THE SCHOOL GOVERNOR'S ESSENTIAL GUIDE TO PFI

UNDERSTANDING the private finance initiative

UNISON

Understanding the Private Finance Initiative:

the school governor's essential guide to PFI

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Preface

"PFI is a difficult decision for school governors, as they hold the key to whether or not a PFI goes ahead, and possibly to whether or not a major redevelopment of their school goes ahead. But they became governors from an interest in children and education, not in finance on this scale, involving perhaps millions of pounds, and stretching way beyond their period as a governor. The decisions they make will bind their successors, and perhaps their friends in other schools, for very many years. They have to balance their desire to get a new school with consideration of the best working practices and employment of those who will work in it, and the financial room for manoeuvre they will have to help the school after it is built. Then they have to think whether they have got a real alternative. It is hard – but there are pointers in this paper to help them make the right decision, and to make it work for them."

(Comments from school governor, North London)

1. *Introduction*

1.1 What is PFI?

The Private Finance Initiative (PFI) has been used by central government over the past five years to increase the use of the private sector in the delivery of tax funded public services.

The Private Finance Initiative is used to buy services and public facilities such as schools and hospitals from a consortium of construction companies, bankers and service providers. Under PFI, a public authority such as a Local Education Authority (LEA) or a hospital trust contracts with the private consortium to design, build and operate schools and hospitals.

Unlike previous school and hospital building programmes which were funded by central government borrowing, under the Private Finance Initiative the private consortium raises the money to build new schools and hospitals from bank loans and through shareholders.

It is important to remember that this way of raising money is *not* new investment. The public authority will ultimately pay back the private consortium the money it has borrowed, interest on the loan and also shareholder profits. PFI is, therefore, government borrowing through an intermediary but at a higher rate than it could normally achieve.

The Private Finance Initiative consists of a contractual arrangement between a public authority and a private consortium which typically lasts between 25-35 years. Under the terms of this contract the private consortium agrees to:

- Design build and maintain the school or hospital over the course of the contract period
- Provide certain services such as cleaning and catering within the school or hospital. These are known as facilities management services or FM services.

For its part the LEA or the hospital trust agrees to make regular payments to the private consortium over the contract period. These payments go towards:

- Paying back the loans and the interest on the loans which have financed the building of the school or hospital.
- Paying for the services provided within the schools.
- Providing a profit for the shareholders.

The private consortia which design, build, finance and operate the schools or hospitals create an independent legal entity for the purposes of each PFI contract that they enter into. This company is referred to as a Special Purpose Vehicle (SPV). Its only income and source of profit is the payments it receives from the public authority. Importantly this means that the parent companies of the Special Purpose Vehicle are not financially liable if the PFI scheme fails.

1.2 Why does the government favour PFI schemes?

1.2.1 NEW INVESTMENT FROM THE PRIVATE SECTOR?

One of the beliefs about PFI, which is often encouraged by the government, is that the Private Finance Initiative is a new source of money. This is because the SPV initially invests money into building or refurbishing schools. However, any money which the SPV invests in schools will be paid back to them out of the public purse.

This is a bit like buying a car. When buying a car most people will borrow the money necessary to purchase the car from a financing company such as a bank. The bank will provide the money for the car up-front. However, the purchaser will still have to find the funding for this purchase from their own income, usually paying back the borrowed money in monthly instalments over a number of years. As a result the bank does not actually pay for the new car at all.

Government, and in particular the Treasury, likes this way of paying for new capital investment because it does not appear as borrowing on the nation's

balance sheet. For all sorts of economic and political reasons it is good for the government to give the appearance that the nation is not heavily in debt to banks or other lending institutions. However, whilst the payments under PFI may not appear 'on the balance sheet' the nation will still have to pay back the private lending institutions from the public purse in the same way as if it had borrowed it directly. PFI is thus government borrowing in a different guise. Any justification for PFI in this sense rests on the way in which central government accounts for the money that it borrows and spends.

1.2.2 IS IT CHEAPER FOR GOVERNMENT TO PROVIDE SCHOOLS AND HOSPITALS UNDER PFI?

The actual cost of raising money to invest in schools is higher under the Private Finance Initiative than it is under the traditional way of building and operating schools. This is because the government can borrow more cheaply than the private sector. Also, when a local authority borrows directly there are no shareholders to pay dividends to.

Under PFI the SPV will raise money to pay for the project in two ways: by borrowing money from a lending institution, and by raising money from shareholders who will require a return on their investment.

At the borrowing stage PFI will cost the local authority more. These extra costs come from two sources.

i) The borrowing rates on loans taken out by the private sector are around 1.5 per cent higher than the rates on loans taken out by the local authority

ii) Shareholder profits. The target rate of return on shareholder investment in a schools PFI scheme is between 12-15 per cent. The actual rate of return may be much higher than this.

In a typical PFI scheme, from 12 per cent to 25 per cent of the money raised by the private sector to pay for building or refurbishing the schools is contributed by shareholders in the form of shares or 'equity'. The remainder is funded through borrowing (debt). The ratio between the amount funded through debt and the amount funded through shareholders (equity) is known as the 'debt:equity ratio'.

The extra cost of PFI:

Take for example a PFI scheme involving investment of £100m in the first year with a 30 year contract.

80 per cent of the finance raised by the private consortia will be in the form of debt (ie loans borrowed from banks) whilst 20 per cent will be contributed by shareholders. The debt: equity ratio in this case is 80:20

Since private sector borrowing rates are 1.5 per cent more expensive than those on government debt this will mean that the interest payments on the debt (£80m) will be £1.2 million per annum more expensive than those on government debt.

If the target rate of return for shareholder investment (£20m) is 15 per cent this will lead to an additional cost of £3.75 million over the course of the project.

PFI schemes are also costly to set up and manage. Most public authorities involved in PFI projects will use external consultants to assist with the specification of contracts and the contractual negotiations. In NHS PFI schemes, payments to external advisors have averaged around 3.5 per cent of the total cost of building and operating a new hospital with the average cost of a hospital calculated at £81 million.[1] Transaction costs for an NHS PFI scheme thus amount to an additional £2.8 million for each new hospital.

Transaction costs in schools PFI schemes are also significant. In the Pimlico PFI scheme, Westminster City Council anticipated that the transaction costs (including the cost of external advisors and other procurement costs) would amount to £1.5 million in a scheme which had a total value of £32.4 million.[2]

Importantly these costs do not include the contract monitoring costs which occur once the contract has been signed.

1.2.3 IF IT COSTS MORE TO RAISE MONEY TO INVEST IN SCHOOLS UNDER PFI WHY DOES CENTRAL GOVERNMENT STILL FAVOUR PFI?

Central government justifies the higher cost of raising money under the Private Finance Initiative in two ways:

- The government says that it believes that the private sector can design build and operate schools more cheaply than local authorities. This will generate savings which will help to compensate for the fact that it costs the private sector more to borrow money.

For example, in KPMG's advice to Haringey council on its PFI scheme they assumed that the costs of running the new schools would be 10 per cent cheaper if a private consortium operated the schools.[3]

However, it is important to note where these savings will come from. In hospital PFI schemes which have been examined and in other contracted out services the 'efficiency savings' have come at the expense of staff terms and conditions, service quality and through reductions in levels of service provision.

- Secondly, the government argues that there are benefits to be gained by building and operating schools using PFI which do not arise under the traditional method of procurement. These additional benefits are supposed to make the higher cost of PFI worth paying. The government claims that under a PFI arrangement the private consortium takes on risks which would normally be borne by the public authority.

The justification for the higher cost of capital under PFI thus rests on the claim that the private consortium will take on a certain amount of risk under the contractual arrangements. The value for money case for PFI depends on real risks being transferred to the private sector. However, in the PFI schemes which have been examined so far the public authority has retained a substantial amount of risk under the project and risk transfer has been largely theoretical.

Many of the issues relating to PFI are often detailed and complex. However, school governors should be aware that there is significant pressure on LEA's to push ahead with PFI schemes regardless of whether they are either value for money or affordable. Being aware of the issues surrounding PFI will allow governing bodies to fulfil their responsibilities as custodians of public funds and to ensure that the redevelopment of school buildings is carried out in the most cost-effective manner.

2. *How do PFI contracts operate within schools?*

2.1 What types of schemes are usually signed?

There are two types of arrangements which local education authorities enter into for the building and operation of their schools:

i) A deal for the refurbishment or building of just one school

ii) A deal for the refurbishment of a group of schools in the borough. This type of scheme is sometimes known as a 'bundled' scheme, where all the schools are bundled together into one large refurbishment scheme.

Many LEAs believe that by asking one private company to refurbish and operate a group of its schools it can achieve savings through 'economies of scale'.

Private companies tend to be more interested in larger, bundled schemes rather than smaller single school schemes.

2.2 Who is the contract between?

The main contractual relationship is between the Special Purpose Vehicle (SPV) and the local education authority (LEA). This means that all the details relating to the contract – how much will be paid out each year, what the new building specifications are, how the contract will be monitored and ultimately what amendments to the contract will take place – are agreed between the LEA and the SPV. The school governing body will be consulted on these issues but the final decision on the details of the contract is made by the LEA.

The contract for services within the schools is not between the school governing body and the SPV. School governing bodies enter into an agreement with the LEA to allow that part of their delegated budget which relates to the operation of the school to be paid over to the SPV.

2.2 Why is the contract so long?

The contract with the SPV is between 25-35 years in length. Usually when a local education authority 'contracts out' services such as catering or cleaning to a private company the contract length is between three and seven years. This allows the LEA to change the service provider at the end of the contract if they are not doing a good job or to find a cheaper provider. In short-term contracts, private companies are keen to have their contracts renewed and so have an incentive to provide a high quality service.

