GUIDANCE PAPER

ASCL Association of School and College Leaders

brownejacobson education advisors

Making your PFI contract work for you

Guidance at a glance

This guidance is relevant to senior leaders, trustees and governors of local authority maintained schools, single academy trusts (SATs) and multi-academy trusts (MATs), school business leaders and managers, chief finance officers, and chief operating officers.

Achieving value for money is notoriously difficult for schools as end-users, and this paper is therefore designed to help all types of school operating within a private finance initiative (PFI) contract understand the language of PFI, and make their contract work for the organisation.

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1 What is PFI?

Operating under the government's private finance initiative (PFI), the scheme's heyday was between 1999 until 2010, when public sector bodies used private finance, rather than public debt, to finance the construction of a wide range of infrastructure projects. As well as funding the construction/refurbishment work, a PFI contractor would also service and maintain the asset over a long period, typically 25 years. As a result, although new PFI schemes have been rare since 2010, there are many projects with ten years or more yet to run.

A new model, 'PF2', was introduced by the coalition government and included features intended to reduce the cost and increase the transparency associated with privately financed deals. There has yet to be a significant pipeline of projects procured under this model, although the relatively small number of the Priority School Building Project builds have been under PF2. PFI and PF2 share many features, and much of this guidance is equally applicable to PF2. From a school's perspective, the main differences are that PF2 transactions tend to exclude soft facilities management (soft FM), and also provide more flexibility in relation to lifecycle replacement. This means that:

- cleaning, grounds maintenance, and similar day-to-day activities would fall outside the scope of the project agreement (PA) and will instead be procured separately by the school or local authority
- the school is less likely to be locked in to 'gold-plated' lifecycle programmes that, under a conventional PFI deal, it could seek to change in order to deliver better value.

A common feature of a PFI scheme is a special purpose vehicle (SPV) set up by the private sector partner to enter into a contractual relationship with the local authority. The SPV is a newly-formed company set up specifically for the purposes of the PFI scheme (hence, special purpose), and its role is to manage the flow of funds, rights and obligations in relation to the PFI.

The ongoing maintenance of the school is commonly known as hard facilities management (hard FM), and includes maintaining the structure of the school. Soft FM includes the day-to-day services required to run the school, for example, catering and cleaning.

The SPV subcontracts both the services and the obligations to build or refurbish the school(s) at the outset of the PFI.

2 The structure of a PFI

PFI contracts are complex, however, there are three key schedules school and college leaders must understand in order to get the best out of their contract or project agreement:

1. The **output specification** details the services that will be provided.
2. The **payment mechanism** sets out how payments will be made, adjusted for inflation and other factors, and how deductions can be applied for poor performance or unavailability.
3. The **contract variation process or change protocol** sets out how changes or variations to the contract will be dealt with, and how costs are allocated.

What are the advantages?

- Site and buildings are maintained for the life of the contract.
- Incentivised performance by specifying service levels and applying penalties to contractors if the contractor fails to deliver.

- Greater risks are transferred to the private sector partner than under a traditional build, including those associated with the construction, maintenance and lifecycle costs of the project.
- The costs relating to capital, interest and ongoing services are smoothed into a single 'unitary charge' across the contract term.

What are the disadvantages?

- PFI contracts can be inflexible and complex. This means:
  - additional costs will be incurred for works, services and equipment which are not included in the initial contract
  - contract management costs can be higher
- PFI contracts entail significant budget commitments which will not necessarily reflect changes in school funding over the contract period

