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To: Governance & Audit Committee
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Subject: Private Finance Initiative

Summary: This paper quantifies the Authority's existing exposure to PFI, and discusses how a number of the risks are being managed. It also compares the cost of two of the Authority's existing PFI contracts against what the cost might have been under a traditional procurement route.

FOR INFORMATION

BACKGROUND

1. This report is on the agenda at the request of Members as a follow up to the report *The risks to KCC resulting from the Private Finance Initiative* that was brought to the Governance & Audit Committee meeting on 1 December 2009, and addresses some specific issues that were raised as a result of the first report.

KCC's EXPOSURE TO PFI

2. The PFI contracts that KCC are currently engaged in are:
 - Swan Valley and Craylands Schools (Swanscombe) (CFE)
 - Six Schools (CFE)
 - BSF Wave 3 (CFE)
 - Westbrook and Westview Recuperative Care Facilities (Westview) (KASS)
 - Gravesham Place Integrated Care Centre – lead by West Kent PCT (KASS)
 - Better Homes Active Lives Extra Care Accommodation (BHAL) (KASS)
3. Appendix A plots the total unitary charge commitments for the remaining terms of these PFI contracts against the PFI credits we expect to receive from Government over the same period.
4. The total 2010/11 "affordability gap" is £10.7m, of which £7.1m relates to the CFE PFI contracts listed in paragraph 2 and £3.6m relates to the KASS PFI contracts. This will be met through:
 - A £6m contribution in respect of the three CFE PFI contracts will be made by top slicing from the Dedicated Schools Grant (DSG) in 2010/11. A further £2.3m contribution will be made by individual PFI school budgets towards maintenance and facilities management costs. This £8.3m contribution is greater than the affordability gap in respect of the CFE PFI contracts in 2010/11. The difference will be taken to the PFI equalisation reserves to help manage future risks.
 - The KASS affordability gap will be met by KASS base budget, and includes a £2.3m payment in respect of the Gravesham Place PFI contract, which is lead by West Kent PCT.
5. Equalisation reserves are held in respect of each PFI scheme lead by KCC in order to even out the annual affordability gap over the lifetime of the contract. With many PFI contracts, the PFI credits tend to remain constant each year over the life of the contract, whereas the Unitary Charges generally increase each year in line with inflation. Therefore, in the early years of PFI contracts, there tends to be a contribution towards the equalisation reserve. This reserve is then drawn down in the later years, when the Unitary Charge is greater.

6. The largest projected affordability gap on the existing PFI contracts outlined in paragraph 2 is £20.3m and is expected to occur in 2032/33. DSG and school contributions are expected to occur in the same proportions as in 2010/11, the only difference being an uplift for inflation.
7. Wave 4 of the BSF Programme was approved by Cabinet in July 2009. This Wave includes four PFI schemes. Financial close is scheduled for early 2011, at which point in time the size of any affordability gap will be finalised after Cabinet approval.

ISSUES RAISED AT/SINCE LAST G&A MEETING

Contract Reviews

8. Within each of the CFE PFI contracts, the main review points (normally every 5 years) are to benchmark or market test some of the facilities management services. These services include: cleaning, catering, grounds maintenance, waste management and pest control.
9. These review points are an opportunity for the Authority and Contractor to review the services to ensure they still offer value for money and are relevant to the schools needs. The exercise also ensures the costs adequately reflect the existing market conditions.
10. Of the two operational PFI contracts in CFE (Swanscombe and Six Schools), only Swanscombe has reached and been through benchmarking. The end result of this exercise was an increase in the annual unitary charge of approximately £100k, which reflected increased labour costs, increased food and preparation costs, and changes in legislation.
11. Each PFI contract has review periods where consumption baselines are reviewed. The utility review period for the Swanscombe contract is annual, and is every three years for the Six Schools contract. Depending on whether the baselines are exceeded or energy savings have been achieved, the Authority and Contractor will share the benefit or downside. These contract schedules are complex and can be influenced by increases in market tariff rates. This has been demonstrated recently within the Swanscombe contract where energy consumption savings have been made but high tariff rates have required the Authority to pay to the Contractor additional monies.
12. There are market testing provisions in the two Kent Adult Social Services PFI contracts for which KCC is the lead Authority (Westview and BHAL). For BHAL the unitary charge is fixed for the duration of the contract. Any increase in costs as a result of market testing is likely to fall on the rents and service charges to tenants, both of which are controlled and regulated by the Homes and Communities Agency.