The value for money unit of the Department for Education and Skills acknowledges the advantages of short term contracts: '[Any contract] that is longer than three years may result in inflexibility particularly if the agreement does not allow the school to vary its requirements in the light of changing circumstances'. [4]

One of the central features of PFI in schools and hospitals is the long term nature of the contract. A contract term of 25 years allows the SPV to raise the money for capital investment at favourable rates and to receive a guaranteed income stream from local authorities over the 25 year period.

The length of the contract is thus determined by the financing arrangements for PFI and not by the needs and interests of the LEA or of the schools. A contract with one private company for the provision

of FM services over 25 years is an inflexible way of delivering services to schools.

Action for school governors 1

School governors should question whether contracting with one provider for 25-35 years is the most effective and flexible arrangement for the delivery of services within schools. They should explore with the LEA the possibility of excluding facilities management services from the overall PFI contract. (*see section 7 on workforce issues*)

2.3 Who owns the schools under PFI?

Under most PFI arrangements the school buildings will be transferred over to the Special Purpose Vehicle (SPV) who will lease the school back to the LEA. Part of the payments that the LEA will pay to the SPV over the 25 year contract can be described as a type of rent. Although the LEA still technically owns the schools and will have full responsibility for them at the end of the contract, the SPV will have responsibility for the upkeep of the facilities – as would a landlord – throughout the terms of the lease. This arrangement is known as 'lease and lease back'

2.4 What happens if the contractor does not provide services up to the standards set out in the contract?

The principle behind PFI is that the payment of the unitary fee is conditional on the SPV meeting certain performance requirements set out in the contract. The fee can be reduced if these standards are not met. This is the basis for the argument that PFI 'privatises the cost of things going wrong': if the SPV fails to provide services to the required standard, it suffers financial consequences.

Thus if the food is not nutritious, the classrooms are not clean and the heating does not work the LEA may make a deduction from the fee to the provider.

The same applies to the availability payment. If a classroom is not available during school hours due to a leaking roof, or worse, if the whole school is not fit for use then this is the responsibility of the SPV and they will have their payments reduced accordingly.

It is important to note that a financial penalty will only be imposed on the contractor if it is explicitly stated in the contract.

This practice of deducting payments for non-performance is one of the main justifications for PFI. The government describes it as transferring operational risk to the private sector.

However, it is important to remember that even though the SPV will be penalised when a classroom is out of action the school and the pupils will suffer too. The school (and in some cases parents and carers) may face additional costs as a result. If a school is closed for the day, or even a number of days, alternative arrangements will have to be made for pupils. It will also be difficult to make good any disruption to the curriculum if classrooms are out of action. It may be possible to re-schedule lessons outside of school hours, however this would depend on either sufficient funding being available or on the goodwill of teachers. Importantly, it may also require pupils to be willing to stay behind after normal school hours.

Given that schools are likely to face the immediate cost of such problems, school governors should ensure that they receive any penalty payments made by the SPV to the LEA. (Also see Section 3.1.1)

School governors and the LEA also need to ensure that the level of penalty deductions will be sufficient to 'incentivise' the SPV from keeping classrooms open when it is not in their financial interest to do so. Indeed, it may be commercially advantageous for the contractor to incur a penalty payment at some point in the operation of the contract. The use of penalty payments should thus not be seen as an absolute guarantee that contract standards will be met.

Action for school governors 2

School governors must be aware that they and the LEA will always retain certain risks under any contracting arrangement. If things go wrong with the operation of the school they will still be ultimately responsible for ensuring that there are adequate facilities for curriculum delivery. Before entering into a PFI contract they should be certain that financial penalties are sufficient to 'incentivise' the provider to meet performance standards. The level of fines which are imposed on the SPV should be transparent and the school's should share in the receipt of any compensation payments made by the SPV. (See also Section 3.1.1)

3. *The contractual relationship*

3.1 The legal status of the 'governors agreement'

Under the School Standards and Framework Act 1998 (SSFA) school governing bodies have the power to enter into legally binding contracts.

The contract for the refurbishment/building of the schools and their operation is between the LEA and the SPV. The school governing body is not party to the main contract.

Instead the school governing body signs an agreement with the LEA to hand over a part of its delegated budget to meet the payments to the contractor. This is sometimes known as the 'Governors Agreement'. In return for this commitment, the LEA undertakes to ensure that the SPV performs to the standards set out in the contract.

However, whilst the PFI contract between the LEA and the SPV is legally binding there is some doubt about the legal relationship between the school governors and the LEA. The legal opinion of the Department for Education and Skills is:

'Arrangements between LEAs and governing bodies relating to the funding of PFI contracts, although they can be binding, are not contractual. They are simply part of the arrangements for the funding of the school by the LEA. It is a different consideration where the governing body want the LEA to guarantee effective delivery of facilities management and related services throughout the 25 year contract. The LEA simply cannot do this'. [5]

What does this mean in practice?

The LEA is responsible for ensuring that the SPV meets the contractual standards on behalf of school governing bodies. The school governing body thus has no direct control over the SPV. Any disputes about the SPVs performance must be resolved via the LEA.

Under a non-PFI arrangement if the school was to contract directly with a SPV for FM services it could penalise and 'incentivise' the SPV itself and ultimately seek legal redress through the courts if performance was not satisfactory.

As far as school governing bodies are concerned the agent responsible for ensuring the delivery of services under PFI is the LEA. However, schools have no legal redress against the LEA if the contract standards are not upheld. In the Governors Agreements which have been examined LEAs have only committed themselves to taking reasonable steps to ensure that the contracts are enforced.

The enforcement of the PFI contract is thus dependent on the LEA being fully committed to managing the contract over the course of 25-35 years. There is no guarantee that all future LEA's will undertake this commitment and no obvious legal redress if they do not.

In effect this means that school governing bodies are taking on a substantial amount of risk over the course of the contract period since they are statutorily responsible for the delivery of school services.

Action for school governors 3

School governors should consider whether contracting for school services in this way is the most appropriate way of procuring and maintaining adequate control over the services that they have statutory responsibility for.

3.1.1 CONTRACT MONITORING

Who has responsibility for monitoring the contract?

Even though the LEA is responsible under the Governors Agreement for enforcing the contract, the responsibility for monitoring the contract often lies with schools. Schools are often required under

governors agreements to ensure that any failure in the SPV's performance are reported accurately and promptly to the LEA.

This means in effect, that schools are responsible for monitoring a contract which they cannot themselves enforce. They are also usually required to take on the additional cost of providing and training staff to provide the monitoring function.

What happens if schools do not monitor the contract properly?

In the schemes which have been examined, the governing bodies are obliged to carry out their monitoring functions in such a way as to ensure that the LEA does not suffer financially from any failure on the governing bodies part (for example, if they fail to identify poor quality work on the part of the SPV in time for the LEA to demand rectification).

The LEA can recover any losses it suffers as a result of inadequate contract monitoring from the schools delegated budget. Thus, ironically, whilst schools cannot seek legal or financial redress against the LEA they may be financially penalised if they do not fulfil their obligations as set out in the Governors Agreement.

3.1.2 HEALTH AND SAFETY

Under the Health and Safety at Work Act (1974) governing bodies are obliged to take all measures within their power to ensure that the school premises are safe and not hazardous to the health of staff, pupils or visitors.

Under PFI schemes, health and safety responsibility will move away from the governing body and on to the SPV in practice although not in legal theory.

Governing bodies still remain legally responsible for health and safety. However, by entering into the Governors Agreement the school is securing a contractual commitment from the SPV to comply with health and safety legislation.

The key to ensuring that the governing body can properly discharge its health and safety responsibilities is its ability to enforce the contract with the SPV.

Action for school governors 4

School governors should ask whether the contracting arrangements with the LEA via the 'governors agreement' is an effective way of ensuring that the SPV will comply with health and safety legislation. School governors should also seek legal advice on the extent to which they remain liable for any breach of health and safety legislation, which is committed by the SPV.

3.1.3 CHANGES IN THE SPECIFICATION OF THE CONTRACT

Throughout the 25-35 year long contract it is likely that the services required by the SPV will change. Departures from the original contract of this type are known as contract variations. For example during the course of the contract a school may need a new classroom or may wish to upgrade its sports facilities. These changes will require additional funding which will come from either the LEA's own resources or from schools' delegated budgets.

Who decides what changes to the contract take place?

Variations can be proposed by the SPV as well as by the local authority and the schools. However, the decision on whether proposed variations should be undertaken rests with the parties to the contract, ie the LEA and the SPV not with schools, who are only entitled to be consulted.

Action for school governors 5

Adjusting the contract will be a cumbersome and costly process. School governors may wish to consider whether this impacts upon their ability to fully control the services which are delivered within the schools and also whether any loss of flexibility can be justified.

3.1.4 CAN SCHOOL GOVERNING BODIES WITHDRAW FROM THE CONTRACT?

Because the school governing body does not enter into the direct agreement with the SPV its only commitment is financial. That is, the school governors are only committed to handing back to the LEA part of their delegated budget each year. Moreover this commitment is not a legal agreement but is a formal agreement relating to the funding arrangement for the school.

This being the case, if the school governors wish to withdraw from a scheme during the contract period they may only do so with the consent of the LEA.

3.2 Contract termination

3.2.1 WHAT HAPPENS IF THE SPV CONSISTENTLY FAILS TO PERFORM UP TO STANDARD?

One of the most frequently quoted statements about PFI and other contracts with the private sector is that if the SPV does not perform then the contract will be terminated and the services will be taken back in-house. Indeed the Treasury sees the threat of contract termination as one way of ensuring that the SPV meets contract specifications.

However, the threat of contract termination is far weaker than is often made out. In most scenarios it is in nobody's interest to terminate a PFI or other long term contract. This is because contract termination often involves a lengthy legal dispute which will incur costs for both sides. There will also be significant costs involved if the LEA wishes to re-tender the contract and even greater costs if the LEA is forced to re-provide the services.

