

Executive

Date: 5 November 2001
Report of: Executive Director, Housing and Executive Director, Corporate Services
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Position: PFI Project Leader and Principal Accountant
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Title:

Private Finance Initiative within the Housing Revenue Account

Purpose of the report

The purpose of this report is to inform Members of progress on the Housing Revenue Account Private Finance Initiative scheme to improve sheltered housing and to seek approval for submission of the Outline Business Case

The Executive is recommended to

- I) Approve the Outline Business Case for the Sheltered Housing Improvement Scheme, which has already been circulated.
- II) Note the affordability analysis and impact on the HRA and approve the approach outlined in paragraph 3.4

- III) Approve continued development of options for working with Rochdale Council and in principle a joint scheme with Rochdale Council.
- IV) Agree to begin the process of selecting financial and legal consultants for the procurement process

Environmental Implications:

The project will attract substantial investment to improve the Council's sheltered stock. This will include some resources to improve the immediate environment to sheltered schemes and the boundary treatment of bungalows.

Crime and Disorder Implications

The project will include resources to improve call entry systems, alarm call systems and other works to improve the security of sheltered housing.

1 Background

- 1.1 In March 2001 the Department of Transport, Local Government & the Regions (DTLR) informed the Council of the success of its bid (expression of interest) for the 2nd round of HRA PFI schemes. The DTLR invited the Council to proceed to the next stage of the bidding process, which is to work up an outline business case for consideration by the Government's inter-departmental Project Review Group (PRG). It is proposed to seek approval from the PRG on 10 December 2001, with a submission of the outline business case on 5 November 2001.
- 1.2 The scheme will renovate and improve 1746 Council sheltered housing properties bringing them up to modern standards and carrying out a range of improvements.
- 1.3 The outline business case has been prepared by a project team comprising officers from the Housing Department and Corporate Services Department. Consultants PriceWaterhouseCoopers (PWC) have been appointed to provide financial advice. Support has also been received from the LGA's Public Private Partnership Programme (the 4Ps) and Partnerships UK.

2 Outline Business Case

- 2.1 Local authority PFI schemes that require revenue support from Government must obtain approval from the Government's Project Review Group (PRG). The Council requires additional housing subsidy for the capital element of the scheme. The existing management and maintenance allowance within the HRA will fund that part of the payment to the operator that finances the running cost. The outline business case acts as an application for approval for these additional resources. It explains why PFI is the preferred option and shows that PFI will provide better value for money compared to other options.
- 2.2 The outline business case sets out the Council's proposals for the PFI scheme. It consists of
 - A demonstration of the need for the project including how it relates to the authorities wider plans
 - A clear statement of service objectives and outputs sought

- An option appraisal comparing PFI with renovating the stock through other routes (such as transfer) and retaining the stock unimproved
- Indicative costs of the project
- An indication of the affordability of the project to the Council
- A proposed allocation of risk between the Council and the PFI operator that ensures appropriate risk is borne by each party
- A clear plan for the management of the project

2.3 The PFI credits will fund a range of capital work including:-

- conversion of existing bedsit accommodation into self contained units
- creating more two bed units by conversions of pairs of one bedroom flats
- modifications to increase mobility including level access showers and mobility kitchens
- kitchen extensions to a number of bungalows
- improvements to specific schemes to make them suitable for extra care sheltered housing e.g. catering kitchens, office accommodation for care staff
- re-wiring incorporating new technology (this allows smart technology like bath monitors, cooker monitors & night time guidance to be fitted where need arises)
- environmental and security works and boundary treatment
- installation of lifts to upper floors where these do not already exist
- replacement of call entry and warden call systems that are reaching the end of their natural life
- replacement of lifts that are reaching the end of their natural life
- replacement of heating systems that are reaching the end of their natural life
- replacement of doors and windows to certain properties
- various other works