Gov.UK Code of conduct for operational PFI contracts

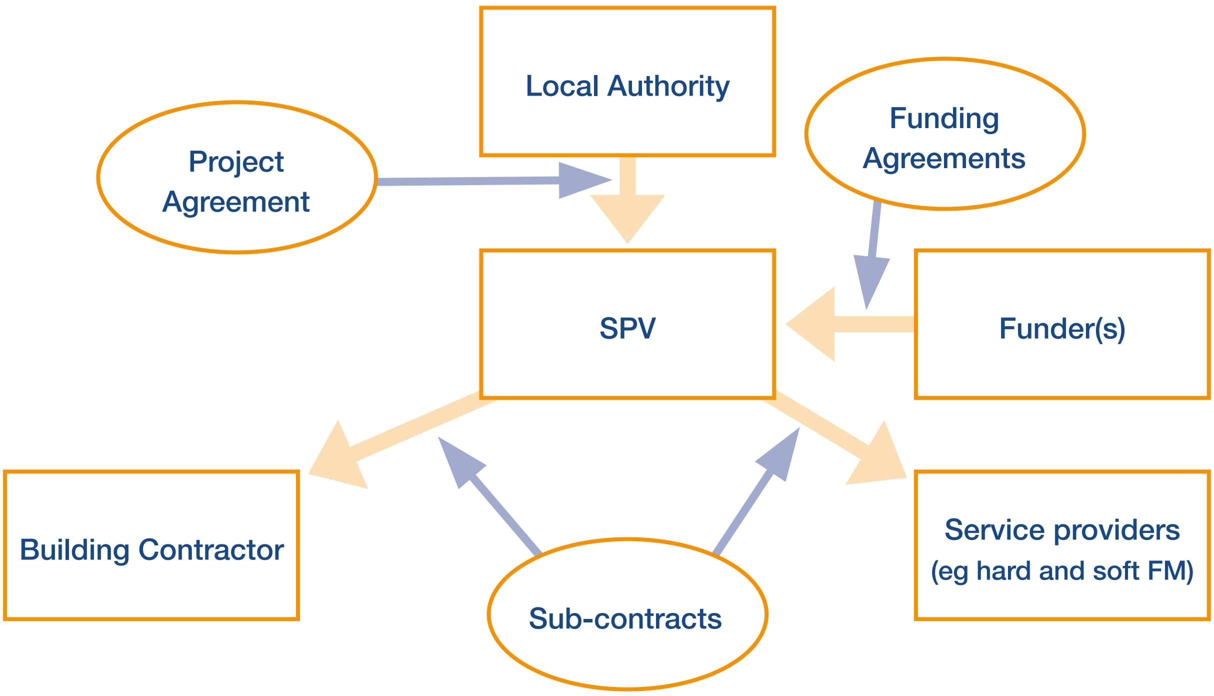
This **voluntary code of conduct** sets out the basis by which public and private sector partners agree to work together to make savings in operational PFI / PF2 contracts.

The code sets out commitments from both public and private sector parties on constructive engagement, flexibility and improving operational efficiency. The aim of the code is to secure overall improvement in contract management relationships and behaviours and the creation of a more effective working environment between customers and suppliers.

Although the code is not legally binding, it is worth considering whether your PFI contractor has signed up to the code.

Structure of a PFI

The diagram illustrates, in simplified terms, the structure of a typical PFI arrangement.



3 Documentation and agreements

Legal Documentation

Project agreement (PA)

The PA is a lengthy document between the local authority and the SPV. Its function is to describe the rights and responsibilities of the parties, with the most important of these obligations to deliver the buildings and services, and the local authority to pay the unitary charge (as payments in respect of initial capital outlay, interest charges, and services are rolled up into a single payment).

The project agreement also allocates risk between the SPV and local authority for issues such as damage, vandalism, increases in insurance premiums and utilities costs, poor performance of the services, or unavailability of the buildings. In the case of poor performance or unavailability, a detailed payment mechanism may result in deductions from the unitary charge.

At the end of the PFI, the facilities built or refurbished by the contractor are transferred back to the local authority, trustees or governing body, depending on the category of school.

Schools and academies do not have any direct rights under the PA as they are not parties to it, and must rely on the local authority to enforce obligations of the SPV through the school agreement or governing body agreement (see 'What will the school or academy have in place for their PFI scheme?'). Although, in legal terms, it is the local authority which has responsibility to manage the PA, the school or academy staff are on site on a day-to-day basis and likely to play an active role in reporting service deficiencies and, where appropriate, request that the local authority take appropriate action under the PA.