The most likely outcome following any disagreement over the contractor's performance is contract re-negotiation. The terms and conditions on which the contract is based may be substantially amended. One of the reasons often given by SPVs for poor contract performance is that the payment under the contract is insufficient. Thus the contract price may also be revised upward under contract re-negotiation. This will undoubtedly have revenue implications for schools' budgets and the LEA.

The ultimate sanction against non-performing private sector companies is thus rarely invoked.

3.2.2 WHAT HAPPENS IF A CONTRACT IS TERMINATED?

The idea that the LEA does not pay out anything if the contract is terminated should be dispelled. In fact, if the company which is providing the maintenance and operation of the schools is sacked the LEA still continues to pay for the buildings.

Why is this?

It is important to remember here that the LEA pays the SPV for two separate services – making the building available and providing facilities management services up to a specified standard (*see Section 4 on Paying for PFI*). If the SPV fails to make the school available or does not provide the services satisfactorily then the LEA will not pay the SPV the full amount agreed under the contract.

The SPV also has an agreement with the banks and other financial backers which lend it money to invest in the school buildings.

The money that the lenders provide goes towards the physical rebuilding or building of the schools. It will receive repayments of its loans to the SPV through the availability charge and *not* through the fee for facilities management services.

The lenders want to be sure that their loans and investments are secure and so have to be certain that the payments that the SPV receives from the LEA are enough to cover the loan repayments. If the SPV does not make the school 'available' and is thus financially penalised by the LEA it may not have a sufficient amount of money to pay back the loans it has borrowed from the lending institutions.

If this occurs then the SPV is in breach of its agreement with the lenders and the lenders can terminate the contract. The contract with the SPV can thus be terminated for non-performance by both the LEA and the lenders.

3.2.3 WHAT HAPPENS AFTER CONTRACT TERMINATION?

In order to minimise the risk involved in investing

money in PFI deals, banks have sought an assurance from central government that they will not lose their investment if the contract with the SPV is terminated due to poor performance. One of the reasons that interest payments on loans for PFI deals are so low – although still higher than if the government borrowed directly – is because PFI contracts contain a clause guaranteeing that the LEA (or other public body) will continue to pay off the outstanding debts of the SPV if the contract is terminated.

This may seem surprising. One of the motivations behind PFI is supposed to be that those investing money in the project are entitled to make a significant profit because they are putting their investment at risk. However, if things do go wrong with the project and the SPV loses the contract, those providing funding for the project will still receive payments from the LEA.

Central government justifies this by saying that if the contract is terminated and payments cease, the LEA will have a newly built school that it will not have paid for in full. Paying the lending institutions the money that they have invested simply amounts to paying for what the LEA has received.

However, this means that only a small part of the payments made by the LEA under PFI schemes is dependent on the performance of the SPV. Or put another way, the LEA is committed to making payments regardless of the contractors' performance. This undermines the claim that the private sector takes on substantial risk under PFI.

Action for school governors 6

School governors and local authority councillors should be aware that contract termination for poor performance does not end the LEA's obligations to pay for schools built under PFI. They should also note that the payments made to the SPV are only dependent on performance to a very limited extent.

4. *Paying for PFI*

4.1 How are payments made?

A single payment is made to the SPV known as the unitary charge. This payment is usually made at six-monthly or yearly intervals. The unitary charge is usually fixed for the period of the PFI arrangement when the contract is signed. Normally the contract allows for an annual increase in the price for inflation. Apart from this the charge will usually only vary if a change is introduced to the contract.

It is important to note that this payment has two components:

1. The availability fee:

The LEA pays the SPV for making the school 'available' for use as an educational establishment. In most PFI contracts for schools the SPV must make the school available for a set number of hours every day and for a set number of days every year. If it does not make the school available then the SPV will not receive the full rent. This part of the payment is known as the 'availability' fee. The availability fee usually constitutes around 60 per cent or more of the unitary charge.

It is important to remember that the longer the school is 'available' throughout the year the more the LEA will have to pay to the SPV. The LEA and the school governors will have to be aware that the flexibility which comes from having the school available for long periods of time will lead to additional expense under the contract.

In order to lower the cost to the LEA, to allow the SPV to generate additional income from third parties, and to allow it to carry out any maintenance work restrictions are placed on when the school is actually available for use by teaching staff and pupils. Thus a set number of days per year and a set number of hours per day are allocated for school use and for extra curricular activities. If teaching staff require the use of the school outside of these core times this will usually have to be agreed with the SPV and the LEA.

Example of restrictions on school availability: London Borough of Haringey

In the Haringey scheme the schools are to be made available to staff and pupils from 7am to 7pm on core school days. Core school days amount to 210 days in any academic year. Any use of the school outside of these hours must be agreed with the private consortium. The initial proposal had been to allow the school to be made available for 240 days but the LEA concluded that this would incur additional expense and a higher annual availability fee.

Action for school governors 7

School governors should be aware that PFI requires school governors to look at their school buildings in a new light. In particular it involves a loss of direct control over when and to what purpose school buildings are used. School governors should ensure that the 'availability' of school premises under PFI allows the full range of extra curricular activities to take place. School governors should be certain that the overall quality of life at the school is not diminished as a result of PFI.

The availability payment has to meet three types of cost:

- Paying off the debt and the interest payments on the loan taken out by the SPV
- Lifecycle costs – capital expenditure that may be required in later years in order to maintain the schools. This 'lifecycle reserve' is the property of the SPV: any unused funds will simply be passed over to the shareholders at the end of the contract.
- Once these two costs have been met the availability fee funds the returns to shareholders.

2. Fee for services:

The other part of the unitary charge is for the services which are provided within the schools. This

will include such things as caretaking, catering, cleaning and any other facilities maintenance (FM) services which are included in the contract.

4.2 *Where does the money to pay the SPV come from?*

The 'unitary fee' paid to contractors covers both the cost of building and maintaining the schools and also the cost of running the services within the schools.

The instalments which are paid by the LEA to the SPV come from two sources. Where the amount received from central government does not match the amount paid out to the SPV there is an 'affordability gap'.

Source 1: Money from central government

Under PFI central government pays LEAs money to go towards the cost of the building work carried out by the SPV. These are known as PFI credits. As is shown below this amount is usually insufficient to meet the payments to the private consortium.

Source2: Money from school budgets

The fee for the services operated by the SPV will come from the budgets delegated from the local LEA to individual school governing bodies under the Fair Funding regime.

Currently school governing bodies are responsible for funding services within their schools out of their delegated budgets. The money which is currently spent providing the services which fall under the PFI contract will be paid back to the LEA who will then pay it to the SPV.

In effect this will require each governing body to relinquish their budgets relating to each of the services contained within the contract. In this sense, PFI fundamentally affects the responsibilities of school governing bodies.

Under PFI the payment to the SPV is a contractual obligation which must be met each year before any other considerations. If a school wishes to spend money on a new teacher at the expense of spending money on cleaning or by deferring non-essential repairs it will not be able to do so under this contract arrangement. Whilst payments to the contractor to provide services within the schools are protected (that is, the school cannot touch them) teaching budgets are not.

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Conventional budget setting tends to put staffing and curriculum delivery as the first priorities. Under a PFI contract the payment to the SPV will be a first charge on the school's budget. School governors should consider whether prioritising funds in this way is in the best interest of pupils and teachers.

4.2.1 HOW DOES THE LEA CALCULATE THE SCHOOL'S CONTRIBUTION? CAN IT CHANGE OVER THE COURSE OF THE CONTRACT?

LEA's usually determine the amount of money which each school is required to contribute by looking at how much has historically been spent each year on the services to be provided by the SPV. Having determined the contribution in this way the LEA will adjust this figure in future years to take account of inflation. LEAs also adjust the contribution made by schools according to how many pupils are in attendance. Thus if pupil numbers increase the school's contribution will increase and if they decrease the contribution will decrease accordingly.

However, if the charge made by the SPV is found to be higher than the total amount paid by the school's and the LEA's own contribution then the LEA may increase the school's contribution to make up the difference.

The arrangements for schools contributions will differ with each PFI scheme. Out of all the schemes examined so far LEAs have been unwilling to set a limit on the amount that schools will have to contribute. This leaves open the possibility that any funding shortfalls which occur over the 25-35 year contract will be made up out of the school's delegated budget.

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School governing bodies need to be sure that they will be able to deliver the curriculum with the funds which are available after the PFI payment has been deducted. They should also seek a commitment from LEAs that a limit will be placed on their contribution throughout the 25 year contract.

4.3 *Affordability: can the local authority afford the scheme?*

4.3.1 WHAT INFORMATION IS REQUIRED TO KNOW IF A PROJECT IS AFFORDABLE?

Given that PFI contracts involve long term financial commitments it is important for school governors to know if they and the local authority can afford them. In many ways it is difficult for schools and local authorities to work this out over the course of a 25-35 year long contract. The way in which central government funds schools and local authorities will undoubtedly change over this period and the assumptions made about investment and borrowing will also vary.

In the Outline Business Case (OBC) for the scheme local authorities should set out how the scheme will be funded. In the OBCs prepared by other LEAs the information on affordability is often presented in such a way as to prevent a proper evaluation of how much the scheme will cost.

The cost of a PFI project is often presented in the OBC in terms of Net Present Value (NPV). A Net Present Value is *not* the total amount that the local authority will pay out to the SPV over the course of the contract. This procedure is used by accountants to compare the cost of a series of payments over a long period of time at today's value. (*see section 5: Value for Money*) The net present value of the project is not the cash cost (that is, the actual amount of money paid out each year) of the project and is thus an irrelevant figure when it comes to examining affordability issues.

This is a bit like a mortgage. In order to know whether you can afford to borrow the money you would need to assess the monthly repayments against your monthly income. The same is true for PFI projects. In order to assess whether PFI schemes are affordable, school governors need to know how much the payment to the SPV will be each year and also how much money they and the LEA have coming in.

Presenting the cost of the scheme in terms of a Net Present Value is thus entirely unhelpful in demonstrating whether a scheme is affordable.

