



## **CABINET – 8<sup>TH</sup> MARCH 2023**

**SUBJECT: PROPOSED VOLUNTARY TERMINATION OF THE CAERPHILLY CBC SCHOOL PFI CONTRACT**

**REPORT BY: CORPORATE DIRECTOR FOR EDUCATION AND CORPORATE SERVICES**

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### **1. PURPOSE OF REPORT**

- 1.1 To provide details of a proposal to voluntarily terminate the Caerphilly CBC School PFI Contract and to seek Cabinet endorsement of the proposal prior to Council consideration.

### **2. SUMMARY**

- 2.1 The report provides details of a proposal to voluntarily terminate the Council's School PFI Contract.
- 2.2 The Welsh Government has requested that all Welsh local authorities with PFI contracts review them to assess whether they continue to offer value for money.
- 2.3 Over a number of years, the Council has sought to achieve savings from the School PFI Contract, to ensure value for money services are being provided to the schools and to minimise affordability implications.
- 2.4 The Council has considered all options including increasing the contract management, reviewing the services provided to identify and implement savings, and using mechanisms in the Contract such as benchmarking to reduce costs. However, despite the funding support from Welsh Government there continues to be a significant affordability gap between the Council's normal school funding levels and the payments made to the Contractor. As such, a business case has been prepared setting out details of a proposal to voluntarily terminate the School PFI Contract.

### **3. RECOMMENDATIONS**

- 3.1 Prior to consideration by Council on 15 March 2023, Cabinet is asked to consider and endorse the proposal to voluntarily terminate the Caerphilly CBC School PFI Contract.

### **4. REASONS FOR THE RECOMMENDATIONS**

- 4.1 To ensure that Cabinet is provided with an opportunity to consider the proposed termination and make an appropriate recommendation to Council.

## **5. THE REPORT**

### **5.1 Background**

- 5.1.1 Caerphilly County Borough Council entered into a concession agreement (the “Contract”) with Machrie Limited (the “Contractor”) on 6 April 2001 in relation to a project (the “Project”) for the provision of two new schools to replace the existing facilities at Fleur de Lys (Ysgol Gyfun Cwm Rhymni) and Pengam (Lewis Boys School). The Contract was for the Design, Build, Finance and Operate (“DBFO”) of the new schools and was procured under the Private Finance Initiative (“PFI”).
- 5.1.2 The Project was an early PFI scheme in Wales. The Welsh Government supports the Project through a grant, paid annually over the contract term.
- 5.1.3 The successful bidder was Ballast Wiltshier but that company, or any related companies, no longer exist.
- 5.1.4 The Contractor was originally owned by a consortium of shareholders comprising of Royal Bank Investments Ltd (49.0%), Ballast Plc (25.5%) and New Anavon Ltd (25.5%). The current shareholding of the Contractor is 100% with Machrie Limited, a specialist PFI investor which is in the same ownership structure as the now dissolved New Anavon Ltd, thus demonstrating an element of continuity in ownership. Machrie Ltd is in turn owned 100% by Machrie Burn Limited with both companies having the same two directors. Machrie Burn Limited is, in turn, wholly owned by BILF Holdco Limited.
- 5.1.5 The duration of the Contract is for 30 years from the operational start date (1 September 2002 until 31 August 2032). As such, there are just over 9 years of the Contract remaining.
- 5.1.6 Mitie Facilities Management Limited has been the services subcontractor since 2007. At the commencement of the Project that role was performed by Wiltshier FM (part of the Ballast Group). The Project requirement is for the provision of fully serviced schools. The services to be provided under the Contract are cleaning and waste management, security, building maintenance, grounds maintenance, utilities management, caretaking, catering, furniture and equipment maintenance and renewal, and provision of a helpdesk function and emergency response.
- 5.1.7 Senior funding of circa £25.4m was provided by Royal Bank of Scotland (RBS). Lloyds Bank took over the senior funder role from RBS on 15 November 2017. This was part of a broader refinancing of the debt of a number of PFI / PPP contracts and the nature of it had no implications for the Council at the time.

### **5.2 Development of the Business Case**

- 5.2.1 Over a number of years, the Council has sought to achieve savings from the Project, to ensure value for money services are being provided to the schools and to minimise affordability implications.
- 5.2.2 The Council has considered all options associated with the Project i.e. increasing the contract management, reviewing the Project to identify and implement savings, and using mechanisms in the Contract such as benchmarking to reduce costs. However, despite the funding support from Welsh Government there continues to be a significant affordability gap between the Authority’s normal school funding levels and the payments made to the Contractor.
- 5.2.3 As such, the Council is considering voluntary termination of the Contract. The Council commissioned a review of the Project to consider whether it was continuing to provide value for money. As part of that process, the Council sought to obtain a preliminary assessment of the potential costs to terminate the Project, which could then be measured against the predicted payments to the Contractor for the remainder of the Project.

- 5.2.4 Local Partnerships LLP (“Local Partnerships”) provided a report to the Council in October 2018, setting out legal, financial, and commercial considerations in undertaking a voluntary termination of the Project under the terms of the Contract. The report demonstrated that significant savings could be achievable through such a termination. As a consequence, and subject to it retaining its Welsh Government grant funding, the Council has decided to progress through the required approvals, working towards termination. Welsh Government requires a business case to be provided before a termination is implemented, as it contributes the grant support payments.
- 5.2.5 Local Partnerships has since prepared a business case for the potential termination of the Project on behalf of the Council (which has now been approved by the Welsh Government), based on a combination of information provided by the Council and experience of the costs of termination, and current market intelligence. Much of the content of the business case is commercially sensitive and needs to remain confidential at this stage so as not to compromise the Council’s position in its commercial negotiations and thereby impact upon achieving best value from the process. The remainder of this report sets out the key elements of the business case without disclosing the commercially sensitive or confidential information.