In the event a PFI school is converted to an academy, it is necessary to vary the PA to, for example, ensure that the academy is an insured party. This will be documented in a deed of variation to the PA, which must be agreed between the local authority and the SPV as part of the conversion process. The DfE standard for this document is straightforward, but lender requirements have tended to add several further conditions, making these variations more complex.

What will the school or academy have in place for their PFI scheme?

Governing body agreement/ school agreement

As noted above, the SPV has no direct contractual relationship with the schools. Instead, schools forming part of a PFI will have a governing body agreement (GBA) or similar document with the local authority. This flows down certain rights and responsibilities from the PA to the governing body. Most importantly, it allows the SPV (or its contractors) access to the school and sets out how the school must contribute to the unitary charge.

When a PFI school becomes an academy it must enter into a school agreement (in place of the GBA if the school converted into an academy). This agreement will contain many of the obligations previously set out under the GBA but, as the academy will no longer be maintained by the local authority, it contains a number of more detailed commitments.

In the same way as a maintained school, an academy will not have a direct contractual relationship with the SPV and must rely on the local authority (through the school agreement) to deal directly with the contractor (through the PA).

Another key feature of the school agreement is setting out the hours during which the academy can use the school buildings. This varies between PFI arrangements, but there are typically some core hours covering the school day, a number of additional periods for out of hours events, and third-party bookings made by the SPV.

Principal agreement

The principal agreement is between the local authority, the academy and DfE. Under the principal agreement, the DfE compensates the local authority for certain payments connected with the PFI arrangements if the academy fails to pay the local authority. In turn, the DfE will then reclaim such payments from the academy's funding.

The principal agreement also sets out the way in which the 'affordability gap' is dealt with. In broad terms, the affordability gap is the difference between the amount of income the local authority receives in relation to the PFI, and the unitary charge payments it must make. Depending on the funding arrangements of the academy, it might receive payments in respect of the affordability gap which must then be passed to the local authority.

4 Lifecycle and benchmarking

When the SPV's sponsor (the private sector company which owns shares in the SPV and who put the bid together) originally tendered for the PFI contract, it will have proposed a unitary charge based on a financial model. Financial models indicate the assumed costs of delivering the services, the income generated (mostly through receipt of the unitary charge) and, therefore, the profit to be made from the PFI. A large part of the costs of delivering a PFI arrangement result from the need to maintain or replace various items of equipment and elements of the building. For example, the model (and accompanying lifecycle schedule) may assume that a boiler must be replaced every ten years. There is no separate cost to the local authority for this – it is wrapped up within the unitary charge – but lifecycle costs can form a significant element of that charge.

The bidder, in seeking to put together the financial model, will have balanced lifecycle costs against ongoing maintenance, heating and other costs. For example, replacing a school boiler is an expensive task. It may be better value to delay this for five years, however, as a result of increasing inefficiencies of the old system, utilities bills may increase.

Recent government guidance indicates that changing generous lifecycle programmes, and delaying or reducing lifecycle spend, are a key way in which better value under existing PFI arrangements could be delivered. As noted above, in the small number of PF2 schemes, the lifecycle arrangements are likely to be more flexible and offer less opportunity to driving better value by removing any 'gold-plating'.

Benchmarking requirements are set out in many project agreements and aim to ensure that the SPV continues to provide the ongoing services at best value, by comparing the service costs included in the unitary charge with the market price of the relevant services. These provisions are important given the complexity and duration of a PFI scheme. As with all contractual issues between the SPV and local authority, this is for the local authority to manage. However, as academies may benefit from reductions to the unitary charge, they may wish to review the benchmarking provisions of their PFI and seek to confirm that they are being used to best effect. This benchmarking exercise is usually carried out every five to seven years, but the frequency of such reviews will vary between different project agreements.

5 Practical steps for optimum efficiency

Understand the contract framework and how the relationship works with regard to reporting mechanisms

It is worth remembering that private sector partners will be accountable to their shareholders and, in the case of their lenders, will be concerned to ensure that the SPV can repay the debt taken out in order to build the facilities. Sustainable efficiency savings can only be achieved by working together to understand each side's objectives, where there is common ground, and when it is necessary to accept that there are some insurmountable limitations.

