

# **A SOCIAL HOUSING FUTURE FUND: SUSTAINABLE FUNDING FOR SOCIAL HOUSING OR A MIRAGE**

*“magical thinking” ... the belief that one's thoughts by themselves can bring about effects in the world or that thinking something corresponds with doing it [Colman, Andrew M. (2012), A Dictionary of Psychology (3rd ed.), Oxford University Press]*

## **Shepherd Shaw Occasional Paper, December 2016**

Shepherd Shaw specialises in project finance, investment and development across the infrastructure and real estate sectors, with particular expertise and background in social housing. Services include strategic advice, investment origination, consortium and process management, asset/investment management, development/project management, and arranging debt and equity funding.

Contact Mark Shepherd for additional information.

### **Disclaimer:**

Shepherd Shaw provides no warranties and makes no representations in relation to the information in this Occasional Paper. Shepherd Shaw is not a legal, taxation, accounting or technical advisor. Information in this Occasional Paper should not be construed as legal, taxation, accounting or technical advice. It is the responsibility of the recipient to separately engage legal, taxation, accounting and technical advisors and to otherwise satisfy itself as to the suitability of the information in this Occasional Paper for use by the recipient.

## CONTENTS

1.	Introduction .....	4
2.	Background to Social Housing .....	5
3.	Current Social Housing System Deficiencies .....	6
3.1	System Deficiencies raised by IPA .....	6
3.1.1	Not Enough Social Housing Dwellings .....	6
3.1.2	The Existing Stock Misconfigured.....	6
3.1.3	Maintenance Costs Accelerating .....	6
3.1.4	Large Maintenance Backlogs .....	6
3.1.5	Inadequate Funding for the Existing Social Housing.....	6
3.2	Additional System Deficiencies .....	7
3.2.1	Estates Renewal Required .....	7
3.2.2	Redevelopment Potential Overrated.....	7
3.3	Take-Out Message.....	8
4.	Issues with the IPA Fund.....	8
4.1	The IPA Scheme and the Validity of its Claims.....	8
4.2	Key Assumptions.....	9
4.2.1	Inflation .....	9
4.2.2	Sale and Acquisition .....	10
4.2.3	Alternative Sale Structure .....	12
4.2.4	Market Rent plus 20% .....	13
4.2.5	Fund Investment Return .....	13
4.2.6	Residential Investment Return.....	13
4.2.7	Can the IPA Fund Generate a Greater Return than Residential Housing?.....	14
4.2.8	Escalation Rate for Market and Social Rent.....	15
4.2.9	Opportunity Cost of Capital.....	15
4.2.10	Transaction Costs, Tax Concessions and CRA .....	16
5.	Analysis .....	16
5.1	Modelling Results .....	16
5.1.1	Summary of Results.....	16
5.1.2	Key Observations.....	17
5.1.3	Investment Returns Required for a Sustainable IPA Scheme.....	17
5.2	Explaining the Divergent Results .....	19
5.3	An Alternate Approach - Concession Agreement .....	19
6.	Concluding Remarks .....	21

## GLOSSARY

CFF	Commonwealth Future Fund
CHP	Community housing provider
CPI	Consumer Price Index
CRA	Commonwealth Rent Assistance
IPA	Infrastructure Partnerships Australia
IPA Fund	Social Housing Future Fund
LAHC	NSW Land & Housing Corporation
LHS	Left hand scale
NSW	New South Wales
RHS	Right hand scale
SAHF	Social & Affordable Housing Fund

## 1. INTRODUCTION

Infrastructure Partnerships Australia (“IPA”) released a report in October 2016 entitled “From Housing Assets to Housing People: Fixing Australia’s Housing System”. This Occasional Paper reviews the IPA report and expresses strong reservations as to the ability of the proposed Social Housing Future Fund (“IPA Fund”) to deliver the outcomes claimed.<sup>1</sup> An alternative approach is outlined that can be expected to optimise value-for-money and concludes: with an outline of the broad cost to taxpayers of the social housing system for a range of future trajectories; with a summary of likely funding sources; and with an appeal for action in place of magical/wishful thinking and procrastination.

The IPA report, notwithstanding the reservations expressed in this Occasional Paper, is a professional, useful and timely contribution to the discussion of how best to provide adequate social housing infrastructure, an issue with which all jurisdictions struggle. The IPA report neatly restates the very unsatisfactory current situation in Australia as documented elsewhere by the Australian Productivity Commission, the Auditor-General of New South Wales (“NSW”) and others. For this reason alone, the IPA report, in conjunction with this Occasional Paper, should be closely read by policy makers and by any community housing provider (“CHP”) or consortium currently working to execute a contract in relation to the NSW government’s Social & Affordable Housing Fund (“SAHF”), or contemplating a bid in relation to the NSW government’s social housing stock transfer initiative. The IPA report, in conjunction with this Occasional Paper, brings a clear focus on the cost of delivering social housing, including the existing level of maintenance backlog in the portfolio and the whole-of-life costs of maintenance and ownership - particularly relevant for anyone contemplating a 20-year contractual commitment.

The IPA scheme involves the sale of the bulk of the Australian social housing portfolio to private owners, with replacement and additional social housing then leased from the private market.<sup>2</sup> Such a sale can be expected to be beneficial to the extent that:

- It mobilises/drives private sector efficiencies (in cost and in outcomes)
- The ongoing operation of the - then more efficient - social housing system is responsibly funded
- The sales proceeds are invested in government projects/initiatives with high economic benefit/cost ratios.

However, the IPA report also proposes the establishment of the IPA Fund for the purpose of investing the proceeds of sale into shares, bonds, and other securities - a Commonwealth Future Fund (“CFF”) for social housing. The investment returns from the IPA Fund would be used to lease the required replacement and additional social housing from the private market through CHPs and other providers. The IPA report indicates that the IPA Fund has been modelled using NSW as an example jurisdiction. Based on this modelling, the IPA report makes strong claims for the IPA Fund, namely:

- That the NSW stock could be increased from 126,000 properties to 157,000 properties over 20 years, thereby stabilising the waiting list<sup>3</sup>
- That the level of support services for social housing tenants could be expanded
- That the cost to government of the social housing system could be reduced to zero
- That additional government revenue could be generated through stamp duties and savings in Commonwealth Rent Assistance (“CRA”)
- That these gains could be achieved in a financially sustainable manner and without excessive risk.

The implication in the IPA report is that further stock growth could be sustainably achieved in later years (i.e. beyond 20 years) and that similar outcomes could be expected in other jurisdictions.

Intuitively, this sounds too good to be true. The most obvious high-level objection is that, if this approach is possible, then surely every jurisdiction in the world would have implemented it already. And yet they do not seem to have done so. Further, if this approach is possible for social housing, then surely it will work for every other

<sup>1</sup> All data in this Occasional Paper is, unless stated otherwise, drawn from one of three sources: a) the latest available published annual reports of the Australian state government housing authorities; b) the latest available “Report on Government Services” published by the Australian Productivity Commission; or c) the IPA report itself. The IPA report has used Productivity Commission data from the 2015 Report on Government Services, whereas this Occasional Paper has, in some places, drawn on data from the 2016 Report on Government Services. In some instances, data was unavailable or required interpretation and in these instances Shepherd Shaw has expressed its own view based on its experience in social housing and more widely in infrastructure and real estate investment and financing.

<sup>2</sup> The IPA report does not say who is expected to buy the properties but it is presumed to be “mum-and-dad” investors since almost all

residential rental housing in Australia is currently owned by “mum-and-dad” investors. The IPA report indicates that only a small number of properties would be retained - strategic sites (i.e. high value) and specialised or high quality properties.

<sup>3</sup> The IPA report actually outlines three scenarios. Scenario 1 involves holding the social housing stock constant. Scenario 2 involves increasing the stock to 157,063 properties, as referred to in this paragraph. Scenario 3 involves increasing the stock to 216,979 properties. Scenario 3 was not, per the IPA report, sustainable and has been ignored in this Occasional Paper. The focus of Shepherd Shaw’s modelling has been Scenario 2.

(cont’d next page)

infrastructure sector - roads, schools, ports, police stations, hospitals, water, etc. Indeed, why do governments not borrow money (at their low cost of borrowing), invest it in securities and use the resulting gains to fund everything we desire? The answer may lie, partly or in full, in the fact that governments generally have other investment options available that will generate higher economic returns than can be earned by an investment in securities.

Notwithstanding the scepticism generated by this high-level objection, the IPA report deserves more detailed consideration. The IPA has not publicly released its model or fully disclosed its key modelling assumptions.<sup>4</sup> While this makes it difficult to be definitive, Shepherd Shaw has undertaken its own modelling using defensible assumptions and has been unable to validate the claims for the IPA Fund. On the contrary, Shepherd Shaw's modelling indicates that, in NSW, the existing \$38 billion endowment (i.e. the market value of the existing NSW social housing stock) could be expected to be exhausted over the long term if the IPA Fund were implemented. This conclusion rests on two key factors:

- For the IPA scheme, the main revenue source for government is the rent paid by social housing tenants, which grows at about the same rate as the CPI. The main cost to government is the market rent that is paid to private owners, which grows at about the same rate as property prices. The CPI, if history is any guide, can be expected to be lower than the rate of property price growth, which means that government net revenue will be squeezed over time forcing the sell down and eventual depletion of the social housing endowment
- To overcome this net revenue squeeze, the IPA Fund must generate a total return that is higher than residential rental housing (about 3.5% higher per Shepherd Shaw's modelling). However, this additional return will be accompanied by additional volatility. Further, returns on residential rental housing and returns on other securities are not well correlated. Thus, Shepherd Shaw's modelling suggests a high probability that the IPA Fund would be depleted over the long term due to the sale of securities to cover rents in periods of poor returns on other securities.

This raises the possibility that the IPA Fund may be a mirage, distracting attention from the core underfunding issue, delaying substantive action and potentially leaving the system in a worse position in the long term.

An alternative concession agreement approach is outlined that preserves the sale of the social housing stock as suggested in the IPA report, but which eliminates the IPA Fund. Instead, the sales proceeds would be immediately deployed into government projects/initiatives having high benefit/cost ratios, with ongoing concession payments funded conventionally and the taxpayer reaping the private sector efficiencies. This is the financial, economic and government affordability equivalent of recycling any other government infrastructure asset, such as a port or an electricity transmission network.

This Occasional Paper concludes with an outline of the broad cost to taxpayers of the social housing system for a range of future trajectories, with a summary of likely funding sources and an appeal for rational discussion and decision making - such as is exemplified by the IPA report and, hopefully, this Occasional Paper - and for action in place of magical/wishful thinking and procrastination.

## 2. BACKGROUND TO SOCIAL HOUSING

Social housing is housing made available to the most disadvantaged households at rents that are heavily subsidised by governments. Rent is usually set at some defined percentage of household income, such as 30%, that is deemed affordable.<sup>5</sup> Most jurisdictions, at least in the developed world, devote large amounts to providing social housing. All jurisdictions struggle with how to provide and fund social housing.

In Australia, the Productivity Commission has reported that, in 2014/15, net recurrent expenditure (i.e. not counting capital expenditure or the costs of capital) totalled \$2.7 billion (\$8,486 per dwelling). The total cost, after accounting for capital expenditure and the cost of capital, was \$10.8 billion (\$33,794 per dwelling). In addition, the Commonwealth spends some \$4.1 billion pa on CRA, a housing support payment for lower income households.<sup>6</sup>

Despite these large expenditures, waiting lists for social housing are long and growing. The Productivity Commission has reported that there are 154,000

<sup>4</sup> This is not a criticism merely a statement of fact. Shepherd Shaw has also not publicly released its modelling.

<sup>5</sup> The IPA report rightly draws distinctions between public housing, social housing, affordable housing and community housing. These distinctions can become quite complex. For the purposes of this Occasional Paper it is sufficient to say that public housing (operated by the government) and community social housing (operated by others - principally CHPs - but targeted at essentially the same highly

disadvantaged households) together comprise social housing - at least as defined in Australia.

<sup>6</sup> Other jurisdictions spend even more. OECD statistics, notwithstanding reservations about data quality, indicate that where Australia spends 0.4% of GDP on housing support, the UK (for example) spends 1.4%.

