Manchester City Council
Report For Resolution

Report To: Executive - 22 July 2009

Subject: The Regeneration Of Collyhurst - Progress On The Private Finance Initiative Outline Business Case

Report Of: Director Of Housing, Deputy Chief Executive (Regeneration)

PURPOSE OF REPORT

To update Executive on the progress of securing approval for the Collyhurst Housing Revenue Account (HRA) Private Finance Initiative (PFI) Outline Business Case.

RECOMMENDATIONS

Executive is requested to:

1. Note the progress being made in securing approval for the Outline Business Cases (OBC) for the regeneration of Collyhurst using HRA PFI.

2. Note the indicative commitment from Communities and Local Government to provide PFI credit of £252m for Collyhurst.

3. Note the requirement from Communities and Local Government for local authorities to estimate potential cost increases in project procurement.

4. Note the updated cost and affordability position for the project and the financial implications of a number sensitivities which might impact on the affordability and confirm support for the way in which the affordability might be managed.

5. Confirm its commitment to fund the costs, as agreed by Executive in December 2006, which are not funded from the PFI credit (such as land acquisition and home loss and disturbance costs).

6. Agree that, should any affordability gap arise, the project will be supported through other mechanisms including housing capital receipts or through reviewing the project without impacting on value for money.

Wards Affected

Cheetham
Harpurhey
Miles Platting and Newton Heath

Community Strategy Spine	Summary of the contribution to the strategy
Performance of the economy of the region and sub region	The PFI scheme proposes to increase the population in Collyhurst by creating development opportunities for homes for sale alongside refurbished Council homes. The proposal is to create an identity and sense of place for Collyhurst and will make a positive contribution to the urban fabric of the City, utilising the Irk Valley and the area's location as a gateway to North Manchester.
Reaching full potential in education and employment	The PFI scheme will develop and co-ordinate the provision of first class services and amenities through the re-population of the area and influencing the provision of mainstream services. A significant number of jobs and training opportunities in the construction industry will be created.
Individual and collective self esteem – mutual respect	The PFI scheme will through excellence in design and neighbourhood management, reduce the incidence of crime and disorder and create safe and secure neighbourhoods.
Neighbourhoods of Choice	The PFI scheme will create socially integrated neighbourhoods by improving the choice, quality and mix of housing, providing modern homes for rent and sale, at a range of values, types and sizes retaining existing residents and attracting newcomers.

Full details are in the body of the report, along with any implications for:

- Equal Opportunities Policy
- Risk Management
- Legal Considerations

Financial Consequences For The Revenue Budget

The whole of the Maintenance Allowance and ninety percent of the Management Allowance which the Council will receive for each property will be used to assist in funding the project costs referred to in paragraphs 3.2 and 3.3.

The Payments to the PFI Contractor will be managed through a "Smoothing Reserve" which will receive the benefit of the Management and Maintenance Allowances plus the special PFI grant. This Reserve will earn interest when in surplus, but paragraph 2.3 identifies how this Reserve might be adversely affected by interest rate movements. Over the life of the contract any potential deficits on the Smoothing Reserve will need to be proactively managed to ensure that the Council retains sufficient resources to fulfil its contractual liabilities.

Financial Consequences For The Capital Budget

An estimated £25m from the capital budget will be required for land assembly, home loss and disturbance and other costs as identified in paragraph 3.1. The costs involved will need to be given priority from within capital resources available to support the Council's capital programme from 2012 onwards.

Should the potential cost increases identified in paragraph 2.3 occur, this could be resolved by making a one off capital contribution of £11.1m from the Council's capital programme in respect of the increased costs identified pre Financial Close.

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Background Documents

Report to Executive 20 December 2006: The Regeneration of the Collyhurst Area (Private Finance Initiative)

1. BACKGROUND

1.1 Executive approved the submission of the draft Outline Business Case to Communities and Local Government (CLG) in December 2006.

1.2 The project was advertised in the Official Journal of the European Union in February 2008 and 6 consortia were long-listed following submission of a Pre-Qualification Questionnaire.

1.3 The request for the consortia to submit their outline proposals was planned to be issued in Summer 2008. However, the global economic crisis led to a review of the assumptions made in the OBC. This review concluded that the project was no longer affordable due, in the main, to the reduction of land value in the area.

1.4 Following consultation with Communities and Local Government it was agreed that the Council submit a new Outline Business Case which went to the Homes and Communities Agency (the agency processing Housing PFI projects on behalf of CLG) on 18 March 2009.

1.5 HCA are currently assessing the Collyhurst OBC and the aim is to present the project to the interdepartmental Project Review Group (PRG) later this year.

1.6 The Outline Business Case submission is affordable based on the standard assumptions allowed. However, HCA require the Council to undertake sensitivity testing on the financial assumptions made to identify any potential financial risk to the Council.

1.7 In line with PFI guidance HCA requires the Council to make provision to cover potential financial risks before it is prepared to sponsor the OBC to PRG.

