Author/Lead Officer of Report: Jayne Clarke, Finance Business Partner

Tel: 0114 2039159

Report of:	Executive Director, Place
Report to:	Co-operative Executive
Date of Decision:	19th January 2021
Subject:	Howden House PFI Contract– Refinance

Is this a Key Decision? If Yes, reason Key Decision:-	Yes	✓	No	
- Expenditure and/or savings over £500,000		✓		
- Affects 2 or more Wards				

Which Cabinet Member Portfolio does this relate to? Cllr Paul Wood, Executive Member for Housing, Roads and Waste Management

Which Scrutiny and Policy Development Committee does this relate to?

The Overview and Scrutiny Management Committee

Has an Equality Impact Assessment (EIA) been undertaken?	Yes		No	✓

If YES, what EIA reference number has it been given? *(Insert reference number)*

Does the report contain confidential or exempt information?	Yes		No	✓

Exemption applies to the appendix

*"The **appendix** is not for publication because it contains exempt information under Paragraph of Schedule 12A of the Local Government Act 1972 (as amended)."*

Purpose of Report:

The Howden House PFI contract ('the Contract') has been set a significant savings target in order to contribute to the Council achieving its challenging budget position and to deliver its workplace strategy.

This report seeks approval to the Council pursuing a contract Refinance to replace the current funder of the Howden House PFI contract with potential new funder, on more favourable terms and the introduction of an energy saving sharing mechanism in order to deliver a saving to the Council and to progress any necessary changes to the contract.

Recommendations:

It is recommended that the Co-Operative Executive:

1. Approve the continuation of the Refinance process and dialogue with the potential new funders in order to determine the optimal route in terms of maximising savings and mitigating risks and subsequently take forward the preferred option.
2. Approve the ongoing dialogue with the DLUHC throughout the refinance process and to submit a business case seeking DLUHC/HMT approval to complete the refinance.
3. Approve the funding of any abortive project costs of the Refinance from Place revenue budget.
4. Approve the variation of the Contract to allow the energy saving sharing mechanism.

5. Delegates authority to the Executive Director of Resources to:
    i. monitor the progress made by Council officers in determining the optimal refinancing option and approve (if appropriate) the recommended option; and
    ii. review and authorise the submission of a business case to the DLUHC/ HMT; and
    iii. complete the refinance of the Contract subject to the approval of commercially acceptable terms by the Director of Legal and Governance

6. Where no existing authority exists, delegates authority to the Executive Director of Resources, in consultation with the Director of Legal and Governance to take such steps to meet the aims and objectives of the report.

Background Papers:

Lead Officer to complete:-		
1	I have consulted the relevant departments in respect of any relevant implications indicated on the Statutory and Council Policy Checklist, and comments have been incorporated / additional forms completed / EIA completed, where required.	Finance: *Tim Hardie* Legal: *Nadine Sime* Equalities: *Louise Nunn*
	Legal, financial/commercial and equalities implications must be included within the report and the name of the officer consulted must be included above.	

2	**EMT member who approved submission:**	Michael Crofts
3	**Cabinet Member consulted:**	Cllr Paul Wood, Executive member for Housing, Roads and Waste Management
4	I confirm that all necessary approval has been obtained in respect of the implications indicated on the Statutory and Council Policy Checklist and that the report has been approved for submission to the Decision Maker by the EMT member indicated at 2. In addition, any additional forms have been completed and signed off as required at 1.	
	Lead Officer Name: Jayne Clarke	**Job Title:** Finance Business Partner
	Date: 15th December 2021	

1. PROPOSAL

1.1 The Howden House PFI contract ('the Contract') has been set a significant savings target in order to contribute to the Council achieving its challenging budget position and to deliver its workplace strategy.

1.2 Savings can be achieved through refinancing the bank debt owing to the more favourable interest rates being offered by the financial markets than those available when the Contract was last refinanced in 2014.

1.3 Following the successful conclusion of an exercise to test the appetite of the existing funder and a range of potential new funders, this report seeks approval for the refinance to be completed. It is estimated that the refinance will secure savings of circa £0.1m to per annum over the remaining 9 years of the Contract Term giving a total saving of circa £0.8m.

1.4 Savings can also be achieved by making an amendment to the way the calculation for energy (heating and electricity) is done. Currently the Council pays for a fixed amount of energy through the contract which results in an overpayment each year. The introduction of a mechanism to share the surplus will result in an estimated saving of £0.7m over the remaining contract term.