(cont'd next page)

households on the Australian waiting list and 57,000 in NSW.<sup>7</sup>

### 3. CURRENT SOCIAL HOUSING SYSTEM DEFICIENCIES

#### 3.1 System Deficiencies raised by IPA

The IPA report does a good job of restating the current parlous state of the social housing system. The key issues noted in the IPA report are summarised in the following subsections.

##### 3.1.1 Not Enough Social Housing Dwellings

There are not enough social housing dwellings (as noted in section 2) and the funding being made available to expand the stock is inadequate. For example, SAHF involves a commitment of \$1.1 billion targeted at generating 3,000 additional dwellings. This is not, in the context of a NSW waiting list of 57,000 households, very much. Further:

- It seems that some unstated proportion of the 3,000 dwellings may end up being affordable housing rather than social housing<sup>8</sup>
- It seems questionable, given that construction of 3,000 dwellings might easily cost \$0.9 billion, that 3,000 dwellings will be procured unless bidders provide much of the required land at a much-reduced cash cost.<sup>9</sup>

##### 3.1.2 The Existing Stock Misconfigured

The existing social housing portfolio is significantly misconfigured relative to demand. Properties have the wrong number of bedrooms (i.e. not enough small properties, not enough large properties and too many medium sized properties) and/or are in the wrong place (i.e. not well located to jobs or services). The existing social housing tends to have a low market value (because it is old and/or poorly located), while newer

and/or better located housing has a higher market value. Reconfiguration will be expensive.

##### 3.1.3 Maintenance Costs Accelerating

The cost of maintaining the existing social housing portfolio is accelerating as the stock ages and as a result of past under-maintenance, exacerbating the maintenance backlogs and the underfunding issue (discussed below).

##### 3.1.4 Large Maintenance Backlogs

The existing social housing portfolio has a significant backlog of maintenance work that needs to be completed to bring the properties to minimum standards. IPA notes that the NSW government estimated (in 2012) that the existing stock of public housing in NSW needed an immediate injection of more than \$300 million just to bring it up to the NSW government's own minimum standards. More recent data is not, as far as can be determined, publicly available. However, it seems unlikely, from looking at LAHC's financial accounts and given the degree to which the NSW public housing agency (NSW Land & Housing Corporation, or "LAHC") is underfunded (as discussed below), that the backlog will have been reduced in the interim.

##### 3.1.5 Inadequate Funding for the Existing Social Housing

The ongoing operation of the existing Australian social housing portfolio is underfunded - over and above the cost of correcting maintenance backlogs. This situation has developed over a period of decades but can, according to the IPA report and anecdotally, be traced back to government decisions to target social housing at those households most in need. In NSW these decisions were taken commencing in the 1980s. While these decisions were entirely defensible, they had two other, presumably unanticipated, effects:

- The amount of rent collected from tenants has fallen significantly. This is because almost all tenants now rely on government benefits for their income and these benefits are much less than the working wages earned by a higher proportion of past tenants<sup>10</sup>

<sup>7</sup> The IPA report, in contrast, states that there are 250,000 households on waiting lists Australia wide and 59,900 households in NSW. The Productivity Commission data also indicates that, since 2006, waiting lists have only grown in NSW, the Australian Capital Territory and the Northern Territory, while they have fallen in other states. However, it is possible that if the Nation Building Economic Stimulus Program had not occurred (i.e. if the 19,700 produced was to be added to the waiting list) then the waiting list would have grown in all states except Queensland. It should be recognised that the waiting list responds to many influences other than the supply of social housing. The IPA report does not provide a source for its waiting list data or explain the discrepancies with the Productivity Commission figures. Figure 2.10 of the IPA report (showing a government projection of social housing demand and supply in Australia) lends some support to the Productivity Commission waiting list data, showing a 2015 projected demand-supply gap of approximately 110,000 dwellings (although this was a

projection made in 2009). However, notwithstanding the apparent discrepancies, the thrust of the IPA report's data remains intact (i.e. that there is a significant shortfall).

<sup>8</sup> Affordable housing is much less heavily subsidised than social housing, being rented at approximately 75% of market rent compared to approximately 46% of market rent for social housing (in NSW).

<sup>9</sup> This may be feasible if the government grants private sector bidders other benefits such as planning concessions, or bidders have a strong philanthropic motivation.

<sup>10</sup> A further, presumably unanticipated, consequence of this decision to target social housing at the households most in need has been that the former tenant group (i.e. working but still low income) must now subsist (*cont'd next page*)

- Many current tenants have high support needs that place significant demands on social housing providers to facilitate and/or provide support services.

While the amount of rent paid by tenants has fallen over the years, the level of government funding has not risen enough to compensate for that loss of revenue.

As an indication of the scale of subsidy provided by government, in NSW the rent and water charges paid by tenants currently cover only 67% of LAHC's reported cash costs. The IPA report uses an alternative measure of subsidy by looking at the difference between the cost of delivery reported by the Productivity Commission (including capital expenditure and the cost of capital) and the rent paid by tenants. By this measure tenants pay only 20% of the cost of delivery.

However, the fact that tenants do not pay the full cost of delivery says nothing about the degree to which the existing social housing system is underfunded. The IPA report erroneously refers to the subsidy - the difference between the cost of delivery and the amount paid by tenants - as the "funding gap".<sup>11</sup> The reported subsidy (circa \$8,100 pa per dwelling in NSW, excluding the cost of capital) is significantly larger than the funding gap (circa \$2,500 per dwelling in NSW, excluding cost of capital) as discussed below.

The funding gap is properly measured as the difference between the funding provided (i.e. the reported cost of delivery) and the funding that is truly necessary to ensure that levels of service are maintained - including, inter alia, that the number of dwellings does not decline through sales, that the stock is well maintained and that tenancy management and tenant services remain appropriate. The funding gap is currently closed, in the main, by allowing maintenance to fall into arrears and by selling existing social housing dwellings (including high value sites).

With respect to the funding gap, the NSW Auditor-General reported, in 2012, that an additional \$330 million per annum (approximately \$2,500 per dwelling pa)<sup>12</sup> was required - over and above the cost of addressing the

maintenance backlog - to merely ensure that the current number of public housing properties did not decline and that those properties were maintained at minimum standards.<sup>13</sup>

## 3.2 Additional System Deficiencies

In addition to the list of woes outlined in section 3.1, Shepherd Shaw would add the issues in the following subsections.

### 3.2.1 Estates Renewal Required

Existing large concentrations of public housing can impose a significant additional cycle of disadvantage on tenants - and additional costs on the broader community and on government agencies - flowing from, inter alia, elevated levels of crime and worse employment, educational and health outcomes than would pertain if those concentrations did not exist. Most Australian jurisdictions have such concentrations in their social housing portfolios; the need for renewal is pressing; and the level of funding available for renewal or other interventions is inadequate.

### 3.2.2 Redevelopment Potential Overrated

The extent to which existing social housing portfolios can be feasibly redeveloped tends to be overrated. Feasible means, in this context, that redevelopment can generate enough sales revenue to fund the following key costs:

- Demolition and replacement of the existing social housing (either on the same land or elsewhere); plus
- Any land remediation costs; plus
- Construction of the new private/affordable housing that is to be sold; plus
- A development profit that reflects the risk; plus (or minus)
- Any reduction (increase) in the value of the social housing; plus

---

in the private market, probably without CRA support since CRA is also targeted at households receiving government benefits.

<sup>11</sup> See Figures 1.3 and 3.1 of the IPA report.

<sup>12</sup> This \$330 million figure is easily confirmed (and revealed, in fact, as an underestimate) by examining LAHC's audited financial accounts to extract the levels of spending on maintenance plus property related capex, and to then compare those figures with industry life-cycle cost benchmarks (say 2.5% of dwelling replacement cost). Further, a 2.5% benchmark may be too low. The Royal Institute of Chartered Surveyors published a report in 2007 indicating that the appropriate figure was approximately 3.17% of dwelling replacement cost, albeit for the UK social housing portfolio (source: "Guide to the Housing Corporation's Life Cycle Cost Measure for Social Housing" and Shepherd Shaw calculations). There is a view that it is possible to avoid these large costs by selling dwellings immediately prior to the need for major expenditures and, instead, buying newer dwellings. The success of this strategy rests on whether the cost of the necessary works is greater than the difference between the sell price and the buy price. This will, in turn, be specific to the individual property and the then current market

conditions. Rational expectations would suggest that the strategy will, on a portfolio basis and over the long-term, fail since it relies on buyers being consistently irrational. Still, one need not look far to find examples of persistent irrational behaviour - underfunding of the social housing system being a prime example.

<sup>13</sup> It is instructive to examine the loss of stock in NSW since 2006. If the Nation Building Economic Stimulus Program had not occurred, the stock of social housing would have fallen by 3,600 dwellings from 2006 to 2015, equivalent to 400 dwellings pa sold and not replaced (source: Productivity Commission "Report on Government Services" and Figure 2.9 of the IPA report). At the average dwelling value (taken from LAHC's annual reports) this is the equivalent of a \$119 million pa cash injection to LAHC. At the average dwelling value for a 3-bed house in outer metro Sydney (\$442,096 from section 3.1.4 of the IPA report) this is the equivalent of a \$176 million pa cash injection to LAHC. Such amounts would have gone some way to closing the annual funding gap reported by the NSW Auditor General, with the rest coming from, presumably, delayed maintenance, upgrade and replacement.

- Enough additional value to compensate for the disruption to the lives of the sitting tenants - many of whom are very disadvantaged/vulnerable - and to pay for the costs of moving those tenants (since they lack the resources to pay) and of mitigating the impacts on those tenants' lives.

There are certainly parts of the social housing portfolio that can be feasibly redeveloped and these should be implemented at the earliest opportunity as a matter of policy, subject to appropriate economic and financial appraisal. However, the extent of feasible redevelopment is limited. For certain existing properties, redevelopment at higher housing densities will be appropriate because it will add value. For many sites, however, higher density redevelopment will destroy value. Even where higher densities would be feasible, planning constraints may prevent the exploitation of that density. Even in high value areas, some existing social housing sites are already at quite high densities making the planning approvals problematic. It certainly seems unlikely that, in the case of NSW, redevelopment action will generate \$330 million per annum of additional cash in perpetuity, which is the minimum required (per the NSW Auditor-General, as discussed in section 3.1.5).

The result of this overrating is that significant resources (management time, advisory fees, political capital, etc.) are expended/wasted trying to torture redevelopment into a grand funding solution when it is plain that redevelopment can only ever be a small component of the funding solution - or projects may be executed that destroy value. In the meantime, the benefits that would flow from a commitment to proper funding are put off into the future.

### 3.3 Take-Out Message

The existing social housing system has some very significant deficiencies and the IPA report makes a useful and timely contribution by restating these deficiencies. For this reason alone, the IPA report, in combination with this Occasional Paper, should be closely read by policy makers and by any CHP or consortium currently working to execute a contract in relation to SAHF, or contemplating a bid in relation to the NSW government's stock transfer initiative. The IPA report and this Occasional Paper put a focus on the true cost of delivering social housing, including the existing level of maintenance backlog in the portfolio and the whole-of-life costs of maintenance and ownership - particularly relevant for anyone contemplating a 20-year contractual commitment.

<sup>14</sup> The IPA report does not say who is expected to buy the properties but it is presumed to be "mum-and-dad" investors since almost all residential rental housing in Australia is currently owned by "mum-and-dad" investors. The IPA report indicates that only a small number of properties would be retained - strategic sites (i.e. high value) and specialised or high quality properties. IPA's assumption for modelling

## 4. ISSUES WITH THE IPA FUND

### 4.1 The IPA Scheme and the Validity of its Claims

The IPA report advocates a scheme wherein the Australian social housing portfolio would be sold to private owners, with replacement and additional social housing leased from the private market.<sup>14</sup> Such a sale can be expected to be beneficial to the extent that:

- It mobilises/drives private sector efficiencies (in cost and in outcomes)
- The ongoing operation of the - then more efficient - social housing system is appropriately funded
- The sales proceeds are invested in government projects/initiatives with high economic benefit/cost ratios.

However, the IPA report also proposes the establishment of the IPA Fund for the purpose of investing the proceeds of sale into shares, bonds, and other securities - a CFF for the social housing system. The investment returns would be used to lease the replacement and additional social housing from the private market through CHPs and other providers.

