Homes &
Communities
Agency

DELIVERING BETTER VALUE FOR MONEY: UNDERSTANDING DIFFERENCES IN UNIT COSTS – SUMMARY REPORT

June 2016

Executive summary

The objective of the social housing regulator is to support a viable, efficient and well-governed sector, with providers delivering value for money in the achievement of their social purpose and objectives. The regulator's expectations of providers in delivering value for money are encapsulated in the VfM Standard. As the sector seeks both to produce savings, and simultaneously deliver investment in new and existing homes, it will be increasingly important that providers optimise the use of their resources and assets. VfM will therefore continue to be a major focus for the regulator over the coming years.

A comprehensive approach to VfM needs to be multi-faceted in order to deliver on-going, year-on-year improvement. As one part of such a comprehensive strategy, boards of providers need to understand the costs of running their businesses, how their costs differ from those of their peers and the main drivers of these variations. The regulator is publishing this analysis, in part, to help boards understand the identifiable factors which drive cost variation across the sector, and, importantly, to allow boards to challenge their own organisation's cost data. The cost savings the sector is forecasting it will achieve in the coming years make it even more important that providers understand the key drivers of their costs.

Key points from the analysis the regulator has undertaken include:

- Over the past five years, the sector has reduced its headline social housing cost per unit in real terms.
- However, providers are forecasting making materially greater cost savings over the coming five years.
- The regulator has defined a 'headline social housing cost per unit' measure to analyse Global Accounts cost data, which aims to provide a consistent and robust general measure of costs across providers.
- Median headline social housing costs were £3,550 per unit in 2015. This is made up of management and service charge costs, maintenance, major repairs and other social housing costs. However, there is considerable variation in costs: with the lower and upper quartiles of headline unit costs being £3,200 and £4,300 respectively, and a minority of providers - mainly supported housing specialists - with headline unit costs in excess of £10,000.
- Around 50% of the variation in unit costs can be explained by seven key measured factors included in our regression analysis, including the provision of supported housing and housing for older people, the area of operations, and Large Scale Voluntary Transfer (LSVT) status.
- However, around 50% of the variation in costs cannot be explained by observable factors. Some of this unexplained variation is likely to be explained by factors that cannot be measured systematically by the available data, for example there is no systematic information on stock condition. Nonetheless, some of the unexplained differences between providers are likely to be due to variations in operating efficiency. If controllable variations in efficiency could be identified and reduced, then this could unlock additional resource to invest in the achievement of providers' key objectives such as new housing supply and regeneration activity.

The regulator considers value for money as an integral part of providers' compliance with the economic standards via its In-Depth Assessments (IDA). IDA reviews will seek assurance of the provider's compliance with the VfM Standard in the round, including how the individual provider maximises its return on its assets and how it makes decisions on the use of resources to maximise delivery of the organisation's objectives. As part of IDAs, the cost measure outlined in this report will be considered alongside value-for-money self-assessments and more detailed cost information for each provider. As part of this assessment, the regulator will specifically seek assurance that providers understand unit costs derived from accounts data and, importantly, the reasons why they are higher or lower than other providers. The regulator will seek assurance that providers and their boards are challenging themselves to make the best possible use of their resources to deliver their social purpose and objectives. Where the regulator does not have sufficient assurance that this is the case, it will reflect this conclusion in the provider's published governance grade.

