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To: Governance & Audit Committee

1 December 2009

Subject: The risks to KCC resulting from the Private Finance Initiative

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Summary: This report serves three key purposes:

i. Provides a detailed explanation of the Private Finance Initiative (PFI)
ii. Outlines Kent County Council's current exposure to PFI contracts
iii. Identifies what our exposure to PFI might be in the future

FOR INFORMATION

BACKGROUND – WHAT IS PFI?

1. The Private Finance Initiative (PFI) is a form of contracting for large projects between the public and private sector, with the aim of introducing private sector resources and/or expertise in order to help provide and deliver public sector assets and services. It is based on:
   - A long term service contract between a public sector body (Authority) and the SPV[1]
   - Integration of design, building, financing and operation by the SPV
   - Allocation of risk to the party best able to manage and price it
   - Required performance standards set out in an 'output specification'
   - Single annual payment from the Authority (the Unitary Charge)
   - 'Pay for what you get' allowing for deductions for poor performance
   - Off-balance-sheet determination, leaving the Authority's borrowing capacity in tact (although this will not be the case for the 2009/10 Accounts)
   - Central Government support delivered through 'PFI credits'

2. The term 'PFI' does not define how services are designed or provided, simply how the provision of services are financed. However, the introduction of private finance and the transfer of operating and financial risk from the Authority to the SPV mean that there are strong pressures on the SPV from its funders to meet (if not exceed) the requirements of the Authority, so that the private capital is not at risk. Hence, additional time and resources are spent during the procurement process in defining in very precise terms the specification of the design, the replacement profiles and the levels of services required.

3. One or more Central Government departments will sponsor a PFI project. The sponsoring department(s) pay a stream of quarterly payments to the authority – the 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. The authority is responsible for funding the planned service package (Unitary Charge) from existing or enhanced revenue budgets.

4. During the procurement of a PFI project, the aim is to match the 'affordability curve' – the profile of PFI credits available to the Authority against the profile of Unitary Charges expected. The 'affordability gap' is the difference that arises between the two.

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[1] The term 'Special Purpose Vehicle' (SPV) refers to the project company with which the public sector contracts

5. The provision of private finance to support the development of public services has been a part of the public sector landscape since 1992. The development of private finance has taken place against a background of public sector reform in virtually every area of the public sector. It should be recognised that PFI is a creature of its time and was entirely cognisant of successive governments' policies of modernising public services.

6. Appendix A provides an outline of the pros and cons of being involved in Private Finance Initiative contracts.

THE IFRS DEBATE: AN UPDATE

7. KCC has several long term PFI contracts. In accordance with the requirements of Application Note F – Private Finance Initiative and similar contracts as an amendment to Financial Reporting Standard 5 (Reporting the substance of transactions)', it is our accounting policy to write out the proportion of the assets that have been transferred, and create a prepayment to recognise this transfer of our assets. This is then written down over the life of the contract. We also create a long term debtor to recognise the residual value of the asset returning to us at the end of the contract, which is built up over the life of the contract. At the end of the contract the value of the long term debtor should match the transferring value of the asset and will be a simple transfer between balance sheet entries.

8. The full introduction of International Financial Reporting Standards (IFRS) in 2010/11 will result in PFI contracts being accounted for on-balance-sheet. SORP 2009 requires PFI contracts to be accounted for in a manner that is consistent with the adaptation of IFRIC12 *Service Concession Arrangements* contained in the Government's Financial Reporting Manual, as this will assist in the transition to IFRS.

9. This means that from 2009/10, there will be a change of accounting treatment for PFI contracts. The new accounting treatment will apply where:
   a. The local authority controls or regulates what services the operator must provide with the property, to whom it must provide them, and at what price, and where;
   b. The local authority controls – through ownership, beneficial entitlement or otherwise – any significant residual interest in the property at the end of the term of the arrangement.

10. The new accounting arrangements for PFI contracts will have no impact on council tax due to mitigating adjustments. CIPFA have clarified that they do not expect to see an increase in council tax as a result of the move to International Financial Reporting Standards.

