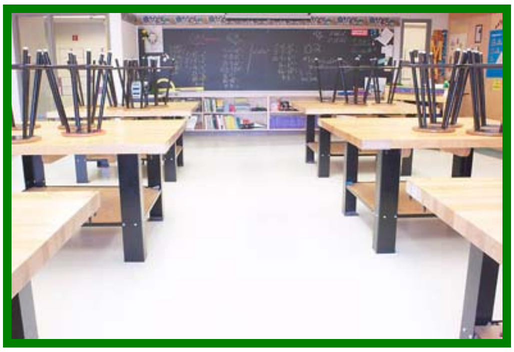
Kirklees MC Overview and Scrutiny Management Committee

Ad Hoc Scrutiny Review into the Financial Monitoring Issues Arising from the First Grouped Schools PFI Contract Part One



Date: 18th January 2006

1. Introduction

1.1 Panel Membership

The review is being carried out by members of the Overview and Scrutiny Management Committee

- Cllr Andrew Palfreeman (Chair)
- Cllr Jean Calvert
- Cllr Robert Iredale
- Cllr Julie Stewart Turner

1.2 Background to the Review

The request for an ad hoc scrutiny review into the financial monitoring arrangements arising from the first grouped schools PFI project was made by Council in January 2005. The request was made in response to the termination of the construction contract previously signed with Jarvis Projects in 2001.

Due to resource constraints within the Overview and Scrutiny Team, the first meeting of the panel was scheduled for June 2005.

1.3 Approach to the Review

Prior to the first meeting, the Chair of Overview and Scrutiny, Cllr Andrew Palfreeman, worked with the Chief Executive to develop an initial terms of reference for the review. It was also agreed at this stage that the review would be carried out by the then Overview and Scrutiny Management Group, now the Overview and Scrutiny Management Committee.

In June 2005 the Overview and Scrutiny Management Committee met to finalise the terms of reference, scope and plan the review.

The terms of reference were refined into three key areas for investigation:-

1. Could the Council have anticipated the financial instability of the Contractor and potential contract overspends at the outset, before the contract was entered into?
2. Could the Council have anticipated and identified the financial instability of the Contractor and contract overspends once the contract was in place (after financial close)?
3. Were the Council's contract management arrangements sufficient to identify and prevent contract overspend?

Because of the complexity of the review the panel agreed to work systematically through each of the areas of investigation. Each area has been planned as a separate project but will be approached in a similar way. The panel will then produce a report at the end of its investigations into each area. This report sets out the panel's findings and conclusions from its investigations into the first key area.

The panel would like to take this opportunity to state that this piece of work is an investigation into past events. Its conclusions have been developed with the benefit of hindsight. They are intended to help the Council reflect and learn lessons from the first grouped schools PFI project for the benefit of future PFI projects.

The panel also wish to emphasise the considerable benefits to schools achieved as a result of the project, which enabled access to over £60m additional government funding.

2. Could the Council have anticipated the financial instability of the Contractor and potential contract overspends at the outset, before the contract was entered into?

2. 1 Lines of Enquiry

In order to address the first key area for investigation the panel identified three main lines of enquiry:-

- What did the Council do to test the financial viability of the **project** and the proposed contract?
- Did any systematic risk analysis and assessment take place during the development of the project and contract and how was this done?
- What mechanisms were put in place to monitor and manage any risks that were identified?

2.2 Methodology

The panel carried out a series of meetings between August and October 2005 in order to address this key area of investigation and the associated lines of enquiry.

The panel held four information gathering meetings with relevant Officers and three 'review' meetings to reflect on the information gathered and identify areas for further investigation. One of these 'review' meetings was attended by the panel's independent expert advisor from the Audit Commission, Mike Allen.

In addition to this, the panel also submitted written questions to relevant Officers.

2.3 Information and Evidence

The panel used a number of key documents as the basis for its work on this key area of investigation:-

- The outline and interim business case for the project.
- The market brief and pre-qualification questionnaire
- The Invitation to Negotiate (ITN) documentation.

The panel also considered reports that were submitted to Policy and Education Committee between November 1998 and July 2001.

2.4 Key Findings

2.4.1 Establishment of the Project

Research has shown that a number of factors influenced the Council's decision to pursue the opportunity to become a pilot authority for the first grouped schools PFI. Details of these factors are set out below.

2.4.1a Investment

There had been a lack of investment in schools in the recent past, both nationally and locally. This lack of investment meant that schools were concentrating their budget on maintaining staffing levels. In addition, the Local Education Authority had a tight capital budget and was unable to help schools as much as it would have liked. As a result, the fabric of school buildings had deteriorated.

The first grouped schools PFI project provided an opportunity for the Council to access much needed capital to improve local schools and provide for a modern curriculum.

2.4.1b Central Government Support

Those local authorities who successfully obtained pilot status would receive support from Central Government to develop their PFI scheme. This support had two elements:-

- Technical and financial advice from the then Department for Education (DfEE) and The Treasury.
- Financial support in the form of a £200,000 grant, to pay for external consultancy.

2.4.1c Preferred Option for Central Government

At the time the Central Government was actively encouraging local authorities to go down the PFI route for major capital projects. It offered a way of ensuring capital investment that would not impact on public sector borrowing and spending.