1. Introduction

1. Boards of private registered providers of social housing ('providers') need to understand the costs of running their businesses, how their costs differ from those of their peers and the main drivers of these variations. Effective boards will have clear strategies to control costs, and ensure that services are delivered as efficiently as possible. Making the most efficient use of the available resources, at a time of fiscal restraint, is essential if providers are to be able to deliver on their own objectives, including to invest in new and existing homes, and provide a quality service to their residents.
2. Transparency over costs is an important aspect of the regulator's Value for Money (VfM) Standard. Landlords are required to understand and publish absolute and comparative costs of delivering services as part of annual VfM self-assessments.
3. Since the launch of the VfM Standard in 2012, there has been increased focus and transparency on value for money in the sector. However examination of self-assessments suggests there is still potential for improvement. Part of the challenge is that of comparing 'apples with apples' in a sector with a diversity of business models and cost reporting approaches. However, notwithstanding this inherent challenge, the regulator believes that there remains scope for greater transparency on the part of providers, and for boards to challenge themselves, and their organisations, even more robustly on the economy, efficiency, and effectiveness of their expenditure.
4. From 1 April 2016, providers will need to reduce their rents each year to 2020. Given the reduction in rental income, it is more important than ever that providers make the most efficient use of their resources and assets, if they are to be able to continue to deliver their organisation's objectives.
5. The financial forecasts submitted to the regulator in October 2015 report that, notwithstanding the impact of the rent cuts, providers continue to plan a major programme of investment in new homes over the next five years. In part, landlords forecast sustaining this investment through greater reliance on sales revenues to offset the loss of rental income. However, most providers also forecast that they will reduce the cost of managing and maintaining their existing properties. In this context, understanding what drives these costs and the scope for making savings without risk to the delivery of organisational objectives, core services to tenants, or the long term sustainability of the business, are vital.
6. This publication summarises the regulator's analysis of unit costs in the sector, refreshing similar analysis published in 2011 and 2012. This analysis aims to help providers, boards and stakeholders better understand providers' costs – at sector and provider level - and how they relate to a range of cost drivers. Our aim is to provoke informed debate on costs and VfM at board level and across the wider sector.
7. The regulator will take cost data into account when it engages with providers on VfM in its In-Depth Assessments (IDAs) of landlords' compliance with the economic standards. Each IDA is unique, reflecting the circumstances of the provider, and the regulator will make use of a range of sources, including the provider's own data, VfM self-assessment, board reports and engagement with board and executives, in order to seek assurance on VfM. Reference information will include headline social housing costs per unit as defined in this analysis, along with more detailed cost data from electronic accounts returns.

8. The regulator takes a co-regulatory approach to seeking assurance on VfM, as it does with all the regulatory standards. It is for boards to decide how they run their businesses and assure themselves that they are complying with the standards. The regulator does not mandate a ‘right’ level of operating costs per unit, and does not seek to drive down costs at the expense of service delivery. However, as part of the IDA, we will seek assurance that providers understand unit costs derived from accounts data and the reasons why they are higher or lower than other providers, and how those relate to investment in the provider’s own objectives. This will be part of the wider IDA review, which will seek assurance on the provider’s compliance with the VfM standard in the round.

2. Value for money regulation

9. The HCA's VfM Standard has been part of the regulatory framework since April 2012. The standard requires providers to articulate and deliver a comprehensive and strategic approach to achieving VfM in meeting their organisation's objectives.

10. Boards are also expected to demonstrate to stakeholders how they are meeting the standard. As part of that process, on an annual basis, they should publish a robust self-assessment which sets out in a way that is transparent and accessible to stakeholders, how they are achieving VfM in delivering their purpose and objectives. The standard sets a specific expectation that the assessment shall:

    - set out the absolute and comparative costs of delivering specific services
    - evidence the VfM gains that have been and will be made and how these have and will be realised over time
    - enable stakeholders to understand the return on assets measured against the organisation's objectives.

11. Since the introduction of the VfM Standard most landlords will have published three annual VfM self-assessments. To date, these self-assessments have been the regulator's key source of assurance of compliance with the VfM Standard. Over this period, we have seen a greater degree of transparency from providers in setting out their overall approach to VfM in their operations.

12. Following wider changes to the regulator's operational approach in 2015, which saw the introduction of annual stability checks, and periodic IDAs of providers' compliance with the economic standards, providers' self-assessments are now reviewed as part of the annual Stability Check process, to seek assurance that landlords continue to meet the transparency requirements of the VfM Standard. The regulator also now considers VfM as an integral part of each IDA, allowing a more detailed engagement with each organisation. The self-assessment is a key resource in setting out the scope of all IDAs, triangulated alongside other key documents and data sources submitted to the regulator.

Cost reporting in value for money self-assessments

13. The accompanying report, *Delivering better value for money: Review of value for money self-assessments,* summarises in more detail the regulator's review of the sector's VfM self-assessments for 2015, and complements similar analysis published for previous years in the Global Accounts. It sets out detail of the sector's responses to all of the requirements of the standard, including providers' reporting on the return on their assets, and the VfM savings that they have delivered and intend to deliver in future, as well as the evidence that providers have published to demonstrate that they understand the absolute and comparative cost of running their services.