The IPA report indicates that the IPA Fund has been modelled using NSW as an example jurisdiction. Based on this modelling, the IPA report makes strong claims for the IPA Fund, namely:

- That the NSW stock could be increased from 126,000 properties to 157,000 properties over 20 years, thereby stabilising the waiting list (see footnote 3)
- That the level of support services for social housing tenants could be expanded
- That the cost to government of the social housing system could be reduced to zero
- That additional government revenue could be generated through stamp duties and savings in CRA
- That this could be achieved in a financially sustainable manner and without excessive risk.

The implication in the IPA report is that further stock growth could be sustainably achieved in later years (i.e. beyond 20 years) and that similar outcomes could be expected in other jurisdictions.

The apparent rationale for the IPA Fund is summarised below:

purposes appears to be that all properties would be sold and would then be replaced by properties leased from CHPs or other private providers.

*(cont'd next page)*

- Currently, social housing tenants in NSW pay rent equivalent to approximately 2% of the market value of LAHC's social housing pa (as shown in Figures 1.3 and 3.1 of the IPA report) - actually 2.21% as calculated from LAHC's accounts
- If that social housing was, instead, sold and the proceeds invested in a fund similar to the CFF, then that investment could be reasonably expected to return CPI + 4.5% pa.<sup>15</sup> This would, over the last 10 years, have equated to approximately 6.9% pa nominal.<sup>16</sup> This investment would produce additional funding, relative to the amount paid by social housing tenants, of 4.69% pa (6.9% - 2.21% = 4.69%). This would appear to be the basis for the "additional funding available" as expressed in Figures 1.3 and 3.1 of the IPA report
- The government would, having sold all its existing social housing stock, then need to lease social housing from the market at market rent.<sup>17</sup> Currently, market rent is running at about 4.85% of market value.<sup>18</sup> The government would still receive rent from the social housing tenants (at 2.21% of market value)<sup>19</sup> and receive the investment returns from the IPA Fund (expected 6.9% pa)
- The end result would be that the government would have 4.26% of market value as additional money to spend on social housing each year (2.21% social rent + 6.9% investment earnings - 4.85% market rent = 4.26%) - approximately \$1.64 billion in year 1.

Intuitively, this sounds too good to be true. The most obvious high-level objection is that, if this approach is possible, then surely every jurisdiction in the world would have implemented it already. And yet they do not seem to have done so. Further, if this approach is possible for social housing, then surely it will work for every other infrastructure sector - roads, schools, ports, police stations, hospitals, water, etc. Indeed, why do governments not consolidate all their tax revenue (and

supplement that tax with low cost borrowings), invest the resulting pool of funds in securities and use the resulting investment gains to fund everything we desire? The answer may lie, partly or in full, in the fact that governments generally have other investment options available that will generate higher economic returns than can be earned by an investment in securities.<sup>20</sup>

Notwithstanding this high-level scepticism, the IPA report deserves more detailed consideration. IPA has not released its modelling publicly or fully disclosed its key modelling assumptions.<sup>21</sup> While this makes it difficult to be definitive, Shepherd Shaw has undertaken its own modelling using defensible assumptions and has been unable to validate the claims for the IPA Fund.<sup>22</sup> This raises the possibility that the IPA Fund may be a mirage, distracting attention from the core underfunding issue, delaying substantive action and potentially leaving the system in a worse position in the long term.

## 4.2 Key Assumptions

Shepherd Shaw was unable, as noted in Section 4.1, to validate the claims for the IPA Fund. The source of disagreement is likely to be found in the assumptions underpinning the modelling.<sup>23</sup> The IPA modelling has not been released publicly or the assumptions fully disclosed publicly.<sup>24</sup> The following subsections outline Shepherd Shaw's key assumptions with the objective of shining a light on possible issues and otherwise opening a transparent and constructive discussion.

### 4.2.1 Inflation

The IPA report does not state its inflation assumptions. The IPA modelling may have been carried out in real dollar terms (i.e. assuming zero inflation).

With respect to the consumer price index ("CPI"). Shepherd Shaw has, as a base assumption, adopted 2.5% pa for the CPI, the rate that has prevailed over the

<sup>15</sup> All returns are (unless stated otherwise) total returns (i.e. assuming dividends and other income is reinvested) after fees and costs, with no leverage and before tax.

<sup>16</sup> This is the total return benchmark as reported by CFF, which implies a CPI of 2.3% pa.

<sup>17</sup> IPA's modelling assumption appears to be that these properties would be leased from CHPs or other private sources at market rent plus 20%. CHPs would, presumably, rent these properties from the investor market. This presumption flows from the expectation that, even with rents at market plus 20%, the net rents (i.e. after costs) would not be sufficient to service 100% debt and that the CHPs accumulated cash surpluses are not (and will not be in the future) sufficient to provide the required equity.

<sup>18</sup> This has been calculated from LAHC's annual reports. These figures are not out of line with other sources relating to private market properties, including figures reported by the Productivity Commission in its Report on Government Services.

<sup>19</sup> The IPA report does not deal explicitly with the treatment of the social housing gross rents, but Shepherd Shaw presumes that, since the CHPs are receiving market rent, the CHPs would pass these social rents through to the government.

<sup>20</sup> This high-level objection does not mean that special purpose funds do not exist or that those that so exist lack validity. Such funds seem to exist either: a) to satisfy specific contractual obligations such as, in the case of the CFF, superannuation liabilities (as opposed to satisfying a general concern for the well-being of a particular group of citizens); or b) because the governments in question have so much money that they lack better immediate investment options or would destabilise their own economies if they invested it all at home (e.g. Norway, Qatar). The point is that such funds involve a trade-off between returns on immediate investment and returns available from future investment.

<sup>21</sup> Refer to footnote 4.

<sup>22</sup> The IPA's modelling has been developed on the assumption that the proposed scheme would be applied in NSW. Shepherd Shaw has followed suite.

<sup>23</sup> Another possibility is modelling errors. While this is always possible, Shepherd Shaw has used its best endeavours to eliminate such errors and expects, from experience, that KPMG will have done the same. As such, the underlying assumptions remain the most likely source of disagreement.

<sup>24</sup> Refer to footnote 4.

(cont'd next page)

last 10 years.<sup>25</sup> Choice of this rate does not make a material difference to results.

With respect to operating costs (and renewal and replacement costs) Shepherd Shaw has adopted 3.5% pa reflecting the fact that such costs have tended to exceed the CPI.

With respect to the revenue lines (i.e. rent paid by tenants to the government and rent to be paid by the government to private owners) these are discussed further in later subsections.

#### 4.2.2 Sale and Acquisition

##### a) Scale of Activity and its Achievability

The IPA report has assumed that, as existing social housing dwellings become vacant, the dwellings will be sold, with the process taking 20 years (circa 6,300 properties pa). There were approximately 208,000 residential properties sold across NSW in the 12 months ending June 2016. As such, the government would be selling 3.0% of the normal NSW sales volume each year.<sup>26</sup>

The IPA report has also assumed that replacement and additional social housing properties would be leased from the private market over the initial 20 years (circa 7,800 properties pa). There were 269,443 new rental bonds lodged in the 12 months ending September 2015. Taking this as a measure of rental property turnover, the government would be seeking to lease 2.9% of the rental market each year.<sup>27</sup>

While this scale of sales and leasing activity does not seem unachievable in any one year, it may be quite difficult to sustain over 20 years. It is also fraught with risks in terms of the effect of sales/leasing on housing prices, the socio-economic sustainability of the areas effected by sales/leasing and the political impact of these effects. Key risks are as follows:

- That the market does not respond with additional housing for rent. In this event, rents can be reasonably expected to rise - both for other renters and for the government - in response to government leasing pressure
- That buyers are not sufficiently well funded to meet the (probably high) maintenance, upgrade and replacement requirements. In this event, the housing can be expected to deteriorate such that the occupants (i.e. buyers or their (probably low income) tenants) will live in progressively worse housing conditions
- That buyers raise rents (to compensate for maintenance, upgrade and replacement costs or otherwise). In this event, rents for equivalent housing elsewhere can also be expected to rise thereby impacting on low income renters
- That the volume of sales drives down prices and/or that buyers reduce rents (to attract tenants). In this event, the finances of buyers, of other investors and of surrounding owners can be expected to be negatively impacted
- That sales in areas of concentrated public housing exacerbate/perpetuate existing levels of social disadvantage. In this event, a re-run of prior poor experience elsewhere can be expected.<sup>28</sup>

There are also a range of practical issues to overcome which will act to limit the number of sales that can be achieved without resorting to management relocations.<sup>29</sup> Key issues are as follows:

- A significant proportion of the existing public housing dwellings do not have separate title. This situation prevails on most public housing estates and in most blocks of public housing units (whether those blocks are large or small). This means that these dwellings cannot be sold individually without expensive physical

<sup>25</sup> Source: ASX-Russell Long Term Investment Reports, CFF annual report for year ending 30 June 2016 and Shepherd Shaw calculations. The adopted inflation rate is derived from the total return figures in the sources, being 2.5% in the ASX-Russell Long Term Investment Reports and 2.3% in the CFF annual report.

<sup>26</sup> Source: NSW Office of State Revenue, Report on Land Related Transfer Duty for Residential Land. It is surprisingly difficult to find data on the volume of sales that is public, at an appropriate level of consolidation and clear. This source is one of the few that Shepherd Shaw could access. Other sources suggest much lower volumes of sales. For example, the Landmark Harcourt "Benchmark" report for 12 months to February 2016 indicates total sales of 86,000 properties ("Residential Housing, 0 to 4 Ha"). Shepherd Shaw has adopted the Office of State Revenue figures, but notes that further work is required to quantify the scale of the sales risk.

<sup>27</sup> Source: NSW Land & Housing Corporation, "Rent and Sales Report" (Quarters ending September 2015, December 2015, March 2016 and June 2016) and Shepherd Shaw calculations. The source also indicates that the Rental Bond Board holds some 693,000 bonds in total. Census 2011 reported that 743,050 households in NSW rented their homes. If you accept that 50,000 properties might be rented without bonds in place, then this lends some support to the LAHC data.

<sup>28</sup> For example, the suburb of Emerton was 100% public housing when constructed and is now 23% public housing. Despite this reduction of public housing concentration (and the very large cost of replacing the stock sold) Emerton is still ranked as the 36<sup>th</sup> most disadvantaged suburb in NSW (among the most disadvantaged 10% as measured by the SEIFA Score). As another example, the suburb of Whalan was also 100% public housing when constructed and is now 33% public housing. Whalan is still ranked as the 35<sup>th</sup> most disadvantaged suburb in NSW (also among the most disadvantaged 10%). Similarly, the suburb of Tregear was 100% public housing when constructed and is now 36% public housing. Tregear is still ranked as the 25<sup>th</sup> most disadvantaged suburb in NSW (also among the most disadvantaged 10%). Similar examples can be found elsewhere.

<sup>29</sup> The term "management relocations" is a euphemism for a tenant being compelled to relocate to another dwelling that suits the tenant's housing needs. Policy varies between jurisdictions and over time but usually requires that tenants be offered two or three suitable alternative dwellings, that tenants' relocation and associated costs are paid and that tenants are properly supported through the relocation process and to re-establish themselves in the new location - including with help to reconnecting with health providers, etc.

work to create separate titles. In many cases the cost of the work would not be justified by the revenue from sale, with other options being preferable (e.g. sale in one line, which would, for the IPA scheme, require vacant possession). Even if separate title is achieved, sales of individual dwellings within concentrations of public housing (i.e. within estates or in unit blocks) tend to occur at very low prices and/or to low income buyers (who are then less able to sustain ownership, especially if interest rates rise)

- While a proportion of public housing tenancies become vacant each year, there is no guarantee that these vacancies will occur in an orderly manner. For example, some properties could come vacant several times while others do not become vacant until a tenant dies
- Sales in some regional markets take a very long time and transact at very low prices, if at all.

The end result may be that management relocations may be required; that it will take longer than expected to achieve sales; and that the government will be left holding those dwellings that are hardest to sell (i.e. dwellings in regional markets; estates and unit blocks without separate title; and low value stock). This residual stock tends to also be the most expensive to operate and the focus of the greatest levels of social disadvantage.

