



REPORT OF THE SERVICE DIRECTOR FOR ENVIRONMENT, TRANSPORT AND PROPERTY

Nottinghamshire County Council PFI Contracts

Purpose of the Report

1. To inform the Committee of the current status and issues associated with the Councils Private Finance Initiative (PFI) Contracts for East Leake Schools, Bassetlaw Grouped Schools and Waste Management.

Information and Advice

How do PFI Contracts work?

2. PFI contracts are generally long term arrangements for the private sector to Design, Build, Finance and Operate (DBFO) assets which might not be affordable to the public sector in other circumstances due to the large capital costs involved in developing the contract facilities.
3. The basic principle of PFI is to ensure value for money is secured by ensuring that the risks and costs of a project are allocated to the people most able to manage them effectively through the lifetime of the scheme.
4. Hundreds of PFI contracts have been let across the UK to deliver new hospitals, prisons and other accommodation projects, roads, schools and waste facilities by various central and regional government bodies and the health sector with varying degrees of success, and not without public controversy.
5. The costs of the construction of the new or refurbished contract facilities are met by the private sector, and are either corporately (ie directly by the companies involved) or by project (bank) finance with the public sector meeting the ongoing cost of the operation and payback of the capital over an extended concession period, often 25 years plus. The assets then transfer back to the public sector at the end of the contract.
6. Most contracts are operated by Special Purpose Vehicles (SPV's) which are companies (with shareholders) specifically established to develop and operate the facilities comprising a number of specialist partners usually including construction contractors facilities management (FM) providers (for accommodation projects), funders, and other specialists companies experienced in specific areas of work (such as waste) or in pulling together all of the partners to provide a seamless service to the local authority.

7. Her Majesty's Treasury (HMT) through sponsoring departments (the Department for Education (DfE), and the Department for Environment, Food and Rural Affairs (DEFRA) in the case of Nottinghamshire) provide fixed (non-inflating) ring fenced grant payments, generically known as PFI credits, to the client organisations to offset some of the costs associated with this private sector finance based on the submission of a detailed business case to support the proposals. This leads to two anomalies;
 - i. No two projects receive the same level of PFI credit payments as they are not based on a fixed formula or calculation;
 - ii. There is an ever widening gap between the fixed level of funding through the PFI credits and the escalating (inflated using a suitable index such as Retail Price Index (RPI)) operational costs.
8. Councils normally therefore establish a "PFI reserve" at the start of a project to build up a sum of money (before the facilities are operational and the unitary charge payments commence or ramp up) to offset these costs through the life of the project, based on expected budgets, modelled costs and inflation assumptions assessed in an affordability model.
9. Unfortunately in some circumstances these assumptions can prove wrong, particularly in turbulent financial times as have affected the UK since 2007. A number of PFI projects are therefore currently proving to be unaffordable to the client organisations (particularly in the health sector).
10. The overall reserves held by the County Council to support the Nottinghamshire PFI projects are however currently deemed sufficient.
11. Contracts are usually output based, with significant freedom allowed to the contractors to meet the agreed specification within the confines of an agreed cost and quality envelope.
12. Various service elements such as hard and soft FM (building maintenance, catering, cleaning and grounds maintenance etc), waste treatment and Recycling Centre operation or additional waste disposal arrangements are subject to regular benchmarking (cost/quality comparison) or market testing (tendering) by the contractor to ensure they continue to offer value for money.
13. Payments to the contractors are made monthly through a "Unitary Charge" which covers all of the service elements provided, offset by any deductions made for performance failures or lack of availability. That way the contractors are incentivised to ensure services are provided effectively and any defects or service failures are rectified promptly.
14. Contracts are often referred to as self-monitoring as the contractor provides the performance data to support the payments requested each month, although a degree of oversight from the client is always required to ensure continued contract compliance.
15. Deductions can be for items as simple as failure to repair a leaking or broken tap or fix a loose tile or clean a floor correctly, to having a waste facility closed due to a major breakdown or not providing accurate billing or performance data. Obviously the timescales for rectification, or any financial penalties applied reflect the impact of the failure on the service provided to the Council and hence the schools and or the public.
16. Added complexity in some projects (mainly schools) comes from the multi layered client structure behind many of the public sector bodies commissioning the works and contracts

where multi use facilities are provided (such as leisure centres and schools under one contract) and the subsequent complications resulting from the programme of academy conversions in schools.