14. However, in summary, the level of clarity that individual providers have published on their operating costs has varied significantly. In general the self-assessments that provide the regulator with most assurance set out the absolute cost data for a broad range of disaggregated named services, benchmarked against a clearly identifiable peer group. The most transparent self-assessments set out areas of weakness, as well as good performance.

Where areas of weak performance were identified, plans to improve or review these services are clearly set out.

15. In previous years, reporting on the cost of services provided the regulator with valuable assurance. In 2015, however, an increased number of providers were less transparent in setting out comparable costs, and not all providers published their latest cost information. In other cases cost comparisons were based on very broad or not obviously relevant peer groups. Other examples of self-assessments that gave the regulator only limited assurance included providers who used different datasets from one year's publication to the next with little or no explanation of the change or of what impact the difference in reporting had on the presentation of the underlying information. It is evident that some providers continue to be selective in setting out the cost of their services, and do not publish clear, measurable targets for future improvement, despite feedback to the sector in previous years.

16. Given the importance of transparency, both as a tool for boards to improve their services, and as a means of allowing tenants and other stakeholders to hold landlords to account, the regulator believes that there is a role for systematic analysis of the drivers of operating cost variations across the sector. The remainder of this publication sets out the results of this analysis.

3. Measuring unit costs in Global Accounts data

17. It is important to be clear about the precise definition of operating costs, in order to permit a meaningful comparison between different organisations. There are a range of cost lines reported in audited accounts and Global Accounts data. The allocation and apportionment for attributing cost to certain cost objects can differ from one provider to another which often reflects the diversity in providers' businesses and permissible accounting approaches. As a result similar activities can equally justifiably be recorded in the different cost lines. If this is not taken into account, inferences drawn from apparent unit cost differences can be misleading. For example, management costs per unit can vary widely due to different approaches to allocating overheads, especially in group subsidiaries, or splitting costs between management and maintenance activities. A provider with ostensibly low management costs may simply be recording some of its costs under a different category in the accounts.

18. The regulator has defined a 'headline social housing costs per unit' measure to analyse Global Accounts cost data (defined in Annex A). This is made up of the main components of management, service charge costs, maintenance, major repairs and other social housing costs. It is a broad measure and so is not generally affected by different approaches to apportioning costs between narrow lines. It is a 'proxy cash' measure that excludes notional expenditure items – depreciation, impairment and bad debts – that are sensitive to different accounting policies and presentation of data within financial statements. It excludes costs of sales and includes capitalised as well as expensed major repairs. It is divided by social housing units.

19. The regulator considers headline social housing costs per unit, as defined, as the best general-purpose cost definition to begin to inform consideration of costs across the sector as a whole. The measure still needs to be used with caution, and with a recognition that no single metric can capture all of the variations across the sector. For example, it may be affected by in-year movements in stock figures, divergence between units owned or managed, or different approaches to recording costs as 'non-social' rather than 'social' activities. Given the diversity of business models, any measure will inevitably have limitations when applied to a minority of individual organisations. However, the regulator believes that this measure is most appropriate to use to permit a meaningful comparison of the costs of different providers.

Unit cost trends

20. In the five years since 2010, headline social housing costs per unit have fallen slightly in real terms. At a sector level since 2010, headline unit costs have grown at a rate slower than consumer price index (CPI) inflation. Compared to CPI growth of 12.4%, management and service charge costs per unit grew by 10.2% and maintenance and major repairs costs per unit by -2.5%[1].Over a longer, ten year period, headline unit costs at a sector level have not grown materially faster than CPI inflation. Compared to retail price index (RPI) inflation, used to determine social rent inflation over much of this period, unit cost growth is even lower in real terms.

21. At a sub-sector level, the picture is more complex with sharp contraction in certain costs for some providers set against growth for others. The stock transfer (LSVT) sub-sector has matured; consequently the average LSVT maintenance and major repairs costs have reduced sharply as there are fewer providers in the post-transfer period associated with high capital investment. This, along with the winding down of the Decent Homes Programme, largely accounts for the real terms reduction in maintenance and major repairs since 2010. As a whole, there appears to have been significant convergence in average costs across the sector: maintenance and major repairs costs in LSVTs have declined in both real and nominal terms as the sector has matured and Decent Homes has been achieved. As a result maintenance and major repairs costs in LSVTs have fallen sufficiently that they are approaching the average for traditional providers. In contrast, management and service charge costs in LSVTs, while starting from a lower base, have grown faster than in traditional providers.