### **5.3 The Strategic Case**

- 5.3.1 The strategic case sets out the rationale and the background for the proposed termination and demonstrates the case for change at a strategic level.
- 5.3.2 The two PFI schools are in generally good condition and the service provision by Mitie is also to a good standard. However, the Council is faced with significant financial pressures. The strategic case for the termination is to realise savings in order to provide additional resource for all the strategic objectives of the Council.

#### Strategic Context

- 5.3.3 In March 2018, the Council adopted a set of Wellbeing Objectives for 2018-2023 within its Corporate Plan. The Corporate Plan is the Council’s over-arching vision, supported by clear objectives and priorities. Within the Plan, “Improve education opportunities for all” was selected as Wellbeing Objective 1.
- 5.3.4 The Council’s vision for education is to raise standards and ensure learners are healthy, confident, proud, and ambitious. In Caerphilly there are bold ambitions to provide every learner with the best life chances and the Council is committed to doing this through the provision of high quality teaching, learning and leadership across its impressive 21st Century school settings. The Education Attainment Strategy “Shared Ambitions” 2019-2022 set out the strategy of how the Authority would work together to achieve the best outcomes for its young people.

#### Forecast Demand for the Schools

- 5.3.5 The Council currently has 72 primary schools, 1 VA primary school, 11 secondary schools, 1 3-18 school and 1 special school. All of these schools (apart from the VA primary school) are maintained by the Council, with only the schools in this Project having their capital expenditure funded through PFI.
- 5.3.6 In March 2019 the Council shared its education strategy for the coming years. Some of the key priorities within the strategy included: -
- improve outcomes at end of Key Stage 4 and 5;
  - improve the performance of boys and pupils receiving free school meals;
  - build on the recent increase in attendance;
  - reduce the number of exclusions across secondary schools;
  - focus on improving standards of literacy, particularly in years 7, 8 and 9; and

- improve the quality of teaching and learning.

5.3.7 The following table shows the number of pupils on roll and forecast at the time that the business case was prepared.

**Forecast net full time pupil numbers at the Schools shown by feeder school.**

School name	2020	2021	2022	2023	2024	2025	2026
<b>Lewis Boys (Pengam)</b>							
Coedybrain Primary	11	21	17	23	20	11	13
Derwendeg Primary	11	9	10	10	14	13	12
Glyngaer Primary	11	12	14	15	20	9	11
Greenhill Primary	8	7	16	11	12	15	15
Hengoed Primary	9	10	13	14	12	12	9
Llancaeath Primary	10	19	24	17	18	20	17
Maesycwmmwr Primary	5	8	11	15	8	11	7
Tiryberth Primary	13	11	13	7	10	6	8
Ystrad Mynach	26	25	32	36	28	33	30
<b>Total</b>	<b>104</b>	<b>122</b>	<b>150</b>	<b>148</b>	<b>142</b>	<b>130</b>	<b>122</b>
<b>Fleur de Lys (Ysgol Gyfun Cwm Rhymni)</b>							
YG Bro Allta	37	35	45	30	42	41	30
YG Cwm Dewen	29	30	24	30	30	22	23
YG Cwm Gwyddon	27	32	33	30	30	21	34
YG Gilfach Fargoed	15	21	14	20	12	18	15
YG Trelyn	23	25	19	25	26	23	26
Ysgol Bro Sannan	14	26	24	23	24	26	22
Ysgol Penalltau	26	26	27	28	28	28	27
Ysgol Y Lawnt	21	25	26	29	21	24	28
<b>Total</b>	<b>192</b>	<b>220</b>	<b>212</b>	<b>215</b>	<b>213</b>	<b>203</b>	<b>205</b>

\*Above figures assume that 100% of pupils in feeder schools will apply to their secondary school whether catchment or not.

5.3.8 The table demonstrates that there is on-going need for the schools into the medium term.

The Proposal

5.3.9 For the reasons outlined above there is no intention to close the schools. The strategic case in relation to the provision of the schools remains the same given the demand for the schools remains. However, the Council is faced with significant financial pressures and a need to realise savings.

5.3.10 The Contract has a further 9½ years to run (until August 2032) and an early termination could result in significant revenue savings over the remaining contract term if the services and the lease arrangements were brought back into the Council.

5.3.11 The proposal is therefore for the Council to voluntarily terminate the Contract. The Contract requires the Council to give the Contractor just under 3 months of notice of such termination.

5.3.12 The Council is conscious that it doesn't want the termination of the Contract to impact the schools in any adverse way. It will therefore take this into account in relation to the timing of termination, and the transfer of services from the Contractor to the new provider. The optimum time of the year to implement the termination to allow smooth transition of the Services would be during the school summer holidays. Therefore, with the expectation that there are no significant backlog maintenance issues, and with only two schools in the Project portfolio, a summer 2023 termination date is achievable. The business case assumption is that the

requisite notice will be given to the Contractor to allow termination to take place at the end of July 2023.