1.8 HCA has given an indicative commitment to provide £252m for Collyhurst HRA PFI. This is the largest Housing PFI project in the country to date.

2. FINANCIAL ASSUMPTIONS

2.1 A number of financial assumptions have been made to establish the key input costs in the OBC. In addition, however, HCA require local authorities to model the potential cost increases and potential savings based on a number of different scenarios.

2.2 Officers are confident that they can successfully negotiate affordable PFI projects based on their experience of earlier rounds of HRA PFI. However, HCA require the Council to identify any potential gaps in funding and to specify how they will deal with such gaps, if they arise.

2.3 The results of sensitivity testing shows that the Council may require up to £12.7m to support the Collyhurst PFI project if all of the adverse high and medium risk scenarios modelled were to happen and officers have been unable to negotiate these costs away.

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	£m
6 month delay to Contract Close	-6.2
Cost of Senior Debt increases by 0.25% at Contract Close	-4.9
Interest on credit balances decreases by 0.25% over contract life	-1.6
	-12.7

2.4 The key assumptions used in the Financial Model, and the sensitivity that may affect those assumptions, are summarised in Appendix 1. The sensitivities that have been tested are by no means exhaustive, as the financial model is constructed using a large number of assumptions, all of which are likely to vary as the scheme moves through procurement. However the tests that have been undertaken look at the key assumptions: timing, the required capital and operating expenditure, indexation and interest rates. In the current economic climate it is more difficult than has been the case on earlier PFI schemes to anticipate how these factors may vary, so a prudent approach in estimating has been adopted.

2.5 Clearly the sensitivities must be interpreted with care. They cannot all happen: so for example the contract cannot be both 6 months early and 6 months late. But there is the scope for two or more sensitivities to happen and to cancel each other out, so the estimate of £12.7m represents a worst case scenario if all of the mutually exclusive medium risk adverse variances were to happen.

2.6 There is also an important distinction to be drawn between the nature of some of these risks. Risks which happen after Financial Close may be borne by either the Operator (for example inflation on Operating Costs) or by the Council (for example interest on credit balances on the Smoothing Reserve). In the case of the former category, the Negotiation strategy will seek to minimise the “risk pricing” in the contract price, and rely on Benchmarking to correct market anomalies. For Council risks the practice has been established of creating at Financial Close a contingency in the Smoothing Reserve, as a buffer against items such as a loss of resource (be that from the Housing Subsidy System or interest received) or unforeseen cost increases on the Unitary Charge.

2.7 HCA require the Council to commit resources to cover any potential cost increases which may arise during the procurement process. Funds to cover this gap will therefore have to be identified in the Council’s Capital Programme or from other sources. Within the HRA the Council is constrained by the resources made available via the Housing Subsidy system supplemented by special grants such as the PFI Credits. It cannot therefore add resources without making equivalent reductions elsewhere.

2.8 Officers intend therefore to procure contracts within the original affordability model and have identified a number of strategies to mitigate the risk of cost increases occurring. If cost increases are unavoidable or outside the control of the Council and its partners (as is the case with the present difficulties in the PFI funding market) then strategies will have to be developed to redefine the scheme to what can be afforded.

2.9 Officers will present further reports on affordability during the procurement process which identify any resources required from the Council**.**

3. OTHER COSTS

3.1 CLG require the Council to identify other potential costs which must be met by the Council and for which PFI credit is not applicable. The costs that the Council is likely to incur are associated with land assembly such as the making of a Compulsory Purchase Order, the purchase of land and property and home loss and disturbance payments. Since the report to Executive in December officers have carried out further work to identify these costs and have estimated them at £25m for Collyhurst.

3.2 The Council has established a PFI Project Team for each project funded by the Housing Revenue Account. A budget is available to procure external legal and financial advice as required.

3.3 The Council will contribute the whole of the Maintenance Allowance and ninety percent of the Management Allowance it receives from Government each year for the life of the contract. The ten percent of the Management Allowance which will be retained will be set aside to contribute towards contract monitoring and management costs.

4. CONCLUSION

4.1 The Outline Business Case was submitted to HCA in March 2009.

4.2 The project is affordable and Value for Money based on the base case assumptions allowed when applying for PFI credit.

4.3 Sensitivity testing shows that the project could be subject to cost changes. HCA require the Council's commitment to meet any affordability gap before they will sponsor any OBC to the interdepartmental Project Review Group. Officers are determined to negotiate affordable projects and further reports on affordability will be presented to Executive at appropriate times.

5. IMPLICATIONS FOR KEY COUNCIL POLICIES

5.1 The implications of this report for the Council's policies of combating poverty and disadvantage are that the improvements to residents homes and the environment will address social exclusion and enhance the quality of life for local people, improving both the overall social conditions and employment opportunities in the area.

5.2 The implications of this report for the Council's environmental policies are that this project will attract significant investment to the areas and substantially improve the environment. Estate redesign will increase permeability and design out crime, making estates more attractive and sustainable areas for residents to live.