3 **Financial Analysis and Impact on the Housing Revenue Account**

- 3.1 Under a PFI contract the Council will pay the PFI provider a unitary charge from the HRA. This charge will combine the capital and revenue elements of the scheme. The theory is that the capital elements will be funded from the additional Housing Subsidy (arising from the PFI credits) and the revenue elements will be funded from existing management and maintenance allowances.
- 3.2 Our financial consultants PriceWaterhouseCooper have developed a financial model which estimates potential providers' tender prices and models expected income and expenditure. As a result of this exercise there is a clear understanding of how a contractor builds up a bid and what the impact of that tender would be on the Council. It should be noted that the Outline Business case submission is only a detailed estimate of the costs of the project. Tenders which are finally submitted could be very different. Nevertheless the estimates have been prepared with PriceWaterhouseCooper who have extensive experience of working for bidders as well as Council and Government departments on PFI projects.

- 3.3 The financial model assesses the unitary payment the operator will require over the 30 year life of the contract. The PFI credit which the local authority receives is calculated by taking that proportion of the total costs that relates to the capital elements of the contract.
- 3.4 There are some differences between the DTLR's standard model and the PriceWaterhouseCooper model in the way they assess the need for PFI credit and the affordability for the Council. The DTLR's model suggests that the Council will require a PFI credit of £51 million. However this figure will not create the level of subsidy needed to make the project affordable to the Council. This view is shared by the Director of Corporate Services and our financial advisors PricewaterhouseCooper. A minimum level of credit that would make the scheme affordable would be £58 million. Even at this level the Council would have to make savings of £1.6 million per annum (see 3.5 below). We have advised the DTLR of the affordability issue. They have suggested that we make our submission on the basis of the level of credit we require and supply background data to justify this. A meeting between the Council and the DTLR will take place to negotiate a settlement acceptable to both parties prior to the Project Review Group. We will report back to the Executive following this meeting.
- 3.5 The Council will have to fund the revenue element of the charge from existing management and maintenance allowances. The Council will therefore need to make savings from ceasing to manage and maintain the properties that are equivalent to these. Based on current management and maintenance allowances this amounts to £923 per property per annum – a total of £1.6 million per annum.
- 3.6 Procurement costs for a Housing Revenue Account PFI are typically in the region of £700,000. Our financial advisors have indicated that we are likely to be able to reduce these to £500,000 as a result of entering into a joint contract with Rochdale MBC. Provision has been made in the Housing Revenue Account for this sum following a report to Housing Committee on 14 June 2001. Procurement costs include external technical, financial and legal advice. Internal costs are mainly salary costs already included in existing budgets following Personnel Committee approval of the establishment of a project team to implement the project.

4 Contract “Bundling”

- 4.1 Rochdale Council are also pursuing a proposal for PFI in the Housing Revenue Account. In order to take advantage of the benefits of close working in pooling certain costs and in sharing expertise we have appointed joint financial consultants to advise us up to the Outline Business Case stage. Indications are that some form of joint procurement of the contract would bring substantially greater savings.

- 4.2 There are likely to be considerable advantages in bundling the two projects into a single contract so as to reduce the transaction costs to the local authorities of the procurement process, maximise market interest and reduce the cost to bidders.
- 4.3 The factors that will be critical in deciding whether a joint contract goes ahead will be:
- Firm evidence of prospective cost savings to both authorities in having a single contract – providers will include their bidding costs, which are substantial, in their bids and therefore a joint contract should roughly halve bidding costs
 - Firm evidence from market testing that a joint contract will be more attractive to the market – competition is vital to ensuring value for money
 - A clear method of disaggregating operators' costs between the two authorities
 - Confidence that we can establish contract monitoring arrangements that protect the interests of both local authorities
- 4.4 PriceWaterhouseCoopers, our financial advisors, have suggested savings on procurement costs will be in the region of 25% to 33% as a result of having a joint contract.
- 4.5 In addition to the reduction in procurement costs to the two local authorities a single contract is likely to be more economical for potential bidders. The Council's advisers, PriceWaterhouseCoopers, have estimated that the PFI provider would save £195,000 on their procurement costs. In addition they estimate that modest efficiency savings of 2.5% on management and maintenance costs could be achieved. These estimated savings should be reflected in lower bids. A soft market testing event has confirmed our expectation that a single contract would be more attractive to potential bidders. We will continue to canvass the views of potential bidders.
- 4.6 The Project Review Group will approve Oldham's Outline Business case in its own right so the Council will have the opportunity to confirm that it wants to pursue the joint procurement approach once we have the full evidence of market testing and the benefit of specialist legal advice.

