MEETING:	**SCHOOLS FORUM**
MEETING DATE:	**24 OCTOBER 2014**
TITLE OF REPORT:	**WHITECROSS PFI SCHEME**
REPORT BY:	**SCHOOLS FINANCE MANAGER**

Classification

Open

Key Decision

This is not an executive decision.

Wards Affected

County-wide.

Purpose

To report on the Whitecross Private Finance Initiative (PFI) scheme and to consider the need for potential additional funding.

Recommendation(s)

THAT: the Cabinet Member for Young People and Children's Wellbeing be recommended to approve that;

(i) The options set out in paragraph 12 are implemented where possible to deliver savings as estimated

(ii) The necessary additional financial contributions to the PFI contract be shared equally between the council and schools (through Dedicated Schools Grant) as follows;

Year	Council Share £'000	DSG Funding £'000	Cumulative £'000
2015/16	12.5	12.5	25
2016/17	25	25	75
2017/18	25	25	125

(iii) **This position to be reviewed if inflation increases take place above those anticipated**

(iv) **Schools Forum will receive a progress report in January 2015 so that the forecasts can be updated.**

Alternative Options

1 The options available are limited and have been discussed with the PFI project's original financial advisors at a meeting on 10th March 2014. Their advice is set out in paragraph 12 below.

Reasons for Recommendations

2 The Whitecross PFI scheme is required to meet its costs over the life of the 25 year contract so that an impossible financial burden is not passed onto future ratepayers.

Key Considerations

3 Cabinet approved the outline business case for the replacement of Whitecross High School under a PFI scheme on 18th July 2001. The approval assumed PFI credits from the Department for Education (DfE) of £19.5m and annual contributions from the authority between £603k and £731k. In November 2003 bids were received from two consortia. Both bids were within the parameters set by the outline business case. Following careful evaluation of the technical, legal and financial aspects of both bids using criteria described in a formal evaluation framework, Cabinet approved a preferred bidder in March 2004 and the scheme moved to financial close on 17th January 2005.

4 Following the tender clarification process, both bids were outside the parameters of the approved outline business case and the DfE imposed new rules on the education revenue budget, making it more difficult to fund the annual payment from the centrally held education budget. Therefore, a three point strategy for managing the cost of the annual revenue payments was approved by Cabinet as follows:

(i) The DfE was asked for an uplift in the PFI credit by making the contract operational after 1st April 2006. This would reduce the average annual payment by around £50k per year

(This happened as the new school opened on 5th June 2006)

(ii) The preferred bidder was offered £1m from the capital receipt of the existing site, thereby reducing the capital cost of the new building to the consortium and in so doing, reducing the council's average annual L.E.A. payment by £75k

(This has not happened as the old Whitecross site has not yet been sold. Given the passage of time since that decision a further Cabinet member decision would be required to ensure such action continued to offer best value)

(iii) Manage the PFI credit across the 25 year period in such a way as to ensure that the build up of annual PFI payments is commensurate with the reduction from 2008, of the cost of the Local Government Re-organisation

(LGR) loan commitment, and consistent with the council's medium term plan. Such an approach should make it possible for the council to meet the government's guarantees to schools within the education revenue budget, whilst also remaining within the defined limits on central LEA spending.

(This happened as the funding released from the council LGR repayments was transferred to meet the PFI payments)

5 The effect of the increased contributions in (i) and (ii) would have been to bring the project back within the agreed financial parameters (i.e. the outline business case).

6 Three major associated risks identified at the time were listed as:

(a) the failure to maintain progress to replace the existing school buildings;

(b) the loss in negotiating position in the move to a preferred bidder;

(c) the ability of the council to afford the annual revenue (the so called unitary) payments over a 25 year period.

Risk (a) was dealt with by Cabinet approving the preferred bidder on 18th March 2004.

Risk (b) was managed by ensuring that all major issues have been settled during the period, November 2003 to February 2004 when both bidders have been in competition.

Risk (c) was addressed by seeking additional PFI credits from the DfE, offering a capital receipt to the preferred bidder, and phasing in the annual payments in such a way as to fit with the reducing repayments charged to education for the council's borrowing at local government re-organisation.