Table 1: Unit cost trends (Source: Global Accounts, 2005-2015)

	Retail Price Index (% change)	Consumer Price Index (% change)	Sector (% change)	Traditional (% change)	LSVT (% change)
Management & service charge costs per unit					
2010-2015	16.5%	12.4%	10.2%	7.1%	14.0%
2005-2010	19.6%	14.3%	19.3%	20.2%	24.4%
2005-2015	39.3%	28.5%	31.4%	28.7%	41.8%
Maintenance and major repairs costs per unit					
2010-2015	16.5%	12.4%	-2.5%	9.9%	-11.9%
2005-2010	19.6%	14.3%	25.6%	36.1%	13.1%
2005-2015	39.3%	28.5%	22.4%	49.6%	-0.4%

[1] Due to discontinuities in some measured cost lines (see Annex A), caution needs to be used in interpreting changes in headline social housing costs per unit between 2005 and 2015. Care & Support costs, measured separately in accounts returns up to 2012 and included in the time series, are assumed to be largely reflected in management & service charge cost lines after this date. There is assumed to be sufficient robustness for the time series shown, but the discontinuity is indicated by a dashed line. This means unit cost growth could be a slight lower bound estimate. The introduction of component accounting in 2011/12 means that some costs may have moved from maintenance into major repairs, hence the two lines are grouped in the time series.

Figure 1: Unit cost trends - Management and service charge

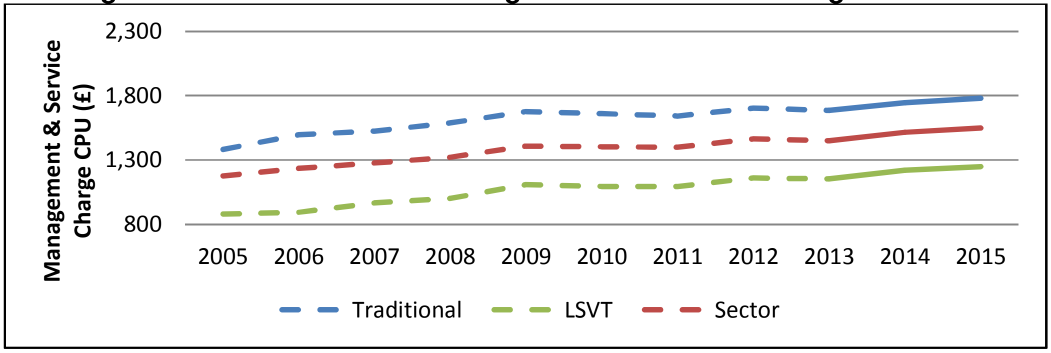
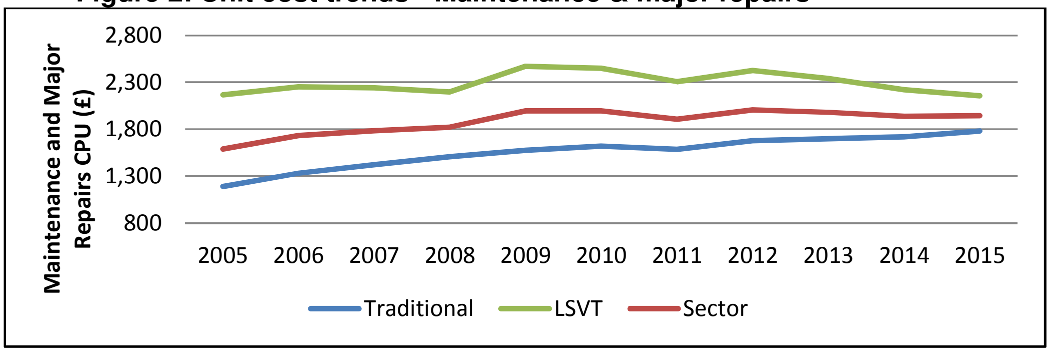