5 Staffing Implications

- 5.1 Under the contract the Council would no longer manage and maintain the properties within the contract. The number of properties in the contract is equivalent to four estate management officer patches. The stock is spread over the Borough and so does not impact

significantly on any one officer's workload. However in order for there not to be a negative impact on the HRA we have to realise savings from ceasing to manage and maintain these properties. Current staff turnover and continuing management of recruitment will enable appropriate staff reductions to be achieved.

- 5.2 A little under half of the tenants who receive a door to door rent collection service are included within the PFI contract. The contract will specify that a rent collection service will be provided. There are two staff employed as rent collectors and it is likely that one member of staff would be entitled to transfer to the PFI operator under TUPE regulations.
- 5.3 The Council will continue to provide the warden service and the helpline service to the properties.
- 5.4 Based on recent years' expenditure, the repairs ordered from Building Services would reduce by £600,000. The spread of stock means that no staff would be entitled to transfer to the PFI operator under TUPE regulations, however it is possible that the successful bidder will want to enter a voluntary agreement to take on building operatives.

6 Tenant Consultation

- 6.1 Consultation sessions have now been held at 32 schemes/ groups of properties. A total of 679 of the 1666 tenants in these schemes attended the meetings i.e. 40%. The meetings identified the major investment priorities of tenants, their views on the existing service and explained the process. Tenants were strongly supportive of the proposals and individuals have been identified to become more involved in a smaller group working on more detail. A full report on tenant consultation is included in the Outline Business Case document.

7 Timetable

- 7.1 The DTLR have advised that a timetable allowing two years between the Project Review Group approval and contract signature would be considered generous. However they have also indicated that they will expect this round of pathfinders to keep to the timetable published in the Outline Business Case.

7.2 The Council will be very keen that the procurement process should be completed as soon as possible both to minimise procurement costs and to ensure that our tenants begin to see the benefits of the contract as early as possible. The timetable indicates a period of 21 months between PRG approval and contract signature i.e. a contract signature in September 2003.

8 Financial and Legal Consultants

8.1 The Council will require the support of financial and legal consultants throughout the procurement phase.

8.2 The role of financial advisors would include:-

- advising on bid documentation
- advising on payment structures
- assistance reviewing bids
- advice during negotiations

8.3 The role of legal advisors would include:-

- advising on contractual issues in bid documentation
- contractual terms and conditions
- assistance in negotiations with bidders
- drafting and settling final contracts
- other more general advice

8.4 The costs of financial advice is estimated to be up to £125,000. The costs of legal advice is estimated to be up to £95,000. The selection and appointment of consultants will be through open tender. In order to ensure that there is not a significant delay between PRG approval and the appointment of consultants it is proposed to begin the selection process as soon as possible.