2.4.1d Benefits of PFI

There were a number of perceived benefits to PFI in general. For example, it offered the opportunity to:-

- Share or transfer risks associated with capital projects to a private sector partner.
- Share any windfall profits made by the private sector partner as result of the project (this was dependent on the approach taken to the scheme).

Conclusion

- **Based on its research and the information set out above, the panel feels that the decision to pursue the opportunity of becoming a pilot authority for the first grouped schools PFI was a reasonable one.**

2.4.2 The Council's Approach to the Project

Details of the Councils proposals for the project were set out in the outline business case. Research of the business case suggests that there were a number of unique elements to it. Details of these 'unique elements' are set out below

2.4.2a Number of Schools Involved

In the first outline business case, submitted in September 1998, the project included seventeen schools. At that time financial analysis indicated that these seventeen schools had a PFI credit need of £47million.

Following the submission of the first outline business case, the Council, its consultants and the schools undertook work to develop the proposals further. As a result of this work the number of schools included in the project was increased from seventeen to twenty.

The final business case was submitted in February 1999. It included a project based on twenty schools and attracted £48.2milion of PFI credits from Central Government. This would clear 30% of the backlog of capital works within the existing school stock.

In order for the panel to appreciate the scale of the project it explored the size of the other four pilot projects. This revealed that the number of schools included in the Kirklees first school project was unique. However, it was not the largest project (see table 1.0).

The panel sought independent advice on the scale of the pilot projects to try and assess whether this could have had any impact on future affordability. The advice it received was that at the time of the pilot projects, PFI was a relatively new initiative for local authorities. In addition, the grouped schools and remodel/refurbishment approaches were completely new. Given this lack of experience and with the benefit on hindsight, a more modest project may have been more advisable and might have minimised the potential for future affordability problems.

Table 1.0

Pilot Authority	Project
Kirklees Metropolitan Council	▪ Rebuild, remodel and refurbishment of twenty primary and secondary schools. ▪ Facilities management for all twenty schools.
Birmingham City Council	▪ Rebuilding and remodelling of ten primary and secondary schools. ▪ Facilities management for all ten schools.
Cornwall County Council	▪ Consolidation of four split site secondary schools and the rebuild or refurbishment of twenty six primary and infant schools which fed the secondary schools. ▪ Facilities management for all thirty schools
London Borough of Tower Hamlets	▪ Twenty seven schools (reducing to twenty five due to the amalgamation of three establishments during the project). ▪ Facilities management for all 25 schools.
Stoke-on-Trent	▪ Remodel and refurbishment of all one hundred+ maintained schools. ▪ Facilities management for all one hundred+ schools.

2.4.2b Delivery Mechanism

In the business case the Council proposed to include a specially created Joint Venture Company (JVC) into the standard PFI methodology. The purpose of the JVC would be to co-ordinate and manage the delivery of the project.

At the time, the Council had already successfully operated in many 'joint ventures' and had a proven track record. Based on its positive experience, the JVC approach was favoured. Some of the benefits cited are set out below.

- It would allow for the maximum transfer of risk but enable the Council to have continued input into the project in a more effective way than a straightforward contract agreement. This input would be secured via:-
- The Council holding equity shares in the JVC, which could be secured at no direct cost to the Council.
- A local authority member sitting alongside the private sector directors who would participate in overseeing the contract was being managed in a way that meets both needs of the contractor, the Council and the schools. The Council would have 'a voice at the boardroom table' and access to information.

- It would facilitate better communication between the Council and the contractor better than a simple contract agreement.

- As a member of a JVC the Council would be entitled to a share of any 'windfall' profits gained by the contractor during the lifecycle of the project. In addition, should the project experience financial difficulties the Council would not be liable. If the project or any of the companies involved in the JVC collapsed, the Council would only lose its initial investment. In the case of this project, that investment was £200,000 that the Council received from a Government grant.

Despite the potential benefits, research revealed that the Treasury Task Force had some reservations about the Council's preferred use of a JVC in a public private partnership. However, these were overcome through negotiations and the business case was approved with the JVC as the preferred option.

Given the initial reservations of the Treasury Task Force, the panel sought independent advice on the use a JVC to deliver a PFI project. It was advised that at the time it was a 'unique and innovative' approach that was not widely used in public private partnerships. This prompted the panel and its independent advisor to carry out an assessment on which companies submitted initial bids for the project. Based on the assessment, the panel was advised that the Council's preference to deliver the project via a JVC may have deterred some of the more experienced companies from submitting a bid. This view was not supported by Officers who maintained that the Council had a good choice from a strong field, which included a number of 'big hitters' and the market leaders.

Conclusions

- **Based on its research, the panel recognises that the business case had to include unique and innovative elements in order to attract the interest of the DfEE and Treasury and to be successful. Therefore the number and diversity of schools involved and the proposal to deliver the project via a JVC approach were reasonable at that time.**

- **Based on the panel's research into the scale of all 5 pilot projects and the independent advice it received, it could be concluded that on reflection a smaller scale project would have been more advisable and may have reduced the risk of future affordability problems. However, the panel does not feel that there is sufficient evidence to enable it to reach a firm conclusion on this.**

- **There are differing views on whether the Council's preference for delivering the project via a JVC had a detrimental impact on the number and quality of initial bids that were submitted. Given this and the fact that this work is retrospective, the panel does not feel that it is able to make a judgement on this issue.**

2.4.3 Pre-Qualification Stage: Financial Assessment of the Initial Expressions of Interest

In February 1999 Kirklees received formal notification that its final business case had been approved and that it had been allocated £48.2million of PFI credits. It was at this point that the procurement process began.