There are, of course, a range of other practical issues. However, these are expected to be relatively simple to deal with through the terms of leases and other contracts. For example:

- The government needs to be able to ensure that maintenance is carried out appropriately. CHPs currently deal with this issue on a routine basis through the terms of their leases with private owners. As such, the issue should, as such, be relatively tractable
- The government needs to be able to ensure that appropriate refurbishment and upgrade is carried out. This issue is less tractable. Given that the government will pay market rent and that market rent reflects property value and amenity, buyers may have an incentive to “reposition” dwellings to maximise rent. This may not be appropriate (in a policy sense) or affordable and moving the tenant out may not be an option. Alternatively, the government may want the property refurbished or upgraded and the owner may not be willing. However, such issues are dealt with in other contexts (such as commercial property leases) and so should be solvable.<sup>30</sup>

#### b) Value of the Existing Social Housing

The IPA report suggests that LAHC’s audited financial statements understate the market value of LAHC’s social housing by approximately 30%. This does not seem credible and Shepherd Shaw has used the market values from the LAHC accounts. Shepherd Shaw understands that the values in LAHC’s accounts are based on a formal market valuation process, which includes making allowances for the peculiar characteristics of elements of the social housing portfolio - particularly that a significant proportion of the portfolio does not have separate title, and/or is impacted by significant social dysfunction, and/or is in poor condition, and/or is outdated in terms of market expectations (size, number of bathrooms, building material, etc.). While understatement is possible, it seems odd to discard the results of a formal market valuation process that has been subject to statutory audit. Sensitivity testing suggests that it makes no material difference to the outcomes.

#### c) Value of Acquired Social Housing

The IPA scheme involves leasing replacement and additional social housing from the market. The rent payable is linked to the value of the underlying properties via the prevailing gross market yield. The IPA report does not state an assumption as to the assumed value of the acquired property or of the assumed rents.

Shepherd Shaw has tested a range of assumptions and has adopted \$550,000 per property. The median strata price is currently \$600,000 for NSW, \$315,000 for regional and rural areas, \$677,000 for Greater Metropolitan Region and \$826,000 in the inner ring of Sydney.<sup>31</sup> The bulk of the LAHC portfolio is in the Greater Metropolitan Region and non-strata prices are significantly higher. As such, the assumed \$550,000 may prove to be quite optimistic.

Sensitivity testing suggests that this price does not make any transformative difference to the outcomes. This is partly because Shepherd Shaw has modelled an adjusted sale structure so as to minimise the number of additional leases required (see section 4.2.3).

#### d) Is it Sensible to Sell the Existing Social Housing?

The IPA report, as noted earlier, indicates that only a small number of existing social housing properties would be retained, with the balance sold and replaced by properties leased from CHPs or other private providers. This is not necessarily a sensible strategy. If a property is perfectly acceptable, then is it sensible to sell that property merely to realise investment funds? Each sale

<sup>30</sup> The IPA report recognises these “maintenance and upgrade” issues and envisages contractually enforceable arrangements with CHPs (and other providers) administered by the proposed “capacity purchasing agency”. This Occasional Paper does not deal with the proposed governance arrangements in any detail, but it is noted that the functions of the various proposed agencies are all currently in place

- which is not to suggest that improvements are not possible in relation to the way these functions are organised or performed.

<sup>31</sup> Source: NSW Land & Housing Corporation, “Rent and Sales Report” (March Quarter 2016).

should be subject to individual assessment of the costs and benefits of the sale.

#### 4.2.3 Alternative Sale Structure

##### a) Outline of the Structure

For modelling purposes, to mitigate the problems with the IPA scheme's sale structure, as outlined at 4.2.2a) and 4.2.2d), Shepherd Shaw has assumed the following:

- The existing 126,000 social dwellings would be sold at market value to a consortium (or consortia) consisting of institutional investors and CHPs - in (say) 20 lots. Each lot would have a current market value of slightly less than \$2 billion. All sales would occur at the same time as part of one process.<sup>32</sup> The existing 126,000 social housing dwellings would then be leased back from these same consortia at market rent. This approach allows the government to:
  - Avoid the market pressures that may flow from sales to mum-and-dad investors at the scale contemplated by the IPA report
  - Have immediate access to sales revenue for investment (instead of gradually over 20 years)
  - Keep those dwellings that already meet requirement, or can be made to meet requirements (through financially feasible refurbishment, modification or redevelopment), without having to change dwelling locations just to release sales proceeds for investment<sup>33</sup>
  - Gradually adjust the portfolio across time - to the extent that dwellings do not meet requirement, or cannot be made to meet requirements (through refurbishment, modifications or redevelopment) - by moving tenants and then either sub-leasing dwellings to private tenants or terminating leases (subject to termination provisions)
- The government then leases an additional 31,000 social housing dwellings from the market over the initial 20 years to bring total social housing to 157,000 as per the IPA scheme. This approach reduces the market pressures that may flow from leasing the entire 157,000 dwellings as contemplated by the IPA report.

Lease payments would be linked to key performance indicators relating to provision of tenancy management, asset management and support services, in the same way as contemplated for the IPA scheme.

<sup>32</sup> The transaction outlined here is, of course, a stylised modelling assumption. The transaction would, in reality, need to be subject to significant market engagement and perhaps staged over a small number of years (five, for example).

<sup>33</sup> The case for refurbishment, modification or redevelopment would be made over time and the works carried out under the terms of the contracts with the CHPs or other providers.

##### b) Institutional Investment Appetite

The key objection to the alternative structure, as outlined at a) above, is that institutional investment in residential rental housing does not currently exist to any significant extent in Australia. Institutional investment appetite is, as such, unproven. In the USA, in contrast, there is a large corporate and institutional investment in residential rental housing, in both single-family and multi-family portfolios.

Commentators have attributed this lack of Australian institutional investment to a range of possible causes, for example:

- The income tax system is said to favour retail investors (i.e. mum-and-dad investors) via negative gearing and capital gains tax relief. This is not really compelling given that, in the USA, retail investors seem to receive similar negative gearing and capital gains tax relief<sup>34</sup>
- The land tax regime is said to favour small scale investors (i.e. mum-and-dad investors) because they generally have only one property and rates escalate for aggregated land values over a low threshold. Again, this is not particularly persuasive given that, in the USA, similar land tax issues seem to prevail
- The cost of administering a large portfolio of rental housing (compared with mum-and-dad investors who may do all or part of the administration without remuneration). Again, the situation in the USA undermines this reasoning
- The low net income returns, with the bulk of the total return coming from capital growth. This reason is undercut by the fact that Australian institutional investors routinely invest in growth stocks having low (or no) dividends and high capital growth prospects. Further, returns from residential housing have not, historically, been highly correlated with equities - which suggests that residential rental housing would produce portfolio diversification benefits
- The difficulties of aggregating a portfolio of rental housing that is sufficiently large to warrant institutional interest.

Of this range of possible causes, only the last seems to carry any real explanatory power. It is, indeed, very difficult to aggregate an institutional scale portfolio of residential rental housing in Australia. In contrast, institutional scale portfolios do exist in the USA and transact periodically. Further support for the "lack of

<sup>34</sup> Shepherd Shaw's understanding is that, in the USA, for people on gross incomes of up to US\$100,000, losses on rental properties can be offset against other income up to a US\$25,000 cap, with that cap declining to zero as income goes to US\$150,000. For people on higher incomes, losses can still be carried forward and offset against future capital gains. Further, capital gains can effectively be deferred indefinitely via a "like-kind" exchange (i.e. sale of a property does not necessarily trigger a capital gains tax event).

scale” thesis can be found in the fact that there are some (very limited) Australian examples of residential rental portfolios being held in corporate and trust structures. For example, blocks of flats held in corporate and trust structures do periodically trade in one line. If a transaction were put to market as outlined at a) above, then this “lack of scale” cause would be overcome and institutions would have the opportunity to access large scale portfolios.

It is important to note that, in the absence of large scale transactions, there seems to be no inherent benefit in institutional investment as opposed to direct investment by mum-and-dad investors. Institutions aggregate funds from mum-and-dad investors and add a layer of costs. If there was a shortage of funds for investment (or a rapid requirement for funds) then the institutions could add value thereby justifying their costs - but there does not seem to be any such shortage, with mum-and-dad investors apparently happy to directly provide the level of funds required. However, if large scale transactions make their way to market thereby creating a need for institutional investment, then the institutions can probably be relied upon to respond.

#### 4.2.4 Market Rent plus 20%

The IPA report suggests that the government will pay rent at market plus 20%.<sup>35</sup> The additional 20% is intended to allow the CHPs to deliver “wrap around” support services (e.g. health, mental health, employment or drug and alcohol services).

Shepherd Shaw has assumed that the government pays market rent only, on the basis that “wrap around” support services should be clearly specified and paid for separately. 20% of market rent may or may not be the appropriate price. Inclusion of the additional 20% in the market rent figure will merge the core discussion (about cost of housing) with a related but separate discussion (about the cost of wrap around support).

#### 4.2.5 Fund Investment Return

With respect to total return (i.e. capital gain plus income return), the IPA report uses the benchmark return for the CFF (i.e. CPI + 4.5% pa), or 7.11% nominal (using a CPI of 2.5% as noted in section 4.2.1).

The IPA report essentially suggests that this may be a conservative assumption because the CFF has beaten this benchmark over the periods from inception to May 2006 (a return of 7.7% pa nominal, beating the nominal benchmark by 0.8% pa), 10 years (by 0.8% pa), 7 years

(by 3.9% pa), 5 years (by 3.9% pa) and 3 years (by 5.1% pa).

The IPA total return assumption seems reasonable and Shepherd Shaw has also adopted this assumption. However, the assumed investment return is a critical assumption and a note of caution is in order as follows:

- Past returns are no guarantee of future returns
- The CFF underperformed its benchmark in the financial year ended 30 June 2016 (a return of 4.8% nominal, missing the nominal benchmark by 0.7% pa)<sup>36</sup>
- The most recent ASX-Russell Long Term Investment Report stated that a balanced fund would only have returned 5.7% pa over the 10 years ending 31 December 2015 (or CPI + 3.12% pa), which is lower than the CFF benchmark<sup>37</sup>
- If history does repeat itself, then there is a 50% probability that the actual return in any one year will be less than 7.11% pa nominal.<sup>38</sup>

As an aside, it is worth noting that the NSW Treasury “Hour-Glass Long Term Growth Fund” returned 10.26% pa (total, nominal, after fees) over the last 5 years compared to the CFF’s return of 10.2% pa (total, nominal, after fees). It seems like a lot of trouble to establish an entire funds management infrastructure for the IPA Fund when the NSW Government has an existing structure in place that seems, on its face, to achieve equivalent investment returns.

#### 4.2.6 Residential Investment Return

The IPA report does not fully explicate its assumptions for residential investment returns. The outcomes from the IPA Fund are materially dependant on the assumed capital return and yield of residential housing investment. This is because capital growth is (to state the obvious) determined by property price rises, which in turn impact on market rents, which then impact on the IPA Fund investment returns - since higher market rents mean that more of the fund balance must be used to pay for the higher market rents, thereby changing the amount of money in the investment pool for the following period.

With respect to yields (i.e. income returns), Shepherd Shaw has adopted the following:

- A market gross rental yield of 4.85% pa nominal (i.e. as paid to private landlords)<sup>39</sup>

<sup>35</sup> The IPA report also says that the government will pay “market rental plus one per cent yield”. This suggests that the IPA modelling assumes market rent at 5% of property value (because 1% / 5% = 20%).

<sup>36</sup> Source: CFF annual report for year ending 30 June 2016.

<sup>37</sup> Source: ASX-Russell Long Term Investment Reports for period ending 31 December 2015. A balanced managed fund was defined as having “70% growth assets and 30% defensive assets”.

<sup>38</sup> This assumes, for discussion purposes, that returns are normally distributed with a mean of 7.11% pa.

<sup>39</sup> IPA appears to have assumed a 5% pa market gross rental yield (see footnote 35).