- 5.3.13 The Council has in-house capability to provide the services that are currently delivered under the Contract, and most schools in the county borough use this service. However, the schools have the right to choose whichever provider(s) they want. This process to determine the basis of on-going services provisions shall only commence if and when the Council approves the business case.

## **5.4 The Economic Case**

### Introduction

- 5.4.1 The Economic Case covers two key areas: -

- An identification of the options available to the Council to deliver the services that are currently provided to the schools under the Contract. Once all potential options are identified a qualitative assessment is undertaken to determine what the preferred option(s) are for that service delivery should the contract be terminated.
- The preferred alternate delivery approach is then subject to a quantitative analysis to determine whether it represents better value for money than continuing with the Contract.

- 5.4.2 The economic case assesses the economic costs and benefits of the proposal to the Welsh economy as a whole.

### Options Appraisal

- 5.4.3 The current contract and service delivery position can be summarised as: -

- The schools have been built, are open, and as the strategic analysis indicates are required for the foreseeable future;
- The schools are in good condition and as at the last conditions survey there was limited backlog maintenance. The obligations under the Contract for asset maintenance and expenditure on asset renewals means the two schools benefit from higher levels of asset related expenditure than the majority of the non PFI schools' estate in the county borough, where spend is prioritised based on a number of factors e.g. condition surveys, fire risk assessments;
- Facilities Management Services (FM Services) are generally good. However, there have been issues in respect of the delivery, quality, and value for money of the catering service which have not been fully resolved to date;
- The costs of catering and cleaning under the Contract are subject to periodic price benchmarking and potentially market testing. The Council brought in independent support from Local Partnerships for the last benchmarking review in 2017, but despite this focus on ensuring a robust process the benchmarking exercises have not identified cost savings to date; and
- The Council has to supplement the costs of the Contract over and above normal levels of support to non PFI Schools.

- 5.4.4 Like all local authorities, Caerphilly CBC continues to face significant financial challenges. The Council is under budgetary pressure. Saving money from the PFI Contract would assist the Council in the delivery of its Medium-Term Financial Plan (MTFP) and may also provide an opportunity for some capital investment across the wider education estate. In addition, the Welsh Government has requested that all Welsh local authorities with PFI contracts review them to assess whether they continue to offer value for money.

- 5.4.5 In this context the available long list of options relates to both the costs of delivering the existing service specification and whether the service and asset maintenance obligations are too

onerous and do not align with the rest of the Council's school estate. As such the identified long list of options is: -

<b>Option 1</b>	Do nothing (continue with the Contract delivering the current services, no savings),
<b>Option 2</b>	FM Services variation of specification (agree a contractual variation to amend or reduce the specification of some or all of the services provided by the Contract. The Contractor would still be responsible for the delivery of the amended Services specification),
<b>Option 3</b>	FM Services removal (agree a contractual variation to remove all the service delivery from the Contract in return for savings. The Contractor would be solely responsible for the maintenance and renewal of the assets),
<b>Option 4</b>	Terminate the Contract by using contractual rights based on Contractor Default (as defined in the Contract), or
<b>Option 5</b>	Terminate the Contract on a voluntary termination basis as defined in the Contract.

5.4.6 For Options 3-5, the Schools would have the option to either use the Council's own in house service provision for delivery of the Services, or to procure Services from the wider market.

#### Shortlisting of the Options

5.4.7 An initial sifting of options was undertaken to identify any that could be discounted without the need for further detailed assessment. The only option that was discounted at this stage was Option 4 (Terminate due to Contractor default). This was discounted on the basis that no events of default had occurred. The Contractor remains a going concern (per the last published accounts), the schools are in generally good condition and service performance is generally satisfactory, with no material deductions levied.

#### Qualitative assessment of the options

5.4.8 Having confirmed the short list of options, a qualitative options appraisal exercise was undertaken. This process involved a range of officers of the Council covering finance, education, procurement, and asset management, as follows: -

- Head of Financial Services & S151 Officer
- Head of Transformation & Education Planning and Strategy
- Sustainable Communities for Learning Manager
- Sustainable Communities for Learning Principal Officer
- Procurement and Information Manager
- Finance Manager (Education)
- Finance Manager (Corporate Finance)
- Interim Head of Property Services

5.4.9 The process was facilitated by Local Partnerships.

#### Process

5.4.10 Firstly, the assessment criteria were determined through consensus amongst the participants. The agreed criteria reflect the delivery of the services performances under the Contract, the financial implications for the Council, and the impact on pupil attainment and wellbeing.

5.4.11 Having determined the assessment criteria, these were given a weighting based on their importance. This was again done by consensus within the group. To make the process easier the criteria were firstly ranked and from this a percentage weighting was able to be more easily derived.

