PFI FOR THE DELIVERY OF SOCIAL HOUSING PROJECTS

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Abstract: The procurement of Social housing is not limited to provision of shelter to those who cannot afford to acquire it at market rate but its role extends to other areas such as social autonomy, unemployment, crime and sustainability. Traditionally this role has been the responsibility of government and local authorities. During the last thirty years the government's policy is to transfer as much risk as possible to the private sector and the sector's structure has evolved to include major private sector participation. PFI is one of the ways in which private finance was introduced into the sector. PFI schemes adopted so far have always included a measure of regeneration, crime reduction and sometimes provision of employment to tenants. This paper examines PFI schemes used in the UK so far and assesses the conditions under which these schemes operate. By investigating the types of packages used, risk allocation processes and related management issues the paper explains the potential for delivery and success as well as provide a framework for effective PFI into future social housing provision.

Key words: Private Finance Initiative, Procurement, Project management, Risk, Social housing.

1. INTRODUCTION

The aim of this paper is to critically appraise the structure of PFI contracts and how they can best be utilised for the successful delivery of social housing projects. The paper forms part of an ongoing research into PFI in social housing. The research is at a preliminary exploratory stage, and will be developed into a major case study in a social housing project. However for the purpose of this paper, public and private sector issued project documentation, government guidance notes and various PFI publications have been used to investigate contracts and their structure. Several interviews with participants in the first operational social housing PFI project, the Grove Village in Manchester have also been used to give the perspective of stakeholders. Interviewees include: local authorities (Manchester, Leeds), members of the SPV, lending body, public advisors on PFI (4Ps).

2. BACKGROUND

Shelter is a basic human need with wider implications not only on individuals but on society overall. Poorer health and education have been linked to poor housing as well as reduced labour mobility which can hamper economic development. The overlap between housing and socio economic problems is almost total. Despite its high cost and management problems social housing has proved a necessary and most cost effective tool to target those groups that tend to be marginalized and a heavy cost to society. Governments invest a huge effort in social housing in an attempt to integrate their diverse societies, reduce urban conflict in a situation of growing polarisation and make the best use of their scarce resources of land and buildings (OECD, 1988). Social housing is housing that is not provided for profit and at rates below market, it is allocated to those whose income does not allow them to let a house independently and is usually regulated by the state (Power, 1993).

Investment in social housing was traditionally financed through a combination of public sector borrowing and government subsidies that kept rents at low affordable levels. Government's programmes are known to have produced unwieldy and inefficient housing structures often as a response to an arising need and not planned within a strategic context. Large bureaucracies have often slow progress that only succeeded in providing large scale developments that did not respond to customers needs and only created further stigmatisation (Power, 1993). Most dwellings in the sector were and remain to be provided by local councils. Privatisation seemed the only way of attracting additional investment and tackling management problems.

ODPM (Office of Deputy Prime Minister) as a central government body responsible for the housing sector, has set decent homes standard as a target to be met by all local authorities in delivering social housing services. The Decent Homes Standards are in line with the sustainable communities' initiative which clearly indicates that sustainable communities need decent homes. A home is said to be decent if (ODPM, 2001):

- meets the current statutory minimum standard;
- is in reasonable state of repair;
- has reasonably modern facilities and services; and
- provides a reasonable degree of thermal comfort

Surveys in 1997 have revealed a £19 billion backlog in renovation and improvement works in local authority housing and a total of 2.1 million homes, owned by councils and registered social landlords (RSLs) that were below the decent homes standard. With a need to provide up to 23000 units of social housing per annum an investment of 1.2-1.6 billion would be required (Barker, 2004). It was clear that the government could not finance this investment and significant legislation was issued to enable local authorities to seek and obtain private capital to finance their activities.
Local Authorities have several main options for introducing private finance into their activities (ODPM, 2005)

- Using mainstream housing funding;
- Large Scale Voluntary Transfers (LSVT);
- Arms Length Management Organisations (ALMO);
- Private Finance Initiative (PFI).

In 1998 local authorities were invited to submit detailed schemes that could be suitable for PFI for HRA. Eight of the participating authorities were selected as pathfinders to maximise lessons on how PFI could be made to work in different contexts for the provision of social housing. Authorities selected ranged from traditionally built estates, high rise towers and street properties to reflect a range of different applications suitable for regeneration, tenure diversification and ability to secure long term improvement in the stock. Only two of the submitted schemes are now operational with others in different bidding stages and a few completely abandoned (ODPM,2001, Housing Corporation, 2005).