Figure 2: Unit cost trends - Maintenance & major repairs



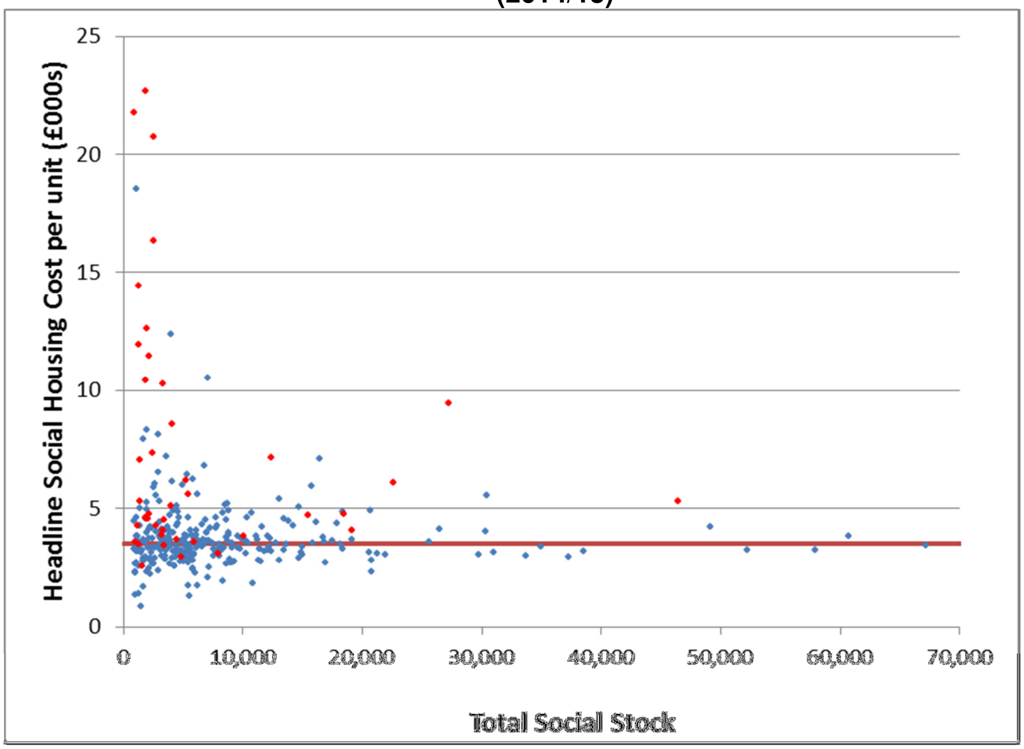
Unit cost headline data

22. Average (mean) headline social housing costs were **£3,950** per unit in 2015. The vast majority of this cost is made up of management and service charge costs, maintenance and major repairs costs. This mean cost per unit is skewed by a small number of providers with large amounts of supported housing, reflected in some providers' unit costs at over **£10,000** per unit per annum. The median average cost, which is less affected by these high cost outliers, was lower at **£3,550** per unit. However, as the scatterplot below shows there remains considerable variation in unit costs between providers (the red dots denote those providers with greater than 10% supported housing stock or 50% housing for older people).

Table 2: Average unit costs (Source: 2015 Global Accounts)

	Sector mean (weighted[2])	Median by provider (unweighted)
Management & service charge costs	£1,540	£1,360
Maintenance costs	£1,010	£980
Major repairs costs	£930	£800
Other social housing costs	£470	£200
Headline social housing costs	£3,950	£3,550

Figure 3: Headline social housing cost per unit by total social stock (2014/15)[3]



[2] Weighted by size of provider i.e. by total social units managed by provider at year end.
[3] Median social housing costs per unit (£3,550) shown by the horizontal line. Red markers identify providers where more than 10% of stock is supported housing (excluding housing for older people) or more than 50% is housing for older people.

5. How much unit cost variation can be explained by measured factors?

Regression analysis

23. The regulator has undertaken a substantive regression analysis in order to understand how variation in headline social housing costs per unit might be explained by measured factors. The results are consistent with those from 2011 and 2012 and are set out in the accompanying technical report to this publication.

