

**HOUSING STANDARDISATION GUIDANCE  
FOR LOCAL AUTHORITY HOUSING PROJECTS – AN UPDATE.**

**May 2002.**

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## 1. INTRODUCTION

- 1.1 4ps, Office of the Deputy Prime Minister (ODPM) and OGC commissioned lawyers Pinsent Curtis Biddle (PCB) to produce an initial volume of guidance material for Housing Revenue Account (HRA) Housing PFI projects in December 2000. The guidance was largely a narrative exploration of the key issues bearing on PFI in the social housing sector and a suggested way forward, although supplementary drafting was produced for some areas. 4ps and ODPM are conscious that much work has been done in the interim by local authorities and bidders to make progress on key issues and also by central government in terms of the legislative and regulatory changes necessary to facilitate and progress housing PFI. It is also apparent that a number of issues not dealt with or not dealt with in detail in the original guidance have come to the fore in the intervening period.
- 1.2 4ps and ODPM have therefore commissioned PCB to produce an update, or supplement to the original volume of guidance. This is intended to consider a comparatively small number of issues, some in detail, promote a way forward contractually and advise of the progress made and timetables for securing legislative/regulatory change.
- 1.3 In order to arrive at the positions outlined in this update, the joint commissioners and PCB have spoken to a wide range of people engaged in housing PFI from local authorities, advisers, funders, contractors and RSLs. Much common ground was evident between those spoken to and the joint commissioners are therefore confident that the solutions and approaches advocated are deliverable and will provide an acceptable way forward for local authorities and bidders.
- 1.4 The status of this update is that of a consultation draft and it is issued to all the local authorities with first and/or second round HRA PFI projects, their advisers and a representative selection of private sector organisations which includes all those involved in bidding consortia, shortlisted for the eight Pathfinders and second round projects at this stage. In addition the joint commissioners are consulting with a number of representative bodies.
- 1.5 Responses are welcomed and these should be sent to Alan Aisbett at PCB via e-mail to 'alan.aisbett@pinsents.com' by 1 July 2002. In addition, Alan Aisbett (tel: 0121 200 1050), Steve Trueman from the 4ps (tel: 020 7472 1555) and David Green from ODPM (tel: 020 7944 3606) are happy to discuss the draft guidance.
- 1.6 The joint commissioners would particularly like to thank the following for their time and input so far:
- Hunter and Partners
  - Laing Investments
  - Deloitte and Touche
  - Pricewaterhouse Coopers
  - Manchester City Council
  - United House Solutions
  - Halifax Bank of Scotland
  - Hyde Housing Association

Abros

Graham Moody Associates

Dexia Public Finance Bank

Nationwide Building Society

Wates Project Services

Sandwell MBC

- 1.7 This Guidance has been published in good faith by the 4ps and ODPM with the help of their advisors Pinsent Curtis Biddle. Neither the 4ps, ODPM nor Pinsent Curtis Biddle will accept any liability arising out of any reliance being placed on the Guidance published, nor for any action or omission of the local authority, other organisation or other person. Local authorities, other organisations and any other person should take their own financial, legal and other relevant professional advice when considering what action should be taken in respect of any initiative, proposal, or other involvement with any public-private partnership or before placing reliance on anything contained herein.

## 2. RIGHT TO BUY

### 2.1 Summary

The Housing Standardisation Guidance (HSG) position on the right to buy (RTB) is set out in Appendix 1. The recommendations in this update in relation to the RTB and can be summarised as follows:-

- Authorities should include provisions in their Invitations to Negotiate (ITN) setting out the parameters within which bidders should bid a methodology for calculating costs in relation to RTBs and the consequent effect on the unitary charge (paragraph 2.2.3);
- Authorities should require bidders to submit a pro-forma or financial model detailing the breakdown of the unitary charge into its various components in respect of RTB's (detailing fixed, variable and semi-fixed (and when semi-fixed will become variable) costs (paragraph 2.2.5);
- bidders should be requested to translate reductions in costs into reductions in unitary charge in "bands" of RTBs in dwelling numbers (paragraphs 2.2.5 and 2.2.18);
- Authorities should decide whether to pay the compensation in respect of fixed costs to the Contractor in a lump sum or over the balance of the period of the Contract, and in the absence of material evidence substantiating one or other options, Authorities should request bids on the basis of both options to test value for money (paragraphs 2.2.6 and 2.2.7);
- bidders should be requested to introduce maximum flexibility in their cost base and financing thereby reducing the level of fixed costs (paragraphs 2.2.8 and 2.2.9);
- lifecycle costs (elemental, programmed or lifecycle renewals) may need to be covered as a formula in the Contract as bidders may well, in practice, bring forward or push back works from dates assumed in the financial model (paragraphs 2.2.10 to 2.2.13);
- the "exiting" of dwellings during refurbishment period should result in the cancellation of an appropriate portion of debt and equity (paragraph 2.2.15);
- bidders' approach to the reduction in costs following the RTB should be evaluated as part of the over-all bid (paragraphs 2.2.16 to 2.2.17); and
- the methodology should apply to both freehold and leasehold sales although the impact of leasehold will be less significant due to certain services (e.g external maintenance) continuing to be provided (paragraphs 2.2.1 to 2.2.3).

### 2.2 RTB Methodology

#### **Purpose**

- 2.2.1 Whilst the general underlying principles of the HSG hold good, experience from the early pathfinders suggests that it is possible to achieve a method for fixing adjustments to the unitary charge at the time of entering into the contract, whenever a RTB occurs, whether freehold or leasehold (although in relation to the latter certain of the services will continue in relation to the leasehold property eg external maintenance). Such a methodology could be automatically invoked

on each RTB adjustment date. It would avoid the need to negotiate adjustments to the unitary charge during the contract period when the Authority's bargaining position may not be strong i.e after the removal of competition.

2.2.2 The underlying principles of the suggested approach are that the Contractor will be compensated for fixed costs and semi-fixed costs (until they become variable). The unitary charge will consequently be reduced by the sum which represents the variable costs calculated by reference to the base costs in the financial model. Obviously, the variable cost reduction will be less significant on a leasehold sale as certain of the services (eg external maintenance) will continue after the sale (or at least until the freehold of the "block" is sold).

2.2.3 It is therefore recommended that Authorities include provisions in their ITN setting out the parameters within which bidders should bid a methodology for calculating fixed costs in relation to RTBs (which will be subject to evaluation) to reflect the following principles.

### **Costs**

2.2.4 From the Contractor's perspective, the unitary charge contains various cost components which will be spread over the life of the contract. These costs will either be fixed, semi-fixed or variable depending on their nature:-

- fixed costs will comprise capital costs reflected in unamortised finance costs and returns due to funders and investors;
- semi-fixed costs will comprise those sub-contractor costs (and perhaps Contractor (SPV) overheads) which are initially fixed and not immediately capable of adjustment as a consequence of works and services to the dwelling ceasing, but which over a period of time may become variable, such as offices and staff used in housing management; and
- variable costs will comprise those sub-contractor costs which are immediately capable of adjustment as a consequence of works and services to the dwelling ceasing such as consumables, insurance, responsive repairs, repairs to voids, cyclical repairs and maintenance and sub-contractor profit.

2.2.5 Authorities should therefore require bidders to submit a pro-forma or financial model detailing the breakdown of the unitary charge into its various components in respect of RTBs. Where the component is comprised of part fixed and part variable costs bidders should identify which are fixed, semi-fixed and variable and the stage at which the semi-fixed will become variable (probably best expressed in bands of dwelling numbers e.g after the first 100 dwellings have "exited" the unitary charge will be reduced to £x). This breakdown should be shown for both freehold and leasehold sales under recognised elements such as:-

- tenancy management services;
- estate management services;
- estate maintenance services;

- responsive maintenance;
- voids maintenance;
- cyclical maintenance;
- elemental, programmed or lifecycle renewals;
- funding; and
- other costs, overheads, insurance, etc.

Bidders should be asked to bid on a unit cost basis and to indicate whether such costs are averaged across all dwellings or apportioned specifically (as informed by the results of the stock condition survey).