17. The major concerns in many PFI deals are the level of ongoing charges levied by the contractors leading to elevated “super profits” and affordability issues. “Gold Plating” where assets well above the standards required to operate effectively were procured during times when funding was plentiful and are now therefore unaffordable. And the perceived inflexibility of the contracts and therefore the assets and services provided, including the inability of the client authorities to renegotiate deals to remove any now unaffordable “Gold Plating”.
18. Additionally financial windfalls achieved by the providers from “refinancing” projects post construction when the majority of the risk has been removed and much more favourable financial terms can be achieved has allowed some providers in early projects to reduce the baseline costs without offering a corresponding financial benefit to the public sector clients.
19. Many of the issues noted above are significantly reduced or removed altogether in later deals concluded under Standardisation of PFI Contract (SoPC) terms, however poor perceptions of private finance deals still exist and few contracts are currently being procured under the latest Private Finance 2 (PF2) process despite it being much more robust for the client authorities.

Nottinghamshire County Council PFI Projects

20. Members will be aware that the County Council is party to three PFI contracts for the provision of schools and leisure centres (on behalf of the relevant Borough and District Councils) in East Leake and Bassetlaw signed in 2002 and 2005 respectively, and waste management signed in 2006. All the contracts follow slightly different standard PFI contract formats as the PFI market developed significantly between the signing of the East Leake contract, and the Waste contract.
21. The County Council was also at one time also involved as a partner in the PFI Nottingham Express Transit (NET) line one tram project (the City Council hold the contract) although the Council subsequently withdrew from those arrangements.
22. Additionally the PFI funded “Building Schools for the Future” (BSF) project, through which the Council had proposed a number of further school renewals, was abandoned by the government in 2010 in response to the austerity conditions prevalent at the time.
23. Details of the contractors, coverage and values of the three live projects are included in Appendix 1.

Change Management within the Nottinghamshire Contracts

24. Despite perceptions to the contrary well developed PFI contracts offer a significant degree of flexibility in the way services are provided, and can deliver adaptable services which can be changed to meet ongoing pressures and developing aspirations.
25. All three Nottinghamshire projects incorporate change mechanisms which allow for minor variations which do not require approval from the sponsoring departments. These mechanisms are used constantly to review what facilities are provided in schools and how the waste service operates, and have been utilised across the majority of the schools and

- leisure sites on a number of occasions to change layouts or add additional capacity, and recently to introduce the Recycling Centre Registration Scheme on the waste contract.
26. It is important however that where these minor variations are made the capital and lifecycle impacts are identified, and revenue streams secured to ensure the changes do not have a significant cumulative impact on budgets.
 27. In Nottinghamshire the academy rollout has left a complex legacy of contractual changes and recharging mechanisms to be managed since the PFI contracts cannot be novated to the individual schools or academy chains, and still have to be managed by the Council which is ultimately liable for making the contract payments.
 28. Therefore back to back arrangements have been put in place to ensure the Council recovers the agreed share of monies due to the contractors from the independent bodies now using many of the sites. This is further complicated by the number of multi-use sites resulting from the leisure provision in the original arrangements.
 29. As a result the day to day contract management, and particularly change management in the schools projects is a complex and time consuming task for the Council, schools, and the contractors alike.
 30. More significant variations are also possible subject to agreement between all the project partners, but do require a more detailed assessment of the impacts. Such variations are often very complex and require a detailed knowledge of the contracts, the services being delivered and more importantly a significant degree of technical and commercial knowledge and awareness in order to ensure changes do not adversely affect the risk and price profile of the project.
 31. Changes to a contract beyond the scope of the original procurement could also potentially open the Council up to the risk of a procurement challenge if the changes are significant enough for the variation to be deemed a new contract. Specialist technical, financial and legal advice is therefore usually sought for major variations, often from outside of the Council.
 32. A variation to the Bassetlaw schools contract is currently proposed to remove the very complex energy recharge formula by which the contract SPV, Transform Schools, recover energy costs from the individual sites from the contract and replace it with a straightforward requirement for the schools and leisure services to meet their own energy costs. This will enable sites to better manage their energy use, and also encourage more investment in energy efficiency technologies, as the site themselves will gain the direct benefit.
 33. The waste contract has previously been varied (in February 2014) using the existing Revised Project Plan (RPP) process included in the contract to change the residual waste treatment solution proposed in the original deal in response to the failure of Veolia Environmental Services (the SPV) to obtain planning permission for the major contract facility, an Energy Recover Facility (ERF) at the former Rufford Colliery in Rainworth.
 34. The RPP provided for the waste which was to be sent to the Rufford ERF by Bassetlaw District Council, and Newark and Sherwood District Council to be delivered to an existing Veolia ERF in Sheffield, and allowed the council to also renegotiate a number of other key contractual terms to deliver a significant financial benefit to the Council and even more flexibility going forward.