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Any assessment of affordability should be measured against the money and the resources that the LEA has coming in. Affordability should not be presented by the LEA in Net Present Values but should be set out in cash costs. A profile of income and expenditure should be made available in the outline business case. School governors should be wary of attempts by the LEA to match the affordability analysis according to the bids submitted by SPVs. They should seek a clear statement from LEAs about when a scheme becomes unaffordable.

4.4 *Affordability gaps*

One of the most difficult problems which face LEAs and school governors is knowing whether or not they can afford to meet the payments to the SPV over the course of the 25 year contract.

In promoting their PFI schemes, local authorities tend to emphasise the funding provided by central government. This funding combined with the money already given to schools to pay for services is supposed to be sufficient to meet the contract payments. In this instance LEAs state that the schemes are 'revenue neutral'; that is the money paid out is equal to the money coming in.

However it is highly likely that there will be a

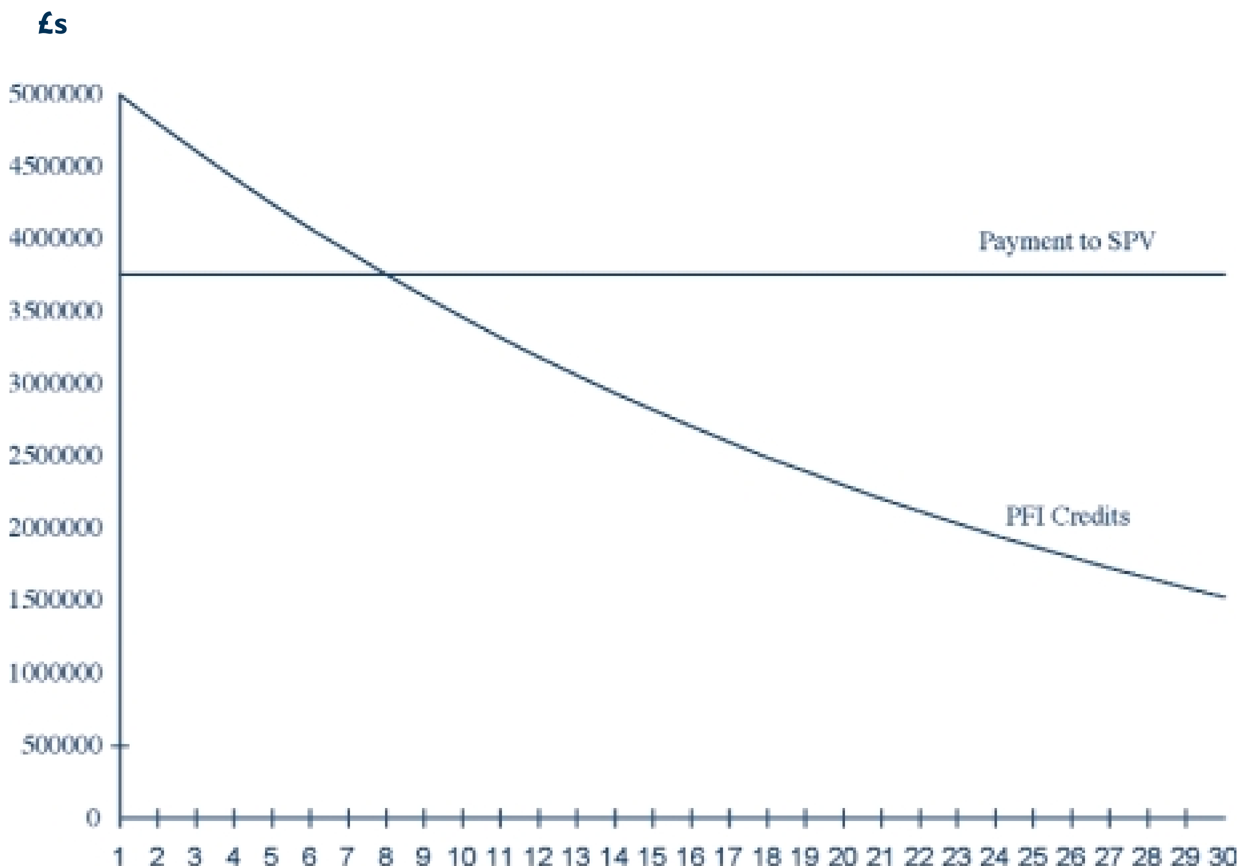
difference between the amount of money which comes from these two sources and the payments to the private contractor. This is because of the way that central government gives money to local authorities to pay for PFI schemes. This is a complicated arrangement which most local authorities are not happy about. It means in effect that there is a mismatch between the funding from central government and the payments to the SPV (*see figure 1 below*).

As the graph shows, in the early years of the contract LEAs receive more than is required from central government to pay the private consortium. However for most years of the contract they receive less than they are required to pay out. They also continue to receive credits after the end of the contract period. For this reason, LEAs often assume that in the long run the amount of PFI credit matches the payments to the contractor. [6]

It should also be noted that the initial bids for PFI credits are made before tenders are invited from the private sector. LEAs have to inform central government how much they think they will need over the course of the project *before* they know how much the SPV will charge them. This can lead to a further shortfall in funding particularly when the initial cost estimate is revised upwards.

Affordability problems can also arise as a result of contract variations. It is almost inevitable that over the course of 25–35 years changes to the contract will take place. Any extra work which needs to be done to the schools will fall outside the terms of the original contract. These additional works will require extra funding. The money from central government in the form of PFI credits will not be increased and so funding for any new work carried out by the SPV will have to be found from other sources (*see Section 4.5 Bridging the affordability gap*)

Figure 1: Revenue support for local authority PFI schemes



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School governors should be wary of claims made by the LEA that central government funding will be sufficient to make PFI projects affordable. There is often a mismatch over the course of the contract between when payments to the SPV are made and when income from central government is received. School governors should examine claims of 'revenue neutrality' carefully.

4.5 Bridging the affordability gap

Where there is a gap between the money coming in and the money being paid out there is an 'affordability gap'.

LEAs can fill this gap in a number of ways:

4.5.1 BRIDGING THE AFFORDABILITY GAP: (1)

- LEAs can invest the extra money that they receive at the start of the contract and use the interest to make up the shortfall which will exist later in the project

Most LEAs do this by establishing a 'sink fund'. However, it is important to remember that LEAs are restricted in their investment to low yielding opportunities such as bank deposits and gilt edged securities. The interest which is generated from investing this money is, in most cases, not sufficient to bridge the funding shortfall.

4.5.2 BRIDGING THE AFFORDABILITY GAP: (2)

- LEAs can use the school facilities to generate new income or 'third party income' and thus reduce the price of the contract.

The government actively encourages this in PFI schemes. LEAs are supposed to make dual use of facilities or services in order to reduce the overall cost of PFI schemes. The LEA can agree with the SPV that the school facilities can be hired out to make additional money. This may mean that the SPV will use the playground as a car park on the weekend or that the sports facilities are hired out to private users. Classrooms may be used during the Summer holidays to hold business conferences or the IT facilities may be used to run private training sessions.

In most cases the money generated from such activities will be taken off the amount that is paid to the SPV. The LEA may share in any of the additional income which is made.

It is important for school governors and the LEA to understand any implications which may follow from using school facilities to generate additional income. School governors may consider certain uses of school facilities as inappropriate and against the best interest of pupils.

In other PFI schemes for the operation of government buildings SPVs have constructed mobile telephone masts on offices in order to generate additional income.

Whilst Department of Education guidelines are strict on the particular issue of mobile telephone masts there may be other areas of concern for school governors.

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Schools should seek assurances early on during negotiations with the LEA about which groups are allowed to use school facilities and for what purposes.

4.5.3 BRIDGING THE AFFORDABILITY GAP: (3)

- LEAs can sell some of the land attached to the school or allow the SPV to develop on the land thus reducing the price of the contract.

Selling excess land is very important in funding some PFI schools contracts. 'Land surplus to requirements' is often one of the major sources of funding for PFI deals.

It is important to note that the Department of Education has published guidance on the minimum

land sizes to be retained by schools.[7] Under the guidance on school playing fields any disposal or change in the use of such land must receive the agreement of the Secretary of State. The guidance states 'the Secretary of State has a general presumption against the need to change the pattern of school playing field provision by disposal or change of use'

Whilst it is likely that a Secretary of State would approve land sales in order to lead to the improvement of school facilities school governors need to assess the effect that any reduction in the schools external recreation areas will have. Will the reduction for instance allow the school to still meet DfES guidelines on minimum school areas? Is there a trade off between losing external recreation areas and having other improved facilities?[8]

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School governors should seek to understand the purpose to which the land will be put after it is sold and whether any development of the land will affect the school's environment.

4.5.4 BRIDGING THE AFFORDABILITY GAP:(4)

- Local authorities can divert money away from other council services to pay for the scheme.

If, after having explored the options outlined above, there is still a shortfall in funding for the scheme Council's can access money used to fund other council services.

PFI affects the budgeting priorities of local authorities. Local authorities will in the future have a number of PFI contracts for the provision of different services (contracts for street lighting, care homes for the elderly, libraries etc). Because these are long term contractual commitments the council is obliged to pay the SPV in each of these cases before it finds resources for other services.

In the same way that school governors will not be able to decide to cut back on the cleaning budget in order to pay for additional teaching staff so local councils must recognise that payments to PFI contractors are similarly protected and take priority over other service areas. The 25-35 year long budgetary commitments under PFI will undoubtedly reduce the council's flexibility in delivering services to the community.

4.5.5 AFFORDABILITY GAPS AND THE IMPLICATIONS FOR SCHOOLS

School governors need to be sure that any shortfall in funding for the scheme will not be made up out of their delegated budgets to the detriment of curriculum delivery. They will need to seek assurance from the LEA that a limit will be placed on the amount that will be taken from their delegated budgets.