2.2.6 When a RTB occurs the Contractor will need to be compensated in relation to its fixed costs. The compensation<sup>1</sup> can be paid in one of two ways:-

- pay the Contractor a lump sum by way of compensation in order to extinguish the unitary charge in respect of a RTB. This could be funded out of the capital receipt from the RTB, the capital receipt having been reduced to take into account the requirement for 75% set aside to redeem existing debt of the Authority (it is not considered that the compensation payment can be construed as an administrative cost of the RTB and thereby deducted from the capital receipt before set aside under Section 58(9) Local Government and Housing Act 1989). The Authority is of course entirely free to use cash from sources in addition to the capital receipt to pay compensation. (This is Option 1); or
- pay the Contractor compensation over the Contract Period (i.e. maintain the capital element of the unitary charge; that representing the fixed costs). There will be no reduction in the level of "PFI Credit" as a result of the RTB and hence a proportion of "PFI Credit" relating to the RTB can be considered as a resource to meet the continuing compensation payments. (This is Option 2).

Option 2 (but not Option 1) will be relevant to leasehold sales as certain services will continue.

2.2.7 In the absence of material evidence substantiating one or other options, Authorities should request bidders to bid on the basis of both options in order to ascertain which is the best option in value for money terms ie measuring the "one off" cost of paying a lump sum against the cumulative costs incurred when paid over the contract period. Whichever option is chosen the Authority will continue to obtain subsidy arising from the "PFI Credits". Bidders should be requested in relation to Option 1 to illustrate how:

- the compensation in respect of a given property will be applied to reducing debt and/or equity;

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<sup>1</sup> The term "compensation" is used in this section to denote the amount of compensation payable to reflect the fixed costs of a dwelling exited under the RTB rather than as the term may be used in the OGC General Guidance in, for example, Compensation Event on termination.

- the compensation will be reflected in a reduction in the unitary charge; and
  - their funding could be structured, so as to minimise the cost of breaking funding and hedging arrangements.
- 2.2.8 Generally, bidders should be requested to introduce the maximum flexibility in the cost base thereby reducing the level of fixed costs, such that the cost per property remains relatively constant over the life of the contract.
- 2.2.9 A key element of the compensation payable on a RTB is the management of debt/equity costs. For example, should a simple interest rate swap be utilised then following a RTB the Contractor would require a lump sum to continue to service the debt and interest on that debt for the period of the swap. If more flexible means of finance were to be used then, potentially, the debt could be discharged and the interest saved, thus reducing the compensation. Consideration should also be given to equity reduction, over time, as the number of dwellings decreases. The flexibility in financing will be linked to the predicted level of RTB's, information on which should be disclosed to bidders as part of the ITN.

### **Lifecycle Costs**

- 2.2.10 One of the principal variable cost items is that relating to elemental, programmed or life cycle renewals where bidders may well, in practice, bring forward or push back works from the dates assumed in the financial model. There will need to be an adjustment to the reduction of the unitary charge and/or the amount of compensation in respect of a RTB to reflect departures from the assumptions made at bid stage. In relation to these works, Authorities should ask bidders to assume that the "exit" of the dwelling will mean that any future life cycle expenditure intended for that dwelling will be applied to reducing the unitary charge. The reduction in costs can be calculated in one of two ways.
- 2.2.11 First, by reference to actual costs reflected in the financial model after programming. This may be achieved by, at the time the Contract is entered into, costing the lifecycle works to be undertaken as programmed in the bidders' financial model and then at each RTB adjustment date costing the lifecycle works again to reflect programming changes to the life cycle works as against the bidder's original recalculated financial model.
- 2.2.12 Second, by reference to an average of costs reflected in the financial model. This may be projected by, at the time the contract is entered into, calculating the original cost of all life cycle works over the contract period. This will be adjusted to the regular period between RTB adjustment dates, e.g annually. On each RTB adjustment date the original annual life cycle cost will be recalculated to reflect the omission of costs projected for future years (at the base costs in the financial model) in respect of the RTBs which have "exited" in the period up to the RTB adjustment date. The unitary charge from then onwards will be adjusted by the difference between the recalculated annual life cycle cost and the original annual life cycle cost.
- 2.2.13 Life cycle costs should be calculated by reference to those contained in the original financial model rather than actual out turn costs.

## **Exit During Refurbishment Period**

- 2.2.14 Where a dwelling "exits" during the refurbishment period, bidders should assume a portion of the Senior Debt and equity investment (whether in share or loan capital) should be cancelled, eg in the ratio of 90:10. This will be done at the end of the refurbishment period as the cancellation of small amounts is expensive. The total amount cancelled will be equivalent to the original projected refurbishment cost of the exited dwelling, plus interest on this amount between the programmed date of draw down of the debt or subscription of the investment until the date of cancellation plus or minus breakage premiums and costs and commitment fees incurred in relation to the portion Senior Debt. The unitary charge will be reduced to reflect savings on the cancellation of the debt.

## **Returns**

- 2.2.15 So far as the rate of return attributed to equity investments is concerned, whilst equity investors made the original decision to invest on the judgement of returns equivalent to the Project IRR, their investment was not without risk. When a dwelling "exits" the equity investor's return thus far on that dwelling will depend upon the timing of the exit. Quite clearly, until exit the equity investment is at risk. However, following exit of the dwelling, if compensation is paid in a lump sum and returns are calculated by reference to the original anticipated Project IRR, the equity investors will receive returns on capital which has not been at risk where ordinarily this would occur only on Authority default. Similarly, the equity investment will not be at risk where compensation is paid over time as the payment and performance mechanism will not apply to the dwelling which has "exited". As a consequence, bidders should assume that, following the "exit" of a dwelling, compensation to equity investors will be calculated by reference to an agreed rate equivalent to that payable on Senior Debt where compensation is paid over time or a sum equivalent to the apportioned original investment (whether share or loan capital) but ignoring any previous distributions and projected future returns, where compensation is paid in a lump sum.

## **Evaluation**

- 2.2.16 It is not possible to evaluate the financial impact of RTBs on each bid through the use of a single NPV calculation. This is because RTBs will occur over time at indeterminate intervals. However, each Authority will have its own RTB profile based on historical predictions. From this data an Authority's financial adviser will be able to run a number of RTB scenarios which will produce a series of project NPV's based upon the bandings of dwellings/adjustments to unitary charge produced by the bidders.
- 2.2.17 In evaluating the RTB proposals in each bid, an Authority should in particular consider the flexibility of the bidder's proposals to give the Authority the maximum benefit, in terms of price, of a RTB "exiting" the Contract including its proposals for the:-
- management "downwards" of fixed and semi fixed costs in housing management and maintenance on the reduction of the size of the Contract;
  - management "downwards of SPV costs on the reduction of the size of the Contract;

- flexibility of debt finance, in terms of its repayment; and
- flexibility of equity, in terms of buying out equity instead of discharging debt.

### Conclusion

2.2.18 As a consequence of bidders responses to the foregoing assumptions the Contract should be able to contain fixed adjustments to the unitary charge probably expressed in "bands" of dwelling numbers. The only calculation which may need to be undertaken on an RTB adjustment date should be in respect of life cycle costs and the extent to which such costs have been incurred other than at the time programmed in the bidder's financial model.

2.2.19 It is considered in due course that the RTB methodology will be capable of being distilled into a standard pro-forma to be included in the Authority's ITN.

2.2.20 A summary of the recommended approach is set out in the following table.

| Cost: fixed/semi-fixed/variable | Cost Element   | Effect on Contract  | Calculation               | Basis of Calculation | Response Required from Bidders           |
|---------------------------------|--|---|---------------------------|----------------------|--|
| Variable                        | Repairs, life cycle costs, staff and other fixed costs after [ ] RTB's                 | Reduction in ongoing unitary charge   | Bands of dwelling numbers | Financial model      | Bid bandings and amounts at ITN          |
| Fixed/semi-fixed                | Unamortised finance costs, equity returns, staff and other fixed costs up to [ ] RTB's | Compensation:<br>1. lump sum;<br>2. pay over time with adjustment for movement in lifecycle costs | per dwelling per dwelling | Financial Model      | bid amounts at ITN<br>bid amounts at ITN |

## 2.3 Termination

When a significant proportion of the dwellings have "exited" from the contract it may not be value for money for the Authority to continue to pay an element of the unitary charge towards management and maintenance of a small number of dwellings. However, this is a matter for decision by the Authority as otherwise the Contractor continues to be paid. Therefore, the correct approach would seem to be for the right to termination to be reserved in favour of the Authority only. This right would be exercisable through the voluntary termination provisions with compensation being paid at the quantum reserved for Authority Default in accordance with the OGC General Guidance.

