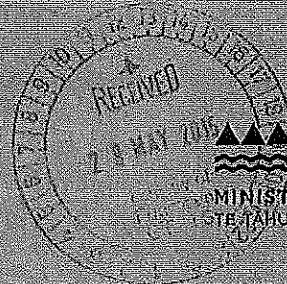
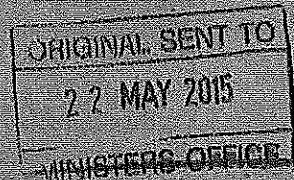


Mo Ref: 27 MAY 2015



22 MAY 2015

MINISTRY OF EDUCATION
TE TAHUHU O TE MATAURANGA

Briefing Note: Further advice on Partnership Schools property funding

Date:	22 May 2015	Priority:	Medium
Security Level:	In confidence	METIS No:	929555
To:	David Seymour MP, Parliamentary Under-Secretary to the Minister of Education		
Copy to:	Hon Hekia Parata, Minister of Education		
Approved by:	Graham Stoop	DDI / Mob	[REDACTED]

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Background and purpose of this report

1. On 11 May 2015 we provided a briefing note to you, copied to the Minister of Education, with a proposed process and timeline for the Immediate Partnership Schools work programme [METIS 927178 refers].
2. In the report we advised that we would provide further advice on property funding and a regional index by 22 May 2015.
3. In your 16 April 2015 memo you also asked for a sensitivity analysis on Cash for Buildings.
4. Contextual background on Cash for Buildings and modelling of the effect of converting Cash for Buildings to a per-student property rate on schools of different type and size are provided in appendices.
5. The paper focuses on ongoing property funding (not property funding incorporated in the establishment rate, which was canvassed in earlier papers [METIS 923191 and 924404 refer]).
6. Your feedback is sought by 9 June 2015.

Objectives for review of the Partnership Schools property funding

Overarching parameters

7. We understand from your 16 April 2015 memo to the Ministry, that the following overarching objectives should guide the development of the property rate:
 - funding should follow the student / a per-student rate rather than a per-school rate is sought (efficiency incentives)

- risk moves from the government toward the sponsor – better aligning the sponsor's incentive to reach desired outcomes in the most efficient way (efficiency incentives)
- a child at a Partnership School should receive no more and no less than a child at a state school / Partnership Schools receive the same funding as an equivalent state school (neutrality with state schools).

Objectives for property funding

8. Your memo of 16 April 2015 indicates that the funding model needs to ensure that the property funding flow:
 - is consistent with real market costs / market rental costs (regional indexing)
 - is aligned with current enrolment / tracks actual enrolments (not maximum rolls)
 - should be approximately the rental cost of a full state school with the same number of students in a similar area (neutrality)
 - allows Partnership Schools to use their property funding as they see best (flexibility)
 - reduces property costs (cost savings)
 - accommodates those sponsors in a position (due to funding by philanthropists) to provide property in excess of the funded level. In such cases they should be funded at the same level as any other Partnership School, with the additional resource seen as a philanthropic contribution (fully funded).

Developing a regional property index

9. We are commissioning the development of a regional list of property leasing costs per square metre, and a regional index if necessary (a regional index will only be required if you wish to pursue option two in paragraph 14). We anticipate that this will cost somewhere in the vicinity of \$50,000, and a further amount to be determined each time the list or index is updated. We aim to have this work completed by 10 July 2015.
10. Any regional list or indexing of leasing costs will need to be granular enough to cover differing costs within a region. We will seek advice on how often the regional list or index needs to be updated from the commercial property specialist commissioned to do this work.

Possible methodologies for applying a regional list or index

11. We have identified two broad options for applying a regional list or index to Partnership Schools property funding, as set out in Table 1 below.
12. Until we receive the regional list or index, the extent to which further property cost savings can be achieved is unknown, over and above the savings from moving to a per-student property funding rate.
13. A leasing-based model will achieve some but not all of the objectives set out in paragraph 8. By using a regional list or index, Partnership Schools would receive

either more or less than an equivalent state school located nearby would receive under Cash for Buildings.