The panel was informed that the procurement process undertaken for this project was in line with the European standard at that time. In February 1999 an advertisement was placed in the Official Journal of the European Community (OJEC) requesting companies to submit expressions of interest in the project.

The OJEC advert generated fifty expressions of interest. Each of the fifty companies received a detailed market brief and a pre-qualification questionnaire for completion.

From those fifty expressions of interest, eleven companies/consortia completed the pre-qualification questionnaire and formally submitted it to the Council for consideration. Details of the eleven companies/consortia are set out below.

- **Focus** – Focus were a consortium led by Bovis Ltd. They were made up of Bovis construction Ltd, Bovis Facilities Management and RCO Support Services Ltd.
- **New Schools –** New Schools were a consortium led by WS Atkins PLC and included Innisfree Ltd together with WS Atkins Consultants Ltd, WS Atkins Facilities Management and WS Atkins Architects Ltd.
- **Jarvis Projects –** Jarvis Projects were a single bidder. They were part of Jarvis PLC which also included Jarvis Construction and Jarvis Facilities Management.
- **Amey/Halifax/Miller –** Amey/Halifax/Miller were a consortium made up of Amey Ventures (facilities management), Miller Group Ltd (design and build) and Halifax plc (investment).
- **John Mowlem &Co –** John Mowlem & Co were a consortium made up of John Mowlem and Co (construction and design), Acqumen Services Ltd (facilities management) and Barclays Capital (financial advisors).
- **Balfour Beatty Capital Project Ltd –** Balfour Beatty Capital Project Ltd was a single bidder and part of the Balfour Beatty Group. For this bid they were joined by Balfour Beatty Construction Ltd and Haden Building Management Ltd.
- **Alfred McAlpine Construction Ltd –** Alfred McAlpine Construction Ltd was a consortium made up of Alfred McAlpine Special Projects Ltd (design and construction), Gardner Merchant Services Ltd (Facilities Management) and Charterhouse Equity Investment Ltd.
- **New Education Services –** New Education Services was a consortium made up of Group 4 Management Services (facilities management), Kleinwart Benson (investment and equity partner) and supported by Scott Wilson Kirkpatrick (design).
- **Canmore Partnership Ltd -** Canmore Partnership Ltd was a consortium made up of Canmore Partnership Ltd, Galliford Northern (design and build contractor), Abbey Hanson Rowe (design) and supported by Noble and Co (financial advisors) and MPM Adams Ltd (project management).

- **The Capita Group and Kajima Corporation -** Capita Group and Kajima Corporation was a consortium made up of Capital Group Plc (facilities management and Kajima Corporation (construction).
- **Pell Frischman Consultant Ltd -** Pell Frischman Consultant Ltd were a consortium made up of Pell Frischman Consultant (facilities management), IAF Group (financial advisors and equity partner) and supported by Rance Booth and Smith (design and energy management).

The panel looked in detail at all aspects of the market brief and pre-qualification questionnaire. However, for the purposes of this review it focussed on:-

- The structure and processes for evaluating the initial submissions.
- The financial evaluation that was undertaken on each on the submissions.

2.4.3a Evaluation Process and Structure

Evaluation Team

The evaluation of the eleven submissions was carried out by a multi-disciplinary Evaluation Team:-

- J Muscroft - Legal Services
- P Kemp/Martin Dearnley - Strategic Finance
- M Ruane - Estate and Property Services
- Ken Gillespie or delegate - Public and Private Partnership Service
- M Parker/D Martin - Education
- S Wood - Corporate Standards
- S Bradbury - Education Schools

The Council's financial consultant, MacQuaries Bank, was also involved in evaluating the financial standing of the applicants and their ability to raise finance along side strategic finance.

Overall Evaluation Process

An initial desk top evaluation was carried out by the Evaluation Team. Following this exercise four companies were eliminated (New Education Services Ltd; Canmore Partnership Ltd; The Capita Group and Kajima Construction and Pell Frischman Consultant Ltd). They were eliminated either because of concerns that they did not have the financial standing to execute the project or deliver the construction.

Seven companies were short listed and invited to discuss their submissions with the Evaluation Team in more detail. This more detailed evaluation was broken down into seven different elements, each with a different weighting and carried out by the relevant Service(s) Officers and external consultants (see table 1.1).

Table 1.1

Issue for Evaluation	Weighting	Lead Service/Consultees
▪ Ability to raise finance. ▪ Financial and economic standing.	25%	▪ Strategic Finance ▪ MacQuaries Bank
▪ Ability to procure and manage the project successfully. ▪ Experience of working in a joint venture with a local authority, public sector or education organisation.	15%	▪ Public Private Partnership ▪ Education ▪ Legal Services ▪ MacQuaries Bank
▪ Experience in design, construction and project management.	20%	▪ Estates and Property Services ▪ Education
▪ Experience in facilities management, estates and property management.	25%	▪ Corporate Standards ▪ Education ▪ Estates and Property Services ▪ Strategic Finance
▪ Equal opportunities.	5%	▪ HRSU
▪ Quality Assurance	5%	▪ Estates and Property Services
▪ Health and Safety	5%	▪ Estates and Property Services ▪ Education

As the table above shows, one of the most critical elements of the evaluation centred on whether companies could demonstrate that they had the funds to support and deliver a project of the size and nature of the first schools PFI.