## 2.4 Regulations 16 and 40

2.4.1 As indicated previously there are two approaches to address fixed costs upon the "exit" of a RTB. These are:

- to pay a lump sum as compensation to the Contractor ("Option1").
- to pay compensation over the remaining contract period through maintaining the capital element of the unitary charge ("Option 2").

It is considered, for the reasons outlined below, that neither the approach in Option 1 or Option 2 would contravene the requirements of Regulations 16 and 40 Local Authorities (Capital Finance) Regulations 1997 (as amended)

- 2.4.2 Provided it is structured correctly, the Contract will fall within the definition of Private Finance Transaction, as defined by Regulation 16 of the Local Authorities (Capital Finance) Regulations 1997. Furthermore, if the Contract, in accordance with proper accounting procedures, does not require the local authority to recognise an asset on any balance sheet then the initial cost of the Contract, although a credit arrangement (which a Private Finance Transaction must be by virtue of Regulation 17), will be nil (Regulation 40). Whether or not the local authority is required to recognise an asset on its balance sheet will be determined by reference to FRS5 and technical guidance on accounting treatment issued by the Treasury.
- 2.4.3 On the assumption that the local authority makes the initial determination that the Contract is a credit arrangement with a nil cost, then what is the effect of following Option 1 or Option 2?
- 2.4.4 In Option 1 the dwelling will need to be recognised as an asset to be sold, thereby momentarily coming back on balance sheet and then going off balance sheet at the point of sale. As the compensation will be used to "terminate" payment of the unitary charge in relation to that dwelling there are no further liabilities to be incurred by the Authority in relation to that dwelling. Following the "exit" of the dwelling there will remain no residual liability for payment of the unitary charge in respect of that dwelling. The content of the Contract will be reduced by one dwelling and there will be a commensurate reduction in the unitary charge to reflect this. The "year 1" structure of the Contract is thus preserved.
- 2.4.5 When the property is sold 75% of the resulting capital receipt must be set aside by the Authority as provision to meet credit liabilities (Section 59(1) and (2) 1989 Act). In accordance with Section 59(9) of the 1989 Act when a local authority receives a capital receipt from the disposal of a dwelling pursuant to the RTB then the amount of capital receipt may be reduced before "set aside" by administrative costs incidental to the disposal defrayed by the local authority. However, as indicated previously, the payment of compensation to "redeem" the Contractor's debt should not be assumed to be such an administrative cost.
- 2.4.6 In Option 2 that element of the unitary charge reflecting fixed costs incurred in respect of the dwelling which "exits" will continue to be paid by the Authority. This element will not attract deductions for inadequate performance otherwise a subsequent instance of unavailability will attract a higher pro rata deduction.
- 2.4.7 However, at the time the Contract is entered into, the Contract will be a Private Finance Transaction provided all of the conditions contained in Regulation 16 are satisfied. In particular, "the fees [i.e. the unitary charge payable to the Contractor] will be determined in accordance with ... standards attained in the performance of the services." Whilst and Authority will need to give consideration to dwellings "exiting" through the RTB throughout the Contract period as part of its accounting determination under Regulation 40, it is not considered that this should affect the determination under Regulation 16 which is undertaken in relation to the terms of the Contract at the time the Contract is entered into.

- 2.4.8 Regulation 40 states that where an Authority determines that a Contract comprises a Private Finance Transaction which complies with the requirements of Regulation 40, the initial cost and the cost at any time of that transaction is nil. However, Regulation 40 must be read in conjunction with section 51 of the Local Government and Housing Act 1989. Broadly, section 51 states that where a credit arrangement is varied then the cost to the Authority of the credit arrangement is recalculated taking into account the effect of the variation. There is no definition of "variation" in section 51.
- 2.4.9 However, if the RTB methodology approach outlined above is followed, the consequent adjustment to the unitary charge (by either a fixed amount or advance formula) on the "exit" of each dwelling through a RTB may be construed as contractual terms which have been taken into account in the original determination rather than an Authority-initiated variation. Furthermore, Regulation 16 allows sums additional to the fees (ie unitary charge) to be paid under the Contract. This would therefore allow for the payment of compensation in addition to the unitary charge.
- 2.4.10 Alternatively, if each RTB were to be treated in the Contract as an Authority variation of the Contract then, notwithstanding the initial compliance of the Contract with Regulation 40, the Authority would be obliged to revisit the cost of the Contract as a credit arrangement and possibly the determination of the application of Regulations 16 and 40.

## 2.5 Housing Subsidy

In respect of making compensation payments to the Contractor either as a lump sum (Option 1) or over the remaining contract period (Option 2) a special determination will be required from ODPM. The dwelling subject to the RTB will by this time, no longer be within the Authority's Housing Revenue Account. Consequently an application needs to be made to the ODPM in respect of an Item 8 Debit Determination. In respect of Option 2 this will need to be made on an annual basis<sup>2</sup>.

## 2.6 Cost Floor

- 2.6.1 A person exercising the RTB may be entitled to discount on the purchase price. Section 131 Housing Act 1985 applies so as to limit the amount of discount available to secure tenants exercising the RTB by providing for a minimum sale price. Section 131(1) in particular provides that the discount shall not reduce the price below the amount which, in accordance with a Determination made by the Secretary of State is to be taken as representing so much of the costs incurred in respect of the dwelling. Furthermore, Section 13(2) provides that the discount shall not reduce the sale price below a prescribed sum.
- 2.6.2 The relevant Determination made by the Secretary of State is The Housing (Right to Buy) (Cost Floor) (England) Determination 1999. The Determination refers to the "relevant costs" as the costs incurred by the landlord (or any specified predecessor body) in relation to the dwelling for the period of 10 – 11 years prior to the date of the RTB notice. Relevant costs are defined by reference to the items set down in paragraph 5 of the Determination including, the cost of acquisition and construction of the dwelling and other works, but excluding most routine works of repair or maintenance or putting right defects unless these exceed £5500 when the costs in excess of this sum may be

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<sup>2</sup> Applications should be made to Theresa Donohue, ODPM 2/J3, Eland House, Bressenden Place, London, SW1E 5DU, telephone number 020 7944 3572

recovered. (Authorities should specifically take note of this exclusion). From the wording of both section 131 and the Determination, the costs relating to the particular dwelling must be identifiable and relate only to the items of expenditure in paragraph 5.

- 2.6.3 The effect of being only able to take into account "costs incurred by the landlord" is that an Authority may thereby only allow expenditure incurred by it (as opposed to the Contractor) as part of the relevant items making up the cost floor. This requires the Authority to be able to match a payment (or an identified part of a payment) made by it with the provision of the works within the items of expenditure in paragraph 5. The unitary charge which the Authority will pay the Contractor will take into account a variety of factors and will represent the consideration agreed for the whole of the works and the services and payable over the whole of the Contract period. It would seem therefore to follow that the Authority will not be able to match any part of the sums it pays the Contractor with the provision by the Contract of the works within the items of expenditure in paragraph 5. If the Authority is unable to show this, it will not be able to prove that the expenditure should be taken into account in the items of expenditure making up the cost floor.
- 2.6.4 Whether the costs are to be taken into account is decided by reference to the "period of account of the landlord" which is defined in sub-section (1A) as the "period for which the landlord made up those of its accounts in which account is taken of those costs". If the Contractor is carrying out works which fall within paragraph 5 of the Housing (Right to Buy) (Cost Floor) (England) Determination 1999 then these costs will not be shown in the landlord's accounts. Therefore, enabling the costs incurred by the Contractor to be taken into account in the cost floor determination may require changes to primary legislation. The Department is considering the options available in respect of this.

### 3. LEASEHOLDERS

#### 3.1 Summary

- 3.1.1 The HSG position on leaseholders is set out in Appendix 1.
- 3.1.2 This section explains the amendment to the legislation applying to leaseholders brought about by the Commonhold and Leasehold Reform Act 2002 namely the substitution of a new Section 20 Landlord and Tenant Act 1985. When the new Section 20 comes into operation the requirement for two estimates before carrying out works, the costs of which are to be recovered through a service charge, will be dispensed with. This section also explains the ODPM's current proposals for consultation with leaseholders in relation to the proposed cost of works recoverable through a service charge and the likely impact of the new and proposed legislation on the PFI contract structure.
- 3.1.3 However, as the original Section 20 Landlord and Tenant Act 1985 (and indeed possibly also the wording in individual leases) refers to the recovery of costs incurred by the landlord, this section also suggests a mechanism to correlate the structure of a PFI Contract with the original statutory provision (and the possible wording in individual leases) (see Section 2.3). The statutory position (if not the wording in leases) will be alleviated by the wording in the new Section 20 (when it comes into operation) which applies to costs incurred by or on behalf of the landlord under a long term agreement.

