Cabinet 6 November 2013	TOWER HAMLETS
Report of: Robert McCulloch-Graham, Corporate Director, Education, Social Care & Wellbeing	**Classification:** Unrestricted
Grouped Schools & Mulberry School PFI Contracts – Review	

Lead Member	**Cllr Oliur Rahman, Cabinet Member for Children's Services**
Originating Officer(s)	Pat Watson, Head of Building Development
Wards affected	All Wards
Community Plan Theme	A Prosperous Community
Key Decision?	Yes

Executive Summary

This report provides an update on the performance and financial positions of the Grouped Schools and Mulberry School PFI contracts.

Following a financial review of the contracts which showed action was needed to ensure the financial position on the contracts remained positive, negotiations with the relevant schools took place which reached agreement on adjustment to schools' charges and the DSG contribution from April 2012.

Recommendations:

The Mayor in Cabinet is recommended to:

1. Note the contents of this report;
2. Authorise the Corporate Director Education, Social Care and Wellbeing to agree revised Governors' Agreements with the 24 schools in the Grouped Schools PFI Contract and with Mulberry School to reflect the current position regarding the contributions made by the schools to the costs of those contracts;
3. Authorise the Head of Legal Services (Environment) to execute all necessary documents to implement paragraph 2 above.

1. REASONS FOR THE DECISIONS

1.1 The Council entered into the two PFI contracts in 2002 for periods of 25 years. The financial position has to be kept under review and corrective action taken where necessary in order that the liabilities under the contract can be met.

2. ALTERNATIVE OPTIONS

2.1 Action was agreed and taken last year to mitigate financial risks to the Council. This report provides an update on the present position and so there are no alternative options at this stage.

3. DETAILS OF REPORT

Background

3.1 In 2002 the Council entered into the Grouped Schools PFI Contract and the Mulberry School PFI Contract for terms of 25 and 26 years respectively. In both cases the contracts provided initial capital investment to improve the schools and then facilities management services and life cycle programmes for the remaining term. Initial capital investment was completed some time ago at all the schools and delivery of the long term services continues.

3.2 During 2011, officers began consultation with the 24 schools in the Grouped Schools PFI contract to consider how the contract could avoid a forecast £34m deficit by contract end. This led to options being considered by Schools Forum in January 2012 and Cabinet agreed a package of proposals in March 2012 to avoid such a deficit.

3.3 This included a formulaic method of calculating the annual contributions from each of the 24 schools, based on the Retail Price Index (RPI) plus 1.2%. It also included a stepped increase in the DSG subsidy (to £2.360m in 2013/14) which would also increase by RPI +1.2%.

3.4 The Mulberry PFI contract is much smaller, includes only one school and is much less sensitive to factors such as the change in indexation. It was expected to break-even by contract end.

3.5 These new arrangements were backdated to April 2011, so they have been operating for two financial years. In the meantime, at the request of the Grouped School PFI schools, Deloittes LLP completed an exercise to review the accounts for that contract.

3.6 Finally, Schools Forum agreed at its meeting in January 2013 that the DSG subsidy for PFI should be excluded from the Minimum Funding Guarantee. The Department for Education were not persuaded that this was appropriate, even after appeal, so the £2.360m provided by all schools is, for the primary and secondary schools amongst the 24 in the Grouped Schools PFI, part of their protected budget. While this will produce little more than marginal discrepancies if circumstances stay the same, if at some point in the future the DSG subsidy were to be reduced (or at contract end, ceased), continued protection for participating schools would be difficult to argue.

Grouped Schools PFI Contract – current position

3.7 The services continue to be delivered at the 24 sites and these are monitored by the LA.

3.8 BSF investment schemes are agreed at 4 secondary schools in the contract (Langdon Park, Stepney Green, Phoenix and Central Foundation). The major works are being carried out by the LEP (Local Education Partnership) but THSL (Tower Hamlets Schools Ltd) remains responsible for all facilities management and other contract responsibilities at the sites in the meantime and to the new areas on completion. These schemes are progressing well and the first is now completed at Phoenix School.