14. We seek feedback on your preferred option, and any further work you would like us to carry out.

Table 1: Options for applying a regional list or index	
Option 1: Apply a regional leasing rate to square metre entitlement	Option 2: Apply a regional index to Cash for Buildings
<p>Description</p> <p>In your 16 April 2015 memo to the Ministry you suggested that per-student property funding should be approximately the rental cost of a full state school with the same number of students in a similar area.</p> <p>This can be achieved by creating a list of property (lease) costs per square metre by region and applying this to the square metre entitlement generated using the School Property Guide calculator, which takes account of school type (providing, for example, proportionately more space for senior secondary schools).</p> <p>It would need to be based on commercial property leases as there are relatively few schools in leased premises.</p>	<p>Description</p> <p>A regional index would be applied to the capital component of the Cash for Buildings formula so that:</p> <ul style="list-style-type: none"> • schools in expensive rental markets (eg Auckland, Christchurch) could have their Cash for Buildings amounts increased by a percentage to ensure they are provided with enough property funding to lease enough space to operate; and • schools in inexpensive rental markets could have their Cash for Buildings amounts decreased to ensure that the school is not over-funded for its property requirements.
<p>Comment</p> <ul style="list-style-type: none"> • Commercial lease rates are likely to be cheaper than Cash for Buildings, and may not adequately reflect school-related costs, such as the high level of wear and tear students generate • Leases may not cover the furniture and equipment, and aspects of maintenance and modernisation costs required by a school • These issues may be able to be mitigated through a mechanism that incorporates school-specific cost adjustments (eg, an annual maintenance grant). 	<p>Comment</p> <ul style="list-style-type: none"> • This option uses an established school funding formula, albeit one predicated on building costs. • The costs of furniture and equipment, and maintenance and modernisation, which are integral to Cash for Buildings, will be increased or decreased in line with the regional index and may result in a degree of over-funding or underfunding. • Under this option, a neighbouring state school also funded under Cash for Buildings, will receive either a higher or lower amount than the Partnership School because of the application of the regional index.

Sensitivity analysis of Cash for Buildings funding formula

15. There are three key variables in the Cash for Buildings funding formula: the discount rate; inflation rate; and asset life / period of analysis. A sensitivity analysis has been undertaken on these variables using primary school funding for illustrative purposes.

Discount rate

16. The Government 10 Year Bond Rate was used to set the discount rate when the Cash for Buildings policy was launched in 2010. Since this time, the bond rate has dropped to around 3.5%. On the other hand, project-specific discount rates are likely to be significantly higher than 6%.

Table 2: Discount rate modelling					
	Low scenario	Medium-low scenario	Current model	Medium-high scenario	High scenario
Range of discount rates	2%	4%	6%	8%	10%
Impact on primary school conversion rate	\$86	\$107	\$132	\$162	\$194

Inflation rate

17. The inflation rate was set at 2.25%. Average annual inflation over the last two years is lower (around 1%).

Table 3: Inflation rate modelling					
	Low scenario	Medium-low scenario	Current model	Medium-high scenario	High scenario
Range of inflation rates	0.50%	1.50%	2.25%	3%	4%
Impact on primary school conversion rate	\$154	\$147	\$132	\$124	\$113

Asset life / period of analysis

18. Forty years is the standard industry assumption for the life of a building. For accounting/depreciation purposes, different building components have different asset lives, with 75 years (building fabric) being the longest. The low scenario of 25 years represents the operating period for a Public Private Partnership.

Table 4: Asset life / period of analysis					
	Low scenario	Medium-low scenario	Current model	Medium-high scenario	High scenario
Range of asset life rates	25	30	40	50	75
Impact on primary school conversion rate	\$157	\$146	\$132	\$125	\$116

19. For shorter time periods, such as 25 years, the conversion rates above assumes that the asset will have no useful life after that point in time – which seems unlikely.

Comment

20. Since 2010, changes in interest and inflation rates have largely netted off and meant there was not a compelling case to update the conversion rates.
21. If the Ministry was to update the conversion rate based on May 2015 interest and inflation rates, and current construction rates, the conversion rate would be \$121 (rather than \$132 currently). The reduction in the conversion rate is around 8%, and is driven by the lower discount rate (around 3.5%).
22. It needs to be noted though, that this rate is significantly lower than a project-specific rate derived using the Weighted Average Cost of Capital (greater than 6%).

Next steps

23. Your feedback is sought by 9 June 2015 on the regional list and index options outlined in this paper.
24. Your feedback will inform our ongoing work and feed into the development of a paper proposing overall changes to the Partnership Schools funding model, which is due by 19 June 2015.

Appendix A: Background to Cash for Buildings

Cash for Buildings is an established methodology for calculating a cashed-up property funding amount that is equivalent to comparable state school property entitlements.