24. A hypothetical 'baseline' provider (with 100% general needs properties, traditional status, with all units meeting the Decent Homes standard, and operating in an area with mean average wages and median deprivation) might be expected to have a cost of £3,300 per unit. Around 50% of the variation in headline social housing costs per unit can be explained by the following key factors, ordered by relative importance, and holding all other factors constant:

    - **Supported housing (not including housing for older people) –** each unit is associated with costs of £10,800 above General Needs properties. This is likely to be associated with the high support costs, and a broader scope of activities undertaken by organisations with a specialised focus. The precise estimate of associated costs is sensitive to the inclusion or removal of more specialised supported housing organisations, with model estimates varying from £8,400 to £14,000 per unit. There is likely to be considerable diversity with the cost associated with each supported housing unit in the sector, for example by the client group and the level of service supplied.
    - **Regional wages –** providers in London have costs of £1,900 per unit above those in the North East. Considering all factors, the difference in costs is broadly proportionate to the difference in average regional administrative and construction wages.
    - **Stock transfers** – stock transfers providers have costs of £1,500 per unit higher than traditional providers in years 1-6 post-transfer. This gap narrows to £300 per unit for years 7-11, and disappears after 12 years**.**
    - **Housing for older people -** each unit is associated with costs of £1,800 above general needs units.
    - **Neighbourhood deprivation –** provider operating in neighbourhoods ranked in the 1% most deprived according to the Index of Multiple Deprivation have costs on average £500 per unit higher than average[4]. This could be associated with a range of factors, including more extensive regeneration and community initiatives, higher voids and turnover, and potentially greater crime and anti-social behaviour.
    - **Decent Homes –** bringing a property to Decent Homes Standard is associated with additional costs of £8,800. The limited residual non-

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[4] £500 per unit higher than a provider operating in neighbourhoods ranked 50% most deprived in England

decent stock in the sector means this is now only an important factor for a small minority of providers.

25. For the factors shown above, there is robust (statistically significant) evidence of a relationship between costs and the measured factor. As set out in the technical report, several other factors were included in testing and were not included in the final model due to the lack of evidence of a relationship with costs. For example, there was no statistically significant evidence that geographical dispersal of stock, or involvement in non-social housing activity, had a material bearing on the cost of running the core social housing business. Further, there was no significant evidence of a clear relationship between scale of a provider and lower costs (once factors are controlled for). This finding is robust to a range of model formulations and is consistent with the regression work published in 2012.

26. The regression analysis is a powerful tool to test the evidence that average costs vary with measured factors. However, it is not a complete model of costs and is not being used to determine what a ‘correct’ cost should be for each provider. Whilst the residual may in part show variations in the efficiency with which providers manage their stock, this will not be the only factor. Some important cost drivers - such as service levels or stock condition – simply cannot be measured from the available data. Therefore, the lack of evidence for economies of scale does not necessarily mean that they cannot be achieved or they are not being achieved by providers. It is possible that economies of scale are achievable, but may not be being delivered in practice. However, it is also theoretically possible that efficiency gains are reflected in higher service levels or better stock condition, which weakens the statistical link between unit costs and size. Cost data alone cannot show whether or not larger providers do deliver improved service in this way. As providers grow, it is important that boards understand whether they are making the most of any opportunities for greater efficiency that expansion could present.

6. Providers' forecast costs

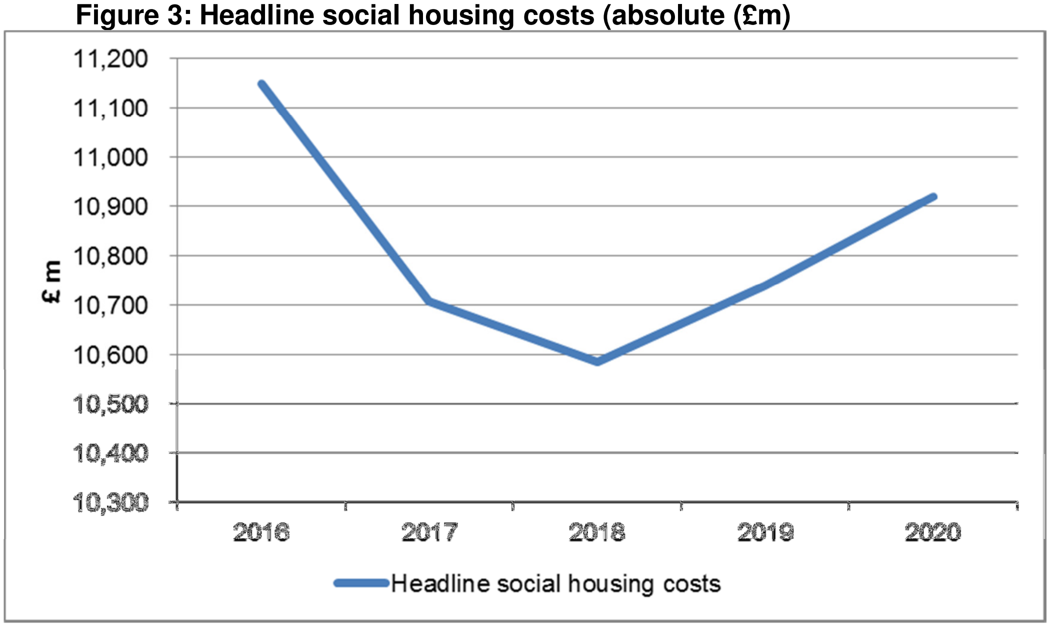
27. The regulator collects financial forecast returns (FFRs) from all providers owning and/or managing 1,000 units or more. The returns represent the financial basis of the organisation's business plans.