KCC EXPOSURE TO PFI

11. The existing charges as outlined in KCC's 2008/09 Statement of Accounts are outlined below.

12. Westbrook and Westview Recuperative Care Facilities

    In 2008/09 the authority made payments of £3.4m to Integrated Care Services (ICS) for the maintenance and operation of Westbrook and Westview recuperative care facilities. The Authority is committed to making payments of £3.2m for 2009/10 under this PFI contract. The actual amount paid will depend on the performance of ICS in delivering the services under the contract, which will run until April 2033.

13. Gravesham Place Integrated Care Centre

    In 2009/10 the Authority is committed to making payments estimated at £2.2m per year under a contract with Land Securities for the maintenance and facilities management, including laundry and catering, of Gravesham Place integrated care centre. The actual amount is subject to an annual inflationary uplift, and is also dependent on the performance of Land Securities in delivering the services under the contract (£2.2m was paid in 2008/09). The contract will run until April 2036.

14. Swan Valley and Craylands Schools

In 2001, the Council contracted with New Schools (Swanscombe) Ltd to provide Swan Valley Secondary School and Craylands Primary School under a PFI. The schools opened in October 2002. Under the PFI contract the Council pays an agreed charge for the services provided by the PFI contractor. The Unitary Charge commenced in October 2002, PFI credits were received from April 2003 and were backdated to October 2002. At the time the contract was signed the total estimated contract payments were £65.5m over the 25 year contract period (termination end of September 2027). In 2009/10 KCC will make a Unitary Charge payment of £2.4m.

15. Six New Schools

In October 2005, the Council contracted with Kent Education Partnership to provide six new secondary schools (Hugh Christie Technology College, Holmesdale Technology College, The North School, Ellington School for Girls, The Malling School and Aylesford School – Sports College) under a PFI. The development of these schools straddles both the 2006/07 and 2007/08 financial years. Three of these schools opened part of their new buildings in 2006/07; the other three schools opened their new buildings during 2007/08. The Unitary Charge commenced in November 2006, PFI credits commenced in June 2007 and were backdated to November 2006. At the time the contract was signed, the total estimated contract payments were £373.9m over the 28 year contract. The Unitary Charge payment in 2009/10 will be £11m.

16. Central Government provides a grant to support the PFI schemes (PFI credit). This Revenue Support Grant is based on a formula related to the capital expenditure in the scheme: this is called the notional credit approval, and amounts to £11.62m of credits for Swan Valley and Craylands and £80.75m for the six schools. This approval triggers the payment of a Revenue Support Grant over the life of the schemes of 25 and 28 years respectively. This grant amounts to just under £23m and just over £177m over the respective periods.

17. Better Homes Active Lives Extra Care Accommodation

In October 2008 the Authority signed a PFI contract with Kent Community Partnership to provide 357 units providing a range of Extra Care accommodation, units for people with learning difficulties, and units for people with mental health problems. The construction phase will last for two years and the contract for the provision of services will last until 2038/39. In 2008/09 the authority paid £66k to the contractor as two of the buildings were completed and ready for occupation. More of the buildings will be completed this financial year, and it is anticipated that the authority will pay £3.8m under this contract in 2009/10.

18. The PFI schemes outlined above have been classified as “off-balance-sheet” in the 2008/09 accounts, and payments to contractors have been treated as revenue expenditure.

19. Appendix C provides a detailed projection of our Unitary Charge commitments for the remaining terms of our current PFI contracts. Appendix D plots these Unitary Charges against the PFI credits we expect to receive from Government over the same period.

BUILDING SCHOOLS FOR THE FUTURE

20. The schools in Wave 3 of Building Schools for the Future (BSF) are at various stages of construction, with some early phases of the non-PFI Schools having already been completed and handed over. The PFI schools are all due to be completed and handed over during June/July of 2010.