Refinancing

13. Both Swanscombe and the Six Schools PFI contracts contain schedules which allow refinancing if the market conditions are deemed favourable. Both parties would equally share the benefit of refinancing once reasonable professional costs are taken into consideration. The same schedules also exist in respect of refinancing in the Westview and BHAL PFI contracts.
14. To date no refinancing has been undertaken in respect of any of the Authority's PFI contracts.

PFI credits

15. One or more Central Government departments will sponsor a PFI project. The sponsoring department(s) pay a stream of quarterly payments to the authority - PFI credits. These are calculated to cover the notional capital element of the project, including both the initial capital expenditure and planned life cycle expenditures. Issuing a PFI credit letter is a promise that PFI grant can be claimed once the project is operational, and the level of PFI credits determines the amount of grant¹.
16. PFI credits are payable by the Government department from service commencement (not from when building work commences), although the amount of PFI credit is set at the date the contract is signed. Whether or not the building usage is the same as that projected at the time the contract is signed, the value of the PFI credits will not differ from what is set out in the contract. Therefore, if fewer school children than projected actually attend a PFI school, or demand for social accommodation built under PFI reduces, the value of PFI credit will not reduce.
17. The risk of these PFI credits being withdrawn is deemed negligible. The opinion sought by our Legal Services team is that no Government could renege on this without seriously risking a judicial review.

PFI Contract termination/break points

18. With respect to both the operational PFI contracts in CFE (Swanscombe and Six Schools), termination can occur for breach of contract by either party. Whichever party (the Authority or the Contractor) causes a breach of contract which leads to termination, that party is responsible for the other party's costs.
19. Kent County Council can also terminate the contracts by giving due notice. If KCC was to terminate the contract, we would be subject to financial penalties based on the remaining length of the concession period and TUPE redundancy costs.
20. No break point exists in either the Swanscombe or Six Schools PFI contract.
21. This also applies to both of the KASS PFI contracts for which Kent County Council is the lead Authority (Westview and BHAL).

Schools Funding Forum

22. The Schools Funding Forum (SFF) has agreed to use the DSG to close the affordability gap for the Swanscombe, Six Schools and BSF Wave 3 PFI contracts.
23. The affordability gaps that the SFF have agreed to fund in 2010/11 are:

Swanscombe	£1.4 m
Six Schools	£3.7 m
BSF Wave 3	<u>£0.9 m</u>
	£6.0 m
24. To date the Schools Funding Forum has been extremely supportive of the Private Finance Initiative. The Forum is fully aware that through entering into PFI deals, the Authority is entering into a contractual arrangement that would be extremely difficult and costly to get out of.

Continued support for PFI

25. No matter what the result is after the General Election on 6th May, we know that there are some deep cuts to come in public finances. However, Schools' funding has already been announced as a protected area.

¹ <http://www.local.odpm.gov.uk/pfi/index.htm>

26. Budget cuts will impact on all authorities in a similar way, through the formula grant and specific grant allocation. These cuts are likely to reduce our scope to be flexible with how we use the grant allocation. Could PFI credits be affected? There are a number of other much bigger areas of expenditure without the same degree of commitment to funding into the future as PFI; these areas are more likely to be cut given the relative impact of that compared to stopping the PFI credits.

Risks

27. The above paragraphs identify that there is a small risk that PFI funding streams may dry up, which has been managed as far as possible.
28. Members should consider whether or not the remaining risks are sufficient to warrant inclusion in the Directorate and/or Strategic Risk Register.

COST COMPARISON: PFI vs. TRADITIONAL PROCUREMENT ROUTE

29. Tables 1 and 2 below provide a speculative comparison between the current cost of two PFI contracts to the Authority and what the cost might have been if we had gone down the traditional route for the procurement of the capital assets. In both cases, we have assumed that the capital cost under the traditional procurement route would have been the same as the capital cost of the assets built under the PFI contracts.
30. It is important to emphasise, when considering the comparisons in Tables 1 and 2, that at the time these contracts were entered into the Private Finance Initiative was 'the only show in town' and no alternative funding options were available. The Private Finance Initiative contracts that Kent County Council is currently engaged in have brought a significant amount of investment into the County. However, for the purposes of this comparison we have assumed in both cases that Supported Borrowing could have been available from Central Government at the same level as PFI credits, if they had chosen to be more flexible in how they support local investment.
31. The Audit Commission have identified an annual spend of between 1.5 and 2.0% of an asset's value as indicative of what might be required for long term maintenance of the asset. In Tables 1 and 2 below, annual maintenance expenditure has been estimated at 1.5% of the capital cost of the asset, for the traditional procurement route comparison.