#### 3.2 Legislative Proposals

- 3.2.1 The ODPM have issued proposals for revised procedures for consulting leaseholders on major works in a Discussion Paper issued in November 2001. The Discussion Paper contemplates substituting a new Section 20 Landlord and Tenant Act 1985 (dispensing with the requirement for two estimates) and new regulations made under that Section in respect of consultation with leaseholders. The substitution of Section 20 has now been achieved through the Commonhold and Leasehold Reform Act 2002, although the new Section 20 is not yet in operation.
- 3.2.2 The ODPM are currently considering the comments which they have received on the Discussion Paper in relation to the proposed regulations and it is hoped that the regulations will be issued for formal consultation by July 2002 and in place as soon as practicable after that.
- 3.2.3 The new Section 20 envisages two stages at which consultation will be required. First, consultation will be required when the landlord is proposing to enter into a long-term agreement (more than 12 months) which will lead to the recovery costs through a service charge. Second, consultation will be required when a landlord is proposing to carry out specific works which would result in costs above a prescribed amount being recovered from any leaseholder through a service charge. Where consultation is carried out on a proposed long-term agreement and competitive estimates are obtained before the agreement is entered into, there will be no requirement to provide alternative estimates again when consulting on proposals for specific works.
- 3.2.4 In relation to contracts for the exclusive provision of all maintenance services (which includes long-term PFI contracts), the landlord will be required to inform leaseholders of the proposed scope of the contract (i.e. nature of works and

services that are expected to take place during the period of the contract). The landlord will be required to obtain bids from at least two contractors (at least one wholly unconnected to the landlord). Details of the bidders will be supplied to leaseholders together with an indicative estimate of the likely costs applicable to their dwelling over the contract period. Leaseholders will be able to make representations on these matters and the landlord will be required to have regard to those representations. In a typical procurement of a local authority housing PFI contract under EU procurement rules, this consultation procedure is likely to be in the period following receipt of tenders/bids at the Invitation to Negotiate stage.

- 3.2.5 The proposed requirements in relation to specific works will generally follow existing procedures save for three changes. First, there will be a common procedure whether or not there is a recognised tenants' association. Second, the requirement to produce at least two estimates and the right to nominate other contractors will not apply where the works are to be carried out under a long-term contract and where the leaseholders have been consulted in relation to the award of that long-term contract as envisaged above. However, leaseholders will be able to make representations about the detail of the proposed works and suggest alternatives. Finally, the trigger for consultation will be the amount payable by any leaseholder rather than the cost of the job as at present. A figure of £250 has been proposed as the initial trigger.
- 3.2.6 The abolition of the requirement to obtain two estimates will assist contractors (and their sub-contractors) delivering the works and services to the leaseholders. Having consulted in relation to the contract there will be no further requirement to obtain two estimates prior to undertaking the works. This reflects the fact that the Authority (as landlord) is under a contractual obligation to use the Contractor to carry out the works. The Contractor will also be under a contractual obligation to use the sub-contractor. Therefore any consultation on the identity of the Contractor and sub-contractor will be meaningless. However, the Contract should allow for varying the works to the leasehold properties if required as a consequence of consultation on specific works. Furthermore, the wording in the new Section 20 refers to costs incurred by or on behalf of the landlord under a long-term agreement and therefore not necessarily only costs incurred by the Authority as landlord, i.e. the costs may be incurred by the Contractor and the need for "artificial" procedures to demonstrate costs incurred by the Authority as landlord can be avoided (however, authorities should verify the wording of their leases as the service charge provisions in those leases may refer to costs incurred by the landlord as opposed to the more general wording in the proposed section).
- 3.2.7 However, the Authority will still need to be able to demonstrate actual costs incurred by or on behalf of the landlord in relation to the dwelling and such costs must be reasonable. Therefore, authorities will have to decide whether the whole of its costs incurred in relation to the dwelling will be recoverable or whether some are retained by the Authority (e.g. risk premia). However, it will also be open to authorities to make an advance application under Section 19 as to reasonableness to the Leasehold Valuation Tribunal (LVT). The new Section 20 also makes it clear that a landlord may apply to a LVT for a dispensation of the requirement to consult before the works are carried out.

Where a landlord fails to comply with a requirement to consult in relation to a long-term agreement or in relation to specific works, the landlord cannot recover

through service charges from any leaseholder any amount in relation to those works which exceeds the prescribed amount.

### 3.3 Transitional Arrangements

Prior to the coming into operation of the new legislation, Contractors will be required to comply with the existing requirements contained in Section 20. A suggested way forward is as follows:-

- 3.3.1 the Contractor will be appointed as agent of the Authority;
- 3.3.2 it will be for the Contractor to ensure compliance with the procedural requirements contained in Section 20 and to consider representations;
- 3.3.3 in particular the Contractor must ensure that two estimates for the works are obtained (it should be assumed by the Contractor that these estimates must be obtained from persons willing and able to undertake the works);
- 3.3.4 the estimates may be obtained on the basis of the Contractors' contractual obligations to meet specific standards;
- 3.3.5 in deciding which estimate to accept, the Contractor should consider the reasonableness of the costs to be incurred;
- 3.3.6 in every case the Authority (as landlord) will have to incur the cost of the works (this may still be the case post-introduction of the new legislation if there is a requirement that the costs are incurred by the landlord in the leases) and in which case the Contractor will need to quantify the cost of the works to individual dwellings and invoice the Authority accordingly;
- 3.3.7 depending upon whether the Authority has decided to require the Contractor to accept the cash collection risk of recovery or whether the Authority accepts this (with an appropriate performance standard) then either the Authority will pay the invoice and respectively deduct or not deduct an amount from the unitary charge;
- 3.3.8 unless the payment of the cost of the works (either by the Authority or leaseholder) the works is "ring-fenced" say, in a suspense account and is available for performance deductions, the cost of works to leasehold properties will be outside the unitary charge and the performance regime and payment mechanism will have limited application to these costs.
- 3.3.9 in any event the Authority should pay any sum in the invoice which is not recoverable due to exceeding the mandatory cap or where the works or costs have not been notified to the leaseholder at the time of purchase under Section 125 Housing Act 1985 and any other sum relating to any other risk which the Authority has agreed to bear; and
- 3.3.10 the Authority will need to give consideration as to the availability of cash flows from which deductions can be made due to inadequate performance of the leasehold services (the suspense account in 3.3.8 above is one suggestion and there may be a limited leasehold unitary charge covering irrecoverable costs).

Where tenancy/leaseholder management is not included in the contract then the Authority will meet the cost of the invoice in full and itself seek recovery from the leaseholder.

## 4. STOCK SURVEYS

### 4.1 Background

- 4.1.1 The information and data produced from stock surveys is key to Contractor pricing. Such information and data must be sufficiently comprehensive to enable bidders to price accurately and reliably and to comply with the Authority's output specification. As the original HSG (section 4.3) recognised, information and data produced before procurement has commenced from traditional stock condition surveys (similar to those used in LSVT) is unlikely to be sufficiently comprehensive to enable such accurate and reliable pricing by bidders. Indeed, experiences from the early pathfinder projects has been that such stock condition surveys have been an inadequate reference point to assess affordability in Authorities' Outline Business Cases (OBC).
- 4.1.2 The HSG therefore recognises the requirement for the commissioning of a more detailed "intrusive" stock survey and sets down options and a recommended approach to such commissioning. The recommended approach is for shortlisted bidders at ITN stage to jointly commission (by agreement with the Authority) the survey to their agreed brief, with the winning bidder reimbursing the others. However, it is accepted by the HSG that there may be occasions where it is more practicable for the Authority to commission the survey (on the basis of an agreed Brief with bidders) with the appointment ultimately being transferred to the winning bidder or warranties given in return for reimbursement of the cost of the survey.
- 4.1.3 Experience from the pathfinder Authorities to date indicates that the recommended (or alternative) option has generally been followed. However, experience has also shown that pathfinder Authorities and bidders have spent significant amounts of time agreeing the Brief and once agreed and the surveys undertaken, bidders are often pressing for further survey work to be undertaken. It is with this in mind that it is considered that further guidance may be of assistance to Authorities.

