CITY OF YORK COUNCIL

Highways PFI Ad-Hoc Scrutiny Committee **26 February 2007**

Highways Maintenance Procurement Process & PFI– Final Draft Report

Background

1. In September 2006, Scrutiny Management Committee (SMC) agreed to proceed with a review of topic No.135, into Highways Maintenance Procurement and the Private Finance Initiative (PFI)[1] bid. SMC were informed that the Expression of Interest (EoI) associated with the PFI bid had already been submitted to the Department of Transport (DfT). They therefore requested that the original topic registration registered in April 2006 by Cllr Tracey Simpson-Laing, be revised to take this development into account.

2. In November 2006 SMC considered the revised registration together with a draft remit which proposed the issues raised be dealt with in two parts. SMC agreed that part A of the review should centre entirely on how scrutiny could help prepare for the procurement of highways maintenance when the outcome of the PFI is known and consequently, how it could contribute to maximizing the Council's efficiencies and improving its procedures. It was felt that this would contribute proactively to the ongoing development work in anticipation of the outcome of the PFI bid in January 2007.

Corporate Priorities

3. It was recognised that this review could contribute to improving 'the actual and perceived condition and appearance of the city's streets and open spaces' by helping to improve the Council's procurement arrangements for highways maintenance. In rationalising our procurement arrangements, it could also help to improve our organisational effectiveness.

Options

4. Members can support all, some or none of the recommendations proposed as a result of this review, for submission to Scrutiny Management Committee and then to Executive.

Remit

5. In coming to a decision to review this topic, the Scrutiny Management Team recognised certain key objectives and the following remit was agreed:

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1 A PFI is a scheme where the Government contracts a private company to carry out an agreed programme of works involving a public service over a fixed term.

Aims

To contribute to the development and establishment of a strategic and effective highways maintenance procurement strategy in York

To understand the cost implications associated with the PFI bid and its outcome if successful.

Objectives

- examining the potential efficiencies from a PFI arrangement;
- making recommendations with regard to available alternative options in the event that a PFI outcome is unsuccessful;
- looking at the cost effectiveness of those options, including improved ways of working;
- profiling expenditure over the lifespan of the PFI and any associated secondary costs.
- To understand the cost implications associated with the PFI bid and its outcome.

Examining the potential efficiencies from a PFI arrangement

Consultation

6. Prior to the commencement of this scrutiny review, the Council had already submitted an Expression of Interest in relation to the Highways PFI. As part of that process officers had fully examined the potential efficiencies which could be gained from a PFI arrangement.

Information Gathered

7. The identified efficiencies and other potential benefits to be gained from a PFI arrangement include:

- Clearing the backlog of repairs
- Improving maintenance services to allow the right maintenance at the right time
- Lower future maintenance requirements
- Effective and efficient network management resulting in improved traffic flows, accessibility and reliability
- Improvements in congestion, air quality and ecological footprint[2]
- A safer and secure environment
- The provision of sufficient investment to contribute to the development of broader Council objectives

Issues

8. Members of the Committee studied the EoI previously submitted. This highlighted the problem facing City of York Council as it identified a substantial

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[2] York is the only city in the country with an Eco Footprint model and a target of 70% reduction on carbon emissions over the next 50 years.

backlog of maintenance works on the highway network valued at an estimated £127.5m. It recognised the council's inability to fund whole life cycle asset management principles through intervention maintenance, resulting in an accelerated decline in asset value and network conditions. To be able to rehabilitate the asset and meet the central Government target of eliminating highways backlog by 2014/15, it is estimated that an additional £155m of capital life cycle replacement would be required to maintain the rehabilitated asset over the next 20 year period.

9 Members considered the options available to the Council listed in the EoI and were confident that consideration had been given to the possible efficiencies to be gained from a PFI arrangement, and that no further work was necessary in relation to this objective.

10. It was recognised that in order to decide whether to proceed to the next stage of the PFI process, the Council would need to weigh up the recognised efficiencies against the annual commitment in terms of budget which would be required over the 25-year term of the PFI[3].

11. Members acknowledged that PFI has the greatest potential to deliver an holistic approach across the entire unitary authority area, compared to other schemes, because of the generous PFI credit arrangement.

Recommendation

12. That the efficiencies and other benefits gained through the PFI approach, as highlighted within the EoI be weighed against any budgetary inflexibility in future years, when deciding whether or not to proceed with the PFI process.

Reason: To ensure the most effective and financially viable outcome for highway repairs and maintenance, within the overall City of York Council budget is achieved.

Implications

13. There are no quantified Financial, HR, Equalities, Legal or other implications associated with the above recommendation.

Available alternative options in the event that a PFI outcome is unsuccessful

Consultation

14. The Assistant Director of City Development & Transport provided the Committee with information on two simplistic alternative options to PFI – see Annex A.