9 Treasurers Comments

AFFORDABILITY

- 9.1 This report highlights in para. 3.4 the crucial issue of the affordability of the PFI project. On the basis of the final figures produced by the DTLR model the HRA will be unable to meet the payments to the contractor throughout the 30 year contract, unless drastic and severe cuts are made in other HRA budget areas.
- 9.2 The details are given in appendix 1. This shows that, even if savings of £1.6m p.a. are made in management and maintenance, by year 21 there is an annual deficit which will rise to £3.6m by the end of the contract.
- 9.3 The HRA accounting rules do not permit the account to be in deficit. Income must match expenditure. If a crisis around year 21 of the contract is to be avoided then savings, not of £1.6m, but of almost £2m p.a. need to be made from year 1. These savings would accrue and earn interest during the early years of the contract and be available from year 21 to meet the predicted deficit thereafter. £2m of cuts equates to 10% of controllable HRA costs. This level of saving is unlikely to be achieved unless a significant part of the RFCO provision is removed.
- 9.4 The only other way in which the affordability problem would be removed is if the PFI credit were increased from £51m to nearer £58m. The report makes clear that this issue will be pressed with the DTLR
- 9.5 A similar issue confronts our potential partner, Rochdale. However their problems are much smaller (i.e. they are required to make easily achievable savings of around £0.3m p.a. in management and maintenance plus further cuts of around £100k p.a. from year 1). Notwithstanding the more modest size of these problems Rochdale are reviewing whether the scheme should proceed.
- 9.6 A further issue is that the Major Repairs Allowance of £523 per property p.a. ceases when properties are transferred to the PFI contractor. In total this will reduce capital resources by £0.9m p.a.. If RFCO resources were also cut to balance the books, for instance by £0.4m the total loss is £1.3m p.a.. In purely capital terms therefore the PFI option affords investment of £34.9m in five years, but might cost £6.5m in lost capital resources in the same period.

OTHER ISSUES

- 9.7 The Outline Business Case includes a VFM appraisal. The following table shows the costs assumed for the options of PFI refurbishment, Transfer, or LA refurbishment:

	LA Refurbishment	Transfer	PFI
Initial capital expenditure (per dwelling)	£25,180	£24,084	£22,045
Total capital investment (1582 dwellings)	£39.8m	£38.1m	£34.9m
Maintenance per dwelling p.a.	£353	£349	£339

- 9.8 These figures have to be interpreted with care. They are driven by the assumption that the PFI contractor, subject to competitive and market pressures and with his own profits at risk, will be more efficient. This efficiency will, it is assumed, also be enhanced by the splitting of risk in a PFI contract. It is also argued that the PFI contractor will, by incorporating life cycle costing in his bid, achieve best value for money.
- 9.9 The figures result in the PFI option passing the “value for money” test.
- 9.10 The cost of funding a PFI scheme will undoubtedly be in excess of that for a LA scheme. Currently LA’s borrow funds at around 5%. The PFI scheme will be funded 90% by bank borrowings (assumed to cost around 7%) and 10% by equity (.i.e. the contractor will invest his own money in the project. It is assumed he will require an index linked return of 13%). Furthermore the bank will insist on certain margins being built into the financing. The profits of the company are also subject to taxation. The DTLR model does not allow for these extra costs. However they have been accounted for in the affordability analysis in appendix 1
- 9.11 The OBC assumes that the initial costs of the contractor will be £1m for the transfer option, and £0.8m for PFI. These costs do not include OMBC initial costs estimated to be in the range £0.5m - £0.8m

LIFECYCLE COSTING

- 9.12 Profiles have been built of the cycles of necessary repairs to the major components of the properties. Provision has been made within the costings for these works to be undertaken. These costs are included in the calculation of the PFI credit.

BUNDLING THE CONTRACT WITH THAT TO BE LET BY ROCHDALE

- 9.13 Bundling almost certainly will offer economies in the up-front costs (e.g. legal costs in preparing one contract instead of two). It is also thought that the larger contract will be attractive to bidders and thus increase competition. On the other hand management of the contract will become more complicated and must not be seen to be more onerous to a potential bidder. The key issues are addressed in para. 4.3. At this stage there is no firm commitment to bundling, it is simply being explored to see if it offers the potential for benefit.

CONCLUSION

- 9.14 It is intended that the Council will bid for the PFI credit it needs rather than that suggested by the DTLR's model. When the outcome of that bid is known a decision must be taken whether to proceed to the next step of the PFI process.

10 The Executive is recommended to

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11 Background Papers

11.1 The following is a list of the background papers on which this report is based in accordance with the requirements of section 100d(1) of the Local Government Act 1972. It does not include documents which would disclose exempt or confidential information as defined by that Act.