Better Homes Active Lives PFI

Table 1			
Estimated cost under traditional procurement route		Cost under PFI contract	
Capital cost	£64.3 m	<u>Average over 30 year contract</u>	
Annual interest & repayment	£5.8 m	Payments to PFI contractor (Unitary Charge)	£5.3 m
Annual maintenance cost	£1.0 m	Contract Management	£0.2 m
<u>less</u> Supported Borrowing (*)	(£5.4 m)	<u>less</u> PFI credit	(£5.4 m)
		<u>less</u> Interest on balances	(£0.1 m)
Annual cost for 25 years	£1.4 m	Cost to KCC	£0.0 m

(*) Assumed at the same amount per annum as received through PFI credit from Central Government

32. Over the lifetime of the Better Homes Active Lives PFI contract, the component charges and credits net off such that the cost to the authority is £nil. Table 1 shows that had we undertaken the build under the traditional procurement route, and received supported borrowing at the same level per annum as we receive PFI credits, the net annual cost to the Authority would equate to approximately £1.4m per year for 25 years. However, it is important to again highlight the fact that no supported borrowing was available, which means the real comparison is between the two options that were available: PFI or prudential borrowing. The annual net cost of PFI to KCC is £nil, compared to the annual net cost of the prudential borrowing route of £6.8m.

Six Schools PFI

Table 2			
Estimated cost under traditional procurement route		Cost under PFI contract	
Capital cost	£96.6 m		<u>2010/11</u>
Annual interest & repayment	£8.7 m	Payments to PFI contractor (Unitary Charge)	£11.6 m
Annual maintenance cost	£1.4 m		
<u>less</u> Supported Borrowing(*)	(£6.1 m)	<u>less</u> PFI credits	(£6.1 m)
<u>less</u> DSG - Schools contributions	(£1.6 m)	<u>less</u> DSG - Schools contributions	(£1.6 m)
		<u>less</u> Interest on balances	(£0.2 m)
Contribution required from DSG – KCC/SFF	£2.4 m	Contribution required from DSG – KCC/SFF	£3.7 m

(*) Assumed at the same amount per annum as received through PFI credit from Central Government

33. Table 2 considers the cost under the Six Schools PFI contract in 2010/11. The difference in cost each year until the end of the PFI contract would be an inflationary increase in the Unitary Charge payment, as well as the required contributions from the Dedicated Schools Grant (both directly from schools and through top slicing from DSG).
34. The total capital expenditure for the Six Schools PFI contract was £96.6m. Procurement through the traditional route would have resulted in a net annual cost of approximately £2.4m over 25 years. This assumes that we would receive school contributions at the same level as under the PFI contract (£1.6m) and that supported borrowing would have been available (which wasn't), so this again is a theoretical comparison, not a choice available to us at the time. The remaining gap of £2.4m would either need to be considered by the SFF for top-slicing from the DSG, in the same way that they have considered and agreed to contribute £3.7m in 2010/11 towards the costs of the Six Schools PFI contract, or would have been a cost to KCC's base budget.