Information Gathered

15. In considering these two alternatives, it was recognised that:

3 The Council would be committed to the PFI irrespective of any future budget constraints

a. both had merits and drawbacks
b. between these two different approaches there were potentially many possibilities for combining elements of each.
c. many Local Authorities have been operating a hybrid approach which incorporates aspects of each of the two alternatives outline in Annex A.
d. careful consideration would need to be given to achieve the optimum solution for each particular aspect of work to be undertaken

Issues

16. The Committee were drawn towards the partnership approach but recognised the complexity of calculating the optimum solution for procuring service delivery. The Committee agreed that, given the timescale, it would be better to look at the key principles which should be taken into account at the time of selecting an alternative approach, rather than attempting to determine which approach should be used. It also recognised that the work undertaken to produce the EoI would assist any other work required if the PFI outcome was unsuccessful. Members identified the following key principles which they felt would need to be considered when deciding how to proceed:

(a) Affordability

The level of funding available will influence which work method is adopted. Any work programme should be accurately costed as far as possible at the outset to avoid any overspends.

(b) Value for Money

Historically, some local authorities engaged in partnerships for efficiency savings which did not ultimately materialise. Some in-house arrangements in the past were not always efficient which led to ? and current evolution. Any contract should ensure that perceived efficiencies are realistic and are delivered.

(c) Sustainability

The Transport Asset Management Plan (TAMP) should be reviewed on a regular basis to ensure that the most sustainable working practices and materials are used.

(d) Risk Management

Members were particularly concerned regarding this issue. It was acknowledged that the balance and transfer of risk is central to any procurement consideration. If a partnership route is adopted, it should be ensured that the appropriate level of risk is borne by each party.

(e) Degree of Control

Regardless of the approach undertaken, the Council should ensure that control of any project is suitable to the selected approach. Where work is held in house, it was acknowledged that there were might be less flexibility in how work was carried out. It was also noted that Members control would have to be exercised differently and probably at a more strategic level. These would not be applicable in a partnership approach.

(f) Innovation

Any contractor should embrace new innovative approaches in working practices, machinery and materials to ensure that any construction is undertaken to the optimum benefit of the Council, contractor and residents and this needs to be contractually encouraged.

(g) Residents Priorities

Priorities of residents should be considered in any undertaking and in the planning and construction of any development. Issues raised should be catered for as much as possible bearing in the mind contractual restraints and provided neither the quality nor the efficiency of work are detrimentally affected.

(h) Long Term Consequences

Members recognised these would exist in any partnership approach and would not necessarily be apparent at the outset of any contractual arrangement. They appreciated, however, that selecting the 'right' partner in any contractual arrangement could help minimise adverse consequences.

Recommendation

17. That in the event that the PFI outcome is unsuccessful, the key issues identified should be taken into consideration when deciding upon an alternative approach.

Reason: To ensure the best alternative option for procuring service delivery.

Implications

18. There are no quantified Financial, HR, Equalities, Legal or other implications associated with the above recommendation.

The cost effectiveness of alternative options to PFI, including improved ways of working

Consultation

19. Officers from the Council's Resources Directorate provided information on various sources of alternative funding. It was recognised that some of the different sources would only be applicable to certain approaches. Some were unlikely to fund maintenance works and others would not provide funding on the large scale required.

Information Gathered

20. The alternative sources of funding identified were:

(a) Venture Capital[4]
This would only be available for partnership working if a case could be made for this.

(b) Venture Fund
It was understood that funds could be drawn down from the Fund (part of the Council's Reserves) with the Fund expecting return of profit. However, it was acknowledged that the Venture Fund was inadequate for the programme under scrutiny.

(c) Prudential Borrowing[5]
This would provide funds with which to undertake a works programme, but this would not have the advantage of PFI credits and it would be necessary to identify where savings could be made in future years to repay the loan.

(d) Yorkshire Forward[6]
It was considered that there would need to be an identifiable improvement to the economic wellbeing of the city over and above the Council's normal maintenance programme, in order to access funding from this source. It was also considered that there would probably have to be a benefit to the region.

(e) National Lottery
It was considered that the amounts of funding would be relatively small and that it would be a support but not a major source. Funding from the Lottery would be for very specific purposes, e.g. heritage, arts, sports, Conservation Areas etc, and would not be available for maintenance programmes.

(e) European funding sources
It was considered that any EU funding would need to be linked with partnership working between countries. Access to funding from this source was likely to be tied to specific projects, separate from normal maintenance and would not necessarily depend solely upon the scheme but also how it would be implemented and what new innovation was involved.

Issues

21. The Committee acknowledged that on the basis of the information received, the Council could not expect to receive sufficient alternative funding on the scale of PFI to finance all of the identified remedial works required to the highways infrastructure. This in turn would result in it's further decline.

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4 Venture capital (VC) is funding invested, or available for investment, in an enterprise that offers the probability of profit along with the possibility of loss.

5 Prudential Borrowing allows local authorities to raise finance for capital expenditure – without Government support - where they can service the debt without extra Government support.