1. Outline Business case for sheltered Housing PFI in Oldham.
2. Public Private Partnership Programme - Option Appraisal and the Outline Business Case
3. HM Treasury - A Step by Step Guide to the PFI Procurement Process

Appendix 1

Year comm	Year No.	PFI charge payable to contractor	Assumed CRI	Add'n subsidy Principal	Add'n subsidy interest	Additional subsidy from PFI Credit of	Estimated mgmt and mtc savings	Difference - annual (surplus) or deficit	Interest on accumulated surplus @ 5%	Cumulative surplus or (deficit)
		£'000				PFI Credit £51,354,000	£'000	£'000	£'000	£'000
01-Apr-03	1	1969	0.084	-1027	-4314	-5341	-1600	-4972	-124	-5096
01-Apr-04	2	3803	0.084	-1007	-4227	-5234	-1640	-3071	-332	-8499
01-Apr-05	3	4499	0.085	-986	-4192	-5178	-1681	-2360	-484	-11343
01-Apr-06	4	5241	0.085	-967	-4108	-5075	-1723	-1557	-606	-13506
01-Apr-07	5	6035	0.085	-947	-4026	-4973	-1766	-704	-693	-14903
01-Apr-08	6	6934	0.084	-928	-3899	-4827	-1810	297	-738	-15344
01-Apr-09	7	7006	0.08	-910	-3639	-4549	-1855	602	-752	-15494
01-Apr-10	8	7080	0.08	-892	-3567	-4459	-1901	720	-757	-15531
01-Apr-11	9	7157	0.08	-874	-3495	-4369	-1949	839	-756	-15448
01-Apr-12	10	7236	0.08	-856	-3425	-4281	-1998	957	-748	-15239
01-Apr-13	11	7317	0.075	-839	-3147	-3986	-2048	1283	-730	-14686
01-Apr-14	12	7402	0.075	-822	-3084	-3906	-2099	1397	-699	-13988
01-Apr-15	13	7489	0.075	-806	-3022	-3828	-2151	1510	-662	-13140
01-Apr-16	14	7579	0.075	-790	-2962	-3752	-2205	1622	-616	-12134
01-Apr-17	15	7571	0.075	-774	-2903	-3677	-2260	1634	-566	-11066
01-Apr-18	16	7767	0.07	-759	-2655	-3414	-2317	2036	-502	-9532
01-Apr-19	17	7866	0.07	-743	-2602	-3345	-2375	2146	-423	-7809
01-Apr-20	18	7968	0.07	-729	-2550	-3279	-2434	2255	-334	-5888
01-Apr-21	19	8072	0.07	-714	-2499	-3213	-2495	2364	-235	-3759
01-Apr-22	20	8181	0.07	-700	-2449	-3149	-2557	2475	-126	-1410
01-Apr-23	21	8294	0.07	-686	-2400	-3086	-2621	2587	-6	1171
01-Apr-24	22	8409	0.07	-672	-2352	-3024	-2687	2698	126	3995
01-Apr-25	23	8529	0.07	-659	-2305	-2964	-2754	2811	270	7076

01-Apr-26	24	8652	0.07	-645	-2259	-2904	-2823	2925	427	10428
01-Apr-27	25	8779	0.07	-632	-2214	-2846	-2894	3039	597	14064
01-Apr-28	26	8911	0.07	-620	-2169	-2789	-2966	3156	782	18002
01-Apr-29	27	9047	0.07	-607	-2126	-2733	-3040	3274	982	22258
01-Apr-30	28	9148	0.07	-595	-2083	-2678	-3116	3354	1197	26809
01-Apr-31	29	9291	0.07	-583	-2042	-2625	-3194	3472	1427	31708
01-Apr-32	30	9439	0.07	-572	-2001	-2573	-3274	3592	1675	36975
		222671				-112057	-70233	40381	-3406	-51329