2. HOW DOES THIS DECISION CONTRIBUTE ?

2.1 There is no impact on the services received by the people of Sheffield.

2.2 The savings realised will contribute to the Council achieving its budget, thereby reducing the risk of additional budgetary pressures being placed on other services delivered to Sheffield people.

2.3 This will be an enabler to the Council's delivery of the One Year Plan and in particular the investment in Our Council and subsequent Corporate plans.

3. HAS THERE BEEN ANY CONSULTATION?

3.1 There has not been any consultation, as this is a financing opportunity which will not directly impact the people of Sheffield.

4. RISK ANALYSIS AND IMPLICATIONS OF THE DECISION

4.1 <u>Equality of Opportunity Implications</u>

4.1.1 As this proposal is purely related to financial restructuring of the Contract and has no material effect upon the services received by the people of Sheffield then there are no equality impacts. The proposal is equality neutral affecting all people the same regardless of age, race, faith, disability, gender, sexuality and so forth.

4.2 <u>Financial and Commercial Implications</u>

Background

4.2.1 Howden House is one of the earlier PFI contracts and so the does not include a mechanism for the Authority to share in the gain created by a Refinancing in the way that later contracts do. The Contract was previously Refinanced and revised terms were agreed with a new funder. Those terms were reflected in a change to the contract with effect from September 2014 but no payment to the Council. However, a new Code of Conduct has been issued by HM Treasury. This a voluntary code which suggests contractors should adopt a Refinance Gainshare mechanism which would give the contracting authority a 30% share.

4.2.2 The Council has therefore explored the potential of a further Refinance with the contract shareholder Equitix. Equitix have agreed to adopt the Code of Conduct and for the Council to receive a 30% share of any gain.

4.2.3 Civic accommodation PFI contracts such Howden House represent the most stable investments and would generally attract a wide range of interest from prospective funders. However, the shorter remaining term of 9 years might put of some funders who would only be interested in longer term steady returns.

4.2.4 PFI projects have performed well during the pandemic compared to other more volatile commercial investments. Additionally, although the funding market stopped lending to new schemes in the initial stages of the C19 lockdown, it soon returned to more normal levels of activity and therefore funders are now keen invest in new PFI projects.

4.2.5 These factors have created a perfect opportunity of well-established contract with very competitive markets that should secure the best level of savings.

Refinance Process

4.2.6 Under the Contract the Refinance process is managed by Equitix and its advisors and the Council has an oversight and approval role.

4.2.7 The Council has appointed Financial Advisors, Local Partnerships and Legal Advisors, Bevan Brittan to carry out the necessary due diligence and provide market expertise.

4.2.8 The Council will incur direct costs to carry out the Refinance. Providing the Refinance is complete, those costs will be reimbursed by Equitix and set-off against the Refinance gain. However, if the transaction doesn’t complete then it will have to bear those abortive costs.

4.2.9 As a result of a Refinance the level of debt will increase because it will include funding for any break costs associated with ending the current funding and the transaction cost of the Refinance. However, this debt will be at cheaper rates creating a reduction in cost overall (the Refinance Gain).

4.2.10 This increased debt will increase the compensation payable if the contracted were Terminated in the early years following the Refinance.

4.2.11 The Refinancing will be subject to Department for Levelling Up, Housing and Communities (DLUHC) approval following submission of a Final Business Case (FBC) at the appropriate time. The FBC will need to demonstrate that the Refinance is on market terms and that it represents Value for Money taking into account the increase in termination Liabilities.

Progress To Date

4.2.12 Equitix have started the market engagement and have sought revised terms from several funders. This includes a mix of existing and new funders and both banks and institutional lenders (Insurance/Pension Funds).

4.2.13 Publicly available evidence of ethical, sustainability and social responsibility policy commitment was a pre-requisite for inclusion within an original long list of potential lenders.

4.2.14 Responses were sought with terms that offered a reduced interest rate on the £12m borrowing and other changes to the structuring of the debt that would make the contract funding more efficient.

4.2.15 Whilst there were only a small number of responses they were from a good spectrum of the market and provided indicative terms that were considerably better than the current funder terms.