35. A further variation to deliver part two of the RPP, and construct a new Waste Transfer Station (WTS) in Kirkby in Ashfield, and conclude long term contracts for the treatment of the waste delivered to that site by Ashfield and Mansfield District Councils, is due to be concluded by the end of November 2016. This will also deliver a further financial saving to the Council.
36. Failure to develop the Rufford ERF has however led to DEFRA reassessing the level of PFI credits payable to the Council, reducing them by around 1/3rd since the capital spend on the project has also reduced. Overall affordability has still been improved as a result of the wider renegotiation with Veolia.

Current Contract Performance

37. Both of the schools projects and the waste contract offer excellent levels of performance, with the school and leisure buildings designed and maintained to a high standard, and although attributable to a wide range of factors, a number of the schools using those buildings are now achieving significantly improving GCSE results year on year.
38. The waste contract is achieving unprecedented levels of customer satisfaction at the Recycling Centres, which also reach class leading recycling performance, and the contract as a whole is delivering significant landfill diversion performance for the Council.
39. Despite judicious application of the payment and performance mechanisms contract deductions on all projects have been minimal, indicating the diligence of the various contractors and quality of the facilities and services provided.

Current Factors Affecting the Projects

40. Common issues affecting all of the PFI projects include the lack of suitably skilled and experienced staff able to manage the detailed operational and commercial issues behind the contracts and the complex interfaces between the partners involved. Resourcing to effectively manage the risk and cost of these (and other) major projects is a key issue for the County Council if it is to ensure that the contracts continue to offer value for money.
41. Economic fluctuations affect the level of inflation paid on contract rates, which can widen the affordability gap by increasing the difference between the fixed payments made by HMT and the monies paid to the contractors. Additionally in the waste arena the state of the economy is directly reflected in the growth of waste tonnages, increasing contract costs.
42. Although contractual disputes do not occur often they are often complex to resolve, and where they involve national government or local authority partners may have a significant political dimension. This is particularly true where shared use sites are utilised.
43. Effective management of school places is also another complex area where the County Councils role as local education authority is impacted by the academy programme, and where PFI schools which are now outside of the Council control and with largely fixed costs need to be utilised effectively if they are to provide a valuable community resource. It is essential that the PFI schools continue to be considered within the wider school place planning by the Council.
44. Going forward, ensuring robust contract management and appropriate financial planning is put in place to ensure the various arrangements remain affordable will be essential to their continued sustainability. Additionally facilitating a more direct relationship between the contractor and the schools, with effective use of communication channels to ensure issues

are logged and actioned by the contractor without any input from the County Council, will ensure the services operate efficiently.