### 4.2 Extent of Survey

- 4.2.1 As indicated previously, a stock survey to be undertaken in connection with a local authority housing PFI contract is fundamentally different to the type of survey which would normally be undertaken in connection with a stock transfer.
- 4.2.2 Essentially a survey undertaken in connection with a stock transfer is intended to illustrate the cost of "catch up" repairs so that the housing stock will be and remain in good and tenable repair to ensure delivery of the transferee Association's business plan. The information and data from the survey will also give funders confidence in the business plan delivery and ultimately repayment of monies borrowed. However, the items in the business plan can be adjusted in time and cost to reflect the then prevailing economic conditions provided individual dwellings remain habitable. This inherent flexibility enables less detailed and comprehensive surveys to be undertaken, often involving a sample of between 10-20%.
- 4.2.3 On the other hand a stock survey undertaken in connection with a local authority PFI transaction must be undertaken by reference to the Authority's output specification with which the Contractor will be expected to comply. Although the Contractor will have a degree of discretion as to methodology to satisfy this

output specification, the Contractor will be liable for deductions from the unitary charge should any dwelling cease to be available or the Contractor fail to adhere to key performance standards. As a consequence therefore, it should be a prerequisite of all stock surveys for there to be an output specification in existence to be used in connection with the survey. The output specification should be at a well developed stage and subject to no further fundamental changes since it will prove difficult for bidders to price for the attainment of those outputs or standards, compliance with which has not been investigated through the stock condition survey.

- 4.2.4 Experience from pathfinder Authorities emphasises the importance of Authorities allowing bidders to determine the extent and content of the survey to enable optimum value for money to be attained in pricing terms.
- 4.2.5 Indications are that bidders will seek a 100% external and at least 50% internal surveys (often seeking an increased percentage of internal surveys with more difficult stock). Although 100% external appears to be the norm to minimise risk pricing, by agreement with all bidders, it may be sufficient to undertake a sample survey where the housing stock in the project is of a standard design. However, these are issues for bidders to determine subject to the views of Authorities on preventing unreasonable disturbance and discomfort to their tenants, the expectation must be that bidders will be able to remove contingencies and risk pricing from their bids if their information requirements with respect to the stock are satisfied.

### **4.3 Timing of the Survey**

- 4.3.1 When should the stock survey be undertaken? In order for a reference project to be developed and affordability to be assessed, there is a strong argument for the stock survey to be undertaken between approval of the project by ODPM and submission of the OBC. The undertaking of the survey much earlier in the process will enable the OBC to benefit from much more accurate costings to determine the estimated cost of the PFI project and thus its affordability with increased certainty. Although the result would be that the Authority incurs the initial cost of the survey, the Authority will have the comfort of some certainty in that the cost would be incurred after ODPM policy approval and would also be recoverable from the successful bidder. However, the Authority must also have prepared an output specification at this early stage, for a survey to achieve its purpose. The brief for the surveyor to be supplied by the Authority would necessarily have to satisfy future requirements of bidders. Therefore in preparing the brief Authorities must have regard to bidders' requirements, effectively putting themselves in the "bidder's shoes" and instructing the surveyor accordingly.
- 4.3.2 However, whilst undertaking the survey of this earlier stage would be the recommended option in a mature market where standard terms and conditions for surveyors are prevalent, it is considered premature to recommend this option at this stage. Rather it is recommended that Authorities should follow the current recommended option in the HSG whilst addressing other issues raised in this supplemental Guidance. It is strongly recommended however that the financial evaluation at OBC stage is informed with a clear vision of outputs and standards and stock survey information which is fit for purpose and drawn from an appropriate sample size. It may well be the case that local authorities need to commission a fresh survey specifically to inform the OBC.

### **4.4 Validation of the Survey**

Whenever the survey is actually undertaken there will be a period of time between survey and financial close. As a consequence, preferred bidders will in some way wish to validate the information and data deriving from the original survey. Authorities should resist a further round of surveys as such would result in additional unacceptable discomfort to tenants. (There may be individual exceptions to this general rule, where for example, a bidder has a unique design solution which would not be supported by the initial stock survey information and data). Therefore, it is recommended that Authorities should ensure comprehensive records are kept in order to supply bidders with information on the extent of works undertaken to the housing stock, post-survey. It would not be unreasonable for the Authority to warrant this information as being true and accurate in order to give sufficient comfort to bidders.

#### **4.5 Other Information and Data**

Apart from information and data deriving from the stock condition survey, Authorities will invariably possess other information and data which will be relevant to the assessment of risks inherent in the refurbishment works (such as asbestos registers).

#### **4.6 Specimen Surveyor's Brief and Checklist**

Examples of a surveyor's brief for a stock survey relating to a PFI contract which are believed to be current best practice and a "checklist" of information which Authorities should provide to bidders will form an additional Appendix to this guidance update and will be made available through the 4ps website ([www.4ps.co.uk](http://www.4ps.co.uk)) when worked up.

## 5. **MANAGEMENT AGREEMENTS**

### 5.1 **Section 27 of the Housing Act 1985**

5.1.1 Section 27 of the Housing Act 1985 is the means by which a Local Housing Authority can let contracts for housing management work. With the Secretary of State's approval authorities can enter into agreements with another person to undertake their management functions. As it stands it will only permit the authority to have an agreement with a contractor where they alone act as agent in carrying out the housing management work. There is no power for the authority to agree to any further sub-contracting arrangements. In the majority of cases, the Special Purpose Vehicles set up by bidding consortia in PFI Contracts will not be undertaking the work directly but will sub-contract the housing management functions.

5.1.2 In order to remedy this situation, the ODPM is proposing to make amendments to Section 27 by way of a Regulatory Reform Order (RRO) which will go out to consultation shortly. The main elements of what is being proposed are at Appendix 2 and your initial thoughts are invited on this with particular reference to Sections 3, 4, 5 and 6. There will be an opportunity for further comments when the consultation paper on the proposed RRO is issued.

## 6. REGENERATION OPPORTUNITIES

- 6.1 Certain of the pathfinder projects go beyond a pure Local Authority Housing PFI contract and contain significant elements of regeneration of the neighbourhood and diversification of tenures etc.
- 6.2 Experience has shown that a Local Authority Housing PFI contract can be a tool for regeneration. Where the regeneration outcomes are clearly defined eg a remodelling of an estate an Authority may obtain the optimum benefits from an holistic approach to both the PFI and non PFI elements of the project. An Authority should consider seeking one procurement for the delivery of both elements although it is accepted that each of the elements may be documented through separate contractual arrangements. Although the contractual arrangements may need to be independent of each other it is possible to inter relate the two to achieve the Authority's desired outcome eg the provision of housing for sale as part of the project may not be capable of being part of the payment and performance mechanism but the project may be constructed to incentivise the Contractor to achieve receipts from the sale of housing land to fund capital works.
- 6.3 However, where the regenerative aspects and aspirations of the project are such that the Authority does not have clearly defined outcomes for eg the creation of employment or the reduction of crime, then such may not be appropriate for inclusion within the Project itself but rather addressed separately, eg as part of a "partnering arrangement".

## 7. PROGRAMMING OF WORKS

Experience from pathfinder authorities who have reached ITN stage in their procurement process, is a variety of responses for the programming of repairs and improvements and life cycle works to satisfy the Authority's output specification and standards. The timing of the programming of these works will impact upon price. Some bidders may programme works to achieve the optimum benefit on the price, the earlier they figure in the life of the contract the greater will be their cost in NPV terms. However, apart from price, an Authority should consider the value for money of the suggested programme and the impact upon tenants. The programming of works is largely a matter for bidders to resolve and for Authorities to take into account at the evaluation stage.

