

## **Briefing Paper**

### **PRIVATE FINANCE INITIATIVE**

**Adrian Waite – July 2004**

#### **Introduction**

A Private Finance Initiative scheme involves the private sector financing and managing public services. A key element in this is the transfer of risk to the private sector.

Sustainable communities need decent homes – homes that are warm, dry and have modern facilities. In 1999, eight local authorities were chosen to pioneer the housing Private Finance Initiative scheme as pathfinders. In 2001 a second round was launched, and an additional nine schemes are progressing through procurement. Two pathfinder schemes, in Islington and Manchester, have now signed contracts with private sector consortia for the management and refurbishment of around 3,000 homes. More schemes are due to sign during 2004.

In housing Private Finance Initiative the local authority retains ownership of the stock and the tenants retain their secure tenancies. A consortium of private sector firms (usually consisting of a bank, a housing association and a building contractor) raise capital to refurbish homes under a contract negotiated with the local authority. The consortium then provides repairs, maintenance and a range of housing management services to the stock as part of a thirty year contract and is paid on a performance basis.

The Office of the Deputy Prime Minister see housing Private Finance Initiative schemes as providing opportunity to ensure that decent homes are set in a sustainable community. The current projects range from remodelling and regeneration of estates, to solutions for tower blocks and street properties. There is also scope for authorities to propose joined up schemes tackling a wider range of issues, for example supported housing or affordable housing in high demand areas.

There have been only two Private Finance Initiative schemes in housing. Those that have taken place have related to a part of the stock where a specific investment need has been identified. In these instances the Council has contracted with the private sector partner to carry out the necessary capital investment and then to manage the stock on behalf of the council for a specified period. The Council retains ownership of the stock and the tenants continue to be council tenants with the council setting the rent. The contractor manages the stock and collects the rent and is paid a management fee to cover the ongoing expenses and the initial capital outlay on repairs, modernisations and improvements.

## **The Characteristics of a PFI scheme**

The characteristics of a Private Finance Initiative scheme are:

- ❖ The local authority is in control and specifies the service to be provided in terms of outputs.
- ❖ The scheme must contribute to strategic goals and meet defined housing needs.
- ❖ Strict value for money tests are applied by making comparisons with alternative means of investment.
- ❖ It must transfer a sizeable degree of risk to the private sector.
- ❖ Subsidy payments are made on an annual basis from revenue. This contrasts with the more traditional way of subsidising new housing by means of an up front capital subsidy.
- ❖ At least part of the payments must be related to performance and be highly geared.

The 'Private Finance Initiative' works on the principle that the contractor recoups up-front refurbishment costs by providing services to the public body over a 25 to thirty year period.

Risk is transferred in a number of ways. A scheme usually involves a number of private partners - a landlord, builder, designer and a funder. The organisations involved decide how to provide the service, meet the contract terms and what subsidy is required. The bidder is taking a risk in the investment of capital, completing the project on time and management and maintenance of the facilities.

The local authority needs to lease the properties to the private sector partners at the start of the contract. This is usually for a peppercorn rent. Apart from that the local authority specifies its requirements and meets the cost of any subsidy required after considering competitive tenders. Payment needs to be partly based on performance.

## **The Annual Programme**

The Comprehensive Spending Review of July 2000 increased funding for Private Finance Initiative schemes with £300million in 2002/2003 and another £300million in 2003/2004. Bids for Private Finance Initiative schemes are invited on an annual basis. In December, the government announces the criteria that it will use to evaluate Councils' bids. The deadline for submission of outline proposals is usually in February. Where outline proposals are approved, Councils have to submit fully developed proposals to a Project Review Group in the summer.

The outline proposals need to include:

- ❖ Basic Information on the Project
- ❖ Preliminary Financial Analysis
- ❖ Managing long-term supply and demand
- ❖ Allocation of risk between public and private sectors
- ❖ Strategies for tenant consultation and participation

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Initial findings from the first round of pathfinder schemes suggest that the Private Finance Initiative works best for estate based renovation projects rather than for improvements.

The government has set a target of 90,000 dwellings to be refurbished under the Private Finance Initiative every year during the period up to 2012.

In August 2003 the government announced proposals that were designed to encourage use of the private finance initiative for housing. The subsidy regime currently links a council's level of entitlement to the average interest paid on outstanding borrowing, as a result of which subsidy varies with interest rate changes. The proposal is to change to using the 'general fund pool rate' that will deliver a fixed amount of subsidy each year called the 'private finance initiative allowance'.

At the same time negotiations are ongoing with the Office of the Deputy Prime Minister over the detail of their model that assesses value for money and the level of private finance initiative credit. Following consultation, these changes will be introduced retrospectively. It has also been agreed that the government will continue to pay the major repairs allowance up to the point of contract signature, so that authorities do not have an incentive to defer contract signature to the start of the financial year.

In September 2003 the government announced a third round of housing private finance initiatives worth £600million. The bidding guidance included a wider scope for the schemes and said that joined-up schemes would be welcome, including social services schemes, those with the aim of preventing social exclusion and creating more sustainable communities. At that point there were 26 private finance initiative schemes in procurement, although only two schemes – at Islington and Manchester – had been signed off in March 2003. Bids were due in December 2003 and bidders will be notified in March 2004. Earlier, the Government had announced that the PFI would no longer be used for projects under £20 million, most of which are undertaken by local authorities. The Government is encouraging local authorities to bid for larger schemes.

Provision needs to be made within the contract for failures by the local authority to perform. For example if the local authority has got the assessment of demand wrong which then leads to under-use of the assets then that is not the fault of the contractor.

The Office of the Deputy Prime Minister has been working on a number of technical and legislative issues to help reduce procurement time and streamline the housing Private Finance Initiative process. Earlier this year legislation was changed to allow local authorities to build new social housing as part of the Private Finance Initiative scheme. Subsidy delivery arrangements have also been reviewed. A procurement pack will be available to third round authorities early next year, which will help speed up the process.

## **Conclusions**

Costs are perceived to be high and Private Finance Initiative schemes will need to overcome the additional costs of capital and fees through cost efficiency. In the longer term the development of 'standard' contracts and perhaps joint procurement may lead to some reduction in the currently high level of overheads.

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The recent developments in the housing private finance initiative can be summarised as follows:

- New build can now be included as a part of the works
- The Private Finance Initiative is still aimed at the minority of the stock
- A New Options Appraisal Model has been delivered
- A new Procurement pack has been published

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