45. It is worth noting that the Bassetlaw Schools soft FM services, which are currently provided by the County Council, are due to be benchmarked or market tested by the contractor shortly. The Catering and Facilities Management (C&FM) Group within the Place Department is very keen to retain these contracts and will be working closely with the PFI provider to hopefully achieve this. Appropriate safeguards will however be put in place to ensure that neither the Council's contract management function, nor the C&FM commercial team, are compromised during this process.

Contract Management Resources

46. The schools and waste projects are valued at around £60m per annum, and are currently managed by the Group Manager, Waste and Energy Management within the Environment, Transport and Property Division of the Place Department.

47. The waste management team (including the non PFI element) is operated by a small group of specialist staff with strong project management and commercial skills, acting as the retained intelligent client function of the Waste Disposal Authority (WDA) for Nottinghamshire. This includes providing waste treatment and disposal arrangements, and strategy and policy guidance in respect to the management of Local Authority Collected Municipal Waste (LACMW) in the County. The PFI contract (and non PFI Contract) management is effectively undertaken by 3 FTE posts within an approved structure of 10 FTE posts, however the service is also currently carrying 2.6 FTE vacancies.

48. The schools PFI's have traditionally been managed by 2 FTE, currently located within the property structure, although one of those posts is presently vacant and the other post is also utilised preparing academy transfers, so resources are currently limited to around 0.5 FTE.

49. The Committee should note that the resource required to effectively manage PFI contracts across the Council is currently under review.

Other Options Considered

50. None – this is an information report.

Reason/s for Recommendation/s

51. Members of the Audit Committee will no doubt appreciate the high value and complex nature of the three PFI contracts currently operated by the County Council and in noting the contents of this report can be satisfied that, with appropriate staff and financial resource allocation, they will continue to deliver affordable and high quality school places and waste management services for the County Council until the end of their relevant contract terms.

Statutory and Policy Implications

52. This report has been compiled after consideration of implications in respect of crime and disorder, finance, human resources, human rights, the public sector equality duty, safeguarding of children and vulnerable adults, service users, sustainability and the environment and ways of working and where such implications are material they are described below. Appropriate consultation has been undertaken and advice sought on these issues as required.

Financial Implications

53. Although this report is for information only the three PFI contracts represent a significant financial commitment for the County Council and continue to offer a value for money mechanism for delivering the relevant services.

Legal Implications

54. Although this report is for information only PFI contracts are complex contractual arrangements for the delivery and long term management of high value projects and as such are subject to significant scrutiny and oversight by the County Council, HMT, and sponsoring Government departments. Contracts have to be managed, and where appropriate varied, within tight guidelines and best practice standards, and therefore both schools contracts, and the waste contract, have been suitably supported by both internal and external legal advice.

Implications for Service Users

55. Ensuring sufficient school places to meet the identified need remain an obligation of the County Council, and the East Leake and Bassetlaw PFI Schools projects help the authority meet these requirements either directly or through a cost effective delivery partnership with a range of facility providers and academy trusts.

56. The school facilities provided offer the students the best possible opportunities to learn in high quality, safe and sustainable environments.

57. The waste service is well liked by the public with high customer satisfaction scores, achieves high levels of landfill diversion, and all at a cost which puts the Council in the bottom quartile of all Waste Disposal Authorities in England.

58. Together the three contracts continue to provide a value for money solution to meet the requirements of the residents of Nottinghamshire.

Implications for Sustainability and the Environment

59. The PFI Waste Contract has delivered significant investment into the County in order to help improve recycling performance and reduce reliance on the use of landfill for waste disposal.

Recommendation

1. That Committee note the current status and issues associated with the Councils Private Finance Initiative (PFI) Contracts for East Leake Schools, Bassetlaw Grouped Schools and Waste Management.

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For any enquiries about this report please contact:

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Constitutional Comments (KK 14/11/16)

None the report is for noting only.

Financial Comments (RWK 14/11/2016)

There are no specific financial implications arising directly from this report.

Background Papers and Published Documents

Except for previously published documents, which will be available elsewhere, the documents listed here will be available for inspection in accordance with Section 100D of the Local Government Act 1972.

None.

Electoral Divisions

All