28. Following the July budget the regulator took the decision to request revised forecast submissions by the end of October, taking into account revisions to business plans in the light of the announcement of the rent cuts. The analysis below provides a summary of the forecasts received.

29. The updated FFRs received in October take into account the impact of the changes in government policy including rent reductions and changes to the welfare system. The October FFRs also reflect mitigating actions providers are beginning to plan in response to the policy changes, including profiled reductions in costs.

30. The figure below shows that the October forecasts are predicated on material reductions in headline social housing costs. For the avoidance of doubt, these figures show the forecast costs associated with running the social housing stock, and do not capture the forecast cost of new development. Mean headline social housing cost per unit is forecast to decrease by 7% in absolute terms (11% in real terms based on the Office of Budget Responsibility's March 2016 CPI forecast), from £4,109 in 2016 to £3,812 in 2018, beginning to rise again thereafter, but to a level that remains lower in real and absolute terms compared to forecast CPI.

Figure 3: Headline social housing costs (absolute (£m)



31. The sector is planning to make cost reductions on all the key cost measures between 2016 and 2020. Mean major repairs cost per unit is forecast to decrease by 10% from £1,032 in 2016 to £928 in 2020, equivalent to a 16% reduction in real terms. Over the same time period planned management and service cost per unit decreases by 5% from £1,721 to £1,629, a 12% real term reduction.

Figure 4: Headline social housing costs per unit including 2015 actual (per unit £ pa)