**8. NEW BUILD AS PART OF HRA PFI**

- 8.1 Occasional mention has been made of the possibility of Authorities demolishing and re-providing dwellings where this is demonstrably the best available economic solution.
- 8.2 As a reminder, the legal position on this can be explained in the following terms. Regulation 16, Local Authorities (Capital Finance) Regulations 1997 sets down the nature of the contracts which are capable of benefiting from the concession for contracts which are private finance transactions. Private finance transactions arise where, amongst other things, the consideration received by the Authority includes the provision or making available of a relevant asset or the carrying out of works in connection with the Authority's functions. However, Regulation 16 defines "relevant asset" as being any asset apart from housing land and "works" as works consisting of the construction .... of an asset, apart from works consisting of the construction of a house or other dwelling on housing land. "Housing land" is land, house or other buildings held within the housing revenue account. As a consequence Authorities cannot currently entertain the construction of new dwellings through a PFI contract which would be accounted for in the housing revenue account.
- 8.3 However, the prospect of regulatory change is not necessarily ruled out and ODPM are willing to receive details of any examples where Authorities believe that the demolition and new build would be the optimum economic solution to particular problems within the envelope of a local authority HRA PFI project. Such an example would need to be evidenced by a clear and robust financial analysis.

## 9. ALTERNATIVE PROCUREMENT MODELS

### 9.1 Introduction

9.1.1 In common with other sectors in PFI, pathfinder authorities have followed the traditional procurement route in selecting their Contractor, namely the EU Negotiated Procedure. However, certain of the pathfinder authorities, bidders and their advisors have identified what they believe are the shortcomings in the use of the EU Negotiated Procedure in local authority housing PFI contracts. The suggested shortcomings can be summarised as the:-

- length of the procurement process prior to the commencement of the contract works;
- high costs involved for both the Authority and bidders;
- difficulty in framing what are frequently complex proposals (eg output specification and Contractor's proposals) in a competitive bidding environment; and
- potential failure to identify the true nature of key risks arising from the complex proposals during the competitive process.

9.1.2 Although the first and second points can be said to be generic to PFI the third and fourth points are seen as specific to, and arising from, the complexity of local authority housing PFI contracts. Proponents of this argument suggest that because the schemes, which are to be the subject of local authority housing PFI contracts, are so complex and will fundamentally affect the lives of a large number of people over a long period of time, the most sensible way to proceed would be to plan the service from the outset in close collaboration with a team comprising representatives of the Authority, specialist experts and the Contractor selected for carrying out the works.

9.1.3 It has been suggested by certain pathfinder authorities, bidders and their advisers, that the solution to these shortcomings could be the use of the specific procedure contained in the EU procurement rules appertaining to "public housing scheme contracts" which broadly enables the appointment of a Contractor following competition under the EU restricted procedure to subsequently work with the Authority and others in developing the scheme proposals. It is also suggested by the proponents of this alternative procedure that it potentially opens up the real possibility of the Authority selecting the optimum permutation of consortium members (eg best refurbishment contractor, housing manager, funder etc).

### 9.2 Legislative Background

9.2.1 Article 9 of the EU Directive on the Co-ordination of Procedures for the Award of Public Works Contracts contains a procurement procedure for "public housing scheme contracts". Regulation 24 of the Public Works Contract Regulations 1991 contains a general definition of such a contract as a "public works contract relating to the design and construction of a public housing scheme", there is no further definition.

9.2.2 The regulation states that when a contracting authority wishes to award a public housing scheme works contract, and where the works require that the planning of such a scheme needs to be based from the beginning on a close working

relationship of a team (which will include the preferred Contractor) then the use of the restricted procedure, as set out in the regulations, is relaxed so as to permit the contracting authority to select the contractor who is most suitable for integration into that team.

9.2.3 Normally under the restricted procedure post tender negotiations are prohibited, to the extent that they go beyond clarification or supplementation of a bid. With a public housing scheme, an Authority would have the scope to depart from this general principle.

9.2.4 The procedural requirements with which the Authority must comply are:-

- advertising the contract with an OJEC Notice for the restricted procedure;
- only pre-qualifying tenders in accordance with the EU rules about criteria for rejection and minimum standards of economic and financial standing and technical capacity; and
- not discriminating on grounds of nationality.

The regulations envisage the existence of a job description for the scheme and such job description can be a traditional PFI output specification.

9.2.5 The "public works contract" may cover not only the carrying out of the works but also the procurement of the carrying out of work corresponding to the output specification (regulation 2(1) Works Regulations).

9.2.6 Under Regulation 24 bidders are shortlisted/selected after considering:-

- whether a bidder is ineligible to tender on one of the grounds described in the regulations;
- whether the bidder fails to satisfy the minimum standards of economic and financial standing and technical capacity required of contractors by the contracting authority in accordance with regulations;
- whether the bidder is "most suitable for integration into the team".

9.2.7 Unlike the negotiated procedure, after making its evaluations of which bidder is "most suitable for integration into the team", the Authority may move straight to negotiations with that bidder – there is no requirement to negotiate with a minimum number of suitable candidates.

### 9.3 **Perceived Advantages of Regulation 24**

9.3.1 The Authority is seeking a team capable of working in close collaboration, including tenants and residents who are "experts" in as much as their local expertise is essential to the sustainability of a PFI housing scheme, seeking to meet local community objectives and needs.

9.3.2 The team based approach of Regulation 24 may also allow the Authority greater scope to facilitate the selection of the optimum permutation of consortium members (eg the best funder, the best refurbishment contractor, the best housing manager and the best professional team) can be integrated into a team, working closely with the community. However, it is difficult to see how this is achievable within Regulation 24 as the natural interpretation of "Contractor"

would be the lead contractor plus sub-contractor's ie a consortium. Unless "Contractor" in Regulation 24 can be construed as encompassing all "Contractor" components of a consortium.

9.3.3 The Regulation 24 process has the following suggested advantages:-

- the overall cost and the period of procurement for both parties is reduced by:
  - a competition framework which is concentrated at the beginning of the process ("front end loaded");
  - reduced serial negotiations with several bidders; and
- the Preferred Bidders' unitary charge can be refined, on the basis of open book accounting, which should enable bidders to eliminate a degree of "risk premium";
- particular concerns of the Authority to achieve the right balance of demolition, refurbishment and for replacement of properties can be addressed, through a "team" approach, leading to contract documentation which reflects a realistic allocation of risk;
- tenants and residents are integrated as "experts" into the contract negotiation procedure; and
- the forum can be created for resolving complex issues such as regeneration; allocation of risk; residual asset value risk; the project agreement; payment mechanism and performance regime etc.

9.3.4 Under the negotiated procedure contracting authorities are encouraged to use the period between issue of the Invitation to Negotiate (ITN) and Best and Final Offers (BAFO) to finalise agreement on the contractual documentation, for completion after financial due diligence. However, in practice many schemes can have a protracted period of negotiation with the Preferred Bidder after BAFO, depending upon the complexity of the scheme in question and the degree of strong project management and commitment on the part of both the Authority and the Preferred Bidder. In local authority housing PFI projects a short rigorous competitive process should be sufficient to enable an Authority to select its preferred bidder for negotiating the Contract with, whilst recognising bidders' concerns about tendering costs.

## 9.4 Conclusion

9.4.1 Whilst the benefits of a team approach to developing complete proposals for local authority housing PFI schemes can be appreciated, the principal concern in relation to this approach is ensuring that value for money can be achieved notwithstanding the appointment of a "preferred bidder(s)" at such a relatively early stage in the procurement process. Although the bidder(s) would be appointed following competition under the restricted procedure, the selection criteria at this stage will be aimed at obtaining the best "team member" rather than price and quality of the bid for the scheme. Furthermore, notwithstanding pricing of the proposals as they develop can be undertaken on an "open book" basis, it is difficult to perceive the circumstances where such would yield greater value for money than the competitive bidding process under the EU Negotiated Procedure.

9.4.2 Finally, the use of the Regulation 24 procedure would appear to give the bidder(s) a strong bargaining position at an early stage in relation to both price and risk transfer particularly in the light of the current immature market for local authority housing PFI schemes due to the absence of completed transactions and agreed risk apportionment on optimum value for money terms.

1. Housing Standardisation Guidance (HGS) Position

2. Management Agreements

9.4.3 However, views are welcomed on the extent to which the Regulation 24 Procurement process could be followed whilst addressing the above concerns in relation to yielding optimum value for money.