5.4.12 The assessment criteria and the related rankings and weightings are set out in the following table: -

Assessment Criteria	Detail	Rank	Weighting (%)
Strategic Flexibility / adaptability	The ease by which the option allows developments or expansion to either or both schools in terms of buildings and equipment, usage, growth, and community activity.	3	15
Maintenance of assets	The extent to which the option allows the buildings, grounds, and equipment to be maintained to a high standard, allows flexibility of use of the existing assets, and ensures that there are appropriate remedies in place for poor asset maintenance. It should be noted that day to day maintenance of assets is an activity that sits within the FM services and is something that can be delivered by caretakers. Therefore, changes envisaged in Options 2 and 3 can impact on the condition of assets as much as major lifecycle replacement works which would remain the responsibility of the Contractor in Options 1, 2 and 3.	3	15
Day to day service provision	The extent to which the option allows the provision of cleaning and waste management, catering, and caretaking services to a high standard, allows flexibility of use of the existing assets and ensures that there are appropriate remedies in place for poor service performance.	3	15
Pupil attainment	The extent to which the option provides an environment and service provision which supports pupil attainment and wellbeing.	1	30
Financial	The extent to which the option is likely to be affordable within the existing budget constraints, and the ability to flex service to meet budget constraints	2	25
			<b>100</b>

5.4.13 The rationale for the rankings and weightings are: -

- **Pupil Attainment** – it is ranked the most important and has the highest weighting as this is the rationale for having schools and related services that deliver an environment where pupils can maximise their potential.
- **Financial** – the financial pressures that the Council faces means that having an affordable solution is very important, and hence why it is considered only marginally less important than pupil attainment.
- **Strategic flexibility / adaptability, maintenance of assets and day to day services** – these criteria could not be split in importance and hence were given equal ranking and associated weightings.

5.4.14 The final phase of the process was to determine a score for how each shortlisted option performs against each of the assessment criteria. Again, a consensus score was agreed. The scoring was in a range of 1-5 as follows: -

5	Likely to exceed expectations to meet the criteria
4	Fully delivers the criteria
3	Largely delivers the requirements of the criteria
2	Only partially delivers the requirements of the criteria
1	Does not deliver the requirements of the criteria at all

5.4.15 Having scored each option against each of the assessment criteria, and applying the criteria weightings, a weighted score was able to be derived. The results of the scoring were as follows: -

		Option 1	Option 2	Option 3	Option 4	Option 5
	Weighting	Do Nothing	Specification Variation	Remove service delivery	Contractor default termination	Council voluntary Termination
Strategic Flexibility / adaptability	15.00	2	2	2		4
Maintenance of assets	15.00	5	3	4		2
Day to day service provision	15.00	2	2	4		4
Pupil attainment	30.00	4	4	4		4
Financial	25.00	1	2	2		4
<b>Total</b>	<b>100.00</b>	<b>14</b>	<b>13</b>	<b>16</b>		<b>18</b>
Weighted score		280.00	275.00	320.00		370.00
Rank		3	4	2		1

#### Rationale for Scoring

5.4.16 **Strategic Flexibility / Adaptability** – PFI Contracts are designed and structured for the delivery of new schools and for the on-going maintenance and delivery of facilities management services to those schools, in order to deliver a specification and meet requirements that were appropriate at the start of the contract. Whilst there are variation mechanisms in PFI contracts, they are clunky and can be expensive for the Council to use.

5.4.17 Therefore, keeping the assets (buildings and equipment), as well as services, relevant to delivering an ever-changing curriculum can be challenging even if the overall strategic requirements do not alter – major alterations to scope, including additional buildings, are even harder to accomplish. It requires a strong contract management team on the Council's side and a willingness to engage and adapt by the Contractor, and the FM Services provider. Based on the contract to date neither has been fully in evidence, and therefore the potential to do this going forward is considered limited on all options that continue the PFI contract (i.e. Options 1-3), and hence the score of 2 for each.

5.4.18 Conversely having the asset management and service delivery back under Schools / Council day to day control allows that greater flexibility hence the score awarded.

5.4.19 **Maintenance of Assets** - The obligations under the Contract for asset maintenance and expenditure on asset renewals means the two schools benefit from higher levels of asset related expenditure than the majority of the non PFI schools' estate in the Borough, where spend is prioritised based on a number of factors e.g. condition surveys and fire risk assessments. The very good state of the schools and the planned renewal programme to the end of the Contract term demonstrate this. Hence Option 1 is scored as exceeding expectations.

5.4.20 As Option 3 is removal of service delivery from the Contract, rather than asset management, it should not have a material impact on asset maintenance but losing that joined up position with caretaking etc (as will be provided by different entities), may have a marginally negative effect and hence scores 4.

5.4.21 Option 2 requires reducing the specification and funding for asset maintenance and was considered to have a greater negative effect on the state of the schools' long term, as the day to day asset maintenance would be to a lower specification, meaning likely shorter replacement intervals and pressure on lifecycle budgets. Hence the score of 3.



- 5.4.22 An even worse position would arise in the event of a termination (Option 5), albeit with lower capital expenditure budgets to effect major replacement works. Capital expenditure would be allocated based on need and aligned with the rest of the school estate. This is the rationale for the low score of 2 for Option 5.
- 5.4.23 **Day to day service provision** – This criterion assesses the quality of the service provided, therefore moving to Option 2 would reduce cost but would reduce the level of service delivered. Therefore, Option 1 and 2 were given the same score of 2 but for different reasons.
- 5.4.24 Removing the services from the Contract (Option 3) and terminating the whole Contract (Option 5) allows a more cost effective service provision to be put in place, hence the scores of 4.
- 5.4.25 **Pupil Attainment** – Although there are significant differences between the service provision and asset management arrangements for each of the options, what each of the options delivers is not likely to relatively impact pupil attainment differently. Consideration was given as to whether the lower level of asset maintenance under Options 2 and 5, compared to Option 1 in particular, could have a negative effect. However, based on comparative attainment levels at PFI and non PFI schools in the county borough, this does not appear to be the case.
- 5.4.26 **Financial** – As stated earlier the costs of facilities management provision under the Contract are relatively high when compared with the Authority's own service provision. Option 1 (doing nothing) will not improve that position and is not affordable. The scoring reflects the known costs of delivering Options 1 and Option 5 within the county borough. Option 1 requires significant financial subsidy. Whilst savings can be made through Options 2 and 3, they are unlikely to materially impact the current cost.