School governors may also want to assess the impact of any affordability problems on other schools who are not involved in PFI schemes. In this respect it is important to remember that the only part of a council's budget which is 'ring-fenced' or protected is that which goes towards paying the SPV. This means that all other areas of local authority expenditure including funding for other schools in the borough can be accessed to make up any shortfall in the payment to the SPV.

Affordability problems can also impact on the eventual design and operation of the school buildings. The funding arrangements for PFI and the additional costs involved can lead to a reduction in the school's capacity. The plans for the refurbishment or rebuilding of schools may well be altered in such a way as to make the project more affordable. These alterations may involve smaller classrooms, a higher classroom occupancy rate or a reduction in social areas for pupils and staff.

Example: Glasgow City Council

A scheme for the refurbishment and rebuild of Glasgow City Council's 29 schools is an example of where school capacity was reduced in order to make it affordable to the council. In every school which has been or is waiting to be rebuilt/ refurbished classroom numbers have been reduced. Six schools had their swimming pools removed and most establishments were cut from two games halls to one games hall. A reduction in the number

of rooms will leave up to a quarter of teachers without their own designated classrooms. Also missing from the PFI plans is the provision of staff common rooms.

Source: PFI Intelligence Bulletin March 2001

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School governors should ensure that they and school staff have a significant input into the design of new school buildings. After all, those who work in and govern the school know the school's requirements best. They should think through how any design changes will impact on the day to day operation of the school and should ensure they are adequately consulted by the LEA.

5. *Is PFI value for money?*

5.1 The value for money appraisal

Under best value, school governing bodies are expected to show that the services that they are responsible for are Value For Money (VFM). This requirement applies to PFI contracts in the same way that it applies to any contract for service provision. School governors must thus assess the value for money case put forward by the LEA.

LEAs must be able to demonstrate to central government that the project is value for money in order to receive approval.

The value for money case of a PFI scheme is an economic appraisal which aims to compare the cost of the LEA borrowing money directly to build the school and of providing the services within the school itself, with the cost of using the private sector. The former is known as the Public Sector Comparator (PSC), the latter as the PFI option.

The value for money appraisal is made up of two parts:

1) the application of a discount rate to the annual payments made under each scheme

2) the valuation of the risks transferred to the private sector.

There are two points to note about the VFM appraisal. First, even though a PSC may be put together by the LEA there is very little chance of the publicly funded option being allowed to proceed. Central government has signalled that PFI is the only source of funds for refurbishing and building schools. As far as LEA officials are concerned, if the PFI option is found to be more expensive than the PSC then the refurbishment of the LEA's schools or the building of a new school will not go ahead. LEAs are very aware of the lack of other options and are thus keen to show that PFI schemes are both affordable and value for money. There is thus an incentive to show that the PSC is more costly than the PFI option.

So far there have been no cases in which, having reached the stage of evaluating private sector bids, a public authority has decided not to proceed with a PFI option on the grounds that the public sector comparator showed better value for money.

Second, the VFM analysis does not compare the actual cash costs of the PFI option and the PSC option. This prevents decision makers from assessing either the true cost implications or the real efficiency savings associated with each scheme.

◗ If the VFM analysis does not use a comparison of cash costs, what figures are used?

An example here is useful. In the Carlisle Hospital PFI scheme the actual *cash costs* of the PFI option and the PSC were £577 million and £550 million respectively. From this it is clear that the public sector option was £27 million cheaper.

The actual figures used by the NHS Trust to justify the use of PFI, however, were not cash costs. Instead, the figures were presented in terms of Net Present Values (NPVs) (*see below*). Under this method of economic appraisal the PSC was valued at £174.3 million whilst the PFI option was said to be £1.2m cheaper at £173.1m as Table 1 shows.

Table 1: Comparison of cash and NPV costs of PFI and PSC in the Carlisle PFI Hospital Scheme

	PFI option	PSC
Cash	£577.0m	£550.0m
Net present Value	£173.1m	£174.3m

◗ If, in cash terms the PFI option is £27 million more expensive how, following the VFM appraisal, does the PFI option work out to be £1.2m cheaper?

The answer to this lies in the use of discount rates and the different expenditure profiles of each scheme.

5.2 Discounting

◗ What are Net Present Values and how are they arrived at?

A net present value is the cost today of paying for something at some point in the future. It is arrived at by applying a discount rate to a payment which is made in the future. Thus making a payment of £100 in five years time is said to have a cost £70.50 today. In this example a 6 per cent discount rate is applied to the £100 payment.

◗ Why is a discount rate applied?

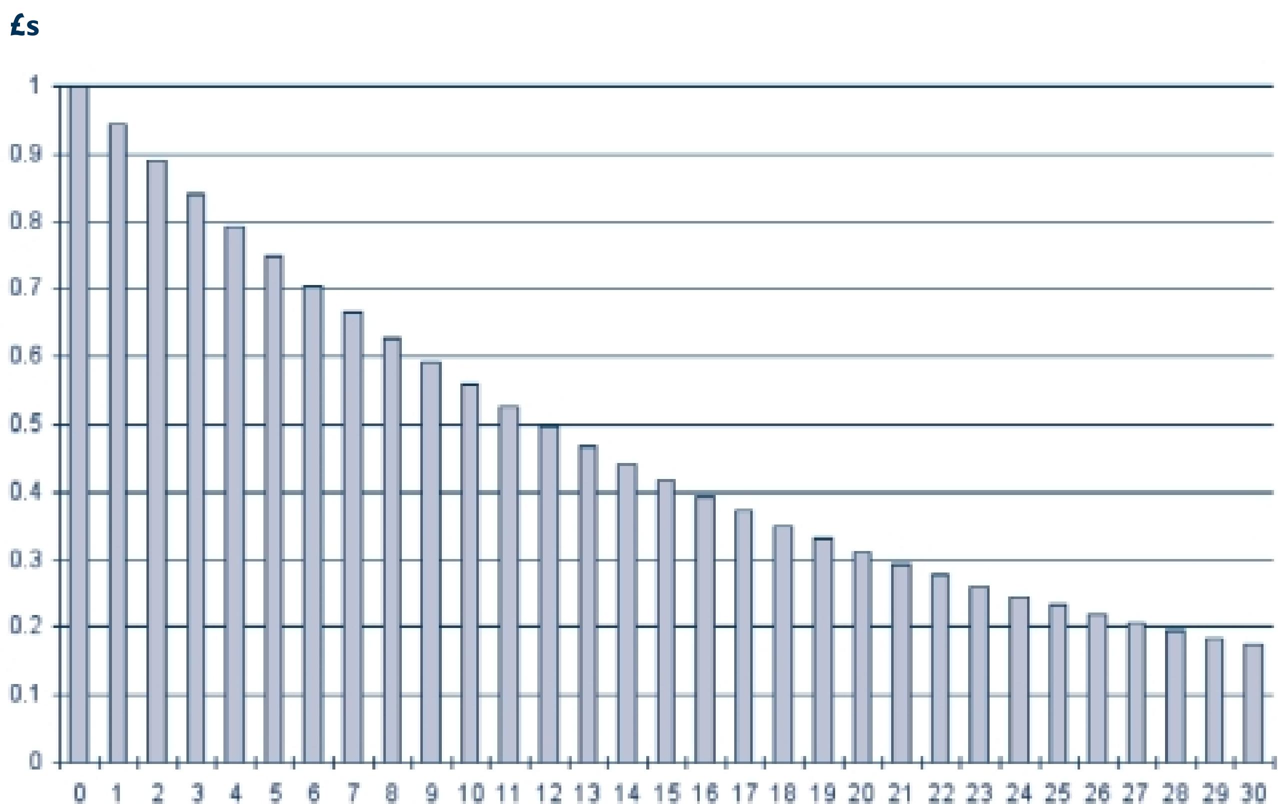
The idea behind using a discount rate is that it is said to be better to pay for something later rather than sooner. The Treasury argues that all things being equal the population would prefer to consume something now (ie have access to a school or a hospital) and pay for it later rather than to pay for it sooner. A discount rate is used to show how much better it is to pay for something in 30 years time than to pay for it now. It is said to reflect the fact that there are less costs to me now by paying for something in ten years time than in paying for the same thing in 5 years time.

Discounting thus places a lower value on expenditure occurring in later years as (*see Figure 2 below*).

The graph shows the Net Present Value in today's prices of delaying a million pounds of expenditure from year one to year 30 using a discount rate of 6 per cent per annum. Thus it can be seen that the effect of delaying one million pounds worth of expenditure to year 30 gives it a net present value of £174,000.

The important point for school governors to note is that under discounting the further into the future that one makes payments the lower the cost is said to be at today's value.

Figure 2: Present value of £1m discounted at 6% per annum over 30 years



Why should discounting make the PSC option appear more costly than the PFI option?

The answer to this lies in the different expenditure profiles for the two schemes (ie, when payments are made). Under PFI, payments to the SPV are spread over 30 years, however under the PSC option payments are made very early on in the project (they are 'front loaded') As shown above payments which are made later are said to cost less than payments which are made sooner.

Table 2 demonstrates the effect of discounting on the payments made each year under the PSC option and the PFI option.

Table 2: Effect of discounting on the expenditure profiles of PFI and PSC

	PSC		PFI	
Years	Annual expenditure (cash costs)	Payments discounted at 6%	Annual expenditure (cash costs)	Payments discounted at 6%
1	15	15.00	0	0.00
2	25	23.58	13	12.26
3	30	26.70	13	11.57
4	10	8.40	13	10.92
5	5	3.96	13	10.30
6	5	3.74	13	9.71
7	5	3.52	13	9.16
8	5	3.33	13	8.65
9	5	3.14	13	8.16
10	5	2.96	13	7.69
11	5	2.79	13	7.26
Total (£m)	115	97.12	130	95.68

There are two points to note from this table.

Firstly, the cash cost of the PSC is £15 million lower than the PFI option although the NPV is around £2m higher. Secondly, the time that a payment is made affects the value of the payment. As can be seen from the table, under the PSC most of the payments are made at the start of the project thus giving them a higher value. For PFI, payments are spread across the contract period thus giving them a lower value.