A PFI contract is an agreement between the local authority and another party that undertakes to refurbish all properties within the scheme up to the Decent Homes Standard and maintain them at or above the standard for the duration of the contract term (up to thirty years). The party will receive an annual payment "PFI credits" based on performance throughout the contract term. This translates into paying tomorrow for services delivered today and although this is quite a controversial issue it does serve the governments purpose in reducing public sector borrowing which is another justification for using PFI procurement. There are two types of Housing PFI: Housing Revenue Account (HRA) PFI and non-HRA PFI. In HRA PFI the local authority owns the properties and the tenants remain tenants of the local authority with all their rights intact including the right to buy. Non HRA schemes are usually in the form of long-term service contracts with RSLs (Registered Social Landlords), involving new build or acquisition and refurbishment, and continuing management and maintenance. The stock will be in the ownership of the private sector operator, and tenants are tenants of the RSL although the authority retains nomination rights (Housing Corporation, 2005).

3. PFI AND VALUE FOR MONEY

In PFI projects value for money is the benefit to cost ratio indicating the project's economic efficiency. The Government defines value for money as: *"the optimum combination of whole-life cost and quality (or fitness for purpose) to meet the user requirements"* (HM-Treasury, 2003/2004, Allen, 2005).
Although there is no specific definition for Value for Money, it is thought to be associated with Economy, Efficiency and Effectiveness (*in public procurement where it can be shown that taxpayers' money has been spent economically, efficiently and effectively it is reasonable to conclude that value for money has been achieved*)(HM-Treasury, 2003). In PFI procurement, Value for Money is thought to be achieved through the adoption of private management practice and skills such as competition and economies of scale. Before selecting PFI as a procurement option, the procuring public authority should provide sufficient evidence that PFI procurement in that specific instance offers value for money. During the initial pre tender stage, the authority identifies business need, in a draft business case, that must clearly demonstrate the project lends itself to PFI. A clear operational need, scope for sufficient risk transfer and adequate market interest that promotes private sector competition during tender are required. At a later stage, after PFI has been identified as the most suitable option, another assessment needs to be made which is based on the full business case, received bids and final negotiations in a Public Sector Comparator assessment (PSC) (HM-Treasury, 2003, ODPM, 2001, Allen, 2005). PSC assessment is based on comparison between the Net Present Value of a PFI project and with a traditionally procured project. In the case of social housing, private finance is already used in the sector for the provision of affordable housing. Comparison in this case is between public sector use of PFI procurement and other private finance routes, LSVT and SHG. (4Ps, 2000). The focus is thus on the delivery of required outcomes and the degree of positive impact on the community.

Once PFI has been selected and approved as the procurement route the public authority needs to set its service requirements and the contract is tendered by companies in the private sector. Initially the private consortium's main concern is to produce the most competitive bid to win the tender. This translates into finding ways of delivering the

required level of service at the lowest cost. The SPV would need to ensure use of optimum solutions during construction and operation of the facility to reduce their cost while meeting performance requirements.
Value for money is implemented in the project through the ways in which the contract structure ensures e.g. that risks are mitigated or partnering and collaboration are promoted. The following paragraphs describe the principles of PFI procurement contracts and how they enable the achievement of value for money.

4. PRINCIPLES OF PFI PROCUREMENT

4.1 Risk Transfer

In any project or contract risk must be transferred to the party best able to manage it.
In PFI procurement the public sector needs to transfer sufficient risk to the private sector to make the project viable. Initially the client starts to transfer risks that it traditionally incurs to the SPV which has more control over those risks and VFM starts to increase. Thus in PFI contracts risk transfer should be optimised in order to maximise value for money. An example of this would be design and construction risks since they can only be managed by the private consortium.
Investors need to ensure that contractors are able to deliver efficiently and to the key performance indicators since any reduction in performance would mean unitary charge performance deductions which would seriously damage the profitability of the consortium and place equity at risk. In a typical consortium risks would be allocated as follows (HM-Treasury, 2004):

- The construction contractor, under a subcontract with the consortium company, take the design, construction and completion risk;
- The service provider, under a subcontract with the consortium company, takes the risk of timely and cost effective service provision;
- The house managers take the risk of dealing with tenants
- Insurers provide protection for risks of damage and business interruption; and
- The lenders and investors of the consortium company are left with a series of residual risks, such as credit risks on the subcontractors' performance.