In a challenging financial climate, it is essential the investment made in training school staff as contract managers reaps rewards. There are many practical steps that can be taken to make sure the contract is working at optimum efficiency levels for the school as the end user. Staff allocated the role of PFI contract monitoring and management should be following these good practice guidelines:

1 Monitor service levels against the agreed output specification

The contract includes an output specification that contains details of the service levels to be delivered and key performance indicators against which performance will be measured (KPIs). Review these aspects of the agreement and use them to monitor the contract against agreed deliver levels rather than a wish list.

2 Use the tools within the contract to drive financial and operational efficiency

The helpdesk function is perhaps the most important tool available for a school to use, but its full potential is often not fully exploited. A cultural change may be required to appreciate fully the potential benefits of a properly utilised helpdesk function. It provides information about workflow for both the sub-contractor (your facilities management provider) and the end user (the school), and is the audit trail that will drive deductions (financial penalties) to the unitary charge for unavailability and other performance failures. The helpdesk can only fulfil all these tasks if it is used to record all the transactions that occur between the school and the FM contractor. Some examples of these transactions might be:

- asking a caretaker to move parcels from reception area to the appropriate resources storage area
- reporting a leak in a classroom
- reporting the unavailability of an area of the outside sports facilities
- a request to set up exam desks in the hall

In almost every case, a verbal conversation will have preceded the activity being raised as an action on the helpdesk – but, without the latter, there is no evidence that a conversation took place and no way of measuring the success of the service requested or the response time taken to correct a failure.

3 Effective operations meetings

The member of school staff with responsibility for PFI should have regular operations meetings with a similarly ranked member of the FM company. This meeting is a good time to review helpdesk statistics.

4 In-house auditing of soft services

Invest time in the monitoring of services provided under the contract. Use regular site walks to review different elements of services provided on a rotational basis (cleaning or grounds maintenance, for example). Evidence of performance failure should be raised on the helpdesk immediately to instigate corrective action or induce a deduction penalty.

5 Use the lifecycle plan to support school planning and the school development plan

Work with the facilities management (FM) provider to understand the lifecycle plan for your school site. Use what you learn to support school planning. Contract limitations may restrict lifecycle purchases to ‘like for like’ but don’t miss the opportunity to negotiate. Basing your argument on curriculum impact can make it more persuasive. As noted above, the small number of deals procured under the newer PF2 model is likely to offer more flexibility in relation to lifecycle costs, without the need to renegotiate the PA.

6 Use the helpdesk to identify trends

Use helpdesk statistics to spot trends in damage. It will be evident quite quickly if the introduction of a new initiative has been successful in reducing the incidence of low-level damage. Also, if the same toilet block is being targeted at the same time each week, for example, this information could be useful to help pastoral staff address a behaviour issue that may not have yet come to light.

7 Works outside the scope of the contract

One of the frustrations of PFI is the sometimes unwieldy nature of the process to change things in school. Unfortunately, it is a harsh reality that trying to find a workaround is rarely successful and can be expensive. Rather, involve the FM provider as soon as you can and issue a clear set of instructions. It is worth bearing in mind you may be charged for any feasibility or design work that is undertaken, regardless of whether the project goes ahead so a little preparatory investigation is a good idea to determine what is achievable. Once you are ready to proceed, make sure that the initial instruction includes everything required under the school agreement/GBA and PA. You may also consider requesting a shopping list of potential changes so that you can compare the costs and benefits of the options available.

6 Frequently asked questions

1 Can we seek to vary the PA?

As a school or academy is not a party to the PA, it has no direct way of changing it. However, an academy’s school agreement will allow it to request a local authority to seek to make changes. The costs of doing so are likely to be passed, in whole or in part, by the local authority to the academy. A maintained school is unlikely to have any such formal right to request changes but should seek to liaise with its parent authority if changes to the PFI are being considered. Therefore, any variations it would like to implement must be actioned by the local authority.