3.9 One school (Old Ford Primary School) included in the contract has converted to academy status from 1 September 2013. The school will remain part of the contract and continue to receive the contract services. The DfE has established a framework to ensure that schools in such circumstances continue to pay the charges as if they remained within the LA in order that the LA's financial position in relation to contract charges and payments to the contractor is not affected. LA officers and the school's advisers worked together on the legal documents to complete the necessary agreements.

3.10 In 2012 a benchmarking review of the defined soft FM services (cleaning, premises management, horticulture, etc) was undertaken. Officers scrutinised the information on services and costs put forward by THSL. An increase of 3.26% on the defined services element has been agreed which has been distributed amongst all the schools pro rata on their 2013/14 bills.

3.11 In 2011 an insurance benchmarking review was undertaken but not concluded until later in 2012. This review resulted in a reduction in insurance costs which has been credited to LBTH in accordance with the contract provisions and this has been passed on to the schools in full.

3.12 The regular monitoring of the services provided by the contractor shows that on average 89% of tasks reported to the helpdesk are completed on time. Where service deductions are applied for failure to meet the service response standards these are credited to the individual school concerned.

Mulberry School PFI Contract – current position

3.13 The delivery of services and performance under the contract continues to be satisfactory. The contractor has good communication links with the school and services are generally performed well.

3.14 Under the contract terms, a benchmarking review was carried out in 2012 – the contract requires this to be done every five years. The previous benchmarking review in 2007 resulted in no payment adjustment. The 2012 review was carried out and showed that an adjustment was applicable. An agreed adjustment of 4.9% of the relevant element of the charge was agreed which amounts to an increase of £31,000 pa (indexed) to the school. The governing body accepted this increase.

Grouped Schools PFI Contract – financial position

3.15 The Grouped Schools PFI Contract has forecast expenditure in 2013/14 of £13.999m. There are 24 participating schools and 3 other stakeholders. The financial arrangements for this contract were overhauled in March 2012 with involvement of all stakeholders, including Schools Forum. This resulted in a stepped increase in the DSG subsidy to the contract and a commitment for all stakeholder contributions to be subject to indexation of the Retail Price Index plus 1.2%.

3.16 During 2012/13 the PFI contract was subject to quarterly RPI indexation that equated to 3.1% year-on-year and there were benchmarking adjustments to the indexation that have been reflected in changes to school contributions for 2013/14.

3.17 This contract had accumulated a deficit at its peak of £11.3m, but that had reduced to £9.518m by April 2012 because of the actions agreed in March 2012. By the end of 2012/13 financial year, the deficit had reduced further to £8.407m. The details of this are in Appendix 1.

3.18 The net elements of this contract that are subject to indexation / inflationary pressures include a specific element of the unitary charge, plus monitoring costs, school and DSG contributions. The net cost of this in 2013/14 is estimated to be £1.663m; the larger this element is the greater the sensitivity of the account to inflationary pressures.

3.19 Deloittes LLP reviewed the accounts for 2011/12 and commented on the financial planning model that was prepared for a meeting with the 24 heads and chairs of governors in February 2013. The outcomes of that technical review have been shared with the stakeholder schools. In summary, there were no material issues in the 2011/12 accounts and Deloittes shared the view that the stated assumptions would suggest a surplus by contract end in the region of £10m. The previous assumptions included a long-term RPI of 2.5% and they suggested that 3%-3.5% might be more prudent. They also indicated that the level of surplus forecast would be sufficient (all other things being equal) to absorb inflationary pressures up to 6.8% without going into deficit.

3.20 The financial model has been updated since Deloittes report, refreshing for:

- the actual financial position in 2012/13,
- bills for schools in 2013/14
- DSG subsidy for 2013/14

- Increasing the long-term inflation rate from 2.5% to 3.5%
- Removing the expected £2m from capital receipts from the sale of school keepers houses (without changing the policy presumption that any such sales will benefit the PFI account).

3.21 The updated forecast suggests a surplus of £10.373m by contract end in 2027. Clearly, this gives the account scope for absorbing inflationary and other pressures. Given the experience of the first 10 years of this contract, it can only be a sensible approach to have such a financial buffer. Indeed, the current position with the contract is that it is in deficit by £8.407m, so until that deficit turns into a surplus itself, the current financial strategy would appear to be the most appropriate.