CONCLUSIONS

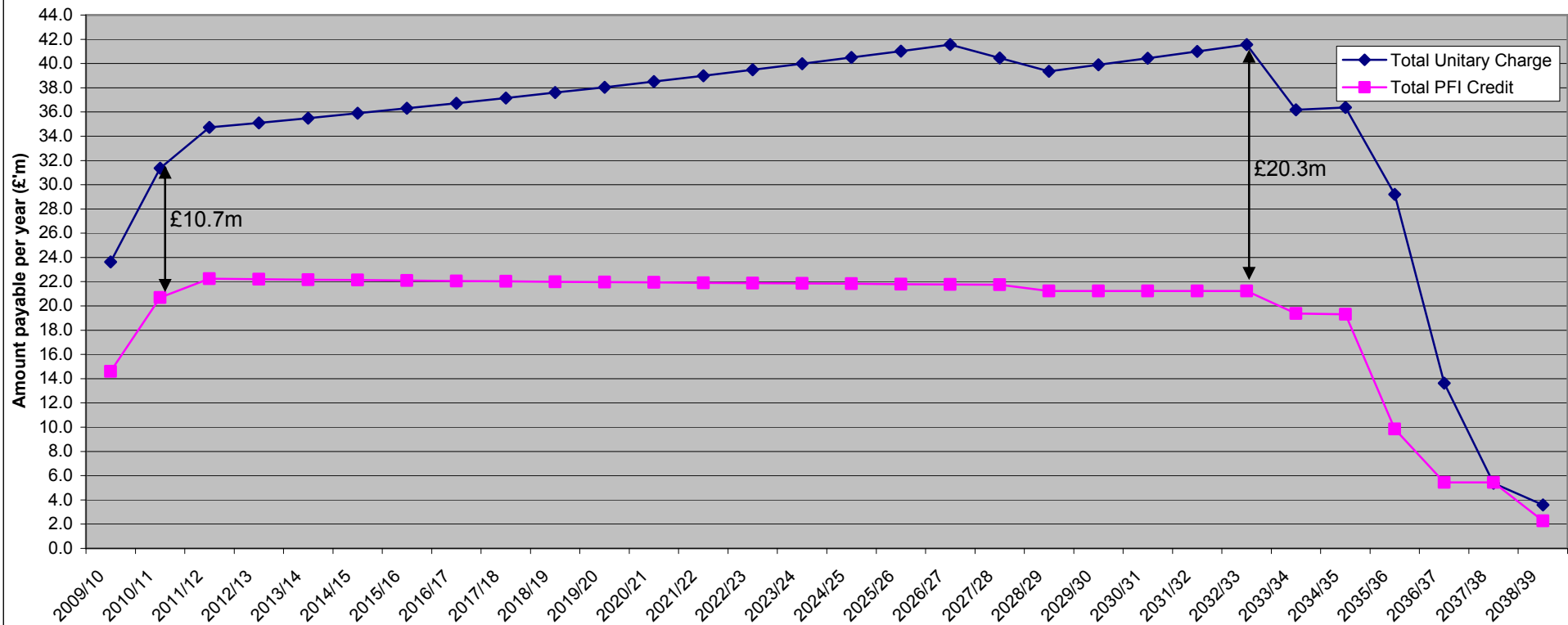
35. In this paper we have quantified Kent County Council's existing exposure to PFI, and discussed how a number of the associated risks are being managed. These risks are considered when the relevant risk registers are being compiled.
36. Ideally, we would be able to take the available funding from Government to enable us to secure the procurement option that would offer the best value for money. However, with many of our PFI contracts the only funding available was in the form of PFI credits, making PFI 'the only affordable show in town'. In these cases, the benefits to the County that have resulted, including excellent facilities and economic investment being brought into Kent, were considered to be better than the alternative of doing nothing.

RECOMMENDATION

37. Members are asked to:

- a) Note this report, which will help achieve their responsibilities under risk management and control, as set out in the Committee's Terms of Reference.
- b) Consider whether or not the risks outlined in this paper are sufficient to warrant inclusion in the Directorate and/or Strategic Risk Register.

Projected Unitary Charges and related PFI credits over remaining term of existing PFI contracts (2009/10 onwards)



This graph shows the gap simply between the anticipated Unitary Charges for the remainder of the contract periods and the PFI credits paid to the Authority for the following PFI contracts: Westbrook and Westview Recuperative Care Facilities, Gravesham Place Integrated Care Centre, Swan Valley and Craylands Schools, Six New Schools, Better Homes Active Lives Extra Care Accommodation, and schools under Wave 3 of the Building Schools for the Future programme.

When considering the liability of the Authority the following points should also be taken into account.

- Indexation - increases or decreases which are different from those anticipated in the financial modelling
- The contract management costs incurred by the Authority
- Interest on balances during the life of the contract
- Market testing of Facilities Management services (every five years)
- Significant fluctuations in cost such as insurance due to changes in the market