Interviews with participants in social housing PFI projects revealed that projects are not considered particularly risky. Social housing projects however have risks that are unique and sensitive. Private consortia's main concern was dealing with social housing tenants. The nature of projects makes that an important issue since tenants, although not the client, have the ability to promote or disrupt project progress. It has to be noted that the sector is newly open to the market and thus many risks would be embedded deep within the sector structure and would only come up during construction or operation. Contracts have to be continuously redesigned and modified to work accordingly. In the Grove Village Project, it has been reported that issues such as boarding up or locking empty properties, issues related to drugs found on properties, or vacating resistant tenants to carry out repairs have been causes of dispute and disagreement between consortia and subcontractors where no one would take responsibility for them.

The Treasury Task Force (TTF 1999) definition of risk in a PFI project states that: *"risk is uncertainty as to the amount of benefits. It includes both potential gain and exposure to loss."*

This is particularly true for PFI projects in social housing that include an element of regeneration. For example the Grove Village project in Manchester included regeneration in the contract and it had about 30% of the properties for demolition and rebuild for commercial use. This achieves tenure mix which is a client requirement. It is also a demand risk for the SPV to fill those properties failure of which would incur penalties. However it is a good opportunity for a private development that could be a source of profit for the SPV.

4.2 Competition

Being based on output specification, the contract gives the SPV an opportunity to find novel ways to deliver a service at the required standard. In order to secure the contract at the bidding stage, the SPV needs to find ways of delivering those standards at minimum cost to the satisfaction of the client/local authority. In other social housing provision routes, such as LSVT, there is no element of competition for properties to be transferred to a Registered Social Landlord or housing association. Similarly in allocating Social Housing Grants to housing associations, the Housing Corporation does not require competition, it only requires that association meet a certain performance standard (4Ps, 2000). This lack of competition means that private sector is not encouraged to search for solutions that can reduce the cost to local authorities. In the first round of pathfinder PFI projects, local councils were not allowed to disclose their affordability to the SPV even at preferred bidder stage. This has put a lot of pressure on SPVs to minimise the total project cost (including whole life cost) as much as they could and to design efficient service delivery mechanisms. Thus competition encourages SPV to seek the maximum value for money solutions for the client. It has to be noted that private consortia invest large sums in the bidding process without any guarantee of winning bids. Local authorities also invested large sums and resources in the process. This has been sited as one of the main reasons parties are discouraged from bidding for PFI projects. The government through ODPM and the 4Ps are working on creating a set of standardised documents to make the bidding process shorter, less costly and more efficient.

4.3 Output Based Specifications:

In a PFI contract the client defines the service to procure in an Output Specification Document. The Output Specification is arguably the most important document in the procurement of a project through PFI. It is the basis through which the Authority and its Stakeholders define the services and outputs that the PFI Contractor needs to provide for the term of the Contract. The aim of the document is to describe what needs to be achieved rather than how it has to be achieved

A well-drafted Output Specification is fundamental to develop a robust PFI Contract and a successful delivery of long-term services. It is part of a process that is different from traditional procurement, as the emphasis is on affordable service outcomes and outputs. Output Specifications encourage a focus on strategic needs rather than the detail of current provision. (4Ps, 2004).

Output specification document describes the service performance output the clients want to provide to the end-users in sufficient detail without specifying the way in which those services are provided. It is then up to the SPV to design optimum ways of delivering the service at minimum cost.

Social housing projects have the added complexity of output based specifications that define regeneration and welfare issues such as reduced crime, increased social mix, improved demand etc. This gives the flexibility to come up with innovative solutions to welfare problems but it also helps the SPV to recognise embedded risks. It also brings out the importance of partnering in the need to include specialists such as housing managers and welfare officers as well as planners to work with the team from the start. In the Grove Village project the winning design provided solutions that exceeded what the local authority has envisaged.