#### Overall Result

- 5.4.27 Option 5 (Voluntary Termination of the Contract) is the highest ranked option. It scores significantly better (16%) than the second ranked option (Option 3 – removal of the services). As such Option 5 has been financially compared with doing nothing.

#### Value for Money Assessment

- 5.4.28 The VFM assessment compares the costs of continuing with the Contract (Do nothing) with the sum of: -
- Paying a termination sum to the Contractor to exit the Contract;
  - The net costs to the Authority of on-going service provision; and
  - An estimate of the net impact on tax receipts for Welsh Government.
- 5.4.29 The assessment is on the basis of a termination on 31 July 2023 and the assessment covers the period from 1 April 2023 (the start of the financial year in which termination is assumed to occur) to 31 August 2032 (the Contract Expiry Date). Information for the assessment has been sourced from: -
- The contractual Financial Model "Caerphilly\_Financial\_Close\_060401". This is understood to be the latest contractual financial model and no changes have been made. Given the compensation payments are based on values from the latest agreed contractual financial model it will be important to ensure there is agreement with the Contractor at an early stage that the correct version is being used.
  - Various financial information supplied by the Council relating to budgeted costs, unitary charge and other Contract payments, and the Council's sinking fund model.

### Contract Termination Compensation Sum

- 5.4.30 The compensation payable as a result of a voluntary termination is set out in the Contract (the "Compensation Sum"). Based on Local Partnership's understanding of how the Contract provisions should work and the relevant information in the Financial Model, a notional best and worst case Compensation Sum has been derived. This gives a reasonable range of the Compensation Sum that is likely to be paid and the transaction costs the Authority would incur in undertaking the termination process. This information is currently commercially sensitive, and if approval is given to proceed with a voluntary termination the final compensation sum will be subject to detailed negotiations with the Contractor.

### Overall VFM Assessment

- 5.4.31 The HM Treasury Green Book guidance (the "Green Book") varies in approach from the Council's own financial assessment as it requires a 'society as a whole' view. In the context of this termination assessment, we are therefore required to include the tax impacts of the termination, which would be (i) the tax gross up element of the Compensation Sum, and (ii) the lost corporation tax that the Contractor is forecast to pay to Contract Expiry.
- 5.4.32 The Green Book requires that value for money is assessed on a net present value basis using a discount rate of 3.5% in real (i.e. uninflated) terms to which forecast inflation (2.0%) is applied using the required formula. This creates a discount rate of 5.57%. The VFM assessment shows a significant net financial benefit for both best and worst case scenarios, but this information is currently commercially sensitive.

### Outcome of VFM Analysis

- 5.4.33 The analysis indicates there is a strong VFM basis for terminating the Contract given that there is both a strong qualitative case and a significant financial benefit from doing so.
- 5.4.34 In applying a range of cost assumptions and including contingency in the Worst Case it is not considered necessary to undertake further risk or optimism bias.

## **5.5 The Commercial Case**

- 5.5.1 The commercial case addresses commercial feasibility and demonstrates that the proposed solution can be delivered effectively.

### Contractual provisions for voluntary termination

- 5.5.2 There is a mechanism set out in the Contract for the Council to terminate voluntarily. These provisions are at Clause 46 of the Contract. These provisions have been reviewed from a commercial perspective but prior to entering into any termination process formal legal advice would be sought.
- 5.5.3 The basis of compensation to the Contractor from the Council is the same as for Council default (Clause 35 of the Contract). This contains defined Compensation Sum payments in relation to the senior debt, costs for the Contractor and its subcontractors, and to the shareholders' subordinated debt (referred to as junior debt in the Contract) or share capital (equity) investments. This has to be paid within 20 business days by way of one lump sum. The defined calculation allows for the Compensation Sum covering: -
- i. The outstanding senior debt including swap break costs and outstanding interest, less upside swap break gains.
  - ii. Redundancy costs only for the Contractor and broader Sub-Contractor breakage costs, both only to the extent they are as a direct result of the termination.
  - iii. Future forecast distributions of subordinated debt and equity for the remainder of the Contract term, each separately discounted at the Financial Model Real IRR respectively.

- iv. Less any amounts standing in accounts, but only to the extent the senior funder has a fixed charge over them.

5.5.4 The Compensation Sum is then increased so as to leave the Contractor with the calculated amount after paying tax as necessary on the relevant elements of the gross receipt (i.e. tax gross up).

5.5.5 There are standard PFI set off provisions which prevent the Council setting off any outstanding amounts from the compensation sum save to the extent it doesn't reduce the senior debt payments.

#### Effecting the termination of the Contract

5.5.6 There are a number of elements of the termination process and Compensation Sum payments which either cannot be finalised at this time and / or are open to interpretation. These are explored in further detail in the business case.

#### Transfer of property and assets

5.5.7 The Contractor's lease arrangements to occupy the schools terminate automatically on termination of the Contract.

5.5.8 The Council has the option that all property and assets transfer to the Council in the event of voluntary termination.

#### TUPE Transfer of employees

5.5.9 Although this has not been explored in detail, Transfer of Undertakings (Protection of Employment) Regulations 2006 ("TUPE") provisions are almost certain to apply as the same Services will continue to be delivered post a termination albeit by a new provider. Until a decision is made on who the provider will be, the staff and TUPE implications cannot be resolved.