4.2.16 The indicative level of financial savings achievable from the responses mean that the Council could realise savings of circa **£0.1m pa**. This equates to a total saving of between **£0.8m** over the contract term. The Council has the option to take the saving as an annual reduction to the contract payment or as an upfront gain.

4.2.17 Its is expected that the Refinance can be completed before the end of the 2021/22 financial year.

4.2.18 The Council has engaged with DLUHC and will continue to do so through the Refinance process.

4.2.19 Given that this would be the second refinance of the contract with the resultant additional debt and termination costs and the shortening contract term, it is unlikely that a further Refinance would be possible and so it is imperative to ensure that the most competitive market terms are secured.

Next Steps

4.2.20 The key next step will be to determine the preferred funding model. The consideration will be based on the most competitive terms and acceptable termination liability.

4.2.21 The shortlisted funder will then go through their own due diligence process relying on Legal and Technical Advisors reports of the performance and risk of the contract. If they are happy with this process, they will then seek formal approval of the terms from their credit committees.

4.2.22 At the same time the Council will develop the FBC to submit to DLUHC for approval.

4.2.23 Once credit committee and DLUHC approval is received the Refinance can be executed.

4.2.24 The credit committee approval will be based on an interest rate margin which will be applied to the prevailing underlying base rate on the day that the Refinance is complete. Therefore, the exact cost of finance and relevant break costs can only be determined at that time. Interest rate movements will be monitored in the run-up to the Refinance and a range of acceptable rates determined to ensure the refinance remains viable.

4.2.25 Risks

Risks	**Impact**	**Mitigation**
Refinance fails to reach	Abortive transaction costs and budgeted	Proven strong market interest in PFI and civic accomodation most straightforward to invest

Financial Close	saving not achieved	in. Majority of fees are for final stages of transaction which woudnt be incurred
Actual Bank Margin higher than assumed	Lower saving	Relatively prudent indicative margin for risk rating of contract but subject to final bank due diligence
Transaction costs higher than assumed	Marginally lower saving	Above savings based on very prudent cost assumptions. Competitve terms secured from SCC advisors. As transaction costs set-off against gain share will have minimal impact on SCC share.
Process takes longer than expected	Lower saving	Delay has more material impact through reduced debt saving but transaction already well prgressed.
DLUHC reject Refi. Business Case	Abortive transaction costs and budgeted saving not achieved.	Concern will be increase in termination costs. Impact which will be quantified and modelled as proposed terms are firmed up.

Energy saving sharing proposal

4.2.26 Under the current terms of the contract the Council pays for a fixed volume of electricity and heating each year which is set and is not subject to change. The unit cost for each utility is amended each year to reflect the current cost of each utility and the Council makes payments to the Service Provider based on this calculation.

4.2.27 The result of this is as follows;

1. The Council is always exposed to the effects of price fluctuations in the market.

2. The risk for consumption usage is in theory shared for example where actual consumption does not exceed the fixed volume the Service Provider retains the surplus and in the event that the actual consumption exceeds the fixed volume the Service Provider would be liable for the additional cost.

4.2.28 The current situation is that the overall actual utility consumption is significantly lower than the fixed amount which is shown in the table below for the previous 4 years;

Year	% actual electric used vs fixed	% actual heat used vs fixed	% combined use vs fixed
2017/18	43	139	67
2018/19	44	122	64
2019/20	44	136	67
2020/21	35	161	67

As can be seen less than half the fixed electricity consumption is actually used on an annual basis. There is an over consumption of heat however the net effect is a significant underconsumption. Whilst Covid has had an effect on the 2020/21 consumption the analysis shows that this is a long-term issue rather than a one off.

The following table shows the effect this has had on the contract payment for energy over the past 4 years;

Year	Fixed cost of energy paid by SCC	Actual cost of energy	Variance (over payment)
2017/18	£413,574.87	£239,303.56	£174,271.31
2018/19	£413,023.09	£260,646.62	£152,376.47
2019/20	£408,719.03	£278,067.39	£130,651.64
2020/21	£395,522.64	£243,489.01	£152,033.63

4.2.29 The proposal is to introduce a mechanism to reconcile the difference between the fixed costs and the actual costs at the end of each financial year and to share the value of the variance on a 50 / 50 basis.