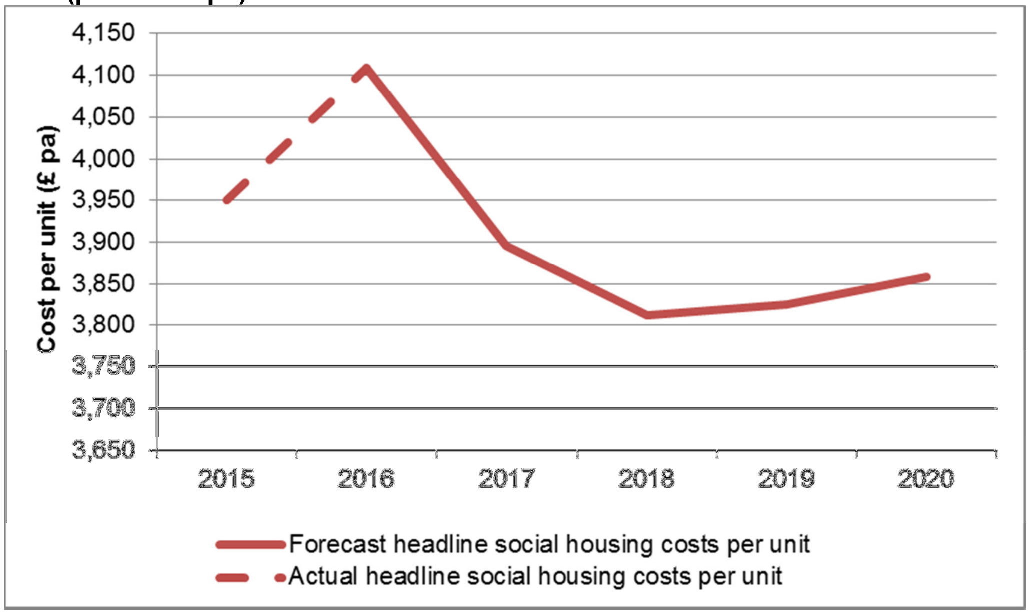
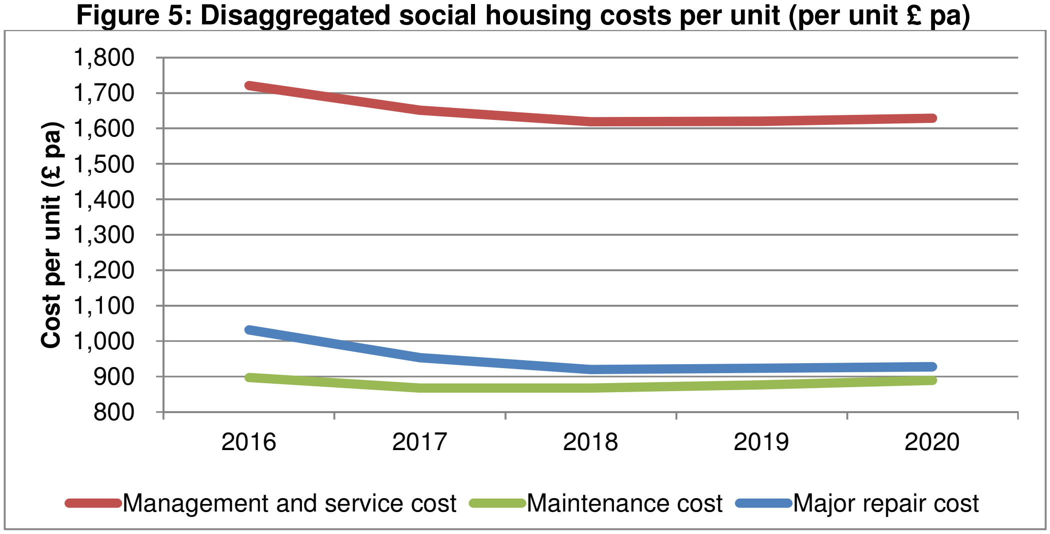


Figure 5: Disaggregated social housing costs per unit (per unit £ pa)



32. These forecast reductions in unit costs are materially greater than those that have been delivered by the sector over the period 2010-2015, when headline social housing costs per unit still rose in nominal terms, albeit by less than the rate of inflation. This highlights the importance of the sector understanding the drivers of its costs and having an effective strategy to manage them.

7. Regulatory approach on operating costs

33. The regulator considers value for money as an integral part of providers' compliance with the economic standards via IDAs. These IDAs will seek assurance of the provider's compliance with the VfM Standard in the round, including how the individual provider maximises its return on its assets and how it makes decisions on the use of resources to maximise delivery of the organisation's objectives. As part of IDAs, the cost measure outlined in this report will be considered alongside value-for-money self-assessments and more detailed cost information for each provider. As part of this assessment, the regulator will specifically seek assurance that providers understand unit costs derived from accounts data and, importantly, the reasons why they are higher or lower than other providers. The regulator will seek assurance that providers and their boards are challenging themselves to make the best possible use of their resources to deliver their social purpose and objectives. Where the regulator does not have sufficient assurance that this is the case, it will reflect this conclusion in the provider's published governance grade. More details of the regulator's approach to regulating VfM will be set out in the next edition of Regulating the Standards.

Annex A – Unit cost definitions

Section	FVA cost lines	**Headline social housing costs**	Components				
			Management	Service charge costs	Maintenance	Major repairs	Other social housing costs
Expenditure on social housing lettings	Management	Y	Y				
	Service Charge Cost	Y		Y			
	Care & Support Costs	2005-12		2005-12			
	Routine Maintenance	Y			Y		
	Planned Maintenance	Y			Y		
	Major Repairs Expenditure	Y				Y	
	Bad Debts						
	Lease Charges	2005-12					2005-12
	Depreciation of housing properties						
	Impairment of housing properties						
	Other Costs	Y					Y
Capitalised major repairs	Capitalised major repairs and re-improvements	Y				Y	
Exp. on other social housing activities	Other social housing activities - Other (expenditure)	Y					Y
	Other social housing activities - Charges for Support Services (expenditure)	Y					Y
	First tranche shared ownership sales	2008-					
Expenditure on non-social housing activities							

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