Mulberry School PFI Contract – financial position

3.22 The Mulberry PFI contract is a much smaller one than the Grouped Schools one and it is structured differently. There is only one participating school, inflation on the contract itself is calculated annually in December and the gross forecast expenditure for 2013/14 is £2.3m (17% of the level of the Grouped Schools contract). Utilities continue to be a feature of this contract, whereas it has ceased to be part of the arrangements for the Grouped Schools PFI contract.

3.23 There was a £0.141m deficit on this account at the start of 2012/13 which reduced to an £8k deficit by the end of 2012/13.

3.24 In the Deloittes review of the Grouped Schools PFI contract they advised that 2.5% may be a low estimate of inflation and they suggested that, for planning purposes 3% - 3.5% may be more appropriate. The financial plan in Appendix 1 has been updated to reflect 3.5% inflation.

3.25 45% of the unitary charge is variable, subject to indexation. Utilities and monitoring costs are subject to inflationary pressures. The school contribution is subject to the same indexation as the variable element of the contract. Overall, for 2013/14, this means that a net expenditure of £0.268m is subject to indexation or inflationary pressures.

3.26 The forward forecast for this account is that by contract end in 2028/29 financial year, the account would be in surplus by £2.428m. While this provides some comfort that pressures arising from the PFI account may be able to be absorbed by that forecast surplus, there is a key assumption that may not be fully resolved until March 2029. The contract itself ends in May 2028 and costs will cease at that point. The documentation for the PFI Grant from central government, however, indicates that the funding is due to continue until two weeks before the end of March 2029. If the grant were to cease at the same time as the contract, £1.3m of income would not be realised and the surplus would be that much lower.

3.27 There is still 15 years to run on this contract, so a prudent approach is imperative, but the overall position is currently sound.

Minimum Funding Guarantee

3.28 In January 2013 Schools Forum confirmed that it wished to have the PFI Subsidy Factor in the main primary / secondary funding formula excluded from the Minimum Funding Guarantee calculations. This would ensure that there was no ambiguity about whether individual schools had received the whole of their subsidy intact and, even although they are obliged to repay the whole of the DSG subsidy in accordance with the Scheme for Financing Schools.

3.29 Where schools are subject to the Minimum Funding Guarantee, if the DSG Subsidy factor were within the MFG calculation, there could be some very minor impacts if 6th form pupil numbers or nursery numbers were changing at a different rate to pupils of statutory schooling age.

3.30 The DfE were not persuaded by the need to exclude this factor from the MFG. They believed that the maximum amount of funding should be distributed on pupil factors within the MFG. They considered the impact of the factor inside and outside the MFG and concluded that the variations amounted to no more than the equivalent of a single age-weighted pupil unit for any individual school. Officers appealed against this decision, but the Secretary of State did not change his view.

3.31 Other authorities have reported that their requests, too, were turned down.

3.32 Officers continue to be concerned about this situation for the longer term. While subsidy levels are rising, this is at the margins, so the current arrangement may not produce any material difficulties for any individual school (ie subsidy factor being inside or outside the MFG may not make any difference while it rises by RPI+1.2%). The difficulties will emerge, however, in two scenarios, both of which may be some time off:

- Where the level of subsidy has a stepped change either up or down where Schools Forum agrees that the balance of risks, the time remaining on the contract and the forecast surplus/deficit on the PFI accounts all justify a change in the DSG subsidy level.
- Where the contract ends and the need for a subsidy ceases.

3.33 If a school is subject to the Minimum Funding Guarantee and there is a stepped rise in the DSG Subsidy, the school could find itself with an unavoidable increase in the contribution it had to make for PFI subsidy, but no commensurate increase in the school's overall budget to pay for it.

3.34 If the DSG subsidy has a stepped decrease or ceases, an individual school could find that its budget is protected for this loss of funding, possibly for some years. This is in spite of the fact that the school would have a corresponding reduction in its spending commitments.