Although the panel recognises the importance of the other elements in the evaluation and the development of the project, for the purposes of this review it focussed largely on the financial aspects.

2.4.3b Financial Evaluation

The financial questions or requirements set out in the pre-qualification questionnaire included standard questions that the Council would ask any company who wished to tender for a contract or get on the list of Council's preferred contractors.

At least 95% were the same as those asked for any procurement project. Broadly, companies were asked to provide:-

- A letter from their bank certifying that the contractor was financially capable of carrying out such a project.
- Details of their accounts. The panel was informed that questions asked about accounts were more detailed than those asked during regular procurement exercises. For example, if the applicant company was a subsidiary of a PLC, the company was required provide their accounts (if possible) and/or those of PLC. If the application was from a consortium, the accounts of all the companies involved had to be provided.
- Details of any likely sources of debt and equity funds that would be used.
- Details of whether any contract, if awarded, would be supported by any indemnity/guarantee, from another party such as a parent company.

In order to assess the robustness of the financial evaluation, the panel compared the financial questions and requests for financial information set out in the pre-qualification questionnaire to those set out in the recent Housing PFI pre-qualification questionnaire.

Generally the questions and requests for information were the same. However, the questionnaire for the Housing PFI did include additional requests that were not within the schools questionnaire. For example, 'please provide details of any announcements in the past 12 months or any anticipated forthcoming announcements for the Applicant Company and each member of the Applicant Group where these would provide further context to the companies' financial situations'.

Following completion of the detailed evaluation at this stage of the project, four companies were notified that the Council would not be pursuing their submissions any further. The reasons for this were either concerns about finances or ability to deliver.

Three companies were short listed to move onto the next stage and submit detailed bids, Jarvis Projects, Focus Education Consortium and New Schools Consortium. The panel was assured that at this stage of the procurement process, all three companies, including Jarvis Projects, provided the financial information that was requested and required. The Evaluation Team and MacQuaries Bank received details of Jarvis accounts for the previous five years, including details of turnover, gross profit and shareholder profit. Based on this information, the Evaluation Team and MacQuaries Bank were satisfied that Jarvis Projects was able to raise the finance for this project and that they were of sound economic and financial standing.

The panel did request to see the information provided by Jarvis Projects during this stage of the procurement process. However, it was informed that this would not be possible as the information has now been disposed of.

Conclusions

- **Based on its research the panel is satisfied that the financial evaluation undertaken on the eleven original submissions was robust, thorough and consistently applied.**

- **Having compared the pre-qualification questionnaire to that of the new housing PFI , the panel is satisfied that it was in line with standard pre-qualification questionnaires used at the time. The panel is of the view that the differences that exist between the two are due to the fact that the procurement process has developed greatly over the past seven years and lessons have been learnt from previous experiences.**

- **The panel is concerned that certain financial information relating to the initial submission from Jarvis Projects has been disposed of. The panel accepts that some financial information could easily be retrieved from other sources. It also accepts that it is Council Policy to only save information for 12 months after contract award. However, the panel feels that given that the duration of this contract is 30 years, it would have been prudent to retain any information relating to contract for lifecycle of the project and recommends that the council review this policy.**

2.4.4 Invitation to Negotiate (ITN): Financial Assessment of the Three Detailed Bids

The ITN was issued to the three short listed companies on the 4th June 1999. The deadline for completion and submission of the detailed bids was the 24th September 1999.

The ITN was split into three parts:-

- Part A contained the instruction to bidders
- Part B contained the output specification.
- Part contained the project agreement.

For the purpose of this review the panel concentrated its investigations on Part A, Instruction to Bidders. Part A, contained information on:-

- How the ITN stage would be carried out and how the detail of the project and the contract would be developed.
- What bidders should include in their submissions.
- Key information that would assist the development of the bids e.g. details of the Public Sector Comparator; the Council's asbestos policy; the Councils preferred approach for delivering the project (JVC); the preferred payment and performance mechanism and staff and TUPE issues.
- What the bids would be assessed against and the how the evaluation would be undertaken.

Following its initial consideration of the document, the panel focussed on two key elements:-

- The overall evaluation process and structure,
- The financial evaluation and associated issues.

2.4.4a Evaluation Process and Structure

Evaluation Criteria

The ITN listed a number of criteria that would form the basis of the evaluation of the bids:-

- Overall understanding of the requirement and quality, coverage and depth of submissions.
- Deliverability of the solutions.
- Quality of the service solutions.
- Consistency of service proposals with the output specification.
- The structure and resourcing of the organisation proposed to fulfil the providers obligations under the project agreement.
- Financial viability, including commitment and understanding of both sponsors and funders.
- Acceptance of the terms and conditions offered in the draft project agreement or the proposal of clearly articulated suitable alternative provisions that do not compromise the balance of risk transfer.
- The bidders understanding of the overall objectives of the Council and the 'business fit' between the bidder and the Council.
- Health and safety applicable to the delivery of the service.
- Credibility of the project pan for progression to financial close.
- The implications of the bidder's risk sharing proposals for achieving an accounting treatment consistent with 'off balance sheet' treatment for the public sector under FRS5.