(cont’d next page)

- A social gross rental yield of 2.21% pa nominal (i.e. as paid by social housing tenants)
- Costs (operating and capital) of 3.66% pa nominal
- Net yield (i.e. income return) of 1.19% pa nominal in the private market (i.e. as earned by private landlords) and -1.45% pa nominal in the social market (i.e. as earned by LAHC).<sup>40</sup>

With respect to capital returns, property prices have, historically, grown at about 3.4% pa real. Shepherd Shaw has adopted a capital return of 3.34% pa real, which translates into 5.92% pa nominal (using a 2.5% pa CPI).<sup>41</sup>

This combination of income return and capital return gives a total return of 7.11% pa nominal.<sup>42</sup>

It is important to recognise that the total return (capital plus income) on residential property is linked to that on other securities by the risk of the respective assets. Thus, if the capital return on residential property falls then, in the absence of a reduction in relative risk, the income return can be expected to increase in compensation.<sup>43</sup>

#### 4.2.7 Can the IPA Fund Generate a Greater Return than Residential Housing?

Shepherd Shaw's modelling confirms that the IPA Fund needs to generate a total return that exceeds the total return from residential housing, not just a return in excess of the rent paid by social housing tenants (as implied in Figure 3.1 of the IPA report) - for the reasons outlined in paragraph 1 of section 4.2.6 and as discussed further in section 5. Can the IPA Fund be reasonably expected to generate such a return?

**Table 1** shows total returns for equities and residential property as reported in the ASX/Russell Long Term Investment Reports.<sup>44</sup> Of particular interest is that, relative to a balanced managed fund (similar to the CFF portfolio), residential housing appears to have shown a higher average total return (at least over the referenced timeframes). This suggests that it may be difficult, in practice, for the IPA Fund to generate a higher total return than residential housing without substantially increasing the risk embedded in the IPA Fund portfolio relative to residential housing and to the CFF portfolio.

It is also the case that returns on residential property are not perfectly correlated with the return on other

**TABLE 1 - 10 YEAR ROLLING RETURNS**

	10 Years to (% pa, total return before tax and debt, after fees and costs)									Mean
	Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14	Dec-15	
Australian equities	13.3%	na	8.4%	8.4%	6.1%	8.9%	9.2%	7.1%	5.5%	8.4%
Balanced managed fund	8.6%	na	5.2%	5.0%	4.6%	6.7%	7.4%	6.5%	5.7%	6.2%
Australian residential property	11.6%	na	10.4%	10.1%	8.0%	6.5%	6.1%	7.0%	8.0%	8.5%

<sup>40</sup> These figures have been calculated from LAHC's annual reports and are all expressed as a percentage of property market value. Different sources give different figures but those adopted here are not out of line with other sources. However, it should be noted that the operating cost figure has been adjusted upwards to properly account for lifecycle maintenance, upgrade, renewal and replacement costs (as discussed at section 3.1.5). The adjustment is \$2,500 per dwelling (\$330 million pa for the existing NSW portfolio) in real terms, being the figure reported by the NSW Auditor-General. This brings the assumed cost of maintenance, upgrade, renewal and replacement to approximately 2.84% of assumed replacement cost. This is still well below the benchmark of 3.17% of replacement cost reported in the study referenced in footnote 12.

<sup>41</sup> Source: long term price indices developed by Abelson (1985), Abelson & Chung (2004) and as published in ABS 6416. There is considerable variation depending on the period of study. For example, the average capital return from 1984 to present is 7.81% pa.

<sup>42</sup> The ASX-Russell Long Term Investment Reports (see Table 1 on page 14) suggest a residential housing total return of 8.4% pa nominal (compared with the IPA Fund total return of 7.11% pa). However, Shepherd Shaw has adjusted the residential total return assumption

downwards to 7.11% pa (by reducing the expected capital return). This is partly because (not to put too fine a point on it) to do otherwise would have destroyed, at the outset, the rationale for the IPA Fund. However, other considerations are that:

- Other sources suggest comparable returns on average over the periods covered by Table 1, but over longer timeframes lend more support to a lower figure such as 7.11% pa
- The relatively high capital returns over recent times may not continue indefinitely, although a lower capital return could be expected, in the absence of a change in relative risk, to be compensated for via an increase in gross yield
- It is best to reflect the near parity of total returns observed between equity investment and residential housing investment (as discussed further in section 4.2.7).

<sup>43</sup> In terms of theory, this linkage must exist because, in the absence of a change in the relative risk between residential housing and other securities, a risk-free arbitrage opportunity would be created if the linkage did not exist.

<sup>44</sup> Source: ASX-Russell Long Term Investment Reports. Shepherd Shaw could not locate the report relating to December 2008.

(cont'd next page)

securities.<sup>45</sup> While this brings diversification benefits, it also means that significant cash (or near cash) reserves may be required to ensure that there are funds available to pay market rent to the private owners as the rent falls due (or may entail additional sales of securities). This may further reduce the returns that can, in practice, be earned from the IPA Fund or even endanger the fund.

If the IPA Fund were to take on more risk to generate higher expected returns, then the required discount rate would also increase (which would tend to cancel out any gain in a net present value sense) and volatility would also increase (which would make it even more difficult to match investment cash flows to the required market rents). It is also relevant, in this regard, to repeat that there is a 50% probability of the actual return in any one year being less than the expected return (see section 4.2.5 and footnote 38). The impact of this is discussed further at section 5.1.3.

#### 4.2.8 Escalation Rate for Market and Social Rent

##### a) Social Rent

The IPA report indicated (in Figures 1.3 and 3.1) that social housing tenants currently pay rent of approximately 2% pa of the property market value. Shepherd Shaw has used 2.21% pa as explained earlier in section 4.2.6.

It should be noted, however, that rents paid by social housing tenants do not escalate in line with the growth rate of property prices (i.e. it is not valid to assume that tenants pay 2.21% of property price each year). Looking at LAHC's financial statements suggests that social gross rent has, over recent years, been growing at about 3.5% pa less than property price growth rates. In terms of the assumptions in this Occasional Paper, this would translate into an escalation rate of 2.42% pa moving forward (i.e. the assumed property price growth rate 5.92% less 3.5%). However, the growth rate from year to year is quite volatile and was only 1.76% in the most recently published report (30 June 2016). It is difficult to understand how such low rental growth rates can be sustained. However, it is just as difficult to see how tenants could possibly afford to pay more if their incomes (comprising, predominantly, social security benefits of one form or another) are pegged to the CPI or (at best) to growth in average weekly earnings.

Shepherd Shaw has adopted the CPI (assumed to be 2.5% pa) as the escalator for social housing rents. This

is a critical assumption and the sensitivity of the outcomes is described further in section 5.

##### b) Market Rent

Market rents, in sharp contrast to social rents, do tend to grow in parallel with property prices.<sup>46</sup> Property prices have, historically, grown at about 3.4% pa real.<sup>47</sup> Shepherd Shaw has, as noted earlier, adopted a real capital return of 3.34% pa (which translates into 5.92% pa nominal), an income return of 1.19% pa nominal for a total return of 7.11% pa nominal (see footnote 42). The net effect for the IPA Fund will be that the market rent it pays to private owners will escalate 3.42% pa faster than the rent it receives from social housing tenants (the 5.92% pa market rent growth rate less the 2.5% pa social rent growth rate).

#### 4.2.9 Opportunity Cost of Capital

Shepherd Shaw has, at a high level, undertaken an indicative financial and economic appraisal, which systematically compares the proposed IPA scheme against the option of achieving the same service outcomes conventionally (i.e. without the IPA scheme). IPA may have completed such an appraisal but it is not mentioned in the IPA report.

In preparing the financial appraisal, Shepherd Shaw has discounted the cash flows at the rate of total return expected for the relevant investment (i.e. residential property or other securities). For the base case, as outlined in sections 4.2.5 and 4.2.6, these rates are the same (7.11% pa nominal).

In preparing the economic appraisal, Shepherd Shaw adopted the central 7% pa real discount rate recommended by NSW Treasury. With a CPI of 2.5% pa, this translates to a 9.68% pa nominal discount rate.<sup>48</sup>

It is worth noting that the returns expected to be earned by the IPA Fund are lower than the economic discount rate. While it would be wrong to read too much into this fact, it does mean that government investments are, in general and if properly justified, expected to produce a higher rate of return than the IPA Fund. This suggests that a better economic outcome might be produced by investing the sales proceeds directly into projects immediately (rather than over time through the IPA Fund) while properly funding the social housing system conventionally.

<sup>45</sup> Based on the data in Table 1 (i.e. on the small sample provided by the ASX-Russell Long Term Investment Reports) the correlation of 10 year returns with the "Balanced Managed Fund" option is 0.018 (i.e. almost no correlation) and 0.50 with the "Australian Equities" option. Calculations using other sources confirm the general correlation picture, although the precise correlations differ.

<sup>46</sup> Source: "A History of Housing Prices in Australia 1880-2010", Stapledon (September, 2010) and Shepherd Shaw calculations. Compare, in particular, Figure 1 and Figure 4 of the source.

<sup>47</sup> Source: long term price indices developed by Abelson (1985), Abelson & Chung (2004) and as published in ABS 6416.

<sup>48</sup> Source: "NSW Government Guidelines for Economic Appraisal", NSW Treasury (July, 2007).

#### 4.2.10 Transaction Costs, Tax Concessions and CRA

Shepherd Shaw has ignored transaction costs such as stamp duty, legal fees, advisory fees and fund set-up costs. These costs are unlikely to be critical to the analysis. Stamp duty, for example, is a normal part of buying a property and so should not interfere with relative pricing or demand etc. Stamp duty will also increase government revenues but, as a transfer payment, should be excluded from any economic appraisal.

Similarly, Shepherd Shaw has ignored a range of advantages that accrue to CHPs and the private sector relative to government delivery. For example:

- CHPs can recover GST credits associated with housing management costs (whereas LAHC and the for-profit sector cannot). CHPs also get the benefit of a range of other tax concessions that do not accrue to others (income tax, payroll tax, etc.). These are real financial benefits. However, the commercial structure of the IPA scheme means that they accrue to the CHP rather than to the government<sup>49</sup> and so have been excluded from this analysis
- Tenants of CHPs (and other private landlords) can, under current rules, collect CRA (if eligible). However, the IPA scheme is predicated on preventing CRA from being payable and so CRA was also excluded from this analysis.

## 5. ANALYSIS

### 5.1 Modelling Results

The IPA report makes strong claims for the IPA Fund. In particular:

- That the NSW stock could be increased from 126,000 properties to 157,000 properties over 20 years, thereby stabilising the waiting list (see footnote 3)
- That the level of support services for social housing tenants could be expanded
- That the cost to government of the social housing system could be reduced to zero
- That additional government revenue could be generated through stamp duties and savings in CRA
- That this could be achieved in a financially sustainable manner and without excessive risk.

<sup>49</sup> A different commercial structure (such as that outlined at section 5.3) could see some or all of the benefit effectively flowing to the government via the competitive bidding process.

<sup>50</sup> The economic benefit from provision of the social housing has, for simplicity, been excluded since it is exactly the same for both forms of

Shepherd Shaw has been unable to validate these claims.