3.35 The easiest way of avoiding these issues is to exclude the PFI Subsidy Factor from the Minimum Funding Guarantee. Given that the DfE has been very reluctant to exclude it, the key principle we would want DfE to agree is that, if there were a stepped change, up or down, in the level of the DfE subsidy that the factor be somehow suspended / excluded for that year.

3.36 Schools Forum agreed at its meeting on 26th June 2013 that officers should approach the DfE again to seek a concession on this matter.

3.37 In September 2013,DfE officials confirmed that the Secretary of State intended to allow an amendment to the Tower Hamlets local formula to exclude the PFI factor for Bow School in the 2014/15 calculation of the Minimum Funding Guarantee. This would set the principle that the MFG may be amended where individual schools are likely to experience material changes in their PFI circumstances, so this ought to represent a resolution to this particular issue.

3.38 The Governors' Agreements (GAs) which were entered into when the PFI Contracts were let have not been revised since 2002 although the schools have been paying increased contributions for the last two years. It is therefore recommended that this position is regularised and the Gas are revised to reflect the current position regarding payments. The decision of one of the schools in the Grouped Schools contract to become an Academy has illustrated the risk to the Council of not updating these documents. A school wishing to convert to an Academy does so subject to the legal agreements already in place and the current GAs do not contain the revised increased payments the schools have agreed to pay . Whilst this has not been an issue with Old Ford School , the conversion to an Academy has highlighted a potential risk to the Council's finances

4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1. This is substantially a financial report and the financial implications have been included in the main text.

4.2. The key points are that there was a cumulative, combined deficit on these PFI contacts of £8.415m at the end of March 2013. The stated assumptions for the future financial performance of the two contracts would point to a surplus of £12.801m by the end of both contracts in 2027/2028; this would appear to be sufficient to cover any risk, particularly inflation risk, that might reasonably be expected to occur over the next 15 years.

4.3. Until the existing deficits have been removed there is no scope for changing the existing basis for school and DSG contributions.

5. LEGALCOMMENTS

5.1. This report deals with a PFI contract which was entered into by London Borough of Tower Hamlets in 2002 for a 25 year term In PFI projects, the private sector consortium raises money to meet the cost of the works initially, and then the Council provides both capital and revenue funding. Grant support for the capital element of the Council's PFI is given by central government. Once a PFI contract is signed, the project receives financial support from the Government to assist with the cost of building and maintaining the premises.

5.2. The private sector consortium receives a Unitary Charge in return for the availability of the school building, rather like a mortgage. However, the school's governing body is also required to agree to pay the Council an annual amount, usually the part of the Unitary Charge that relates to the facilities management content of the contract.

5.3. The PFI contract has the first call on the school's budget and so the Council must have written approval from a governing body to use its delegated budget in any way. This is done through a Governing Body Agreement which all of the schools have signed These agreements provide for the schools to make payments each month from their delegated budget to contribute to the payments to the private sector consortium. The amount of these contributions is recorded in the schedule of each school's agreement. Whilst there is no specific provisions providing for the treatment of inflation the schools have through the annual reviews agreed to meet the additional costs.

5.4. Under the School Standards and Framework Act 1998 (SSFA) school governing bodies have the power to enter into legally binding contracts although there is a legal view that one part of an organisation cannot enter into a binding legal contract with another part . This commitment is then reflected in a revised delegated budget for the length of the contract period.

5.5. The opinion of the Department for Education 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."

5.6. The funding arrangements are set out in the School Finance (England) Regulations 2012. Regulation 12 allows the local authority to redetermine individual school budget share "at any time or during the funding period" However it cannot reduce the individual school budgets unless it has obtainedauthorisation from the schools forum or the Secretary of State (Reg. 12 (2)(b). If differential funding is to be adopted under regulation 18 the factors which can be taken into account are listed in Schedule 3 to the Regulations and one of these criteria (para 14) is "Payments in relation to a private finance initiative (including actual or estimated cost)

5.7. This report sets out the circumstances under which the funding could be put at risk and the consultation with the schools. A further approach to the DfE is to be made to resolve the issue

6. <u>ONE TOWER HAMLETS CONSIDERATIONS</u>

6.1. Sustaining the provision of safe and suitable education establishments remains an important element of improving achievement in schools. The continuation of services under the PFI contracts enables schools to maintain effective education environments.

7. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

7.1 There are no specific implicationsarising from matters included in this report.

8. RISK MANAGEMENT IMPLICATIONS

8.1. Actions taken to address financial risks have been and will continue to be kept under review to ensure that financial risks are identified and mitigated where necessary.

9. CRIME AND DISORDER REDUCTION IMPLICATIONS

9.1 There are no specific implications arising.

10. EFFICIENCY STATEMENT

13.1 There are no specific implications arising.

Linked Reports, Appendices and Background Documents

Linked Report

- NONE.

Appendices

- Appendix 1 – Summary Position on PFI Contracts as at June 2013

Background Documents – Local Authorities (Executive Arrangements)(Access to Information)(England) Regulations 2012

- NONE

Officer contact details for documents:

- N/A

Appendix 1

Summary Position on PFI Contracts as at June 2013

	Mulberry			**Grouped Schools**		
	2012/13 actual	**2013/14 forecast**	**2014/15 to contract end**	**2012/13 actual**	**2013/14 forecast**	**2014/15 to contract end1**
Payments to the contractor	2,310	2,292	36,833	14,601	13,884	221,516
Monitoring costs	11	18	297	103	115	1,995
Total expenditure	**2,321**	**2,310**	**37,130**	**14,704**	**13,999**	**223,511**
School contributions	-713	-718	-13,001	-5,777	-5,050	-92,293
Other contributions	0	0	0	-105	-113	-2,110
DSG subsidy	-104	-104	-1,932	-2,161	-2,256	-42,840
PFI Grant	-1,637	-1,637	-24,484	-7,772	-7,743	-103,885
Total income	**-2,454**	**-2,459**	**-39,417**	**-15,815**	**-15,162**	**-241,128**
Net expenditure / income	-133	-149	-2,287	-1,111	-1,163	-17,617
balance b/f	-141	-8	141	-9,518	-8,407	-7,244
balance c/f	-8	141	2,428	-8,407	-7,244	10,373

NB Needs to be seen in conjunction with stated assumptions on the following page

Key Assumptions in forward forecasts

Mulberry

1. Outstanding deficit on the PFI account was -£0.141m at 31st March 2012
2. 2012/13 figures based on provisional outturn position suggesting a balance of -£8k at 31st March 2013
2. Actual RPI forecasts are used to 2013/14, then 3.5% RPI to the end of the contract.
3. DSG and school contributions continue to the end of the contract, adjusted annually for RPI.
4. PFI grant is now fixed.
5. Unitary charges are 45% variable and 55% fixed)
6. Utilities costs are included on both sides.
7. No account taken of performance, 3rd party income, additional hours.

Grouped Schools

1. Outstanding deficit on the PFI account was -£9.518m at 31st March 2012.
2. 2012/13 figures based on provisional outturn position, suggesting a balance of -£8.407m at 31st March 2013.
3. Unitary Charge payments based on net fixed annual elements of £4.917m, with the balance being inflated quarterly by RPI.
4. PFI grant is now fixed at £7.743m each year, the one-off adj for 2012/13 relates to a small balance brought into the account.

5 £2m of capital receipts for sale of school keepers houses has been removed from the financial forecast, but remains a policy presumption.

6. School and other stakeholder contributions to be adjusted by pupil numbers then uprated by RPI plus 1.2%, using the previous November figures each year.
7. DSG subsidy to be distributed to PFI schools for automatic repayment. This was increased for 2012/13 and will increase by the previous November's RPI plus 1.2% each year, but this element is the one that will vary to balance the overall account in the long term.
8. School ACRs for capital are paid in-year; on-going ACRs are paid on estimates / adjusted for actuals the following year.
9. Performance Deductions reduce the Unitary Charge, but also reduce the school contribution.
10. Benchmarking operates periodically to calibrate the RPI and this would result in an adjustment up or down to school contributions.
11. Contributions from Bow School would cease when they move to their new building in September 2014. (ie there is currently no assumption about a successor occupant making a contribution, or the Unitary Charge being abated, both of which scenarios would produce a positive financial outcome for the account).