Thus under discounting the PFI option appears to have less cost than the PSC simply because of the fact that payments are spread over 30 years and take place further into the future. This is despite the fact that the actual cash cost of the scheme is higher. PFI appears value for money in this instance *only* because the expenditure profile is different from the PSC option.

The long repayment period under PFI is critical in demonstrating that PFI is value for money. It is interesting to note, however, that the public sector could also spread payments for the PSC scheme over a 30 year period thus removing the disadvantage given to the PSC.

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School governors should note that claims about value for money and PFI are based on an appraisal methodology which is widely acknowledged to be biased against the PSC. The claim that PFI is value for money in these circumstances should be treated with caution. This method of appraisal does not permit LEA officers to show that PFI is either cheaper or a better use of public funds than a project which is funded in the traditional way. School governors should also ask the LEA to provide the cash costs of the two projects to gain a full understanding of the real cost implications.

5.3 The choice of discount rate

The choice of discount rate can also determine whether or not a project appears to be value for money.

The discount rate for comparing the PFI with the PSC is set by central government at 6 per cent. Most economic commentators believe that this rate is too high and unfairly disadvantages the PSC.

An example here is useful. These figures were taken from a value for money appraisal for a PFI hospital scheme in Carlisle.

Table 3: Comparison of PFI and PSC Options in Net Present Values

Discount Rate %	PSC	PFI	Difference in favour of PFI
6	£174.3m	£173.1m	£1.2m
5.5	£185.8m	£186.7m	-£0.9m
5	£198.8m	£202.0m	-£3.2m
4.5	£213.9m	£219.5m	-£5.6m
4	£231.2m	£239.3m	-£8.1m
3	£275.0m	£288.6m	-£13.6m

The Hospital Trust in Carlisle had to decide whether the PFI scheme was 'value for money'. They compared the cost of the PFI scheme against the Public Sector Comparator. As recommended by the Treasury a 6 per cent discount rate was applied to the payment profiles for each option.

As can be seen from Table 1 when a 6 per cent discount rate is used the PFI scheme is said to have a value for money margin of £1.2m. However, when the discount rate is altered only very slightly to 5.5% the PSC appears to better value for money. Indeed the lower the discount rate the better value for money the non-PFI option appears.

In the end, the Hospital Trust chose to use the Private Finance Initiative even though it appeared to be only marginally better value for money than the PSC option. Moreover, the scheme would not have been considered value for money at all if the discount rate was lowered by only half of 1 per cent.

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School governors should note that the choice of discount rate can significantly affect whether a scheme appears to be value for money. School governors should thus treat with caution any figures which show a small of value for money margin. Lowering the discount rate can cause the alleged benefits to disappear.

Having examined the first part of the VFM analysis it is now necessary to turn to the second part; risk transfer.

5.4 Placing a value on the risks involved in the project

5.4.1 WHAT IS RISK TRANSFER?

When a LEA contracts for the building of a school there are certain risks and potential cost involved. These risks include such things as higher than expected construction costs, a delay in the completion of the building and any unforeseen costs involved in maintaining the buildings.

In a normal non-PFI scheme the LEA will have to meet the additional costs involved if these problems arise. As they are responsible for operating the building they take on the financial risk of something going wrong.

Under PFI the idea is that the private contractor will take on the risks usually involved in building and operating a school. They will take on the financial risk of the project being late (they will not be paid until the building is completed) and they will take on the risk of any unforeseen costs involved in maintaining the building and operating the services (the payment to the SPV is fixed throughout the course of the contract – any unforeseen costs which arise will be met from its own resources).

The SPV will factor the cost of some of these risks into the charge that it makes to the LEA. One of the reasons why shareholders are said to be entitled to significant profits from PFI schemes is that they put their investments at risk. If the project is not completed on time and the company does not receive full payment from the LEA then shareholders do not receive a dividend. However, if the additional costs of something going wrong are already included in the charge to the LEA it is hard to see how shareholder investments are substantially at risk. In this sense most PFI schemes are very good investments for shareholders seeking a profit.

5.4.2 RISK ADJUSTING THE PSC.

In the final business case for the schools PFI scheme in Haringey the Net Present Value of the two schemes were as follows:

PFI option (NPV)	PSC option
£97.5 million	(NPV) £83 million

The Haringey PFI scheme for the refurbishment of

nine secondary schools was given approval by central government. Why was the PFI scheme approved if the PSC option was better value for money?

The public sector comparator at this stage has not been adjusted to take account of the risks associated with the project. The cost of the PSC thus needs to be 'risk adjusted' that is, the potential cost of something going wrong with the project needs to be added to the PSC. The PFI option is already risk adjusted because the charge made by the private company to the LEA includes the potential cost of something going wrong.

In Haringey the total potential cost of things going wrong over the course of the 25 year long project (such things as construction cost overruns, design faults, problems with the operation and maintenance of the buildings) was valued at £16 million. The value of the risks transferred are thus said to be £16 million.

The value of this risk is thus added to the total cost of the PSC. When the PSC is adjusted according to risk the total cost of refurbishing the schools using the traditional non-PFI method comes out at £99 million, i.e. £83m+£16m

This is compared to the PFI option of £97.5 million. The PFI option thus proves value for money by a margin of £1.5 million.

Again it is important to remember that PFI is presented by the LEA and the government as the only source of funding for rebuilding schools. If the PFI scheme is not found to be better value for money then the LEA is led to believe that it will not receive any other funding to upgrade its schools. In these circumstances those constructing business cases for PFI projects are under pressure to come up with the 'right' answers. Identifying and placing a value on which risks exist over the course of a 25-35 year contract often relies on subjective judgement. At the point when the contract is drawn up risk valuation is theoretical and not real.

As a result risk adjustment becomes prone to manipulation. Several examples have been documented of risks being attributed to PFI consortia that they have not in fact taken on under the contract. There have also been instances of exaggeration of the value of risk transfer.* Both types of error make the public sector comparator appear relatively costly when compared with the PFI option and have been important factors in 'proving' the value for money of PFI schemes.

For a more in depth examination of how the PSC can be adjusted in order to demonstrate that the PFI option is better value for money (see Appendix B).

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Risk transfer is a crucial component of PFI schemes and is the main justification for the additional cost of private sector borrowing. School governors should thus seek to ensure that real risks are actually transferred to the SPV. They should ask project managers to identify the risks which have been transferred and the values which are placed on them. School governors should also note that where the 'value for money' margin between the two schemes is small following risk adjustment of the PSC school governors and councillors should not automatically conclude that the PFI option represents the best use of public funds.

**Examples of the manipulation of risk transfer come mainly from PFI schemes in the NHS. In these schemes risks transferred from the NHS to the private sector have been exaggerated in order to illegitimately demonstrate that the PFI option is better value for money. The main item of risk transfer relates to construction cost overruns. The capital cost overruns on conventionally financed NHS construction projects averaged 7 per cent of the total cost of the scheme in the late 1990s. However the evaluation of NHS PFI options in most cases assumed that public sector projects overrun by 12.5 per cent or more. This added additional costs to the PSC which had the effect of making the non-PFI option appear more expensive in comparison. It has also been shown that the cost of the public sector comparator in the hospital scheme in Carlisle was inflated by £7.2 million to allow for risk of clinical costs saving targets being missed and for risks of costs arising from medical litigation. Under the contract neither of these risks is being taken on by the PFI consortium. (see Gaffney et al 1999, BMJ, 'PFI in the NHS – is there an economic case?' Also Price et al – 'A report on the Cumberland Infirmary Carlisle', PFI UNISON 1999.)*

6. *Risks retained*

6.1 General risks retained

Risk is transferred through the PFI contract and by no other means. If the SPV has not taken on a liability through the contract, it remains with the LEA and the school governors.

Furthermore, the transfer of risk only has meaning if the SPV faces financial loss if something goes wrong. It is not enough for the LEA to assert that risk has been transferred. It has to show that legally enforceable financial sanctions of sufficient seriousness to 'incentivise' the SPV are available.

Risk transfer is also only meaningful to the extent that if something goes wrong with the project then the party which has responsibility for that problem should pick up the pieces. However this is not always the case. Particularly in contracts for the delivery of public services it is often the public, and not the SPV, which pays additional costs and suffers inconvenience if projects go wrong. Under any PFI scheme involving risk transfer the public will always retain certain risks. An example of this was the recent problems with the Passport Agency PFI contract.

Passport Agency: PFI Project

The SPV (Siemens) which had been contracted to develop a new IT system for processing passport applications was, under the contract, supposed to take on the risk of late delivery or system failure. In the event when the IT system encountered difficulties the processing of passports was disrupted, long queues developed outside Passport Offices around the country and the additional cost of rectifying the problem was passed on to the public in the form of higher charges. The overall cost to the public sector of service failure was £12.6m, which was in part recouped by an increase in the fee for a standard ten year passport from £21 to £28. Whilst Siemens made a compensation payment of £2.45m it was clear that the risk of something going wrong was still borne and paid for by the public.

Source: J Shaoul 'Passport to Paralysis' Public Finance July 21-27 2000

The same very much applies to schools. If a classroom is out of action the SPV will not receive full payment under the contract. However, this will cause disruption to pupils and staff and will impede curriculum delivery. Alternative arrangements would have to be made and additional cost may well be incurred by the school. Whilst in theory the SPV takes on the risk of a room not being available in practice the pupils and staff will still suffer adverse consequences. School governors and the LEA should be aware of any risks they retain in practice as a result of the SPV taking operational responsibility for school premises.

6.2 The risk of the school no longer being needed

There are certain risks which the LEA will retain under the PFI contract which are not transferred to the SPV. The most important of these is that of predicting the number of pupils who will attend the schools in 25-35 years time. This is a significant risk for the LEA. Because the LEA is contractually obliged to make payments to the contractor irrespective of whether they actually need a fully operational school the LEA is relying heavily on its ability to accurately predict future demand over a 25-35 year period.