21. The capital expenditure for Wave 3 (excluding Portal House Special School which has been delayed until Wave 4) is broken down as follows:

Wave 3	Capital Expenditure £m	% of Total
Design & Build Schools (Conventionally Funded)	127.87	64.7
PFI	69.75	35.3
Total	**197.62**	**100.0**

22. PFI credits of £98.94m were allocated to the Wave 3 PFI schools and the annual affordability gap, at Financial Close in October 2008, was £901k (based on April 2009 prices). This affordability gap will be charged to the Dedicated Schools Grant (DSG). The figure of £901k per annum was a considerable reduction from the estimate contained in the original report to Cabinet of £3.3m per annum.

23. The level of PFI credits allocated to projects in Wave 3 was based on 100% new build, rather than the usual funding model of 50:35:15 (new build/refurbish/refresh). This generated a higher level of PFI credits for Wave 3 than would otherwise be received. Although the allocation of funds towards the PFI projects beyond the 50:35:15 split generates a more efficient funding model, there may not always be sufficient funding to be able to achieve this, in which case the annual affordability gap would be higher than experienced on Wave 3.

24. The capital expenditure for Wave 4 is estimated as follows:

Wave 4	Capital Expenditure £m	% of Total
Design & Build Schools (Conventionally Funded)	120.9	58.2
PFI	86.8	41.8
Total	**207.7**	**100.0**

25. BSF Wave 4 will involve £138.3m worth of PFI credits (subject to final approval by Partnership for Schools), with a current estimated affordability gap of £3.22m per annum. This has been agreed by Cabinet in principle, subject to sign-off of the final business case, and will be included in the next capital programme.

26. It is intended that any affordability gap will be charged through the DSG for Wave 4 and future BSF Waves.

27. Plans for Waves 5 and 6 are yet to be agreed by Members. For Wave 5, current figures indicate four PFI schools with an estimated capital cost of some £104m out of a total of £223m and an estimated affordability gap of some £3.65m per annum. For Wave 6, current figures indicate four PFI schools with an estimated capital cost of some £83m out of a total of £157m and an estimated affordability gap of some £3.3m per annum.

28. Given the current economic climate and the added uncertainty of a potential change in Government in the near future, there is not much clarity to help in planning for future waves of BSF (ie. Waves 7-15). However we have a very early estimate of PFI capital expenditure of £176m from a total capital expenditure of £726m (i.e. approximately 24%) with an estimated affordability gap of some £9m per annum.

RISKS

29. The PFI approach to risk is to pass as much as possible to the private sector. The more risk transferred, the higher the unitary charges paid by the public authority. This risk transference can be considered to be worthwhile, due to the better track record of the private sector's ability to deliver capital projects on time and on budget compared to the public sector.

30. However, questions need to be asked as to whether risk transference under PFI deals is always appropriate, notwithstanding the problems associated with placing a value on risk transfer. This issue is particularly pertinent at this time, as the global credit crunch is making PFI schemes even more expensive due to rising risk premia. In essence, the pricing of risk may not always have been optimal.

31. Under PFI, responsibility for the design, build, financing and operation of a project is transferred to the private sector, along with the associated risks. It is accepted that, while it may be a more expensive route, the private sector is better equipped to handle the risks and responsibility for the designing and building elements. However, it is suggested that the operating stage of PFI deals would be better handled by local authorities.

32. Other risks associated with KCC's future involvement in PFI contracts include:

- Can the Government afford to keep providing support through PFI credits?
- Will the Government continue to provide financial support to existing contracts over the long life span of those contracts?
- Can we afford to keep plugging the affordability gaps which arise in many PFI contracts?
- If schools agree to take a charge from the Dedicated Schools Grant (DSG) to contribute towards the Unitary Charge, there is a risk to KCC

33. The Building Schools for the Future Board fully considers all the risks before entering into PFI contracts. This Board helps the Authority to mitigate against these risks.

CONCLUSIONS

34. KCC has hugely benefitted through the Private Finance Initiative. For example, we already have ten new secondary schools and one new primary school (one secondary and one primary under the Swan Valley and Craylands Schools PFI, six secondary schools under the Six Schools PFI, and three secondary schools under BSF Wave 3).

35. The change in accounting treatment for PFI contracts from 2009/10, resulting from the introduction of IFRS, will have no impact on council tax.