It has provided a link to the state system and is a way to ensure neutrality between Partnership Schools' and state schools' property funding.

Rationale underpinning Cash for Buildings

Cash for Buildings gives state schools the option of receiving annual cash payments instead of new buildings when they become eligible for additional space under the New Teaching Space for Roll Growth or School Property Guide Deficiency programmes.

Before the introduction of Cash for Buildings, an increase in a school's space entitlement could only lead to the construction of new buildings. Cash for Buildings gives schools the option of receiving cash payments which can be used for any educational purpose, providing greater flexibility for schools in a manner similar to that intended through the Partnership Schools funding model.

The annual cash payment is set at a rate that is fiscally neutral for government (from a Net Present Cost perspective over a 40 year timeframe), whether a school takes the cash payment or a new building is constructed, maintained and modernised according to standard Ministry funding models over that same time period.

Cash for Buildings amounts are not pegged to leasing costs to ensure fiscal control. If a state school cannot find suitable leased accommodation with their Cash for Buildings payment, it is possible to default to the cheaper option of constructing new buildings on the school's site and maintaining these for 40 years.

Cash for Buildings formula

The level of funding is calculated by multiplying a school's entitlement to additional space by a conversion rate.

Square metre entitlements are calculated using the School Property Guide calculator, a fundamental element of School Property policy that sits outside of Cash for Buildings.

Students at different year levels generate different amounts of space and different types of space, such as more specialist space and gyms for senior secondary students. Teaching space allowances are also linked to teacher:pupil ratios. These ratios are hardwired for state school staffing, and property funding follows suit.

The conversion rate is an amount per square metre that approximately averages the cost of providing one square metre of space over a 40-year period (ie the economic life of the forgone building). It includes three components:

1. **capital costs** – site works costs and the cost of constructing the building(s), and a furniture and equipment grant
2. **maintenance costs** – averaged over 40 years of Property Maintenance Grant funding, which covers items such as ICT cabling, painting and repairs
3. **modernisation costs** – averaged over 30 years of Five Year Agreement (5YA) funding rather than 40 years because buildings less than 10 years old are unlikely to require modernisation, and covers items such as replacement of desks and seating, and installation of new technology.

The conversion rates vary by school type, reflecting the differing amount of specialist spaces required, as set out in Table 1 below.

Table 1: Cash for Buildings conversion rates as at May 2015	
Type of school	Conversion rate \$/m ²
Primary (years 1-6 or 1-8)	132
Intermediate (years 7-8)	147
Composite (years 1-13)	145
Restricted composite (years 7-10)	155
Secondary (years 7-15)	157
Secondary (years 9-15)	162

Appendix B: Modelling of the effect of proposed changes to property funding

In an earlier paper Cash for Buildings was converted to a per-student property rate [METIS 924404 refers]. We have modelled the effects of the conversion to identify potential impacts for Partnership Schools (while recognising that you are seeking alternatives to Cash for Buildings). See Tables 1 and 2 below.

Table 1: Primary school (Years 1-8)			
Maximum Roll	Cash for Buildings plus insurance	Per student property rate	Percentage difference from previous roll step
50	60,232	1,205	na
100	105,167	1,052	-13%
152	162,803	1,071	2%
200	189,710	949	-11%
248	227,679	918	-3%
300	298,018	993	8%

Table 2: Secondary school (Years 9-13)			
Maximum Roll	Cash for Buildings plus insurance	Per student property rate	Difference from previous roll step
200	590,193	2,951	na
250	654,659	2,619	-11%
300	745,112	2,484	-5%
350	804,748	2,299	-7%
400	863,218	2,158	-6%
500	977,491	1,955	-9%

The tables show that on a *per-school* basis larger schools receive significantly more funding than smaller schools. However, in moving to a per-student property rate, it becomes more transparent that on a *per-student* basis funding diminishes, and at an uneven rate. This reflects certain parameters built into the School Property Guide calculator which determines a school's entitlement to space for a given roll.

For example, no matter how small a school is, it needs an office for the principal, but at a certain threshold it also becomes eligible for additional office space (eg for a deputy principal), creating a significant funding step. Smoothing of the formula would depart from matching funding to actual costs.

It may be worth noting that making the steps in per-student property funding more visible may disincentivise roll growth at certain points. For example, for primary schools the per-student funding drops sharply between rolls of 50 and 100, and 152 and 200, which may provide an incentive for Partnership Schools to maintain their rolls at the lower rate for as long as possible in order to attract the higher level of funding.