If people move out of an area because of employment reasons, or high house prices, or one area becomes more fashionable to live in than another the need for a school may no longer exist or may diminish. It is perhaps pertinent to think of school closures, mergers and new builds which have occurred over the past 25-35 years. This may highlight the possible disadvantages of being committed to paying for schools irrespective of changing need.

This type of risk comes with the length of contract which is peculiar to PFI.

Action for school governors 18

Whilst central government may focus on the innovation, new investment and value for money which is said to go with PFI school governors should pay attention to the restrictions which are placed on local authorities when it comes to making services responsive to changing community needs. Any contract of 25-35 years inevitably restricts the flexibility of service providers.

7. Workforce issues

7.1 Do facilities management services have to be included in a PFI deal?

In most PFI schemes local authority staff are transferred to the private consortium. One of the justifications given for staff transfer is that in order to provide maximum value for money under a PFI scheme services such as catering cleaning and caretaking must be included in the contract arrangement.

The private sector argue that by having direct operational control of staff they are able to run these services more cheaply and this will lower the overall cost of operating the school for the LEA.

However, it is important to ask where these operational savings are to come from. Efficiency savings and productivity gains are difficult to achieve in labour intensive occupations such as cleaning and caretaking. As a result savings often come at the expense of the staff's terms and conditions or at the expense of quality. Efficiency savings in catering services may also result from worse employment conditions and lower quality food.

School governors and the LEA should not automatically accept that PFI involves the private consortium operating all services within the schools. Central Government guidance clearly states that LEAs have other options when it comes to staff transfer. They can:

- exclude certain services from the PFI contract
- or involve their direct service organisations or direct labour organisations as a subcontractor to the PFI consortium.

The guidance states: 'Some authorities and/or their private sector partners may see benefits in involving the authority's direct service organisation (DSO) or direct labour organisations (DOL) in PFI projects. There could be a value for money case for doing this when a particular service can be delivered more efficiently in house by the DSO/DLO. At an early stage a decision should be made on whether particular services should be excluded from the scope of the PFI contract and undertaken by the DSO/DLO, or whether a particular service within the scope of the planned PFI contract might be undertaken 'in house' (Local Government and the Private Finance Initiative DETR HMSO 1998 Paragraph 5.20)

Thus transfer of staff to the private consortium would have to show value for money in its own right through a separate economic appraisal of the services component of each PFI scheme.

Action point for school governors 19

In order for school governors and the LEA to assess whether PFI schemes should include facilities management services they must be able to compare the cost and quality of services offered by the private sector with those already provided by the LEA or by the schools themselves.

7.2 Staff transfer, TUPE and the two tier workforce

Many local authorities maintain that any staff who are transferred to the private consortium under a PFI deal will have their terms and conditions protected. The Transfer of Undertakings (Protection of Employment) Regulations 1981 (TUPE) governs staff transfer to the private sector. The purpose of the regulations is to ensure that staff terms and conditions are protected from any transfer.

However, despite government's commitment to protect the terms and conditions of staff transferring to the private sector, new staff will have no such protection. This will lead to a two-tier workforce in which there is a difference between the rates of pay of those transferred to the SPV and those taken on directly by the SPV. The different rates of pay are unlikely to reflect different staff functions. Not only does this mean that some workers who would

otherwise have been employed on public sector rates will be paid less, it also undermines the collective bargaining process by, for example, giving contractors the incentive to allocate overtime to lower paid staff.

Thus it is not the case that either staff transferred under TUPE or those taken on directly by the SPV have the same level of protection as if they remained in the public sector.

Action point for school governors 20

School governors should be aware that the TUPE regulations are not sufficient protection against the SPV reducing staff terms and conditions. Poorer terms and conditions for staff will also mean lower service quality.

Glossary of terms

Affordability Gap – The difference between the payments made to the SPV and the income that the local authority receives from central government and from schools delegated budgets.

Availability Fee – The fee paid to the SPV to cover the cost of capital investment. This forms one part of the unitary charge.

Capital Expenditure – Government spending on public infrastructure such as schools, hospitals and expensive equipment.

Cash Cost – The actual payments made each year under the PFI option and the PSC which are aggregated.

Debt: equity ratio – Refers to how the SPV raises the money for the project. The ratio between the amount raised through debt (borrowing) and the amount raised through equity (shareholders)

Discount Rate – The percentage by which costs are adjusted to today's value.

Facilities Management Services – Services provided within schools such as routine maintenance and repairs, caretaking, cleaning and catering.

Fee for Services – The fee paid to the SPV to cover the cost of operating services within schools. School services are funded out of the school's delegated budget.

Governors Agreement – The agreement signed between the school governing bodies and the LEA as part of a PFI scheme. Under this agreement the school governing body agrees to hand back to the LEA that part of its delegated budget which relates to services within schools.

Net Present Value – the sum of cash flows over time, discounted to the present value.

Outline business case – The document agreed by the LEA and Local Council setting out the case for PFI. The OBC should demonstrate that the PFI scheme is both value for money and affordable.

PFI Credits – Revenue support from central government to help local authorities meet the cost of the unitary charge. PFI credits go towards the cost of any construction work involved in building or refurbishing schools.

Public Sector Comparator – An estimation of what it would cost the local authority to borrow money to build and operate schools. This is measured against the cost of using PFI in order to demonstrate value for money.

Risk Transfer – Central government's main justification for using private finance to build schools and hospitals. The additional costs of PFI (including higher borrowing rates and shareholder profits) are said to be worth paying because the SPV takes on the risk of something going wrong with the school or the hospital over the lifetime of the contract.

Special Purpose Vehicle – An independent legal entity set up especially to design, build and operate a school or a hospital under a PFI contract. The company established by a consortium of bankers, construction companies and service providers has limited liabilities. If the project fails there is no recourse to the SPV's parent companies.

Transfer of Undertakings (Protection of Employment) Regulations 1981 (TUPE) – The legislation designed to protect the terms and conditions of those staff transferred to the private sector.

Two Tier Workforce – The difference between the staff terms and conditions of those transferred to the SPV under TUPE and those taken on directly by the SPV.

Unitary Charge – The yearly or bi-annual payment made to the SPV. This payment includes the availability fee which covers the cost of capital investment, loan repayments and shareholder profits and the fee for services which covers the cost of operating the services within the schools.

Appendix A. *The stages of PFI*

A. The outline business case

The OBC:

- Identifies the need for capital investment
- Demonstrates the case for PFI
- Shows that PFI is affordable and value for money
- Includes an estimate of how much a traditionally funded scheme will cost known as the public sector comparator or PSC.

On the basis of the OBC local authorities seek central government approval and make an application for project funding.

B. Selecting the SPV

1. Place notice of the scheme in the Official Journal of the European Union (OJEC) and invite companies to express an interest.

2. Shortlist bidders.

3. Refine the appraisal:

- Further development of the OBC and the PSC in the light of bids received
- Re-affirmation of affordability and funding commitment

4. Invitation to negotiate – detailed prospectus for shortlist that includes:

- Services required in output terms
- Proposed contract terms
- Timetable for procurement
- Criteria for evaluating bids
- Extent to which variations in bids will be accepted.

5. Receipt and evaluation of bids:

- Establish that bids meet value for money and affordability
- Ask bidder for a 'best and final offer'.

6. Selection of preferred bidder and the final evaluation:

- Revisit the key issues of affordability and value for money
- Compare the preferred bid to the public sector comparator.

C. Contract negotiation

1. Contract award and financial close

- Negotiate final details
- Sign contract.

2. Contract management:

- New process that follows the procurement phase.

Appendix B. Refining the comparator

(Taken from Public Services Private Finance – *Affordability Accountability and the Two Tier Workforce UNISON 2001*).

Despite the advantage to PFI options created by the use of a high discount rate and the assumption that public bodies cannot spread their costs through borrowing, the history of PFI procurement shows a marked tendency for public sector comparison (PSC) costs to be revised upwards in the light of bids from the private sector.

Earlier work on NHS PFI schemes suggests that many of these adjustments are illegitimate, carried out with the clear intention of receiving approval for PFI schemes rather than an objective measurement of relative costs. Revisions to the PSC for the Haringey schools scheme suggest that the same is happening in the local government sector.

Table A: Haringey outline business case: PSC and PFI options

	PSC (1998) NPC (£m)	*PFI (1998) NPC (£m)*
Base Cost	*69.8*	*82.7*
Risk Adjustment	*12.2*	
Private sector efficiencies		*-2.8*
Lower educational achievement	*4.8*	*N/A*
Total	*86.8*	*79.9*

In the original OBC, Haringey estimated the future PFI charge at £82,668,000 net present value. This estimate was then reduced by £2,787,000 to take account of assumed efficiencies on the part of the PFI consortium and assumed extra income from commercial use of premises outside school hours. This brought the projected net present cost of the PFI option down to £79,881,000.

The PSC was initially costed at £69,760,000 (NPC). This value was then adjusted upwards to reflect the value of risk transfer (£12,218,000) and the value of improved educational attainment as a result of PFI (£4,828,000). This brought the value of the PSC up to £86,806,000 (*see Table A*)

The assumption that PFI would give greater educational benefit than a public sector option is surprising. In the OBC the council lists a number of factors which are held to contribute to this objective including better regulation of temperature in classrooms, 'improvements to the visual and operational aspects of the buildings' and health and safety improvements such as reducing the potential for injury from substandard buildings and building services' (Haringey OBC, p.24)

In order to translate these claimed advantages into financial values the council assumed that one per cent more school leavers would get a job as a result of the PFI scheme yielding a net benefit to the Exchequer of £4.8 million.

We are unable to accept the reasons the council gives for its assumption that the PFI scheme would yield greater educational attainment than a public sector option which was intended to deliver exactly the same outputs. As these would also be features of a publicly funded scheme, the additional advantage claimed for the PFI scheme seems inexplicable.