36. The new accounting treatment of PFI contracts under IFRS will result in the value of the assets and full liabilities being disclosed in the accounts. This will make the disclosure of PFI contracts more transparent.

37. In 2009/10 we are committed to paying a total Unitary Charge of £23.6m in relation to our PFI contracts. This will peak in 2026/27 at £41.6m.

38. We expect to enter into further PFI contracts in the future Waves of the Building Schools for the Future programme, therefore the Authority's Unitary Charge commitments are likely to increase in future years.

RECOMMENDATION

39. Members are asked to note this report.

APPENDIX A

PFI: the pros and cons

Successful PFI projects are able to achieve budget savings and are more likely to be completed on time compared to conventionally procured projects. There are a number of possible contributing factors towards this:

i. Integration of service delivery with design, construction and maintenance
ii. Identification and allocation of risks during the procurement phase
iii. Investment in service delivery is possible over the full contract period
iv. Focus on the needs of service users linking through to payment mechanism (though it is questionable whether PFI leads to unnecessary over-specification of assets/services)
v. Incentivisation to provide services to the required standard as quickly as possible through the operation of deductions from the Unitary Charge
vi. Stability and certainty in the delivery of services and level of payments required during the operational phase
vii. Standardisation of project documentation allowing for quicker resolution of ideas.

The disadvantages associated with the PFI include the following:

i. The resources required to deal with procurement is significant – the time and cost of delivery is high
ii. Bid costs borne by the successful SPV will be recouped from the authority through the Unitary Charge (albeit as a price for risk transfer, which is difficult to quantify)
iii. Preferred bidder games – if competition is less, there may be unplanned price increases to financial close
iv. Potential inflexibility in accommodating changes in service provision, although this should be properly negotiated in the change mechanism to leave the Authority 'no better or worse' than before
v. Termination payment where Authority chooses to exit contract prematurely
vi. Inflexibility in reducing payments where Authority is facing revenue pressures – the unitary charge stream is effectively fixed
vii. Approvals required – internally and from Government – adds to procurement time
viii. Perceived loss of control over public services to the private sector.

The National Audit Office report, *The performance of PFI construction*, which studied public sector building projects worth over £20m completed in 2008, has found that 35% exceeded budget and 31% suffered time delays. This indicates a slip in PFI performance in the last five years. However, the report also found that the PFI remains more reliable than alternative methods of financing public building projects, where only 63% of non-PFI projects were completed on time, and 54% to the contracted price[2]. KCC building projects tend to be worth less than £20m, and have much more positive outcomes than those in the National Audit Office report.

An attraction of the PFI to Central Government has always been that the costs of procuring a new asset are treated as revenue expenditure in the accounts of the public sector organisation. It records neither the asset nor the debt, but it is required to disclose its future commitments under PFI contracts as a note to the balance sheet. This means that within the balance sheet, UK public sector borrowing is not shown to be increasing as much as it otherwise would. However, as outlined in Section 5 of this paper, the introduction of International Financial Reporting Standards (IFRS) will require that PFI contracts be accounted for as a public and not a private sector balance sheet entry. This technical change could have a significant impact on the government's appetite to push PFI.

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[2] PFI projects going over budget, auditors find (Public Finance, 5 October 2009, David Williams)

Irrespective of the balance sheet treatment, a legitimate question to ask is, “Do PFI schemes offer value for money?” A PFI scheme is unlikely to be the cheapest solution, but in 2001 the NAO reported that, “Acceptance of the lowest priced bid does not provide value for money in construction cost or life cost.”

As PFI project experience increases it has become apparent that it is best used for high value, high risk areas which have not previously been identified as possible areas for procurement and for which the employer would not have the capital available to invest upfront. However, the question of whether PFI is the most appropriate route needs to be tested by qualitative and quantitative value for money analysis.

The experience of local authorities has resulted in a sense of mixed feelings about whether PFI projects deliver good value for money.

There is an uneven playing field between the PFI and other procurement routes, because of the availability of PFI credits. In many cases therefore, PFI has been “the only game in town”, because projects would otherwise be unaffordable.