7 The economic situation was much different at the time of the agreement of the scheme to the situation now. It would have been very hard to predict what has happened to interest rates and to public sector finances, particularly over the past six years from 2008. There were assumptions made about the level of public sector finance, including the passing on of inflation which did not occur particularly during the period of austerity.

8 The current financial pressure on the PFI scheme is due increases in the unitary charge being higher than planned inflation. The financial model assumed inflation (excluding mortgage interest) at 2.5%. However, since 2006 inflation has been an average 3.6% pa which has increased the PFI payments by an extra £95k in 2013/14. Furthermore, new investment in the intervention centre on the Whitecross School site has added capital costs of £298,000 resulting in further increases in the unitary charge.

9 As an example of the impact of inflation, the PFI financial model calculates the unitary charge in 2031/32 at £3.24m per year at 2.5% inflation, but if inflation were to continue at 3.6% (the average inflation rate since 2006) the unitary charge would be £590,000 higher. Such a relatively small increase in inflation (+1.1% pa) would cost an extra £7.4m over the PFI contract period.

10 The Retail Prices Index (excluding mortgage interest) (RPI(X)) inflation rate for May 2014 has been published at 2.5% which is the first time the planned 2.5% has been achieved. The annual Consumer Price Index (CPI) index for May 2014 is 1.7%. Any

return to the high inflation rates of the 1970s (26%) or 1980s (7%) will place severe and unaffordable costs on the PFI contract. The long run UK inflation average is 3.3%.

11 A review of the PFI project documentation suggests that inflation risk was not formally addressed within the project. Discussion with the PFI scheme's financial consultants suggests that it was common practice for PFI schemes at that time, to assume that increased costs arising from higher than planned inflation rates would be met from increased income to the council. The assumption being that if the unitary charge increased by 5% then the council's income would increase by the same 5% to meet the extra cost.

12 The PFI contract has been reviewed with the project's original financial consultants to identify seventeen areas of the PFI contract which are worthy of further discussion with the PFI supplier. The advisors suggest that the options open to the council are relatively limited, and refinancing of the project would not be cost effective. All seventeen recommendations have been discussed with the PFI supplier and are set out in the table below, for information.

PFI contract area	Opportunity	Actions/Review	Potential Savings
1. Payment Mechanism	Non performance penalties to accrue to council	Governing Body Agreement requires corresponding reduction in school contribution	None
2. Specification – FM Service	Reduce service specification to reduce costs	Service specification reviewed annually and meets school needs. Agreement with banks does not permit further reductions	None
3. Specification – FM Service	Remove components of FM service	Service specification reviewed annually and meets school needs. Agreement with banks does not permit further reductions	None
4. Specification – IT Service	Reduce service specification to reduce costs	Following benchmarking review ICT service being redesigned by school and supplier to achieve savings	Min £20,000
5 Specification – IT Service	Remove components of IT service	Following benchmarking review ICT service being redesigned by school and supplier to achieve savings	As (4) above.
6 Governing Body	Renegotiate requesting greater	Reviewed in detail on academy conversion.	None

	Agreement	contribution from school	DfE categorically refused any change in school contribution.	
7	Programmed Maintenance	Reduce hard FM costs	Future lifecycle costs to be index linked to CPI not RPI(X)	Will reduce Unitary charge by min £10,000 p.a. on a compound basis.
8	Benchmarking & Market testing soft FM services	Reduce soft FM costs	Ensure benchmarking applied to reduce future cost increases. Small scale	Future cost avoidance
9.	Third party usage	Maximise third party income	Existing shortfall in contracted income	None
10.	Out of Hours usage	Reduce level of usage	School agreed to reduce hours used	£5,000 pa
11.	Annual Service Report	Seek proposals from the PFI supplier to reduce costs	PFI supplier constructively engaged in reducing costs but constrained by PFI agreements with banks.	None – already included elsewhere
12.	Vandalism	Ensure cost recovery from the school	School already meets cost and recharges pupils where possible	None
13.	Insurance Benchmarking	Reduce insurance costs	Cost savings included in PVI Management costs (see line17)	None
14.	ICT service benchmarking	Reduce ICT service costs	Following benchmarking review ICT service being redesigned by school and supplier to achieve savings	As above
15.	ICT Lifecycle	Reduce levels of lifecycle refresh	Future lifecycle costs to be index linked to CPI not RPI(X)	As above
16.	Refinancing	Undertake refinancing to reduce level of unitary charge	On current market rates there is no benefit in refinancing particularly the contract costs involved and the benefits sharing mechanism in the contract.	None