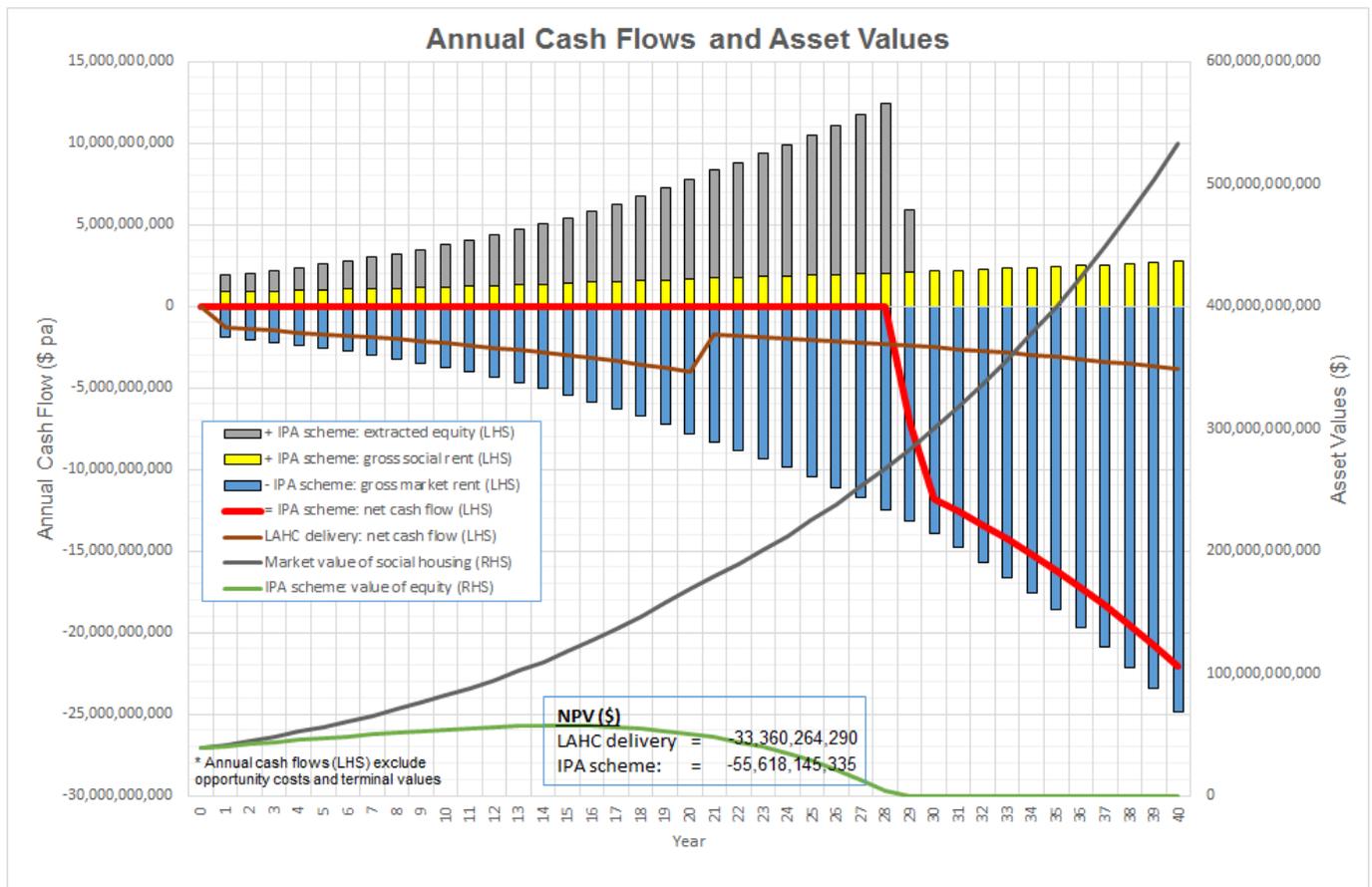
#### 5.1.1 Summary of Results

**Figure 1** summarises the outcomes from Shepherd Shaw's modelling, using the assumptions as described in section 4.2 earlier. As noted earlier, the modelling focuses on the IPA's Scenario 2 and follows the IPA report in focusing on the NSW social housing portfolio. Key features of **Figure 1** are as follows:

- The left hand scale ("LHS") shows annual cash flows in nominal dollars pa, while the right hand scale ("RHS") shows asset values in nominal dollars
- The graph covers 40 years to allow the annual cash situation to be more clearly illustrated
- The columns show the various components of annual cash flow (on the LHS) for the IPA scheme, namely the rent received from social housing tenants, less the rent paid to private owners and plus dividends paid from (and/or securities sold from) the IPA Fund (as necessary or available to cover any cash deficits).
- The thick red line shows the net cash flow for the IPA scheme (on the LHS)
- The thick green line shows the value of the IPA Fund investment portfolio (on the RHS)
- The thick brown line is the net cash flow (on the LHS) for LAHC delivery (i.e. no IPA scheme but the same number of dwellings as the IPA scheme)
- The thick grey line shows the value of the social housing. This value is, for LAHC delivery, on the LAHC balance sheet. For the IPA scheme, the value is on the balance sheets of the private owners
- The text box shows the financial net present value of the two forms of delivery, that is:
  - For LAHC delivery, the annual net cash flows as shown, minus the opportunity cost (being the initial market value of the existing social housing portfolio), plus the terminal value (being the then market value of the social housing portfolio)
  - For the IPA scheme, the annual net cash flows as shown, minus the opportunity cost (being the initial market value of the existing social housing portfolio), plus the initial sale (being the initial market value of the existing social housing portfolio), plus the terminal value (being the then market value of the IPA Fund investment portfolio).<sup>50</sup>

delivery. This is because both arrangements have been modelled so as to deliver the same number of social dwellings with the same timing of delivery and the same market value.

FIGURE 1 - MODEL RESULTS - BASE CASE ASSUMPTIONS



### 5.1.2 Key Observations

Key observations from **Figure 1** are as follows:

- Rents paid to private owners (which are linked, via the gross yield, to growth in property prices at 5.92% pa nominal) grow faster than do rents received from social housing tenants (which are linked to the CPI at 2.5% pa nominal)
- The IPA Fund investment portfolio is, as a result, completely sold after 29 years
- The net present cost for LAHC delivery is lower than that for the IPA scheme
- In terms of government cash outlays:
  - For the first 28 years, for the IPA scheme the cash cost to government is zero, while for LAHC delivery the cash cost to government averages circa \$1.6 billion pa real
  - By year 40, for the IPA scheme the cash cost to government is circa \$22 billion pa (approximately \$8.2 billion pa real) and growing fast, while for LAHC delivery the government is paying circa \$3.8 billion pa (circa \$1.4 billion pa real) and growing much less quickly.

### 5.1.3 Investment Returns Required for a Sustainable IPA Scheme

For the IPA scheme to deliver on its claims, it needs to transform the results outlined in sections 5.1.1 and 5.1.2 by producing a higher return on its investments. For example:

- With residential rental returns assumed to be 7.11% pa nominal, the IPA Fund needs to earn an investment return of circa 10.7% pa nominal - about 3.59% higher
- With residential rental returns assumed to be 8.5% pa nominal, as has been the average over the last 10 years (see Table 1 on page 14), the IPA Fund needs to earn an investment return of circa 12.27% pa nominal - about 3.77% higher.

This does not, on first glance, look too difficult. It is, surely, just a matter of taking on some additional risk! However, two considerations are relevant in this regard:

- Firstly, it has been difficult, over some timeframes, for investments in equities (or other securities) to consistently generate any returns in excess of residential rental housing - let alone circa 3% margin. As discussed in section 4.2.7, over the period from 1997 to the present, the average 10-year rolling return on residential rental housing was 8.5% pa

compared to the ASX/S&P All Ordinaries index at 8.4% pa and a typical balanced managed fund at 6.2% pa (and the CFF at 7.7% pa as noted in section 4.2.5)

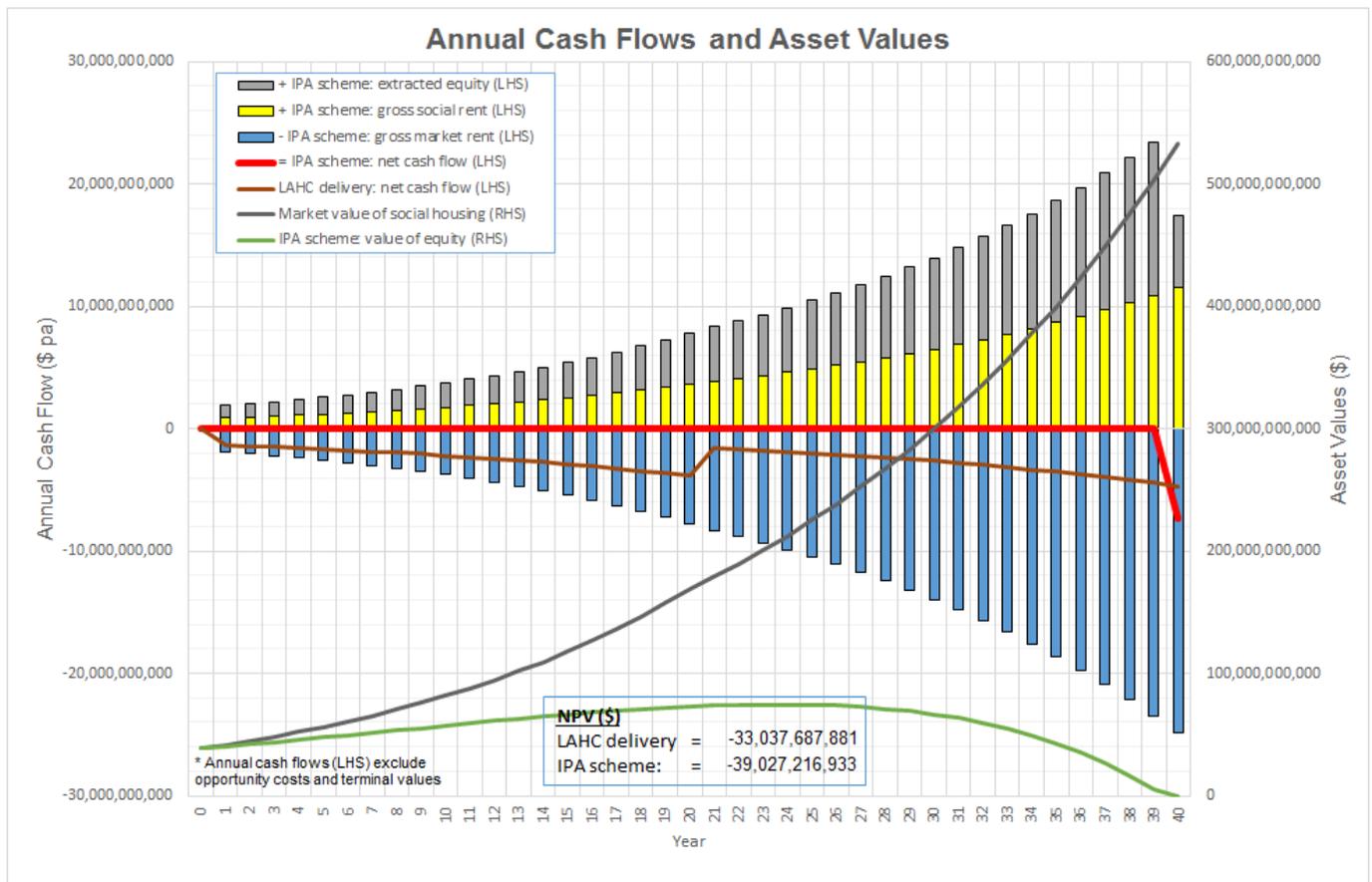
- Secondly, the volatility of (and correlation between) returns for the IPA Fund investment and residential rental housing is a serious issue. Some important points to note in this regard are as follows:
  - While it is certainly possible to increase expected investment returns by, for example, investing in emerging markets or by borrowing money to invest, the increased return will be accompanied by increased volatility
  - Further, as noted in section 4.2.7, the correlation between these investment classes is far from perfect. As such, government may need to hold significant cash (or near cash) reserves to ensure that there are funds available to pay market rent to the private owners as and when the rent comes due. For example, a run of poor results (high

residential price rises combined with low investment returns) could endanger the IPA scheme - and higher volatility would increase the danger

- It would seem to be entirely possible for the IPA Fund to earn, on average, a higher annual return than residential housing, but for the fund to, nevertheless, be depleted over (say) a 40-year period. Shepherd Shaw has run a preliminary Monte Carlo simulation which indicates that, even if the fund was earning a 3% margin over residential housing, there would be a circa 45% probability that the fund would still be exhausted by the end of year 40 (and a circa 65% probability that it would be exhausted by year 80) - purely as a result of the volatility of returns and the low correlation between the asset classes.<sup>51</sup>

It is, perhaps, a measure of the current desperate situation that "rolling the dice" on \$38 billion worth of taxpayer assets, with a 45% (or 65%) chance of total loss, might seem vaguely attractive.

FIGURE 2 - MODEL RESULTS - SOCIAL HOUSING RENTS ESCALATE WITH PROPERTY PRICES



<sup>51</sup> This preliminary Monte Carlo simulation is indicative/illustrative only and requires detailed actuarial analysis for confirmation. The calculations assume that the IPA Fund replicates the risk return profile of the ASX/S&P All Ordinaries Index and that the social housing portfolio replicates the risk return profile of the Sydney residential housing market (in both cases from June 1984 to the present). Note

that the All Ordinaries returned circa 12% pa (total) over that period while the Sydney residential market returned only circa 9% pa (total) but with much lower volatility. This simulates the circa 3% pa margin required for the IPA Scheme.