4.4 Partnering

The public authority outlines its service requirements in the bid which goes out to tender and companies compete for the contract. To deliver the specified service private sector companies must build a consortium with different qualifications to meet the requirements usually involving construction contractors and facilities as well as housing management companies. The consortium needs to either include or subcontract to designers and maintenance contractors.

Again social housing projects can pose unique problems that only specialists can deal with. In the Grove Village project contractors had to deal on a first hand basis with tenants. They had to face situations ranging in difficulty from tenants refusing to cooperate to allow repair works to members of the consortia receiving death threats. It is also difficult to contractually set out a responsible party for such risks and therefore a strong sense of partnering is required to deal with such issues. As mentioned earlier in sector that is newly open to the market partnering is increasingly important in creating a knowledge base for all different participants to learn about the role of others and how different problems can be dealt with. This is particularly true at the design stage of any regeneration project where social welfare comes to the fore of the problem rather that general planning and design and hence expertise of different specialists is required.
Another problem faced by the Grove village SPV was dealing with a large number of subcontractors who were faced with difficulties in the projects that are new to them, often causing delays. The SPV reported situations of laying the blame, and lack of recognition of responsibility. Subcontractors were not partners in this project nor were they partners to the SPV. There is nothing in a PFI contract that requires or even encourages partnerships with contractors despite this being an issue raised by all those who were interviewed.

4.5 Contract Duration and Whole Life Cost

Whole life costing can be defined as the systematic analysis of all relevant costs and revenues associated with the acquisition and ownership of an asset (Robinson & Krosky, 2000). These costs would include initial construction costs and expected occupancy costs such as rent collection, maintenance and management. Whole life costing makes a building behave as an asset rather than a liability by including revenues it generates. This concept is particularly important in the case of PFI where project parties need to assess and price risks associated with the long-term operation and maintenance of a building where cost and performance need to be monitored. The whole life of a building in this case differs from the intended occupancy for the term of contract. In social housing PFI contracts provision of a building can be either through refurbishment of buildings to meet the Decent Homes Standards or through new build as in the case of Non-HRA PFI. Whole life costing involves the assessment of the most cost effective solutions such as disposal, new build or maintenance and renovation. Whole life costing includes the initial cost of the asset, its operation (energy), maintenance and salvage value. Its calculation is based on total capital cost, total revenues, inflation and tax. Social housing PFI contracts run typically for a duration of 30 years. This long duration encourages the SPV to make a large capital investment, knowing that it will be returned over time. The SPV would have an added incentive to invest in innovation and technology since improvements can be seen over time. The long duration also gives the SPV the chance to build on the skills and competence of the workforce and develop staff for other projects. The SPV would have to consider the performance of the asset over a long period which means they would have to make whole life cost considerations from the earliest stages to ensure adequate performance during the contract term. The SPV needs to create a balance between capital cost and maintenance cost that would achieve value for money.

The nature of housing in general and social housing in particular means that attention has to be given to whole life costing. The public sector has had a bad history of social housing provision particularly because of the short life of their stock and this is one of the main justifications of bringing in private sector expertise. Tenants of social housing usually take no pride in their homes, leading to neglect of properties. Providing good quality housing that tenants can take pride in, encourages more care of homes and neighbourhoods. Social housing should be designed to last for generations, and this highlights the importance of whole life of the assets.

4.6 Incentive based contract:

Incentives are management techniques that deliver the aspects that are of value to the promoter by eliminating or minimising wasteful activities that do not contribute towards aspects of value (Smith, 2000). Incentivisation in PFI contracts is based on risk transfer and payment mechanisms. By transferring risks to the SPV the client creates an incentive for the SPV to avoid risks through improved performance.

In PFI contracts, the SPV is paid for services provided which means that the SPV will only receive payment when the facility is designed, built and is fully operational. Thus the SPV have an incentive to complete the facility within time and budget to avoid additional cost of borrowing and to start earning revenue.

PFI contracts usually include penalty clauses to ensure service provision to the required level. This means that in case service provision does not meet output specifications, the SPV would not receive payments. An increased number of penalties can lead to contract termination. Payment mechanisms should be designed such that the cost of a penalty is greater than the savings of not meeting output specifications. This process is usually based on a set of performance indicators designed by the client to determine the required level of service.