Evaluation Team

The evaluation was undertaken by a multi-disciplinary Evaluation Team. The team was made up of an 'Evaluation Core Group' which included all those on the pre-qualification Evaluation Team, plus representatives from McQuaries Bank and the Council's legal advisors, Irwin Mitchell. Under the core group sat a number of sub groups, which were broadly based around the evaluation criteria:-

- Accommodation Services
- Estate Services
- Support Services
- Finance
- Partnership and Legal.

Finally beneath the sub groups were a number of feeder groups, set up to examine specialist areas, or issues which covered all aspects of the project (e.g. health and safety, staffing). Both the sub groups and feeder groups had the opportunity to bring in additional specialist advice and support if it was required.

In addition to this, the project schools were involved via a Grouped Schools Feeder Group. This was made up of representatives from across the project schools and examined specific aspects of each bid.

A detailed evaluation document was developed for each of the five sub groups. However, although the panel considered each of evaluation documents and recognises the importance of other factors in the evaluation process, for the purpose of this review it focussed its attention on the financial evaluation (see below).

Overall Evaluation Process

The evaluation itself involved each sub group considering the relevant areas of the detailed bids, often requesting further information and clarification of particular areas. Evaluation interviews were also held with the bidders to discuss their submissions and relevant issues in more detail.

After an initial round of detailed evaluation known as 'stage one', a decision was made not to pursue further negotiations with New Schools Consortium. This decision was made on the basis that the bid was least competitive in terms of affordability to the Council and could not be justified using the required value for money analysis.

Further evaluation and negotiation took place with the remaining two bidders, Jarvis Projects and Focus Education Consortium. 'Stage two', as it is referred to, was carried out within the existing evaluation framework but concentrated heavily on financial aspects, particularly affordability and value for money to the Council.

Conclusion

- **Based on its research the panel is satisfied that the evaluation process undertaken at ITN stage was robust, thorough and applied consistently.**

2.4.4b Financial Evaluation

The financial evaluation that took place on each of the detailed bids did not concentrate on whether the companies involved were financially stable. It was the view of Officers that this has been assessed thoroughly at pre-qualification stage.

The financial evaluation at ITN stage focussed on:-

- The proposed structure and re-sourcing of the JVC and the project.
  - Robustness of the proposed funding structure
  - Rationale for the funding structure.
  - Indication of appropriate due diligence testing.
- The financial viability of the project.
  - Overall affordability to the Council. How did the bid price compare to the shadow bid?
  - Overall value for money when compared to the public sector comparator.
  - Robustness of cost assumptions.
  - Indexation proposals. What level of indexation were the bids asking for? Was it RPI plus 2.5% or just RPI?
  - Cost sensitivities e.g. if the facilities management costs increased could bidders and the Council meet the costs?
- The bidders proposals for risk transfer/payment and performance mechanism
  - Were the proposals compatible with FRS5 test i.e. was there sufficient transfer of risk to ensure that the project was 'off balance sheet'?

- Was the payment and performance mechanism compatible with the output specification?
- Were risks placed with the party best place to manage them?

As mentioned above, this level of financial evaluation was carried out on all three detailed bids. However, further financial evaluation (based around this framework) was carried out on the remaining two bidders.

2.4.4c Key Issues Associated with the Financial Analysis

The panel's investigations into the ITN process and the financial evaluation of the detailed bids prompted it to explore a number of issues in more detail:-

- The development and accuracy of the Public Sector Comparator (PSC).
- The development and accuracy of the Shadow Bid.

Public Sector Comparator (PSC)

The process set up by Central Government for the approval of PFI schemes requires proposed projects to be justified on value for money grounds by comparison with a risk-adjusted Public Sector Comparator (PSC).

The PSC represents the cost of a project similar to the specification of the proposed PFI project, but procured by traditional public sector methods. Any proposed PFI project must demonstrate a lower Net Present Value (NPV) than the PSC.

Kirklees PSC estimated an NPV of £92.793million. It was developed during the early stages of the first schools PFI project and was key to securing the approval of the business case. It was developed by the Council's independent financial consultants, McQuaries Bank with support from the Treasury Task Force. Now Partnerships UK.

The PSC was based on projected construction costs and lifecycle costs (planned and reactive maintenance to school buildings and capital equipment over the life of the project) for the project. These projected costs were developed using surveys undertaken by Tozer Capita in support of Kirklees Estates and Property Services

As part of the financial evaluation at ITN stage, the NVP of each detailed bid price was compared to Kirklees PSC to assess its value for money. This occurred at both stage one and stage two of the financial evaluation.