17. Right to audit	Request greater clarity over PFI supplier management costs	Savings have been made on project Insurance costs	£10,000 pa

13 The PFI project agreement and school agreement provide for savings on insurance and ICT benchmarking to be retained by the school so that the authority is in a no better and no worse position than before the benchmarking and market testing procedures. Discussions are taking place with the school regarding these matters.

14 The PFI financial planning model indicates that if the CPI index is used from April 2015 at the current 1.7% through until 2031/32 and assuming that the school and DSG contributions continue to be index linked then additional funding of £25k in 2015/16, a further £50,000 in 2016/17 and a further £50,000 in 2017/18 will be sufficient to meet the unitary charge over the life of the contract. However, as it is unlikely that CPI will remain at 1.7% until the end of the PFI contract it is essential that the PFI model is reviewed annually to ensure that funding is sufficient.

15 The council is currently contributing £760,811, which is more than the range of funding originally planned – see paragraph 3, and Whitecross School contribute their premises and facilities budget of £240k as these services would be provided through the PFI contract. The shortfall in funding was made up by School Forums' agreement on 9th February 2006 to contribute £150k from the new Dedicated Schools Grant (DSG). As set out in the original governors' agreement, the DSG sum has been index linked to maintain parity with the school's contribution and is now £190k in 2014/15. Across the country there is a range of funding arrangements in place, depending upon the agreements established at the time. There are different levels of contribution from the DSG and some areas where total PFI schemes are DSG funded.

16 The PFI contract was signed in good faith by all parties in January 2005, on the best financial advice available. The contract has worked well with the supplier and provides a first class secondary school for Herefordshire that otherwise would not have been possible. Both the council and schools (through DSG) are contributing more than originally intended. The actions taken as set out above will reduce costs going forward and it is suggested that, the additional contributions as set out in paragraph 14 should be shared equally between the council and schools (via DSG) for the three years until 2017/18.

17 It is suggested that Schools Forum receive a progress update in January 2015 to confirm the actual level of savings made and to confirm the required additional contributions necessary for 2015/16. Further reports will be necessary in January 2016 and January 2017.

Community Impact

18 At this stage, there is no significant community impact.

Equality and Human Rights

19 At this stage, there are no implications for the public sector equality duty.

Financial Implications

20 The estimated total cost of the scheme is £73.7m (assuming inflation at 1.7% until 2032). The scheme is funded by £43m PFI credits from the Department for Education, £18.4m by the council, £6.4m by the school and £5.9m contribution from Dedicated Schools Grant. The Schools Block within DSG is £93.5m in 2015/16 and the cumulative additional DSG contribution (over three years) of £62,500 is less than 0.1% of annual DSG.

21 The financial implications are fully set out in the report above; it is recommended they be reassessed annually as the inflation rate changes to ensure that the PFI scheme is appropriately funded.

Legal Implications

22 Legal will need to review the contract documentation as it currently stands to asses any changes necessary to implement the recommended areas for discussion via contractual amendment which will necessitate a deed of variation. Legal may also recommend further changes to ensure the contract provides for suitable provisions as to risk apportionment, indemnities and termination. Amendment cannot take place unilaterally and if agreement cannot be reached then advice will be provided as to risks posed.

Risk Management

23 The PFI funding contribution must be assessed annually to ensure that the PFI contract continues to be fully funded to the end of the contract in 2031/32. The three major risks identified in 2005 are set out in paragraph 6 of the report and how they were addressed. The funding risk arising from higher future than planned inflation rates will be dealt with by annual review.

Consultees

24 Both the school and the PFI provider have been consulted and both are supportive of the work being undertaken within the constraints of the PFI contract. Both the school and the PFI provider will continue to be consulted.

Appendices

None

Background Papers

None identified.

Further information on the subject of this report is available from
Malcolm Green on Tel (01432) 260818