5.5.10 These will be the subject of discussion both with the Contractor and Mitie. The Council's Education and Human Resources teams have expertise and experience with TUPE transfer arrangements of staff between organisations and anticipate no significant issues.

#### Reprovisioning of the Services

5.5.11 In the event of termination, the schools have the right to choose who provides the services that are currently delivered under the Contract. The Council provides such services to other schools in the county borough, but the schools could select other private sector providers and / or deliver services in-house. Time has been allocated in the programme to allow the schools to make that decision and for the schools and new provider(s) to be engaged and feed into the termination and handover process with the existing Contractor.

#### Schools condition at handover

5.5.12 The schools were subject to a condition survey in 2018. These surveys concluded that both schools were in generally good condition. There was some backlog maintenance identified in those surveys, but the vast majority was low category, and it is likely that this would be built into the Contractor's upcoming lifecycle plans.

5.5.13 However, given the passage of time it is recommended that updated condition surveys are procured during school holidays prior to the issuing of a Termination Notice to obtain an up to date position. In particular, given the schools are around 20 years old, there are a number of items that would be due for major overhaul or replacement, including the boilers.

- 5.5.14 Identifying the latest assets conditions will support discussions on handover and financial settlement with the outgoing contractor, and the implications for lifecycle spend by the Council in upcoming years.

#### Risk Assessment

- 5.5.15 The most critical risks associated with the termination and with the Council providing the Services going forwards have been assessed. The allowances and risk contingency built into the business case are discussed in the economic case.

### **5.6 The Financial Case**

- 5.6.1 The financial case represents the Council's own assessment of the financial impact of terminating the Contract. This differs in some specific areas from the Green Book assessment captured in the economic case. In particular, it ignores the tax implications to government of the termination, and it factors in how the Council will fund the Compensation Sum.
- 5.6.2 The assessment demonstrates that the proposed termination significantly reduces costs compared to the current position, therefore improving affordability and budget positions. However, this is only the case if the Welsh Government continues to provide the grant support. Importantly, having reviewed the business case, the Welsh Government has now confirmed that the grant support will continue in the event of voluntary termination.
- 5.6.3 As with the economic case assessment the analysis is done over a period from the 1 April 2023 (i.e. the start of the financial year in which the assumed termination date of 31 July 2023 occurs). The assessment is considered in NPV terms based on the same 5.57% discount rate as applied in the economic case. The analysis applies the same underpinning assumptions as for the economic case and includes both Best Case and Worst Case scenarios.
- 5.6.4 As with the VFM assessment the analysis shows a significant net financial benefit for both Best Case and Worst Case scenarios, but the details of the financial case are currently commercially sensitive. However, at a high level early indications are that the revenue budget savings for the Council may be circa £2m per annum. The actual level of savings cannot be determined with certainty unless a termination actually takes place, but it is clear that the financial benefit is significant and will make an important contribution to the Authority's Medium-Term Financial Plan (MTFP) and may also provide an opportunity for some capital investment across the wider education estate.

### **5.7 The Management Case**

- 5.7.1 The management case identifies the key management responsibilities and key individuals for the proposed solution.

#### 5.7.2 Ultimate Responsibility

- The Chief Executive of the Authority is Christina Harrhy.
- The Senior Responsible Officer for the proposed termination is Stephen Harris, Head of Financial Services & Section 151 Officer.
- The Project Manager for the proposed termination is Sue Richards, Head of Transformation & Education Planning and Strategy.

### Timetable for Termination

5.7.3 Based on the contractual requirements for serving of termination notices, and the requirements in respect of negotiation of the commercial terms of the termination, as well as the logistical handover issues, the following draft timetable has been set out which assumes a termination on 31 July 2023. The programme has been separated into two phases:

**Phase 1** – Council decision making process and preparation for Phase 2.

**Phase 2** – The contract termination and transition phase (this will only happen if the Council decision from Phase 1 is to terminate the contract).

Action	Date	Comment
Council business case Approval	February – March 2023	<p>The decision making process to be as follows: -</p> <ul style="list-style-type: none"> <li>• Joint Scrutiny (28/2/23)</li> <li>• Cabinet (8/3/23)</li> <li>• Council (15/3/23)</li> </ul> <p>A full Council decision is required due to the need for borrowing to pay the termination compensation sum to the Contractor.</p>
Discuss and agree process with Schools	February - March 2023	Includes how services will be delivered post the termination of the Contract. This will commence ahead of final approvals to allow sufficient time.
Appoint adviser team to manage the termination process	March onwards 2023	Includes legal, technical, commercial, and financial advisers.
Undertake surveys at schools	March/April 2023	Allows for any contractual remedies to be implemented should issues be found ahead of finalising the compensation sum and the assets handover.
Issue termination notice	Early May 2023	Provides the 84 days' notice required for 31 July termination.
Engage with the Contractor and funder and finalise termination sum and agree process for handover including finalising a termination settlement agreement	March – July 2023	Discussions to cover financial, commercial, and logistical / staff related issues.
Compensation sum agreed and finalised	June - July 2023	Finalise funder breakage costs.
Handover process	March -July 2023	Process to be agreed and most activity to happen in school summer holidays.
Terminate Contract	28 July 2023 (Friday)	Handover for the purposes of responsibility, insurance cover etc to happen on this date.
Contractor final accounts settled, and Compensation Sum paid	July – September 2023	Contract requires Compensation Sum to paid within 20 business days

- 5.7.4 Whilst the above timelines are achievable and have been delivered on other projects it requires the co-operation of the Contractor and Sub Contractor, and also the ability to be able to get alternate services in place for a smooth handover.
- 5.7.5 Should there be delays to the timetable the termination could happen at a later date and would not materially impact on the value for money. October half term 2023 or Christmas 2023 are alternate options. However, the Council will have to be comfortable with the actual termination date before issuing the Termination Notice as that is a formal contractual trigger. Therefore, engagement with the schools and the Contractor before formally starting the process will be important.