The SPV in the Grove Village project for example are penalised on things such as grass in lawns reaching a certain height, number of times the telephone rings, on the tenant complaint line, before it is answered. In total the project has 298 performance indicators that must be met on a monthly, quarterly or annual basis. Although these indicators may seem restrictive, the SPV's comment was that these are the standards they work to anyway. Despite this being the case, it has taken a lot of effort and expense to draw out the legal documents involved.

The SPV monitors its own performance and the client audits SPV's monitoring. There is also a possibility for users/tenants to report service failures. Payments are made upon delivery which satisfies output specifications. The SPV faces penalties and reduced payment if delivery is below set standards and termination of contract is the last resort. Service provision should be set at a reasonable level by the authority which needs to recognise that 100% performance level may not always be necessary. In this case, the SPV would incur a set of negative points before suffering financially.

Unitary Charge should relate to the delivery of the overall input not only certain elements. Payment mechanisms are designed such that they should not contain a fixed element that can be received irrespective of performance. This ensures that Senior Lenders will not commit to contract unless they have confidence in the SPV's ability to perform.

Lenders in PFI contracts have a significant power since they need to make sure that their investment will be repaid. It therefore is in the interest of Private Lenders to ensure that incentives are designed to ensure delivery and thus payment.

4.7 Regeneration

Sustainable communities are places where people want to live and work, now and in the future. They meet the diverse needs of existing and future residents as they are sensitive to their environment. Sustainable communities also contribute to a high quality of life. They are safe and inclusive, well planned, built and run, and offer equality of opportunity and a good service for all (ODPM). The Deputy Prime Minister's Sustainable Communities Plan, published in February 2003, sets out an action programme for building successful, thriving and inclusive communities. The plan searches for a scope for PFI contribution in regeneration mostly due to risk allocation practice which is considered suitable for major capital assets.

The Decent Homes standards are part of the government's sustainable communities plan as explained above. By setting improved demand for social housing stock as a required output the private sector is given the opportunity and incentive not only of assessing the state of disrepair of houses but also improving whole areas. Grove village in Manchester was a highly undesirable area characterised by socially excluded tenants living within a community with a very high level of crime and drug abuse. In redesigning Grove to reduce crime, open up the community towards its neighbouring areas and trying to attract commercial tenants to increase SPVs profit the area was dramatically regenerated with a waiting list of up to 99 month. This has simultaneously improved housing conditions, reduced social exclusion, crime and drug dealing and enhanced image of the area. The value of properties in the area has also increased while they remain within the ownership of the local authority.

Often this is linked to the broader regeneration of an area which, in order to be successful, might be dependent on a range of social, economic and environmental improvements. These might include demolition of existing stock and re-provision with a mixture of tenures, estate remodelling and environmental works, the provision of re-establishment of shopping and retail facilities, health and leisure facilities. Not all of these will necessarily be delivered through the PFI contract itself although the project, in its widest sense, may well be delivered by the PFI contractor.

The Authority may carry out some initial master-planning or design works in order to help scope the project at the tender stage which can then be developed through the bidders' responses to the ITN.

Clearly, in due course, additional facets of the output specification may need to be developed in order to properly encapsulate these requirements to the extent that they are to be delivered under the terms of the PFI project agreement.

5. EFFECTIVE PFI CONTRACTS

The nature of PFI means that in trying to upgrade the stock to meet the Decent Homes Standards other benefits can be incurred most of which are related to improved efficiency in delivery and performance. There are a set of issues that need to be present for PFI contracts to work effectively:

5.1 Clear definition of Client's needs:

PFI presents a challenge to the private sector to deliver facilities and services which will genuinely enhance housing standards. This challenge can only be met effectively if the client/authority are clear about their requirements, and communicate these in a way that allows the private sector to develop the optimal solution. This puts a large amount of responsibility on the Local Authority to produce adequate documentation to make their objectives and their expectations clear. Delivery of a PFI contract relies mainly on output specification documents that are produced by the council. It is imperative that these documents state clearly the requirements of the client such that private sector bidding consortia can produce a service that is suited to the project within the affordability range.