It is worth noting that, due to the complexity of PFI arrangements, variations to the project agreement (and, in all likelihood, the sub-contracts the SPV has entered) can be costly and time consuming. Transaction costs alone (including legal and other professional fees of the SPV and its lenders who may wish to review in detail the legal, technical, and financial impact of all proposed changes) can be significant. This means that although the possibility of change is expressly contemplated by most project agreements through inclusion of a detailed change mechanism, there can be considerable financial and practical hurdles.

2 Who controls school premises and how is it used?

The PA sets out the rights the SPV, local authority, and school/academy have to use school premises, and how any income received through third party use is distributed. It will include details of any entitlements of additional use by the school outside of school hours, and community use. The arrangements will also be reflected in the school agreement.

3 Can the school use the building at all times?

No. The school will generally have use of the building for the hours specified in the PA, for example, core hours Monday to Friday during term time. The school may also have a fixed number of 'additional hours' built in to cover events such as parents' evenings, open evenings, and performances. These events should be programmed into the contract calendar well in advance. School use outside contract and additional hours can often be arranged but may carry an additional cost.

4 What about access for staff who work all year round, such as finance, administration and IT teams?

This should be built into the project agreement, offering limited access to these staff. Arrangements for events such as exam results days, booster classes and summer schools will also need to be included. If they are not, then school may have to hire the space at a cost.

5 Can the school control who the SPV hire the school out to?

There will probably be a clause in the PA that gives the local authority the option to refuse use of the building if the event is not deemed suitable. These rights should be passed down from the local authority to the school through the school agreement.

6 The contribution we are required to make under the school agreement is too expensive and we can get the services more cheaply elsewhere. Can we terminate the PFI?

PFI arrangements all contain the ability for a local authority to terminate them without cause, known as 'voluntary termination'. It is therefore legally and technically possible for the local authority, at the request of an academy, to terminate its PFI – either in its entirety or in respect of a particular school.

However, in practice this may be prohibitively expensive as the project agreement will contain 'compensation on termination' provisions, meaning that, in the event of termination, the SPV will receive payments from the local authority so that it can, for example, repay the lenders and shareholders who funded construction. Therefore, although a legal mechanism exists to end a PFI, the financial ramifications of this should be carefully considered. It is likely that early discussion with the local authority, and financial and legal advisers, will be necessary as part of consideration of any such proposals.

7 The contribution we make to the unitary charge under the school agreement is too high. Can we reduce it?

There is no way, unilaterally, for a school or academy to reduce its contribution. Indeed, the contribution is likely to increase over time, and school agreements often contain detailed provisions allocating increases to the unitary charge to the relevant PFI schools. These increases can result from indexation (for example, inflationary increases), increases in insurance and utilities costs, and variations which lead to additional costs.

However, there are practical ways in which the costs of ongoing PFI arrangements may be reduced, some examples of which are as follows:

- **Are there changes that can be made to the level of services?** Government guidance on operational PFIs note that such services were often 'gold plated', and that reductions in service, and therefore cost, are a possible way to mitigate PFI payments.
- **Are the insurance cost sharing provisions being properly used?** These clauses often provide for the parties to share the benefits of any reductions in insurance premiums.

- **Have the benchmarking / market testing provisions been used to ensure that services are being delivered at market prices?**
- **Is the lifecycle provision also gold-plated – are there changes that could be made that will reduce overall cost?**
- **Have the services always been delivered to the required standard?** If not, the unitary charge may be subject to deductions to reflect the reduced service delivery, or unavailability. The school agreement will often allocate some or all of these deductions to the academy, so it is in its interests to make sure that poor performance is properly recorded and managed.

Craig Elder, Partner, Browne Jacobson LLP

ASCL Funding Specialist Julia Harnden

Association of School and College Leaders
130 Regent Road, Leicester LE1 7PG
T: 0116 299 1122 E: info@ascl.org.uk W: www.ascl.org.uk

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