context of additional capital grant; this is because revenue pressures are more likely to be delivered via savings/cuts in budgets as opposed to reduced levels of borrowing in extensive borrowing programmes.

PWLB borrowing rates

Two levels of input: either 1) a reduction on rates for all new borrowing (but not affecting refinancing), or 2) a general reduction in rates across the board - which is highly unlikely as this would be a 50-60% cut in average interest rates/costs

For 1) it is difficult to model an extensive degree of support – assuming 4,000 new homes pa @ £250k build cost (likely to be on the high side of average), 70% leverage @ 4% interest cost would be £25-30million – therefore would assist but not prevent the need for other areas of savings/cuts

Housing Benefit / UC

Requirement to ensure HB uprate is fully implemented and overall benefit/UV increases to minimise pressures on spending (especially for those on partial benefit)

There is a risk of more households breaching overall benefit caps with 5% rent increases for 2 years and no uplift in caps.

6.2. Comment in relation to the HRA Self-Financing Debt Settlement 2012

The self-financing settlement of March 2012 set an opening debt based on a projection of cashflows where:

- Rents increased at inflation + 0.5%
- There were much lower levels of right to buy sales

- Expenditure provided for all authorities to complete decent homes standard works (if they had not already by then) – and, critically, to maintain those standards with no stock improvements.

There was no allowance in the settlement for enhanced capital or revenue service standards.

The rent cut between 2016-2020 has already significantly undermined the basis of the settlement but local authorities have responded positively by securing efficiencies and maintaining investment, particularly since the debt cap was lifted in October 2018.

We have undertaken a specimen calculation of the various changes to financial, economic and policy conditions since 2012 and these are summarised below for reference:

- The debt settlement in 2012 was £29.188billion
- The 4 years rent cut would have reduced the settlement to £21.032billion
- A rent cap at 7% would imply the addition of a minimum net 5% real cost pressure to repairs, maintenance and management budgets in 2023-25 – implying a reduction of c£10.490billion in the settlement
- To accommodate £7.5billion of additional capital works, the implied required reduction in the debt settlement would be a further c£3.3billion (or £5billion+ if taken in 2012).

Whilst it has not been a critical part of this research to exemplify how the self-financing settlement might be changed as it is not felt that such a policy outcome is possible, the above serves as a reminder that income within the HRA is not only lower than provided for in the self-financing settlement, but that this income is now expected to cover both higher costs and higher standards of stock and service delivery.

Annex 1: Copy of briefing letter for participant local authorities

Dear

Local Government Association Research into the Housing Revenue Account

Savills Affordable Housing Consultancy has been jointly appointed by the Local Government Association, and its partners the Association of Retained Council Housing and the National Federation of ALMOs, to undertake research into various aspects of the policy, financial and technical operation of the Housing Revenue Account (HRA).

There are three projects in total, each addressing a key area for review and exploration:

1. HRA Expenditure: incorporating a review of expenditure pressures affecting services provided to council housing within the HRA including: landlord services and housing management, building safety, net zero carbon and other pressures.

2. HRA income: incorporating a review of income pressures, possible alternative approaches to rent policy, future rent increase policy and all other areas of income.

3. Towards a more sustainable Right to Buy: not challenging the RTB policy itself but researching and exploring issues around sales volumes, the operation of discount levels, the recycling of RTB receipts – aimed to come up with some thoughts around future policy ideas to make the policy more sustainable for local authorities.

For each of these research projects, the LGA and its partners are keen to engage with example/case study local authorities in order to test our modelling outcomes in a "real life" environment and to gather local insight into the challenges faced by local authorities. In identifying these exemplar groups, we hope to be able to enhance the findings of financial modelling and analysis research and to ensure that experiences "on the ground" are captured for the benefit of the research. The work will help to inform policy positions for the LGA and the two trade bodies for the forthcoming Spending Review in the autumn of 2022.