### 5.2 Explaining the Divergent Results

What are the factors driving such a marked difference between the IPA modelling and the Shepherd Shaw modelling? The IPA modelling indicated that the IPA Fund balance would, without taking on any excessive risk, continuously increase and stand at circa \$110 billion in 2044 (see Figure 1.5 of the IPA report). This Occasional Paper, in contrast, suggests that there is every chance that the IPA Fund will fail to deliver on its claims and may be totally depleted. Without access to the IPA modelling it is difficult to be definitive. However, two possible explanations are discussed in the subsections below.

#### a) Escalation Rates for Gross Market Rent and Gross Social Rent

Shepherd Shaw has assumed, as discussed in section 4.2.8, that market rents are linked to property prices, while social housing rents are linked to CPI. If instead, implausible as it may be, social housing rents were assumed to be linked to property prices, then this makes a very large difference, as can be seen in **Figure 2**. However, it can also be seen from **Figure 2** that the IPA Fund investment portfolio (the thick green line) would still, eventually, be entirely depleted. Government outlays then escalate dramatically.

#### b) Return on Residential Property

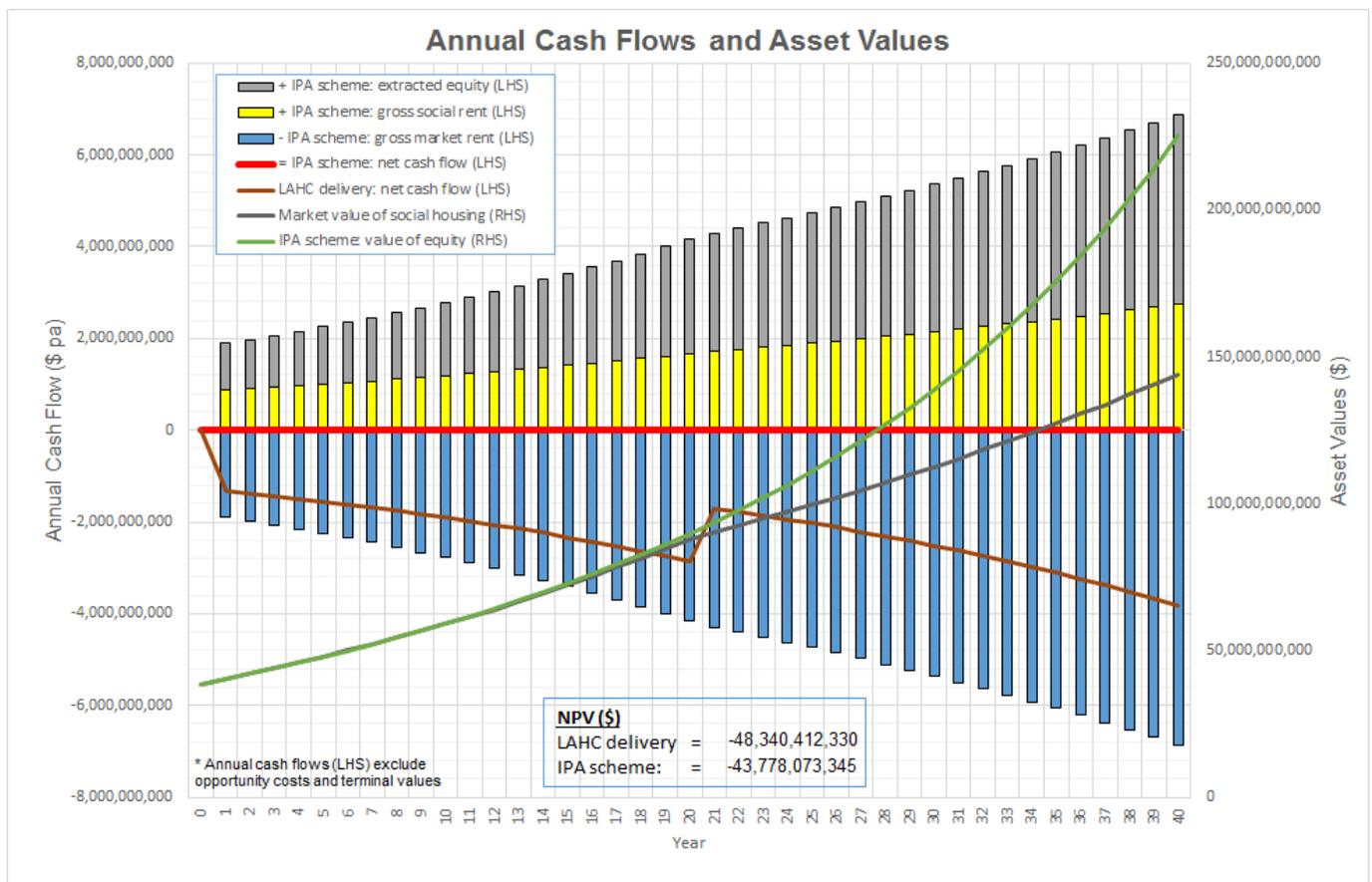
Shepherd Shaw has assumed, as discussed in section 4.2.6, that residential property capital growth is 5.92% pa nominal and total returns are 7.11% pa nominal. However, if property price growth were to fall to the CPI, without rents then escalating to compensate (so that the total return also falls), then this would have a transformative effect as can be seen from **Figure 3**.

However, it is implausible that such a change could occur unless the risk of investment in residential rental housing were to fall dramatically relative to other investments - and it is difficult to think of anything that would cause such a re-rating of risk.

### 5.3 An Alternate Approach - Concession Agreement

One of the key high level problems with the IPA scheme is that the expected return on fund investments (7.11% pa nominal) is lower than the government economic appraisal hurdle rate (i.e. 9.68% pa nominal). As such, the transaction could be improved by simply eliminating the IPA Fund and instead using the sales proceeds for immediate investment into government projects/initiatives with high benefit/cost ratios (or the funds could be rebated to taxpayers).

**FIGURE 3 - MODEL RESULTS - PROPERTY RETURNS FALL**



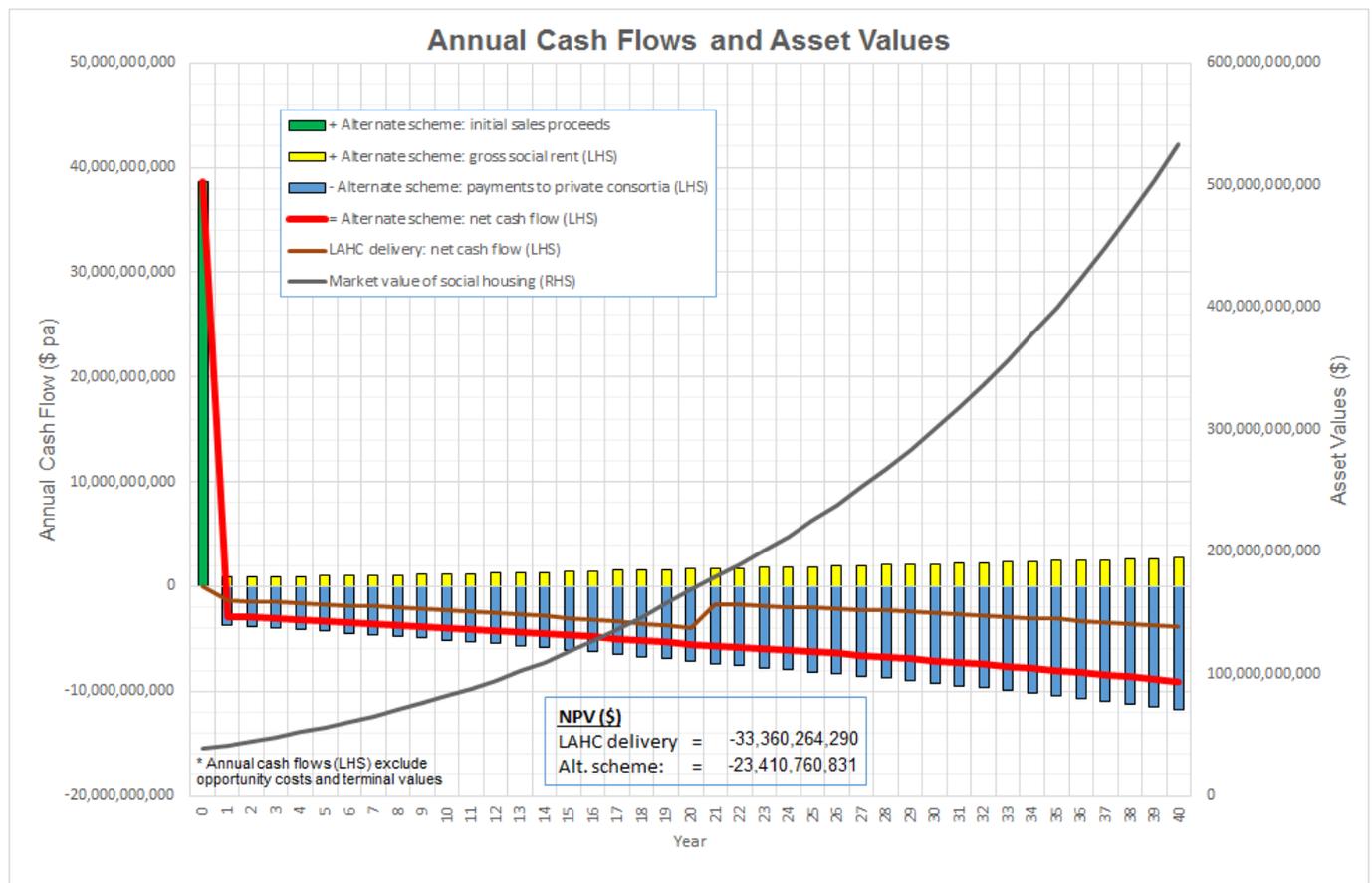
However, the resulting structure would still leave significant value-for-money on the table. Here, in outline, is an alternate approach that would optimise value-for-money:

- As discussed at section 4.2.3, the existing 126,000 social dwellings would be sold at market value to consortia consisting of institutional investors and CHPs - in (say) 20 lots.<sup>52</sup> Each lot would have a current market value of slightly less than \$2 billion. All sales would occur at the same time as part of one process<sup>53</sup>
- The government would expend the funds immediately on projects/initiatives with high benefit/cost ratios (or rebate the funds to taxpayers)
- The consortia would acquire an additional 31,000 social housing dwellings over the initial 20 years to bring total social housing to 157,000 as per the IPA scheme. These properties could be purchased, or developed or leased against a government output

specification (principally in relation to location, number of bedrooms and other key outputs)

- The government would pay the consortia an availability payment, with payment linked to key performance indicators relating to provision of tenancy management, asset management and support services, in the same way as contemplated for the IPA scheme (and other schemes including the SAHF and the Bonnyrigg PPP)
- The government could adjust the portfolio (and other service elements) across time in response to changing need via change mechanisms in the contracts with the consortia
- At the end of a nominated period, say 40 years, the consortia would transfer ownership of the properties to the government at nil cost and in specified good order. The government would then be free to re-sell the portfolio under a new contract or to resume in-house operations.

FIGURE 4 - CONCESSION AGREEMENT



<sup>52</sup> It is not necessary that freehold title be sold. A leasehold interest would be sufficient. However, the value of the sale should reflect the market value of the social housing to ensure that risks and incentives are aligned to the economic scale of the underlying asset. Drawing a parallel to regulated assets, if the concession was a regulated asset, then the market value of the housing portfolio would be the appropriate "regulated asset base" value.

<sup>53</sup> The transaction outlined here is, as noted at section 4.2.3, a stylised modelling assumption. The transaction would, in reality, need to be subject to significant market engagement and perhaps staged over a small number of years (five, for example).

(cont'd next page)

**Figure 4** shows the cash flows associated with this alternate approach.<sup>54</sup> While the annual cash out-flows are higher for the alternate concession agreement, the circa \$38 billion inflow of sales proceeds (being the market value of the social housing portfolio, which is available for investment elsewhere) takes the concession agreement to a superior financial outcome. In net present value terms the alternate concession agreement costs the government \$23.4 billion, compared to \$55.6 billion for the IPA scheme and \$33.3 billion for LAHC delivery.