Appendix B contains a recent article from Public Finance magazine, which identifies that a recent National Audit Office inquiry has been unable to find strong evidence that private funding for building schemes offers the best value for money.

No evidence that private funding schemes provide value, says NAO

By Tash Shifrin

Public Finance, 13 November 2009[3]

Ministers do not have strong evidence to show that private finance funding for building schemes offers the best value for money, auditors have warned.

In evidence prepared for a parliamentary inquiry, the National Audit Office said there were now more than 500 Private Finance Initiative projects in England. They have a capital value of more than £28bn, with other public-private partnerships adding £18bn.

But it warned: ‘Our view is that private finance can deliver benefits, but it is not suitable at any price or in every circumstance.’

The warning comes as Wakefield Metropolitan District Council confirmed it will not sign off its £700m waste disposal contract until next year.

The scheme was set to be the next major PFI deal, but the council has struggled to reach financial close since selecting preferred bidder VT Group in November 2007. Construction had been planned to begin in 2009.

Wakefield chief executive Joanne Roney told *Public Finance* that moving towards financial close had been ‘a complex and challenging process in view of the economic climate’.

The NAO paper, produced for the Lords economic affairs committee, noted that ‘assessing the pros and cons of alternative procurement routes is especially important in the recession’. Rising costs of private finance since the credit crunch had ‘implications for their value for money’.

The paper added: ‘We have yet to come across truly robust and systematic evaluation of the use of private finance built into PPPs at either a project or programme level’ – evidence that committee chair Lord Vallance described as ‘quite unequivocal’.

Systems to collect comparable data from projects using different procurement routes were ‘not in place’, the paper said. ‘Unless such systems are established, together with robust evaluation of the overall whole-life costs of alternative forms of procurement, government cannot satisfy itself that private finance represents the best VFM option.’

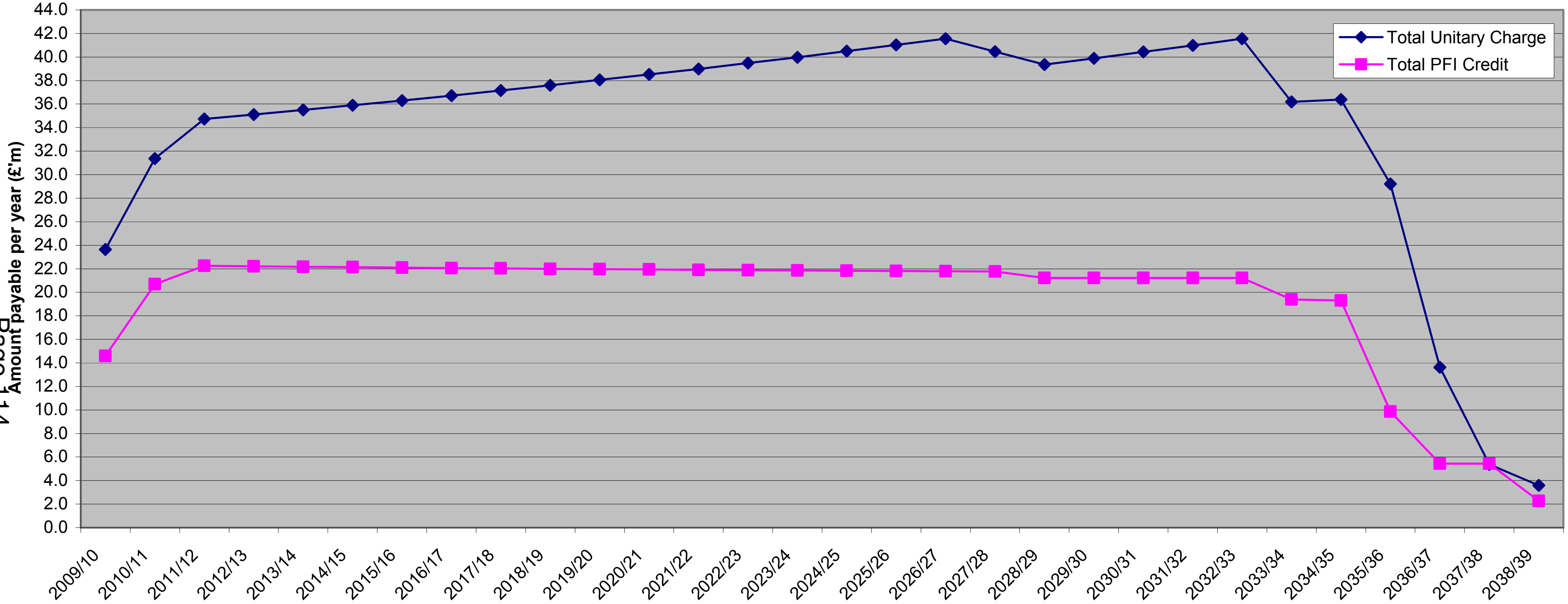
NAO head Amyas Morse told the committee: ‘I think it’s symptomatic of... how little of a universal culture of evidence and measurement there seems to be in a number of complex government activities.’