Given the apparent importance of the PSC in evaluating the bids, the panel looked in detail at the information, which underpinned its development. Its investigations highlighted a number of issues which the panel feels may have had an impact on the accuracy of the PSC. They are as follows:-

✶ Surveys

The surveys, which determined the capital costs and lifecycle costs used in the PSC, were neither intensive nor intrusive. When the panel explored the reasons for this it was revealed that due to the fact that much of the work related to this project was refurbishment or remodelling, it was difficult to carry out detailed intrusive surveys on school buildings.

In addition to this, the panel was informed that Estates and Property Services (EPS) were not engaged fully in the development of the project. Due to Union opposition of PFI initiatives, Union members within EPS did not participate in the survey work. This amounted to 90% of the staff. Given this, a pragmatic decision was taken by EPS at the time to only utilise their principal surveyor on the project.

The panel tried to explore further whether the lack of involvement from EPS staff could have had an impact on the quality of the surveys i.e. did it hinder the provision of existing information to Tozer Capita. However, they did not receive information that would enable them to make a firm judgement on this.

Both these findings prompted concerns about the quality of the surveys and the impact this may have had on the accuracy of the projected capital costs and subsequently the accuracy of the PSC. The findings also prompted concerns that the involvement of EPS could have ensured that the surveys and subsequent capital costs were accurate.

Also, from the documentation provided it does not appear to have been made clear to the bidders that the surveys were neither intensive nor intrusive. In fact assurances were given in the ITN that the surveys were complete and accurate. There is also a warranty in the ITN in support of this. Bidders did not carry out any further detailed surveys themselves and based their bids on the surveys provided. Officers recognised that this was an issue, although they had expected the bidders to recognise the fact that further survey work was advisable. However, they informed the panel that in hindsight they would have insisted on further detailed surveys and this has been specified in the special schools PFI contract.

✶ **Projected Costs for Facilities Management (FM)**

The projected FM costs that were used in the development of the PSC were based on what the Council currently had to spend on FM plus 2.5% annual inflation. They were not based on what it might cost to maintain the schools at their completed standard.

Officers have accepted that this was not an accurate projection and was a contributing factor to future affordability issues (see section 2.3.5 below). However, it was stated that this was the only approach that could be taken due to a lack of available data to enable them to benchmark future costs.

The panel looked further at whether it would be possible to develop a more accurate projection for future FM costs. An analysis of those companies/consortia who submitted initial bids revealed that there was already a well developed FM Market at the time this project was being developed. Therefore, it may have been possible to access benchmarking data or additional advice and support. In addition, to this the panel's independent advisor also stated that the FM market was sufficiently developed at the time of the project to allow for some benchmarking to take place.

These findings prompted concerns that the projected FM costs were inaccurate and in turn this too could have affected the accuracy of the PSC. They also prompted concerns that more could have been done to project accurate FM costs.

Shadow Bid

The shadow bid was developed to enable the Council to assess the affordability of the proposed project and the detailed bids. Unlike the PSC, it was not a comparison of NPV, it was a comparison of the total bid price.

As with the PSC, the shadow bid was developed by the Councils independent financial consultants, McQuaries Bank with support and guidance from the Treasury Task Force. It was also developed using the same figures that were used to develop PSC.

Given that the PSC and the shadow bid were developed using the same figures, the panel has concerns about the accuracy of the shadow bid that was used to demonstrate the affordability of the project in the business case and to assess the affordability of the detailed bids. These concerns have been generated for the same reasons as those set out above (see section on PSC).

During its research the panel was informed by both Officers and its independent advisor that lessons have been learnt from these early projects and the methodology and guidance for developing the shadow bids has progressed.

Conclusions
Based on its research:-

- **The panel is satisfied that the process for financially evaluating the detailed bids (at both stage one and stage two during the ITN) was robust, thorough and applied consistently.**
- **The panel is concerned about the accuracy of the PSC. In line with this, it also questions whether the 'value for money' assessments that were carried out during the development of the Councils business case and on the detailed bids were accurate.**
- **The panel is concerned about the accuracy of the shadow bid. In line with this, it also questions whether the project itself was affordable from the outset and whether the 'affordability' assessments carried out on the detailed bids were accurate. In particular, the panel believes there were sufficient examples of FM contracts from which more accurate benchmarking could have been obtained.**
- **However, the panel appreciates that at the time projects of this kind were new to the public sector. It is satisfied that in recent years the methodology for developing the PSC and the shadow bids has progressed as PFI has matured and that lessons have been learnt both nationally and locally.**

- **The panel accepts that the nature of this PFI project (refurbishment and remodel) meant that it was difficult for extensive and intrusive surveys to be carried out on the schools involved. However, it is concerned that during the development of this project 90% of staff from EPS were disengaged from the PFI process.**

- **The panel is concerned that during this project the three companies involved at ITN stage, used the survey information to inform the development of their bids. The panel feels that the lack of depth and questionable quality of the surveys could have affected the accuracy of these bids and the bid prices. However, it is pleased to note that lessons have been learnt from this project and bidders are now asked to carry out more detailed survey work to inform the development of their own bids.**

- **The panel is concerned about the methodology that was used to project future FM costs and feels that more could have been done by the Council and its consultants to develop a more accurate projection. However, again it is satisfied that lessons have been learnt from this project and the methodology has developed.**

- **Finally, the panel was concerned to find out that the documentation relating to the detailed bids submitted by Jarvis Projects has been disposed of. The panel accepts that it is Council Policy to only save information for 12 months after contract award. However, the panel feels that given that the duration of this contract is 30 years, it would have been prudent to retain any information relating to the contract for lifecycle of the project.**

At the end of the ITN process, Jarvis Projects were recommended and subsequently appointed as the preferred bidder for the first grouped schools PFI project. The panel was informed by Officers that the bid submitted by Jarvis Projects was the **most** affordable and the only one that represented value for money in the PSC test.