The consortia would, in effect, be purchasing concessions to provide social housing services to the government with the scope of service encompassing the provision of housing, tenancy management and wrap around support and the taxpayer reaping the private sector efficiencies. This is the financial, economic and government affordability equivalent of recycling any other government infrastructure asset, such as a port or an electricity transmission network. The risk taken by the consortia, relative to the IPA scheme, would be low, being largely devoid of property market risk. The return required by the consortia could, as a result, also be expected to be low relative to the IPA scheme. Further, the property market risk is not one that the private sector can manage any better than can the government. As such, there is no value to be added by transferring that risk to the private sector. On the contrary, if the risk is transferred then the government would pay a price for the private sector to absorb the risk - the government would be paying for risk management but would simply crystallise the value of the risk.

## 6. CONCLUDING REMARKS

The IPA report advocates the sale of the Australian social housing portfolio to private owners, with the sales proceeds invested in the IPA Fund and the investment returns used to lease replacement and additional social housing from the private market.

Shepherd Shaw's analysis does not oppose the sale. As stated in section 4.1, such a sale can be expected to be beneficial to the extent that:

- It mobilises/drives private sector efficiencies (in cost and in outcomes)

- The ongoing operation of the - then more efficient - social housing system is appropriately funded
- The sales proceeds are invested in government projects/initiatives with high economic benefit/cost ratios.

Shepherd Shaw's analysis does, however, cast doubt on the wisdom of placing reliance on the IPA Fund and on the sustainability of the investment returns that can be generated by that fund. Shepherd Shaw's modelling indicates about a 45% probability that, in NSW, the existing \$38 billion endowment (i.e. the market value of the existing NSW social housing stock) could be exhausted within 40 years via the IPA Fund. If this analysis is accepted, then the IPA scheme is not a prudent source of the funding required to stabilise the social housing waiting list or to otherwise provide funding for the social housing system. This analysis suggests that the IPA Fund is a mirage, distracting attention from the core underfunding issue, thereby delaying substantive action and potentially leaving the system in a worse position in the long term.

An alternate concession agreement approach was outlined (at section 5.3) that would achieve the same housing outcomes as the IPA scheme but would eliminate the IPA Fund. Instead, the sales proceeds would be immediately deployed into government projects/initiatives having high benefit/cost ratios, with ongoing concession payments to the consortia funded conventionally and the taxpayer reaping the private sector efficiencies. This is the financial, economic and government affordability equivalent of recycling any other government infrastructure asset, such as a port or an electricity transmission network. After a defined period (say 40 years), the social housing would be transferred to the government, at nil cost and in good order. The concession agreement approach would optimise the value-for-money outcomes from private sector involvement and offer very good value-for-money compared to both LAHC delivery and the IPA scheme.

However, while the IPA scheme does not appear to offer a prudent funding solution, the alternate concession agreement approach is certainly not self-funding. There appears to be no escaping the unfortunate reality that stabilising the waiting list will require large amounts of taxpayer funding. The broad numbers from Shepherd Shaw's modelling are as follows:

<sup>54</sup> **Figure 4** assumes that:

- a) The private sector is able to extract capital and operating cost efficiencies of circa 30%. The private sector should also be able to extract these efficiencies under the IPA scheme. However, because of the procurement structure for the IPA scheme, the efficiencies will remain with the private sector rather than be reflected in a lower concession payment
- b) The private sector requires the same return as an investor in residential rental housing (assumed, in this Occasional Paper, to be 7.11% pa nominal, pre-debt and pre-tax). Given that the risk

to the private sector has been reduced (by eliminating most exposure to the property market) further savings may be achievable. However, these savings have not been brought to account so as to compensate for the possibility that institutional investors may require a premium for lack of liquidity

- c) There are no risk transfer benefits for the government. In reality, risk would be transferred and so additional benefits will accrue to the government. These benefits will also accrue to government under the IPA scheme.

(cont'd next page)

- If only the current level of government funding is provided, then running the NSW public housing system will cost taxpayers circa \$18 billion (in real \$ terms) over the next 40 years (approximately \$0.43 billion pa). However, at this level of funding, the public housing can be expected to run down at an increasing rate: poorer quality dwellings, fewer dwellings, poorer services, escalating waiting lists, escalating levels of homelessness, escalating social issues, escalating social expenditures by sister agencies (e.g. health, justice, child protection, employment, etc.), escalating affordability pressures on the private stock, etc.<sup>55</sup>
- If sufficient funding is provided to sustain the NSW public housing system at its current size (i.e. the current number of public housing properties does not decline and those properties are maintained, refurbished, upgraded and replaced as necessary to sustain good condition) then the public housing system will cost taxpayers circa \$33 billion (in real \$ terms) over the next 40 years (approximately \$0.83 billion pa). However, at this level of funding, it can be expected that services will still decline - escalating waiting lists, escalating levels of homelessness, escalating social issues, escalating social expenditures by sister agencies (e.g. health, justice, child protection, employment, etc.), escalating affordability pressures on the private stock, etc.
- In contrast, if the waiting list is to be stabilised (by leasing about an additional 28,000 social housing dwellings) and the system is properly sustained (i.e. properties are maintained, refurbished, upgraded and replaced as necessary to sustain good condition) then the public housing system will cost taxpayers circa \$61 billion (in real \$ terms) over the next 40 years (approximately \$1.5 billion pa).

In each case, procurement via the alternate concession agreement approach could be expected to produce better value-for-money outcomes than LAHC delivery or the IPA scheme.

However, stabilising the social housing system - regardless of how that stabilisation is procured - will not magically fund itself. Interposing a government guaranteed financial intermediary will not produce the funding required. Development activity alone will not produce the funding required. Efficiency measures alone will not produce the funding required. Nor will any other approach that seeks to magically create the required funding.

We as policy makers and practitioners can - ad infinitum - create financial guarantees, establish financial intermediaries, dream up wild money making schemes (that would actually diminish taxpayer assets), and other such mechanisms.<sup>56</sup> However, the reality is that, until governments provide additional funding, no increase in the overall quantity or quality of social housing will be achievable.<sup>57</sup> Whether that funding is provided directly (through its agencies) or indirectly (via the private sector as revenue or grants or tax concessions, as may be required to service/repay any debt and equity financing) is immaterial except that the indirect route can be expected to offer better value-for-money due to private sector efficiencies.

In the absence of any additional funding, what options are available to governments? Firstly, governments should continue to seek efficiencies and to maximise the value extracted through redevelopment. Governments should also, to the greatest extent possible, transfer the existing stock to CHPs.<sup>58</sup> However, given the likely limits of efficiency and redevelopment gains and the Commonwealth's likely low tolerance of increased CRA payments<sup>59</sup>, governments may well need to scale back

<sup>55</sup> This situation will persist notwithstanding efforts by LAHC to realise net revenue from high value sites or from sites with development potential - as these situations are very unlikely to be sufficiently numerous or remunerative to enable closure of the funding gap.

<sup>56</sup> This is not to suggest that government guaranteed financial intermediaries and such like cannot enhance value-for-money or that government guarantees in general are never efficacious. The government can obviously make a project or business feasible for the private sector by absorbing some (or all) of the risk. But the place of a guarantee is generally limited and at the margin. It cannot provide the revenue stream that underpins a project or business.

<sup>57</sup> One possible exception is social housing provided by philanthropists. However, such dwellings are unlikely to be available in sufficient volumes.

<sup>58</sup> If there is any possibility that significant additional funding might be made available then, given the potential of the alternate concession agreement approach to produce better value for money, it would probably be better that transfers be reversible. This would allow the government to then run a rigorous procurement process to maximise value-for-money. This reversibility could be achieved with, for example, appropriate "termination for convenience" clauses in leasehold transfers or, for freehold transfers, side deeds dealing with nil cost buy-back arrangements. These arrangements would, plainly, be structured to keep the CHPs whole in the event.

<sup>59</sup> When a social housing tenant moves from having a State housing agency as landlord to having a CHP or other private entity as landlord, the tenant probably becomes eligible for CRA. As a result, the Commonwealth is unlikely to tolerate uncontrolled transfers of existing stock to CHPs due to the increased cost for the Commonwealth. However, such transfers would probably largely solve the underfunding issue for the existing stock. CRA paid was \$3127 per "income unit" in 2014/15 (source: Productivity Commission "Report on Government Services" - an "income unit" is closely analogous to a household). A CHP could probably, at this level of CRA, sustainably fund the average social housing dwelling (and generate a profit margin) if:

- a) The stock was transferred from the State housing agency for nil consideration and without a significant maintenance backlog
- b) The CHP was in receipt of social housing rent plus CRA (a situation that can be achieved if the CHP is the landlord)
- c) The CHP received the benefit of the various tax concessions available to CHPs (particularly with respect to GST)
- d) The CHP was able to extract efficiencies relative to LAHC delivery (although these efficiencies would need to steadily increase over time if costs rise faster than revenue - as assumed in this Occasional Paper - which undermines the sustainability).

However, there are a range of other caveats that make for uncertainty. For example, the amount of CRA paid is linked to market rent and is subject to both a floor and a ceiling, so properties in low rent areas and large properties (for example) might still present challenges. If the  
*(cont'd next page)*

their social housing portfolios to a financially sustainable size.

The NSW Auditor-General reported current underfunding of circa \$330 million pa (about \$2,500 per property pa) - in addition to the existing maintenance backlog of circa \$300 million (as separately estimated by the NSW government). This suggests, as an indication, that if funding were held constant, a sustainable NSW portfolio would consist of circa 99,000 dwellings.<sup>60</sup>

Currently, in NSW, the required scale back, or “shrinkage”, appears to be happening via a process of natural attrition as dwellings fall out of service and/or are sold and not replaced. If funding is held constant then the shrinkage process might be expected to eventually stabilise after about 27 years<sup>61</sup>, although probably at a lower level due to the inherently inefficient shrinkage process. An orderly process would be preferable.

This “shrinkage” option is hardly attractive. From a purely economic perspective the outcome would be sub-optimal with high and escalating: waiting lists; levels of homelessness; social issues; social expenditures by sister agencies (e.g. health, justice, child protection, employment, etc.); etc. Looked at in human terms it would be appalling.

How then to raise additional funds? If Shepherd Shaw’s modelling is accepted, then the IPA Fund is not the solution.

Unfortunately, this is one of those situations where taxpayers are going to have to cough up.

It is, after all, hardly unusual for government to impose additional taxes in pursuit of a good cause. These additional taxes are particularly attractive when they can

be imposed as user charges (e.g. tolls on roads, water charges, port charges, etc.), levies or surcharges (e.g. developer charges/levies such as Section 94 and Special Infrastructure Contributions in NSW, the Medibank levy, etc.), because the use of such taxes can be readily explained to a sceptical public.

The Greater Sydney Commission has recently revealed an inclusionary zoning initiative for affordable housing. An inclusionary zoning arrangement targeted at social housing would be a logical extension - one which would further promote the development of healthily mixed income communities and otherwise add great economic value. For example, SGS Economics recently published a paper that reported a very strong economic benefit/cost ratio of 7.4:1 for an inclusionary zoning scheme targeted at social housing.<sup>62</sup>

There are, of course, other options. For example, governments could also consider a broad-based land tax surcharge with the proceeds hypothecated to social housing. The important point is that, if the community wants to grow - or even just maintain - its social housing portfolio then additional tax funding will be required and mechanisms are readily available to efficiently raise that additional tax funding.<sup>63</sup>

Let us not continue to fall victim to magical/wishful thinking. The IPA report is an excellent contribution to the rational discussion and decision making that is desperately required. Hopefully this Occasional Paper will also make a positive contribution.

Now let’s stop the procrastination, bite the bullet and get it done.

## Mark Shepherd

Principal

Mobile: + 61 421 618 238

Email: [mshepherd@shepherdshaw.com.au](mailto:mshepherd@shepherdshaw.com.au)

Web: [www.shepherdshaw.com.au](http://www.shepherdshaw.com.au)

---

transfer was packaged with funding for works (e.g. to address the backlog maintenance) then the government could optimise value for money via the concession agreement approach.

<sup>60</sup> The sustainable number of dwellings would, in reality, be smaller because some system costs are fixed.

<sup>61</sup> Assumes an average market value of about \$300,000 per dwelling.

<sup>62</sup> Source: “Revisiting the Economics of Inclusionary Zoning”, SGS Economics and Planning, Occasional Paper, April 2015.

<sup>63</sup> Further consideration is required for all these potential sources of funding relative to the Commonwealth Grants Commission formula for distributing GST between the States.