## APPENDIX 1

### Housing Standardisation Guidance (HGS) Position

#### 1. Right to Buy

Section 11.2.1 of the HSG contains by way of background, an explanation of the right to buy (RTB) legislation and Section 11.2.2, the recommended approach, in broad terms, to dealing with RTBs resulting in dwellings "exiting" the contract. The then recommended approach can be summarised as follows:-

- the Contract should contain a change mechanism to deal with the adjustment to the Unitary Charge following the exercise of the RTB and consequent withdrawal of the dwelling from the Contract (although such may be a partial withdrawal eg where the sale is of a leasehold interest);
- the Authority and Contractor should agree a regular RTB adjustment date (the "RTB adjustment date") in the Contract (either by reference to number of sales or time period or both) following which the unitary charge will be adjusted to take into account RTBs in the period between the last RTB adjustment date and the current one;
- the withdrawal of dwellings should be treated as a change as opposed to a partial termination;
- the methodology for calculating the change should be that contained in the OGC General Guidance for changes in the Service generally;
- the Contract should contain a procedure for arriving at the adjustment of the unitary charge and if agreement on a specific procedure is not possible then the procedure in the General Guidance for Authority Change should be followed;
- where the RTB occurs during refurbishment the unitary charge should be adjusted to reflect the net reduction in capital costs, finance costs and operating costs albeit also reflecting that such an adjustment is unlikely to be linear;
- where the RTB occurs after full service commencement the unitary charge should be adjusted to reflect changes in operating costs with the debt and financing costs relating to the refurbishment works and investor returns continuing to be payable albeit again reflecting that any adjustment is unlikely to be linear;
- the loss of dwellings should not result in a greater proportion of the unitary charge being subject to deductions for unavailability i.e the payment and performance mechanism should not apply to costs continuing to be payable in respect of the exited dwellings;
- the Authority should have the discretion (but not the obligation) to use the available balance of any capital receipt from the RTB to make an advance payment of the unitary charge; and
- Authorities and Contractors should give consideration to a threshold representing the number of dwellings below which the Contract ceases to be viable, which

would result in automatic termination at the option of either party with compensation being the equivalent to that payable on a voluntary termination.

## 2. Leaseholders

The HSG (Section 10) covers the position of leaseholders in a local authority housing PFI contract in some detail. The guidance on leaseholders may be summarised in the following terms:-

- Where leasehold properties are part of the buildings that are the subject of the contract, and where housing management is part of the Service, then it is likely that the optimum value for money will be achieved by including leaseholder management services in the contract;
- An Authority should, at an early stage, ascertain the extent to which the cost of carrying out the refurbishment works and providing the Service can be recovered from the leaseholder under the terms of the lease;
- The risk of recovery of service charges from leaseholders should be apportioned in the way that provides the best value for money to the Authority and therefore the risk of exceeding limits on recovery of service charges as a consequence of the mandatory cap on the level of service charges (currently £10,000 in any five year period under the Mandatory Reduction of Service Charges (England) Directions 1999) and costs not covered by a notice under Section 125 Housing Act 1985 should remain with the Authority.
- Leasehold services are capable of being subject to performance criteria;
- It is for the contractor to ensure that the proposed level of service charge is reasonable and that the works are of a reasonable standard and thereby comply with Section 19 Landlord and Tenant Act 1985.
- It is for the Contractor to ensure compliance with the Authority's procedural requirements in carrying out the works as contained in Section 20 Landlord and Tenant Act 1985 (in particular the requirement to obtain two estimates for the cost of the works to be recharged to leaseholders).
- It is unlikely that bidders will be able to comply with Section 20 during the procurement process.

Compliance with Sections 19 and 20 during the refurbishment works period will involve, the extent of works to be actually undertaken to each property/dwelling being identified, the Contractor obtaining at least one independent estimate in relation to the cost of the works, the cost of the works being reasonable, the contractual commitment by the contractor in relation to the works reflecting the reasonable cost and the leaseholder being invoiced for the actual cost of the works to his/her dwelling.

## APPENDIX 2

### Management Agreements

#### 1. Section 27 of the Housing Act 1985

- 1.1 Section 27 of the Housing Act 1985 enables a local housing authority, with the Secretary of State's approval, to enter into an agreement with another person to undertake the authority's management functions in respect of its housing and land. As originally enacted it only empowered management agreements with housing co-operatives. Since that time a number of changes have been made to it to reflect changing Government policy. The purpose of the approval function given to the Secretary of State is to enable him, in the public interest, to control or influence authorities' decisions in entering into management agreements.
- 1.2 An approval may be given specifically or generally. A General Approval has been given by the Secretary of State (issued on 14 November 1994) which enables agreements to be entered into in certain defined circumstances without further reference to himself. However, the circumstances are quite narrowly defined and exclude PFI type arrangements largely because of the requirement to limit agreements to five years. In considering requests for approval for proposals which fall outside of the General Approval the Secretary of State takes into consideration whether tenants have been consulted on the proposals.

#### 2. The Issue

- 2.1 A problem arises from the limitation Section 27 imposes. It will only permit the authority to have an agreement with another person (or contractor) where that person alone carries out the housing management work. There is no power for the authority to agree to that person requesting another person (or sub-contractor) to exercise all or part of the delegated housing management work. Consequently it is not possible for a local housing authority to enter into a PFI contract (or any similar arrangement) in circumstances where the PFI Operator intends to sub-contract the housing management functions.
- 2.2 In PFI projects, most contracts will be let between the authority and a specially formed company, known as a 'special purpose vehicle' (SPV) or 'company' (SPC). The SPV will be a shell organisation, set up in these instances to bring together a consortium. In its simplest form, for housing this will consist of a Registered Social Landlord (RSL), a building contractor and an investor (although there are likely to be variations on this arrangement). The SPV will take on the responsibilities of the contract but in most instances will not carry out the management work. This will be subcontracted under separate agreements between the SPV and one or more management providers. A simplified diagram of the likely composition of a consortium bidding for such a scheme is attached at **Diagram 1** as an example; it reflects a variation on the model outlined above.
- 2.3 Under PFI arrangements (and any future, similar arrangements), Section 27 also prohibits any agreement between the authority and any sub-contractors because the terms of Section 27 require that the sub-contractor must be able to carry out the discretionary, policy related elements of the work independently of others. Where a SPV arrangement is envisaged this will not be the case as the sub-contractors will have their own agreements with the other members of the SPV. They cannot therefore be said to be acting independently.

#### 3. The Options

- 3.1 The Department has considered four ways of dealing with this as following:
- 3.1.1 do nothing;
  - 3.1.2 using the powers already available in Section 27;
  - 3.1.3 enable management agreements between local housing authorities and those directly undertaking the work in situations where they will not be acting independently;
  - 3.1.4 enable management agreements between local housing authorities and service providers which can include sub-contracting arrangements.
- 3.2 Taking each in turn, the likely consequences of **not addressing the problem** (paragraph 3.1.1 above) are that no HRA PFI contracts or similar arrangements can be entered into where the arrangements involve sub-contracting. This reduces the flexibility available to authorities in delivering their housing strategies. It may well prevent them from achieving the value for money, best value in housing services, provision of decent homes etc. benefits that such long-term arrangements are intended to bring.
- 3.3 **Use the powers already available in Section 27** (paragraph 3.1.2 above). Section 27 gives the Secretary of State the power to give approvals either generally to all authorities, or by identifying specific authorities or specific cases or types of cases. Approvals under this power would not be of assistance as they would still be limited by the wording of Section 27. The power to exclude the requirements of Section 27 from applying to certain housing management functions by regulations would also not assist as there would then be no power for the authority to delegate any of the excluded functions.
- 3.4 **Enabling management agreements between local housing authorities and those directly exercising any of the specified functions where they will not be acting independently** (paragraph 3.1.3 above) could be a workable solution. However, it is likely to require numerous management agreements depending on the number of sub-contractors involved and the extent of the housing management functions included in the scope of the PFI contract. There may be situations where the work is sub-contracted further which would make the process very complex.
- 3.5 **Enabling management agreements which permit the PFI Operator to sub-contract the housing management functions** (paragraph 3.1.4 above) would seem to be the option which would deliver the necessary changes to enable PFI and other, similar arrangements to be entered into. Any such change could also take account of further tiers of delegations (or sub-sub-contracting).