Jarvis Projects bid was £96.2million as compared to the two other bids of £115 and £119 million. The bid price passed the PSC test and was closest to the shadow bid.

During these discussions the panel explored whether Jarvis Projects would have taken this project as a 'loss leader' to break into the PFI market. This was considered to be unlikely. However, the view of the panel's independent advisor was that this was not unlikely, particularly given the significant difference in overall bid price between Jarvis Projects and the other two bidders. The view was that a difference of 20% should have 'rung alarm bells'.

Conclusions

- **The panel was informed that the evaluation of the three detailed bids demonstrated that the bid from Jarvis Projects was the only project that represented value for money in the PSC test and was the most affordable. However, given the questions and concerns it has raised about the accuracy of the PSC and the shadow bid, the panel questions whether this was the case.**

- **Based on its research the panel is concerned that Jarvis Projects may have taken this project as a 'loss leader'. The panel recognises that the Council based its judgement on a PSC and shadow bid, which they believed to be accurate at the time. The panel also recognises the point raised by Officers that it was unlikely that banks would put money at risk for a 'loss leader'. However, it still feels that given the 20% difference in bid prices, more should have been done to assess why this was the case.**

2.4.5 Affordability Checks and Affordability Gaps

2.4.5a Affordability Checks

There was a period of eighteen months (September 1998 – March 2000) between the submission of the outline business case and the appointment of Jarvis Projects as the preferred bidder. Following that there was a further twelve months until financial close.

Due to length of time involved in developing and closing on this project, the panel was interested in whether an affordability model had been developed and whether regular affordability checks had been carried out on the project.

The evidence showed that an affordability model was developed by the Councils Strategic Finance Team. It was developed for the outline business case in order to test the affordability of the project to the Council and was maintained throughout the development of the project, up until contract signature.

The model was initially based on the shadow bid plus the projected income from PFI credits, schools contribution from devolved capital and the Council's contribution. However, as the project progressed and the detailed bids were developed, it was updated to include the figures from all three bids and finally the preferred bidder costs.

The model was updated whenever there was a significant change in key inputs e.g. bid prices, interest rates, income etc. During the most intensive stages of the project (in the run up to the appointment of preferred bidder and contract signature) the model was run on a weekly basis.

Regular reports on the status of the affordability were made to the Joint Policy Committee and Education Management Board during the development of the project. All these reports stated that the project was affordable up until the time during the ITN stage when the first affordability gap arose.

Conclusions

- **Based on its research the panel is satisfied that an appropriate affordability model was developed and that regular affordability checks were carried out on the project from the development of the outline business case until contract signature.**

- **Based on its concerns about the accuracy of the shadow bid, the panel is concerned that the data for the affordability model may itself have been flawed in some way. However, the panel recognises that now the methodology for developing the shadow bid has progressed, this could help to mitigate any future problems with the affordability model.**

2.4.5b Affordability Gaps

Two affordability gaps arose during the development of this project. The first arose during the ITN stage, the second following the appointment of Jarvis Projects as the preferred bidder.

✶ Affordability Gap One

The first affordability gap arose for the following reasons:-

- The bid prices submitted at ITN stage were higher than estimated. The bidders took a more cautious approach to risks and project development costs and included higher FM costs.
- There was reduced income from PFI credits due to a change in notional interest rates.
- The inclusion, by the Council, of £50k per annum for contract management costs.

The gap was addressed in the following way:-

- The Council secured an increase in PFI credits from £48.2million to £59.2million.
- **All** bidders involved at this stage reduced their bid price. Jarvis Projects reduced their bid by approximately £1million.
- Schools devolved capital for three years was signed over to the project.
- Kirklees increased the annuity payment, estimated in the shadow bid, from £266k to £300k.

Fundamentally, the affordability gap arose because the bid prices were higher than the PSC and the shadow bid. However, the change in notional interest rates compounded the problem. The change in interest rates occurred because the Council missed the deadline which it set itself for the appointment of preferred bidder (31st March 2000). The deadline was missed because of changes in the project plan to allow more time for the preparation of detailed bids and thorough evaluation. However, the Council was not aware that missing the deadline would lead to a change in interest rates which would affect the value of the credits.

Officers informed the panel that at the time the Council did not know that the interest rates would change and the value of the credits would reduce once the deadline had passed. They stated that in hindsight the 31st March deadline

was ambitious and assured the panel that lessons had been learnt and such a deadline would not be imposed for future projects.
The panel also looked further at the inclusion of £50k per annum for contract management costs. Although not as critical in creating the affordability gap, it was a contributing factor. Over the life cycle of the project it will add another £1500000 onto the costs.

Up until this point no resources had been allocated for contract management. Again, Officers accepted that with hindsight this should have been included from the outset and assured the panel that lessons had been learnt from this experience.