#### The Working Group

- 5.7.6 The Project Manager will be supported in the proposed termination exercise by a Working Group consisting of key Council Officers. In addition to the internal team, the Authority will be supported by Local Partnerships, providing commercial and financial advice in relation to the termination, and supporting the project management. Other external advisers that will need to be appointed are: -
- Legal Advisers – potentially Counsel input may be additionally required to provide advice in relation to some of the aspects of the voluntary termination Contract provisions. This would be determined on appointment of legal advice.
  - Technical advisers – primarily in relation to School condition surveys and broader advice in relation to schools' condition on hand-back.
  - Swap benchmark advisers – to advise on the breaking of the funding agreements and negotiation of the swap breakage cost.
  - Accounting & tax advisers – due diligence on behalf of the Council relating to the financial consequences on termination of final company accounts and tax liabilities of termination.

- 5.7.7 The cost of external advisers has been factored into the business case.

#### Approval Process

- 5.7.8 Following Cabinet consideration on 08 March 2023, this report will be submitted to Full Council on 15 March 2023.
- 5.7.9 If a decision is made to proceed with the voluntary termination, then Council approval will be sought for delegated authority to be given to the Head of Financial Services & Section 151 Officer, the Head of Legal Services & Monitoring Officer, and the Cabinet Member for Finance and Performance to agree the final terms of the termination.

### **5.8 Conclusion**

- 5.8.1 The business case sets out a robust case for the Council to voluntarily terminate the Contract, on the basis of the financial benefits that can be achieved. In reaching this conclusion full consideration has been given to HM Treasury's five case model as it applies to this process.
- 5.8.2 Subject to the effective management of the termination process and the risks involved the termination of the Project represents the best solution identified. This will allow the schools to continue to provide much needed educational facilities, whilst achieving savings which the Council can utilise as part of its budget planning.
- 5.8.3 In order to achieve these savings for the Council and for the benefit of the local community, no additional funding is required from the Welsh Government, now that approval to proceed and confirmation that the grant support payments will continue unchanged for the original Contract period has been provided.

## **6. ASSUMPTIONS**

- 6.1 There are a range of assumptions in the business case which are presented as best and worst case scenarios.
- 6.2 If a decision is made to proceed with the voluntary termination, then it is currently assumed that the contract can be terminated by the end of July 2023. Should there be delays to the timetable the termination could happen at a later date and would not materially impact on the value for money assessment within the business case.

## **7. SUMMARY OF INTEGRATED IMPACT ASSESSMENT**

- 7.1 An Integrated Impact Assessment has been completed and concludes that in line with the processes and rationale outlined as part of the report being taken to Members, that Members endorse the proposal for voluntary termination of the Private Finance Initiative (PFI) agreements at Lewis School Pengam and Ysgol Gyfun Cwm Rhymni – Gelli Haf site only.
- 7.2 The Integrated Impact Assessment demonstrates that the proposal would have no impact on the current Educational provision offered at the two PFI sites.
- 7.3 The proposal will also ensure equity in terms of investment across the entire school estate.
- 7.4 Therefore, Members are asked to consider the Integrated Impact Assessment alongside the formal report and provide a final determination in support of the Voluntary Termination of the PFI contract.
- 7.5 The full Integrated Impact Assessment is available through the following link: -  
[Integrated Impact Assessment](#)

## **8. FINANCIAL IMPLICATIONS**

- 8.1 Like all local authorities, Caerphilly CBC continues to face significant financial challenges. Saving money from the PFI Contract would assist the Authority in the delivery of its Medium-Term Financial Plan (MTFP) and may also provide an opportunity for some capital investment across the wider education estate. In addition, the Welsh Government has requested that all Welsh local authorities with PFI contracts review them to assess whether they continue to offer value for money.
- 8.2 The financial assessment in the business case shows a significant net financial benefit for both Best Case and Worst Case scenarios. No detailed financial values are included in this report so as not to compromise the Council's position in its commercial negotiations and thereby impact upon the Council achieving best value from the process. However, at a high level early indications are that the revenue budget savings for the Authority may be circa £2m per annum. The actual level of savings cannot be determined with certainty unless a termination actually takes place, but it is clear that the financial benefit is significant.
- 8.3 The obligations under the Contract for asset maintenance and expenditure on asset renewals means the two PFI schools benefit from higher levels of asset related expenditure than the majority of the non PFI schools' estate in the county borough, where spend is prioritised based on a number of factors e.g. condition surveys, fire risk assessments. However, the Council has supplemented the costs of the Contract over and above normal levels of support to non PFI schools. The proposed voluntary termination will result in an equitable process across all schools in terms of capital expenditure post termination.