5.2 Creating a healthy market:

PFI Housing schemes are much more complex than other PFI projects as they will affect the lives of large numbers of tenants and leaseholders over a long period of time. To be successful the sector must be attractive to public sector (local authorities and central government) and private sector (housing associations, funders, and contractors). The central government has made it very clear that PFI is one of their preferred options for procuring public services and infrastructure under the right circumstances. The government is willing to support PFI procurement and this support can be seen in the provision of legislation, guidance and financial support. This leaves two major groups: the procuring local authorities with their tenants and private sector bodies (funders, contractors or housing managers). Procuring authorities need to be able to identify areas where PFI can be fully utilized to produce results bearing in mind that it might not be suitable for all their housing projects. According to the government the main driver for PFI procurement is achieving value for money mainly through the transfer of risk to the private sector. This aim may be slightly vague in the sense that it does not specifically state to who value for money has to be achieved: users, the taxpayers, the government itself or the society in general. Despite the fact that these sector groups are all interrelated achieving value for money for one does not necessarily achieve it for the others. Social housing in particular is a special case since users are not taxpayers but in fact are a non taxpayers group. In this instance understanding whether a project may in reality achieve VFM for taxpayers would be a complicated process of trying to understand the impact of improved social housing on different parts of the community through a series of cost benefit analyses.

The other part of the market is the private sector. Again the focus is on procuring public authorities to understand and take account of the profit making objectives of private sector consortia. This would mean that the public sector needs to provide opportunities for new developments that can encourage private sector to take adequate risks and produce the expected results. The length of pre contract processes and high bidding cost has been continuously identified as the shortcomings of the procurement route. This issue continues to discourage private sector potential bidders from PFI projects. For this reason, the government is trying to create standardised documents to make the process less onerous and less expensive.

5.3 Robust Contract Structure:

In the provision of major capital assets PFI's potential lies in its risk allocation and incentives structure that ensure delivery. The above described elements of a PFI contract cannot work in isolation but need to be interrelated and to operate simultaneously to deliver value for money. For example *because of their long life, assets could benefit from design, construction and costing made on a whole of life basis by private sector parties incentivised to ensure best value (Asenova et al., 2000).* This means that long term of contract requires whole life cost consideration to operate which in turn draws out the partnership approach that is required of the consortium. Incentives built into the contract are related to risk transfer and mitigation. Output Based Specifications are linked to the element of competition.

In creating a robust contract structure the clients' objectives need to be clearly understood by the bidding private sector consortia bearing in mind that these objectives should not be in conflict with the private sector's objectives of making profit. PFI has been quoted as the only realistic source of finance into the sector (ODPM, TTF, LA's, Housing associations). It involves key roles by private and public sector participants and the alignment of their objectives is key to its success. This in essence is the basis of PFI procurement and contract structures is the creation of opportunities for the private sector while delivering the objectives of the public sector.

It is apparent that there is a need for more investment into the social housing sector. As mentioned earlier there are a several options of attracting private sector investment open to local authorities. However these options continue to be heavily reliant on government policy particularly in the case of non-profit organisations and the nature of non paying customers (Whitehead, 1999). According to the 4Ps, the way in which other private investment routes in social housing are funded through loans means that the focus is always on maximising the value of the stock rather than on welfare community issues. Alternatively in PFI contracts lenders security relies on the performance of the PFI contractor, through specifications which should include welfare issues such as reduced crime and increased demand. The 4Ps also suggest that in retaining ownership of the housing stock local authorities are still responsible for the strategic management of their investment and in this way can create a better balance in the housing market in their community (4Ps, 2000).

The history of PFI is relatively short. The history of PFI in social housing is particularly short and only four projects of the first eight pathfinder projects have reached financial close. The social housing sector is characterised by its social nature and a tradition of not for profit operation. There is therefore a limited amount of research into the implementation of social housing PFI projects. There are significant gaps in knowledge on how the principles of PFI work in social housing projects. There is also a need to identify the aims of all parties to a contract and how those can be aligned together.

Although most participants interviewed acknowledged that projects have limited risk and great potential it is apparent that different stakeholders or sector players seem to be reluctant to get involved in social housing PFI projects. Investigation should be made to identify elements in PFI contracts that can either encourages or discourages involvement. Further research needs to investigate the real reasons behind this. Further research is also required to find correct ways of evaluating the performance of PFI projects. Evaluations done thus far have mostly focused the impact on one type of stakeholders and the need now is for analysis of the impact of different stakeholders on each other, on projects and on the sector as a whole. The social housing sector is new to PFI, and can therefore offer good opportunity of investigating performance against differing contractual solutions.

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