The proposal would introduce some additional risk to the Council, as in the event that overall consumption was in excess of the fixed amount the Council would be liable to pay 50% of the excess amount. This risk is assessed as being low on the basis of the consumption table presented in 4.2.28 and the fact that the building is well established, building use is set within strict parameters and it would take a significant change of use to reach the fixed consumption levels.

The following table shows the outcome of the proposal and saving the Council would have achieved based on the previous 4 years of data;

Year	Variance	SCC share 50%
2017/18	£174,271.31	£87,135.66
2018/19	£152,376.47	£76,188.24
2019/20	£130,651.64	£65,325.82
2020/21	£152,033.63	£76,016.82
		£304,666.53

<u>The actual size of the saving is also affected by the cost of energy which as previously stated the Council is also exposed to, however based on the historic data the predicted saving would be circa £0.7m over the remaining term of the contract.</u>

<u>Proposals:</u>

4.2.30 To continue with the Refinancing with potential new funders in order to determine the optimal route in terms of maximising savings and mitigating risks and subsequently take forward the preferred option; and

4.2.31 Continue the ongoing dialogue with the DLUHC throughout the refinance process and to submit a business case seeking DLUHC/HMT approval to complete the refinance.; and

4.2.32 Fund any abortive project costs from the Refinance from the Place revenue budget; should the refinance not be possible to complete; and

4.2.33 In order to progress the refinance within the time constraints described in this report, the Co-operative Executive is requested to delegate its authority for some of the process to the Executive Director of Resources, as detailed within the recommendations.

4.2.34 Proceed with the introduction of an energy saving sharing mechanism.

4.3 Legal Implications

4.3.1 In terms of the refinance the Howden House contract provides for a refinance and therefore the refinance itself carries no legal implications. The refinance has been explored due to Equitix agreeing to adopt the voluntary HM Treasury Code of Conduct referred to at 4.2.1 and 4.2.2 above. The Council will carry out the refinance in accordance with the Contract and its provisions. In respect of the introduction of an energy saving sharing mechanism, this can be achieved by varying the Contract to include this mechanism, the financial details of which are detailed above.

4.3.2 The Council has a general power under section 1 of the Localism Act 2011 to do things an individual may generally do (including vary a contract in accordance with its terms) provided, it is not prohibited by other legislation and the power is exercised in accordance with the limitations specified in the Act e.g. around charging for the provision of a service.

4.3.3 When it was procured this Contract was above the public procurement financial thresholds and consequently was procured under a regulated procurement procedure. If the Contract is changed to a material degree, it may be held that there is, in fact, a new contract, which should have been re-tendered in accordance with the Procurement Regulations and the resultant contract could be held ineffective.

4.3.4 The proposed changes are not considered to be material changes to the existing contract because there will be no variation to the services to be provided. Although Equitix will make additional profit as a result of the changes, this is a usual consequence of a standard PFI Contract where Refinance clauses and gainshare mechanisms exist and are commonly executed.

4.4 Other Implications

4.4.1 *n/a*

5. ALTERNATIVE OPTIONS CONSIDERED

5.1 Do Nothing

5.1.1 Under this option no further action would be taken now in relation to a Refinance or other contract changes and all activities would be stopped.

5.1.2 In this scenario the Council would have to bear the abortive transaction costs and would not generate the expected ongoing contract saving.

5.1.3 This would have the advantage of being able to carry out a Refinance in future years should the finance market be deemed to be more competitive.

5.1.4 However, there is no certainty that there would be an improvement on the current market conditions and the benefits of a refinance reduce with time as more of the debt is paid off at the current higher rates. This is particularly the case with a contract that only has 9 years remaining.

6. REASONS FOR RECOMMENDATIONS

6.1 The Howden House contract (‘the Contract’) has been set a significant savings target in order to contribute to the Council achieving its challenging budget position and delivery its workplace strategy.

6.2 The well-established nature of the contract makes it more attractive to the funding market and there are a limited number of competing relatively safe investments for funders in the current economic environment. These combine to give the Council a high chance of success in achieving a Refinance of the contract on the most favourable terms.

6.3 The Do-Nothing option will result in more pressure on achieving the Council’s current and future budget and may result in more drastic cuts to front line services.

6.4 Failure to carry out the Refinance will result in more pressure on achieving the Council’s current and future budget and may result in more drastic cuts to front line services. There is no evidence that deferring the Refinance will result in a more viable outcome in the future.