- 8.4 The Council has in-house capability to provide the services that are currently delivered under the Contract, and most schools in the county borough use these services. However, the schools have the right to choose whichever provider(s) they want. The process to determine the basis of on-going services provision will only commence if and when the Council approves the business case.
- 8.5 If the proposed termination is approved the two schools will receive funding through the schools' funding formula for the ongoing provision of services.
- 8.6 The final compensation sum and other associated external adviser costs will be funded through a combination of existing PFI reserves and borrowing, which will require Council approval. If a decision is made to proceed with the voluntary termination, then Council approval will be sought for delegated authority to be given to the Head of Financial Services & Section 151 Officer, the Head of Legal Services & Monitoring Officer, and the Cabinet Member for Finance and Performance to agree the final terms of the termination. The final quantum will be reported back to Council along with proposals to utilise the revenue budget savings arising.
- 8.7 It is important to note that the Council already has a legal obligation to make repayments under the existing PFI contractual arrangement and the proposal in the business case is to replace that current liability with one which provides better value for money for the Council.

## **9. PERSONNEL IMPLICATIONS**

- 9.1 Although this has not been explored in detail, Transfer of Undertakings (Protection of Employment) Regulations 2006 ("TUPE") provisions are almost certain to apply as the same Services will continue to be delivered post a termination albeit by a new provider. Until a decision is made on who the provider will be, the staff and TUPE implications cannot be resolved.
- 9.2 These will be the subject of discussion both with the Contractor and Mitie. The Council's Education and Human Resources teams have expertise and experience with TUPE transfer arrangements of staff between organisations and anticipate no significant issues.

## **10. CONSULTATIONS**

- 10.1 A briefing note has been shared with the headteachers and Chairs of Governors of the two PFI schools which is largely based on the content of this report.
- 10.2 Responses have been received from the Governing Bodies of both schools, and Officer responses have been provided (see Appendix 1 and Appendix 2).
- 10.3 The report on the "Proposed Voluntary Termination of the Caerphilly CBC School PFI Contract" came before a joint-meeting of the Policy and Resources Scrutiny Committee and the Education Scrutiny Committee on 28 February 2023. The key points raised during the meeting were as follows: -
- One Member asked what the preferred option for providing maintenance services would be should the current PFI Contract be terminated at the two schools. The Member enquired if future provision would be provided by in-house or private operators. The Head of Financial Services and Section 151 Officer advised that this would be for both schools to determine individually should Council approve the business case.
  - A Member observed that if the contract was terminated, she would like to see any savings made kept within the Education service area. The Head of Financial Services and Section 151 Officer highlighted that a process to agree compensation would follow a decision to



voluntarily terminate the PFI Contract under discussion. It was also outlined how the joint-meeting of both Scrutiny Committees would be reconvened in the future to discuss options around any potential savings.

- One Member enquired why it had taken so long to reach this stage of the process given that Local Partnerships LLP provided their original report to Council in 2018. Members heard how the original decision to commission the development of a business case was made in 2018 and that a review of the subsequent findings had been delayed by the need to redirect resources due to the national Covid-19 pandemic. The Member also asked if legal considerations had been fully explored around the fact that the original successful bidder for the PFI contract “Ballast Wiltshier” no longer existed. Members received assurances that such matters had been fully considered. Mr Mike Read (Project Director with Local Partnerships LLP) outlined how the terms of the agreement had not changed, how the contract was now with Machrie Limited, and that external legal advice would be sought if the Council decided to voluntarily terminate the PFI contract.
- A Member expressed concern over the lack of consultation and information highlighted by the Ysgol Gyfun Cwm Rhymni governing body in Appendix 1. The Head of Transformation and Education Planning and Strategy highlighted the commercially sensitive nature of data within the Business Case and provided details of meetings that have taken place with both schools and the support that would be made available to them if the process progressed.
- One Committee Member wished to know if there was a risk that the level of compensation due as a result of terminating the PFI contract would make the decision economically unviable. The Head of Financial Services and Section 151 Officer advised that the contract would not end until a notice of termination was officially served and that this would not happen if it was not financially viable for the Council. The Member asked why the original contract had not been circulated as it was not confidential due to being initially signed by school representatives. During the ensuing discussion the issue of the need for commercial confidentiality was highlighted and it was suggested that distribution of the original contract should be discussed outside of the meeting. It was also suggested that the contract with sensitive information redacted could be circulated to Committee Members. Members also heard how release of the contract was the subject of a recent Freedom of Information request and that this had been refused by the provider on the basis that putting the PFI contract into the public domain could affect their commercial interests.
- The Head of Financial Services and Section 151 Officer provided assurances to one Member on the provision for any slippage in terms of the timescale set out in the report.

- 10.4 Having noted the content of the report, it was moved and seconded that the following recommendation be forwarded to Cabinet for approval. By way of Microsoft Forms (and in noting there were 18 for, 0 against and 1 abstention) this was agreed by the majority present.

RECOMMENDED to Cabinet that they:

Consider the content of the report and support the proposal to voluntarily terminate the Caerphilly CBC School PFI Contract prior to Council consideration.

- 10.5 All other consultation responses have been reflected in the report.

## **11. STATUTORY POWER**

- 11.1 The Local Government Acts 1998 and 2003.

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Appendices:

- Appendix 1 Response by Governing Body of Ysgol Gyfun Cwm Rhymni regarding the potential termination of the Caerphilly CBC School PFI Contract.
- Appendix 2 Response by Governing Body of Lewis School Pengam regarding the potential termination of the Caerphilly CBC School PFI Contract.