5.3 The implications of this report for the Council's equal opportunities policies are that any new build homes will be designed to full 'Design for Access 2' compliance and will therefore provide improved opportunities for disabled people seeking accommodation in this part of Manchester. Improvements to sheltered housing in both areas are planned and will be carried out with full knowledge of the Council's Valuing Older People strategy.

5.4 The implications of this report for the Council's policies on employment are that a significant amount of long-term investment in the area will be targeted to attract employment opportunities for local people. This will build on the work that has already been carried out by the regeneration teams working in the wider area.

5.5 The implications of this report for the Council's Green Plan are that all new build homes will be built to Code for Sustainable Homes Level 4. These homes will be energy efficient and more cost effective to run.

5.6 This report does not directly engage any Convention Rights. However, if and when a decision is taken to progress this project any Human Rights Act implications will be reported to Executive.

6. KEY POLICIES AND CONSIDERATIONS

(a) Equal Opportunities

Residents will be treated fairly and equally and provided with clear, consistent information regarding their rehousing options in line with the Council's rehousing policies. Every attempt will be made to engage with residents and assist them with their rehousing options.

(b) Risk Management

Risks associated with the project will be managed by the Housing PFI Project Team using the Manchester Method Project Management methodology. The Risk Log will be updated and reviewed regularly.

(c) Legal Considerations

The PFI project will be developed following standard guidance on the procurement of PFI projects. The Council has allocated the resources of an Assistant City Solicitor to provide detailed legal advice.

Appendix 1

Base assumption	Sensitivity being tested	Mitigation Strategy	Unitary Charge NPV £m	Impact of Change [1] £m	Probability
OBC as submitted	No Change		260.43		
The contract is signed in April 2012	6 month delay to Contract Close, starting October 2012	Application of the Council's Project Management Methodology	265.24	-6.2	High [2]
The capital costs associated with building new homes and refurbishing existing homes were estimated using available data	The data used for the initial estimates is increased by 3.5%	Clear information to Bidders on the affordable capital expenditure. Specifications that match the funds available.	267.71	-9.4	Low
From Financial Close to completion of the main Construction phase, capital expenditure is subject to 4% per annum inflation	Capital Expenditure Indexation increases to 5% p.a up to contract close and 5% p.a after construction start	Our bid has been prudent in estimating the effects of inflation. Clear information to Bidders.	276.41	-20.5	Low
Operating costs are subject to 3% per annum inflation in the Operating Period	Operating costs Indexation (as estimated by the Bidder) increases to 3.5% in the Operating Period	After Financial Close the inflation risk lies with the Bidder. Negotiations will seek to remove over cautious pricing, and rely on benchmarking provisions to rectify later market movements.	262.40	-2.5	Low
The interest rate on Senior Debt (the "Swap rate") is 5.5% at Financial Close	Swap rate increases by 0.25% at Contract Close	The final negotiated price will allow for a contingency in the Council's Smoothing Reserve to be established.	264.25	-4.9	Medium [2]
Funding terms are specified in the Data Book and reflect pre-credit crunch terms as agreed with HCA (and supported by soft market testing carried out in June 2009 assuming a 2012 Financial Close)	Funding terms reflect current (Summer 2009) position (including debt terms, covenants, returns to investors, LIBOR)	Seek savings elsewhere within the project without compromising quality or Value for Money	264.73	- 5.3	Low
The contract is signed in April 2012	Contract Close and Operational Start 6 months early in October 2011	Very low probability, but if it happens plans will be prepared to capture the added value for example by an improved specification, OR may retain the benefit as a contingency.	255.80	6.1	Low
The capital costs associated with building new homes and refurbishing existing homes were estimated using available data	The data used for the initial estimates is decreased by 3.5%		253.64	8.7	Low

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Base assumption	Sensitivity being tested	Mitigation Strategy	Unitary Charge NPV £m	Impact of Change (1) £m	Probability
Credit Balances in the Council's Smoothing reserve earn 4.25% interest	Interest on credit balances increases by 0.25%	Retain the benefit of interest rate increases for times when it reduces.	260.43	1.1	Low
Credit Balances in the Council's Smoothing reserve earn 4.25% interest	Interest on credit balances decreases by 0.25%		260.77	-1.6	Medium (2)
The cost of Land Remediation is estimated to be £14.6m	Land Remediation Costs reduce to £8.7m	Plans to capture the benefit as above.	252.23	5.9	Medium

Notes

1. The Impact of Change represents for a negative figure the additional one off payment the Council would need to make in year one to make it affordable, or for a positive figure the value of the saving if realised in year one. A saving could be translated into an improved contract specification.
2. The sum of the high and medium probability adverse movements is £12.7m. Thus if all of these events happen (which is possible), the Council would have to bear the sum of the impacts. However, in the case of reduced interest on credit balances, this will happen over a long period, while the others will be recognised at Financial Close.