Table B: Haringey – revision of PSC and PFI cost estimates

	PSC NPC (£m) (ITN)	*PFI NPC (£m) (ITN)*	*PSC NPC (£m) (2000)*	*PFI NPC (£m) (2000)*
Base Cost	*79.6*	*N/A*	*87.9*	*102.7*
Risk Adjustment	*14.4*	*N/A*	*16.6*	*N/A*
Total	*94.0*	*N/A*	*104.4*	*102.7*

Source: Invitation to Negotiate (December 1998) Annex 5, p7; Report to governing bodies 3 July 2000

The council has continued to develop the PSC since the OBC stage (Table C). Costs are not directly comparable between the OBC and the current position due to the adoption of different discount rates by the council. Most of the changes introduced have had the effect of increasing the cost of the public sector option. These revisions to the PSC deserve closer examination, as they took place after bids had been received which were clearly in excess of the original PSC. The effect of the changes was to increase the PSC to the point where the PFI schemes showed better value.

The reasons given by the council for the increase in PSC costings between 1998 and 1999 are outlined in Table C.

Table C: Haringey – reasons given for the increase in PSC costings between 1998 and 1999

Upward revision of services costs	*+7.4*
Construction delay	*+3.0*
Risk	*+2.1*
City Learning Centre Costs	*+1.5*
Design development	*+1.4*
Removal of St Thomas More School	*-5.0*
Total	*10.4*

Source: Report to governing bodies 3 July 2000

Several of these factors deserve critical attention:

◗ Upward revision of services costs

The cost of services was the main contributor. In the original PSC, private sector efficiencies were expected to reduce the cost of the PFI charge by nearly £2m. According to the council in revising the PSC, services were re-costed at prevailing market prices increasing the PSC by £7.4m. Why the council should do this, rather than make use of the current cost of services is not explained. Clearly if services were costed in the PSC at their current price, the PFI scheme would not show better value.

◗ Establishing the market price

What is particularly surprising is the council's approach to establishing the market price.

The council states:

'For each line in the services section of the PSC the benchmark price has been taken as the lowest quote from the three bidders in response to the council's ITN.'

In other words having established that the cost of services was higher under all the PFI bids than under the public sector comparator, with the result that the deal did not represent value for money according to Treasury criteria, the council appears to have substituted the higher PFI costs for the lower public sector costs in the comparator.

◗ Risk adjustment

The council added on to the cost of the PSC costs associated with building inflation, apparently on the assumption that the availability of PFI capital would lead to an earlier start on the project. This would seem to conflict with government policy statements to the effect that PFI should be used only because it represents better value, not because it makes funding more easily available.

We do not accept that these extra costs – a total of £12.5m genuinely reflect advantages associated with the PFI deal. It is particularly surprising that the council should have increased the cost of services in the PSC in the light of PFI bids. If the PFI bids were higher than the current cost of providing services the council should have excluded the services from the contract, as transferring staff to a PFI contractor clearly does not represent value for money in its own right.

Appendix C. *Summary of action points for school governors*

Action for school governors 1

School governors should question whether contracting with one provider for 25-35 years is the most effective and flexible arrangement for the delivery of services within schools. They should explore with the LEA the possibility of excluding Facilities management services from the overall PFI contract. (*see section 7 on workforce issues*)

Action for school governors 2

School governors must be aware that they and the LEA will always retain certain risks under any contracting arrangement. If things go wrong with the operation of the school they will still be ultimately responsible for ensuring that there are adequate facilities for curriculum delivery. Before entering into a PFI contract they should be certain that financial penalties are sufficient to 'incentivise' the provider to meet performance standards. The level of fines which are imposed on the SPV should be transparent and the school's should share in the receipt of any compensation payments made by the SPV. *(see also section 3.11)*

Action for school governors 3

school governors should consider whether contracting for school services in this way is the most appropriate way of procuring and maintaining adequate control over the services that they have statutory responsibility for.

Action for school governors 4

School governors should ask whether the contracting arrangements with the LEA via the 'governors agreement' is an effective way of ensuring that the SPV will comply with health and safety legislation. School governors should also seek legal advice on the extent to which they remain liable for any breach of health and safety legislation which is committed by the SPV.

Action for school governors 5

Adjusting the contract will be a cumbersome and costly process. School governors may wish to consider whether this impacts upon their ability to fully control the services which are delivered within the schools and also whether any loss of flexibility can be justified.

Action for school governors 6

School governors and local authority councillors should be aware that contract termination for poor performance does not end the LEA's obligations to pay for schools built under PFI. They should also note that the payments made to the SPV are only dependent on performance to a very limited extent.

Action for school governors 7

School governors should be aware that PFI requires school governors to look at their school buildings in a new light. In particular it involves a loss of direct control over when and to what purpose school buildings are used. School governors should ensure that the 'availability' of school premises under PFI allows the full range of extra curricular activities to take place. School governors should be certain that the overall quality of life at the school is not diminished as a result of PFI.

Action for school governors 8

Conventional budget setting tends to put staffing and curriculum delivery as the first priorities. Under a PFI contract the payment to the SPV will be a first charge on the school's budget. School governors should consider whether prioritising funds in this way is in the best interest of pupils and teachers.

Action for school governors 9

Governing bodies need to be sure that they will be able to deliver the curriculum with the funds which are available after the PFI payment has been deducted. They should also seek a commitment from LEAs that a limit will be placed on their contribution throughout the 25 year contract.

Action for school governors 10

Any assessment of affordability should be measured against the money and the resources that the LEA has coming in. Affordability should not be presented by the LEA in net present values but should be set out in cash costs. A profile of income and expenditure should be made available in the outline business case. School governors should be wary of attempts by the LEA to match the affordability analysis according to the bids submitted by SPVs. They should seek a clear statement from LEAs about when a scheme becomes unaffordable.

Action for school governors 11

School governors should be wary of claims made by the LEA that central government funding will be sufficient to make PFI projects affordable. There is often a mismatch over the course of the contract between when payments to the SPV are made and when income from central government is received. School governors should examine claims of 'revenue neutrality' carefully.

Action for school governors 12

Schools should seek assurances early on during negotiations with the LEA about which groups are allowed to use school facilities and for what purposes.

Action for school governors 13

School governors should seek to understand the purpose to which the land will be put after it is sold and whether any development of the land will affect the school's environment.

Action for school governors 14

School governors should ensure that they and school staff have a significant input into the design of new school buildings. After all, those who work in and govern the school know the school's requirements best. They should think through how any design changes will impact on the day to day operation of the school and should ensure they are adequately consulted by the LEA.

Action for school governors 15

School governors should note that claims about value for money and PFI are based on an appraisal methodology which is widely acknowledged to be biased against the PSC. The claim that PFI is value for money in these circumstances should be treated with caution. This method of appraisal does not permit Local authority officers to show that PFI is either cheaper or a better use of public funds than a project which is funded in the traditional way. School governors should also ask the LEA to provide the cash costs of the two projects to gain a full understanding of the real cost implications.

Action for school governors 16

School governors should note that the choice of discount rate can significantly affect whether a scheme appears to be value for money. School governors should thus treat with caution any figures which show a small of value for money margin. Lowering the discount rate can cause the alleged benefits to disappear.

Action for school governors 17

Risk transfer is a crucial component of PFI schemes and is the main justification for the additional cost of private sector borrowing. School governors should thus seek to ensure that real risks are actually transferred to the SPV. They should ask project managers to identify the risks which have been transferred and the values which are placed on them. School governors should also note that where the 'value for money' margin between the two schemes is small following risk adjustment of the PSC school governors and councillors should not automatically conclude that the PFI option represents the best use of public funds.

Action for school governors 18

Whilst central government may focus on the innovation, new investment and value for money which is said to go with PFI school governors should pay attention to the restrictions which are placed on local authorities when it comes to making services responsive to changing community needs. Any contract of 25-35 years inevitably restricts the flexibility of service providers.

Action point for school governors 19

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4. Value for Money Unit DfES
Website: http://www.dfes.gov.uk/vfm/contracts.shtml

5. See Noel Thompson 'Investing in schools: the experience of the PFI in Brent' –in Rachel Lissauer and Peter Robinson (eds) *A Learning process – Public Private Partnerships in Education*: IPPR London: 2000.

6. See: 4Ps *Calculating the PFI Credit and Revenue Support for Local Authority PFI Schemes* http://www.4ps.co.uk/the4ps/guidance012.htm

7. DFEE Bulletin 82 Area Guidelines for Schools also DFEE The Protection of School Playing Fields: Circular No:3/99

8. For a more in depth examination of how land sales are used to fund PFI deals see www.unison.org.uk/

Resources

AVAILABLE FROM UNISON COMMUNICATIONS:
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Stock No.	Title
1763	Challenging the Private Finance Initiative: Guidelines for UNISON branches and stewards (May 2000)

Written by the School of Public Policy:

1858	Public Services, Private Finance: Accountability, affordability and the two tier workforce (March 2001)
1704	The Only Game in Town? A Report by UNISON Northern Region on the Cumberland Infirmary Carlisle Scheme (November 1999)
1604	Downsizing for the 21st Century (2nd Edition) An analysis of the failings of PFI in the North Durham, Acute Hospital PFI Scheme

Useful reading

Investing in schools: the experience of the PFI in Brent – Noel Thompson in *A Learning process – Public Private Partnerships in Education* eds. Rachel Lissauer and Peter Robinson: Institute for Public Policy Research :2000.

Passport to Paralysis, J Shaoul, *Public Finance*, July 21-27, 2000 (available from the UNISON website)

Lessons of Pimlico, J Shaoul and Pam Edwards, *Public Finance*, October 29-November 4, 1999.

Useful websites

There is a special PFI page on the UNISON web site:
www.unison.org.uk/

School of Public Policy
www.ucl.ac.uk/spp/about/health.htm

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