We have agreed with the LGA and its partners that engagement with exemplar local authorities should reflect a balance of geography, size, type, political leadership and known exemplars of good practice, and have nominated 12 authorities for each project with a core of 5 authorities involved in all. We have agreed that it would be really helpful to involve your authority in the HRA Income project.

We anticipate that the engagement will incorporate the following:

- An initial meeting (via Teams or Zoom) to discuss the nature of the project in more detail and to set out what we are looking for in terms of our engagement
- A follow up review of the key issues emerging within the review, testing assumptions around rent increase assumptions in the light of possible government policy towards rent increases
- Capture in particular your authority's approach to service charge policies for tenants and leaseholders
- Capture your authority's approach to any other elements of HRA income
- Capture any areas of positive and best practice for exemplification within the research reporting.

We would discuss any requirements for anonymity and we have an unequivocal commitment to share details of exemplar authorities strictly only if agreed by you.

In the first instance, I would be grateful if you could confirm that you and your colleagues are comfortable to participate in the research, and if so, who would be invited to an initial meeting to discuss the research and information needs. Assuming you are able to confirm, I will follow up with a more detailed spec for the project and initial discussion, and any in-advance information needs along with a request for dates from my colleague Robyn Law (robyn.law@savills.com).

We expect the work to take place during the course of the summer and early autumn, notwithstanding the holiday period.

I very much hope that you will feel able to engage with the project and I look forward to meeting with you shortly.

In the meantime if you wish to discuss any further information or background, please do not hesitate to get in touch. You can speak to the Savills team, led by myself (steve.partridge@savills.com 07968 354948) and Simon Smith (simon.smith@savills.com 07815 612458), or the following trade body representatives:

- LGA: Calum Davidson calum.davidson@local.gov.uk
- ARCH: Matthew Warburton matthew.warburton@arch-housing.org.uk
- NFA: Chloe Fletcher chloe.fletcher@almos.org.uk

Thank you for your attention to this letter and I look forward to catching up with you shortly, and working with you on this research.

Annex 2: Copy of questions/topics for discussion

Local Government Association Research into the Housing Revenue Account

introduction

The aims of the LA engagement element of the research are to:

- Moderate the modelling we are undertaking at the national level, to ensure that our assumptions are based on as wide an evidence base as possible
- Understand the income, expenditure and RTB pressures facing authorities – picking up particular pressures applying in particular locations or authority areas
- Provide an opportunity for authorities to feed ideas for change into the research.

Following an initial discussion, we may ask you to provide some further information, but I would emphasise that we would only ask for information that is readily available, and nothing that involves any additional work to compile. All information will be aggregated and anonymised.

Income Project: discussion prompts

Rent policy

1. How far off target/formula rents are actual rents across the stock?

2. Do you relet properties at target rent (If they were not at that level already)?

3. What has been the policy towards rent increases at your authority since 2020?

Future rent increases

4. Will your members have the appetite to put rents up CPI+1% next April given that September CPI is likely to be 10%?

5. There has been talk of rent increases being capped In April 2023 and April 2024 – have you modelled such a cap, and what impact could caps at different levels have on your HRA?

6. If rents are capped, either by the government, or as a result of decisions by members, there is a debate around whether rents from 2025 onwards should be able to “catch up” with CPI+1%; do you have any thoughts on this approach?

7. Have you done any modelling to work out what minimum rent increases need to be next April to cover cost inflation pressures?

Service charges

8. Have you fully de-pooled service charges from rents across all relevant properties?

9. Communal costs are increasing – in ordinary circumstances these would be passed onto tenants and leaseholders; given the massive increases in (for example) utility costs, do you think that members will have the appetite to pass on such increases as increased service charges?

Arrears

10. What has been the experience of arrears been during and since the pandemic?

11. Have you seen arrears behaviour change as a result of the roll out of Universal Credit? Are you making increased provisions as a result?

Other issues

12. Are there any other issues or experiences around income, income collection or income policy that you would like to flag?

13. Are there any other issues around the HRA more generally that you would like to flag?