With respect to the ways in which the gap was addressed, the panel was informed that the Council managed to close the gap without watering down the specification of the project. This prompted the panel to try and explore:-

- How and where Jarvis Projects made their savings in order to reduce the bid price by approximately £1million.
- Whether Officers were concerned that such a reduction would impact on the deliverability of the project.

Unfortunately the information on where and how the £1million reduction was made was unavailable. However, Officers did state that at the time, they were not concerned that it would have a detrimental impact on the deliverability of the project. When pressed further on whether, in hindsight, it may have had an impact Officers stated that it was possible. In the interests of getting the best deal for the Council, perhaps they had negotiated too hard to reduce the bid price during the ITN stage and had been 'too successful'.

Conclusions
Based on its research:-

- **The panel is satisfied that the Council addressed this affordability gap before moving to the appointment of Jarvis Projects as the preferred bidder.**

- **The panel is concerned that there was a lack of appreciation of the importance of the 31st March 2000 deadline and a lack of consideration of contract management needs during the development of this project. However, it is satisfied that the Council has learnt lessons from the development of this affordability gap, particularly around project planning and project management.**

- **The panel feels that the fact that the detailed bids were unaffordable in comparison to the shadow bid is further evidence that the shadow bid may have been inaccurate.**

- **The panel is concerned about the impact that the reduction in Jarvis Projects bid price had on the future affordability and deliverability of the project. It accepts that Officers negotiated hard in order to ensure the best deal for the Council and the affordability of the project. However, given existing concerns about the affordability of the original bid prices (highlighted earlier in this report), if feels that it may have compounded future affordability and deliverability problems.**

✶ Affordability Gap Two

The second affordability gap arose for the following reasons:-

- The European Investment Bank (EIB) stipulated severe borrowing conditions and stated that their funds would only be available two years after the construction work had been completed (subject to further performance tests).
- There were lengthier and more involved negotiations on outstanding commercial details, FM arrangements and schools designs.
- The time delays that arose due to the above, gave rise to inflation increases and extra development costs.
- The bid price was fixed for a period of 12months (as stipulated in the ITN). Negotiations exceeded 12months and costs increased.
- Time delays led to more staff hours and this also contributed to increased costs.

The gap was addressed in the following way:-

- Jarvis Projects introduced AXA Investments to the project. They matched the EIB's 'soft interest rates' without the severe borrowing conditions, which enabled the Council and Jarvis Projects to proceed to contract signature.
- Lengthy and involved negotiation took place between the Council, Jarvis, banks, The Treasury, the Department for Education and Skills (DfES) formally the DfEE, and schools over outstanding commercial arrangements and school designs.
- Interest rates improved and this enabled the Council to sign the contract with interest rates at 5.5% as apposed to 6.5% (originally included in the affordability model).

The key factor in the development of this affordability gap appears to be time delays. For the panel the most critical delay was caused by the protracted negotiations with the EIB. On investigation it appears that these occurred because there was a lack of knowledge about how the bank operated.

Early on in the development of the project, the Council was advised by the Treasury Task force that the EIB offered favourable borrowing conditions and was a good source of investment for potential bidders. Based on this advice, the Council, along with the other pilot authorities, recommended the EIB to bidders.

Given that the EIB was recommended by Treasury Task Force, the Council had no reason to suspect that it would operate in a different way to other investment banks. Officers stated that in hindsight further research could have been undertaken into how the bank operated, however, there was no reason to doubt the advice that they had been given.

Once the second affordability gap was resolved the contract was signed with Jarvis Project in March 2001. The view of Officers is that on paper the contract was value for money, it was affordable, it met the output specification and quality that the Council and schools wanted and a reputable company had been secured to deliver it.

Conclusions
Based on its research:-

- **The panel is satisfied that the Council addressed this affordability gap before moving on to contract signature.**

- **The panel feels that due to the fact that this was a pilot project and a new initiative for all those involved (particularly the Council and Schools) time delays resulting from lengthy negotiations on commercial issues, schools design and FM were understandable.**

- **The panel is concerned that there was a lack of understanding about the borrowing conditions set by the EIB until the latter stages of the project. However, it accepts that the Council was acting on the advice of the Treasury Task Force and that lessons have been learnt from the experience.**

2.5 Closing Summary

The key area of investigation for part one of this project was 'could the Council have anticipated the financial instability of the Contractor and potential contract overspends at the outset, before the contract was entered into?'

Following detailed analysis of the information and evidence that it has gathered, the panel has concluded that the Council could not have anticipated the financial instability of the Contractor or potential contract overspends at the outset, before the contract was entered in to.

The panel found that the financial evaluation carried out by the Council and its consultants at each stage of the procurement process was thorough, robust and applied consistently. It is satisfied that adequate affordability checks were carried out at throughout the procurement process and that the identified affordability gaps were dealt with appropriately.

However, the panel has raised serious concerns about the accuracy of the information used to test the value for money and affordability of the project and the detailed bid submissions throughout the procurement process. The accuracy of the PSC, the shadow bid and the affordability model have all been questioned in this report. It is accepted that these concerns have been raised with the benefit of hindsight. But had some of these issues been identified and addressed during the development of this project, the panel feels that some of the affordability issues and contract overspends may not have occurred.