#### 4. **The Proposed Solution**

- 4.1 On balance it is considered that the option (in paragraph 3.1.4) above, ie amending Section 27 in a way that enables a management agreement to exist between an authority and their preferred contracting partner which includes agreeing that other persons may exercise some or all of the management work, would be the most appropriate way forward. This would retain the underlying policy intentions behind Section 27 as well as being relatively simple to implement. The changes must be framed in a way that does not adversely impact on requirements under the right to manage regulations or tenants' or leaseholders' rights to consultation.
- 4.2 The Department proposes that the changes should not be restricted to HRA PFI projects but should apply generally in order to enable authorities to enter into other, similar arrangements (for instance PPPs) where similar situations may arise.

4.3 As at present, the authority would have to apply to the Secretary of State for his approval at the initial stage of letting such a contract and would have to identify the various persons who would exercise the management functions (i.e. the sub-delegations/sub-contractors). Where the PFI Operator (or manager, in the terms of Section 27) wished to:

4.3.1 appoint a further person to exercise any of these functions; or

4.3.2 change either a person appointed; or

4.3.3 change the terms of the management agreement; or

4.3.4 change the subsidiary management agreement,

then they would have to consult tenants where this was part of their specified functions (if not, the authority would be obliged to consult the tenants). Once tenants' views were taken into account, the PFI Operator would approach the authority under the terms of the management (or project) agreement for consent. If the authority were satisfied with the proposal, they would in turn approach the Secretary of State for approval under Section 27 and give their consent once his approval had been given. Likewise where changes to the composition of the SPV are proposed during the course of the contract or a new housing manager appointed, a similar process would need to be followed including consultation with tenants and further approvals from the Secretary of State required.

4.4 Where a sub-delegated manager needs to be replaced as a matter of urgency (e.g. the existing manager becomes insolvent) it is proposed to have an interim period before the Secretary of State's approval must be sought. This would enable a temporary manager to be installed and tenant consultation to take place on a new, permanent manager, before the Secretary of State is approached to give his approval. This would enable the continuous provision of services for tenants without there being a hiatus. The suggestion is that the interim period should be three months.

## 5. **Implementing the Changes**

5.1 Consideration has been given as to whether these changes could be implemented through secondary legislation. However, as discussed in paragraph 3.4 above, the Secretary of State's powers under Section 27 are of no help here.

5.2 The Regulatory Reform Act 2001 enables a Minister to make an order to reform legislation where that legislation has the effect of imposing burdens in the carrying on of any activity. In the current circumstances an authority is prevented by Section 27 from appointing a manager to undertake the housing management functions through sub-contracting arrangements which may offer better value for money than other solutions as well as other benefits such as best value improvements. In the majority of proposed HRA PFI projects, this prevents PFI Operators from undertaking the activity at all where they propose to sub-delegate the work. A Regulatory Reform Order (RRO) would therefore be the most appropriate way forward.

5.3 Such an order may only be made if the Minister is of the opinion that it does not "remove any necessary protection or prevent any person from continuing to exercise any right or freedom which he might reasonably expect to continue to exercise." Tenants rights as tenants of the authority will not be removed or altered. Likewise the change will not remove tenants' rights to consultation as required by Section 105, nor will it affect other existing rights such as Right to Buy and Right to Manage. Likewise for leaseholders where their rights to consultation over the cost of works would remain. There is no intention to remove the requirement to seek the Secretary of State's approval for housing management agreements which are outside of the terms of the Secretary of State's

general approval. It is therefore considered that the amendments proposed would meet the requirement of such an order.

## **6. Timing and Interim Solutions**

- 6.1 The proposed RRO will take some time to complete the Parliamentary procedures. Allowing time for consultation and the sixty days laying before both Houses, the earliest any changes could be in place would be February 2003. A number of PFI pathfinder authorities are well advanced in the procurement process and contracts could be ready for signature later this year. We have therefore given some thought to the likelihood of contracts being ready for signature but unable to proceed, and have considered interim solutions.
- 6.2 One possibility is for the authority to continue to provide the management and service functions during the period when the PFI operator undertakes the initial refurbishment of the properties. This will be possible where the refurbishment work is defined so that the contractor is not exercising any of the management functions in carrying it out within the meaning of the term 'management' in Section 27. However, the authority would have to make any necessary decisions on issues not resolved at this stage such as adjustments to the sequence in which properties are refurbished, which involve the exercise of a management function.
- 6.3 Although not entirely satisfactory, nevertheless the refurbishment element of the contract would be similar to 'works' contracts already commonly let by authorities. These do not involve the exercise of a housing management function and so do not need to comply with the requirements of Section 27. Since it is likely to be only a matter of one or two months before the changes come into effect, the provision of associated services could be delayed until that time.
- 6.4 Options are still being considered but at the moment this seems to be the more viable solution.

## **7. Analysis**

- 7.1 Section 105 of the Housing Act 1985 requires the local authority landlord of secure tenants to consult those tenants on matters of housing management where for instance a change of housing manager takes place or changes to the management functions are proposed. There is no intention to limit tenants' rights under Section 105 through the proposed changes to Section 27. The requirement to consult in circumstances where the management work will be sub-delegated will remain in place.
- 7.2 Likewise, where arrangements are proposed which fall outside of the Secretary of State's general approval under Section 27, the Secretary of State seeks to ensure that tenants have been consulted and their views taken into account when he considers proposals. Under the new arrangements for Section 27, the Secretary of State will still require local housing authorities to submit to him details of their proposed agreements, together with details of those to whom the work is being sub-delegated. He will want to be satisfied that tenants have been adequately consulted on all of this in the process.
- 7.3 In addition, it is proposed that the Secretary of State will be informed in advance of any changes either to the make-up of the SPV or changes in respect of those to whom the work has been sub-delegated. In both instances he will want to be satisfied that tenants have been adequately consulted in the process.
- 7.4 An exception to this might be as mentioned in 3.8 above where a sub-delegated manager needs to be replaced as a matter of urgency.

- 7.5 While continuing to protect tenants' rights and giving authorities more flexibility about the arrangements which may be made for the exercise of the specified management functions, the proposed changes may be seen as imposing some additional burdens on PFI Operators which were not apparent to them at the time of bidding for the work. The additional burden is likely to be in the form of:
- 7.5.1 providing additional information about changes to sub-contractor partners and agreements in order for the authorities to approach the Secretary of State for approval;
  - 7.5.2 awaiting the Secretary of State's approval before any changes can take place either to the SPV or within the SPV, within its sub-delegated partners or to the management agreements;
  - 7.5.3 the potential for the Secretary of State's approval to be withheld;
  - 7.5.4 a short delay in providing the full range of services envisaged under the PFI project agreement depending on the timescale for legislative change and the progress with the PFI contract.
- 7.6 Paragraph 7.5.1 above is not considered to be a significant additional burden since management (or project) agreements require PFI Operators to provide the authority with these details in the first instance. Any changes to management agreements are likely to have to go through existing contract variation procedures.
- 7.7 Paragraph 7.5.2 above is not considered to be a significant additional burden since most management (or project) agreements require written consent from the authority. The Secretary of State's approval would form part of this consent procedure and would be a requirement anyway under Section 27.
- 7.8 Paragraph 7.5.3 above may be perceived as an additional burden. However, it is probably no more of a burden than authorities withholding written consent under project agreements being drafted at present. If the requirements of Section 27 are met then it is unlikely that approval will be withheld.
- 7.9 Paragraph 7.5.4 above is only likely to affect one or two contracts and then only for a short period of time and therefore not significant.
- 7.10 In the light of the preceding paragraphs, it is our opinion that the extent of any additional burdens should be minimal. Moreover, it would be reasonable to impose an additional burden of this size bearing in mind the Secretary of State's responsibility to protect tenants' rights and the fact that authorities themselves are under similar obligations when they want to let management agreements under current arrangements.
- 7.11 Consultation with tenants on any changes should not be considered a burden but part and parcel of working with tenants. In addition, it is considered that the proposed changes impose no additional burdens on local housing authorities over and above those that are already in place.
- 7.12 Bearing in mind the benefits from such arrangements i.e. for the tenants and authorities in improved housing (which may not be achieved otherwise) and services provided to agreed standards, and to PFI Operators in entering into long-term contracts where income is fixed for thirty years, the burdens imposed will be outweighed by the benefits. The proposals are intended to enable authorities to enter into new types of arrangements which will be beneficial to them while at the same time satisfying the Secretary of State's existing requirements and aims.



Diagram 1

SPV relationship between consortium members, service providers and advisors