[3] Article available at www.publicfinance.co.uk

APPENDIX C

Year	Projected Unitary Charge Payable						
	Swan Valley & Craylands £'m	Six schools £'m	BSF Wave 3 £'m	Westbrook & Westview £'m	Gravesham Place £'m	Better Homes Active Lives £'m	Total £'m
2009/10	2.5	11.9	0.0	3.2	2.2	3.8	**23.6**
2010/11	2.6	12.0	5.9	3.3	2.3	5.4	**31.4**
2011/12	2.6	12.1	9.0	3.4	2.3	5.4	**34.7**
2012/13	2.6	12.2	9.0	3.5	2.4	5.4	**35.1**
2013/14	2.7	12.4	9.1	3.6	2.4	5.4	**35.5**
2014/15	2.7	12.5	9.2	3.7	2.4	5.4	**35.9**
2015/16	2.7	12.6	9.3	3.8	2.5	5.4	**36.3**
2016/17	2.8	12.8	9.4	3.9	2.5	5.4	**36.7**
2017/18	2.8	12.9	9.5	4.0	2.6	5.4	**37.2**
2018/19	2.9	13.1	9.5	4.1	2.7	5.4	**37.6**
2019/20	2.9	13.2	9.6	4.2	2.7	5.4	**38.0**
2020/21	2.9	13.4	9.7	4.4	2.8	5.4	**38.5**
2021/22	3.0	13.5	9.8	4.5	2.8	5.4	**39.0**
2022/23	3.0	13.7	9.9	4.6	2.9	5.4	**39.5**
2023/24	3.1	13.8	10.0	4.7	2.9	5.4	**40.0**
2024/25	3.1	14.0	10.1	4.9	3.0	5.4	**40.5**
2025/26	3.2	14.2	10.2	5.0	3.0	5.4	**41.0**
2026/27	3.2	14.4	10.4	5.2	3.1	5.4	**41.6**
2027/28	1.6	14.5	10.5	5.3	3.2	5.4	**40.5**
2028/29	0.0	14.7	10.6	5.4	3.2	5.4	**39.4**
2029/30	0.0	14.9	10.7	5.6	3.3	5.4	**39.9**
2030/31	0.0	15.1	10.8	5.8	3.4	5.4	**40.4**
2031/32	0.0	15.3	10.9	5.9	3.4	5.4	**41.0**
2032/33	0.0	15.5	11.1	6.1	3.5	5.4	**41.6**
2033/34	0.0	15.7	11.2	0.3	3.6	5.4	**36.2**
2034/35	0.0	16.0	11.3	0.0	3.6	5.4	**36.3**
2035/36	0.0	16.2	3.9	0.0	3.7	5.4	**29.2**
2036/37	0.0	8.2	0.0	0.0	0.0	5.4	**13.6**
2037/38	0.0	0.0	0.0	0.0	0.0	5.4	**5.4**
2038/39	0.0	0.0	0.0	0.0	0.0	3.6	**3.6**

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 been 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