6 Yorkshire Forward is the Regional Development Agency charged with improving the Yorkshire and Humber economy

22. In order to complete all of the remedial works required and sustain a full maintenance programme, the Council would have to make a much larger annual commitment in terms of budget than that which would be required over the 25-year term of the PFI. This again would have far reaching financial implications.

Recommendation

23. That in the event that the Council's EoI is successful, the decision to proceed to the next stage of the PFI process, i.e. submitting an Outline Business Case[7] (OBC), be weighed against the resulting greater annual budget commitment required from the Council if the highways repair and maintenance works are to be carried out.

Reason: To ensure the most cost effective method for funding the required works.

Implications

24. There are no quantified Financial, HR, Equalities, Legal or other implications associated with the above recommendation.

Profile of expenditure over the lifespan of the PFI and any associated secondary costs

Consultation

25. The Assistant Director (City Development & Transport) provided information on some of the factors which will affect the overall cost of a PFI arrangement to the Council. One of the main factors would be managing the risks involved. As part of the process of drawing up a PFI contract between a potential partner and the Council, an appropriate level of risk should be considered and agreed by each party.

26. Contract costs would be influenced by the level and amount of risk accepted by the partner. Therefore, the Council will need to take account of this within the negotiations.

Information Gathered

27. Two main risks were identified as follows :

(a) <u>Project Risk</u>
i)Not achieving a signed contract at the end of the PFI bidding process. This is a pathfinder project i.e. the Department of Transport (DfT) want to identify a best practice approach for future use. As a result, it is recognised that the whole process could take longer to complete which would result in higher costs than the £2.5m previously identified. It is

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7 The term "outline" refers to the fact that in the initial stages of a project, a business case can only be drawn up in outline form. The intention is, that as the project progresses it will become a "living document" and be subject to further iterations and refining of the content.

expected that the DfT will provide advice, resources and possibly financial support to assist the process.

The investigative works are likely to have significant cost which would be beneficial for a PFI contract though, if unsuccessful, the benefits from the information gained would not necessarily outweigh the costs incurred. The survey may also highlight unforeseen problems generating additional work and costs.

(b) <u>Contract Risk</u>

There are several areas within the contract where the amount of risk to be transferred would need to be carefully considered:

i) Latent Defects[8]

The cost of latent defect risk will be priced by the Service Provider (SP) dependant on the level of transfer the Council attempt to pass down in the PFI contract. In general the market is willing to accept uncapped liability for Carriageways and Footways on the basis that the highway network is mature and works associated with their rehabilitation and on-going maintenance will not involve major excavation below the existing construction layers. There are two areas which cause concern to the market:

- Drainage - Structural failure on the Council network e.g. collapsed gully connections in the carriageway which did not occur through improper maintenance by the SP. The position the SP adopts in respect to the Council drainage is largely dependant on the availability and size of asset data, existing maintenance regime, and records of past works undertaken resulting from latent defect failure. Should the negotiation of the contract result in risk being taken by the Council, the assessment of the engineering scenarios and relative costs suggest this exposure will be low risk low cost.

- Structures - an inherent fault resulting in major structural failure of a bridge which did not occur as a result of inadequate maintenance by the SP. The contract will contain a liability cap on the SP to cover latent defects in structures which can be limited to the Council's key structures, i.e. those structures of high capital replacement value in light of major catastrophic failure. The caps are operated on an individual and aggregate basis. The adequacy of the cap and exposure to risk will be informed by the technical review of the data room information and priced accordingly. Ultimately, the value of caps will be set to represent a commercially affordable solution and demonstrate sufficient risk transfer to offer value for money.

ii) Legislation

No contractor would accept risk related to changes in legislation. This is a non-transferable risk and the effects are unforeseeable.

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8 A latent defect is a hidden or dormant fault/defect that could not be discovered by observation or by a reasonable thorough inspection.

iii) Inflation
Any contract will allow for a certain level of inflation but over such a long term project it is impossible to completely cater for extreme variances. Any contract will be vulnerable to higher inflation in the early years.

iv) Vandalism
It is impossible to foresee what effect this may have on any contract and any partner would be reluctant to accept this risk without some form of indemnity from Council.

v) Breach of Contract
A breach could stem from a deterioration of service over a period of time. This could have a significant impact on the level of management and maintenance. Although there is recourse through contractual and financial arrangements, there would be a level of disruption while a satisfactory solution was achieved.

In the unlikely circumstances of a company liquidation the Council will have the additional protection of the bank's involvement, including early warning, which is more secure than the current private arrangements.

vi) Affordability
The long term nature of this type of contract raises questions regarding the level of funding which the Council could and would commit with the internal and external funding pressures and legal constraints it faces.

vii) Insurance
The risk would be where the contractor would accept the risk, to a certain limit, after which point the Council would be expected to bear the balance, though there could be a cost-sharing basis to a certain level.

viii) Climate Change
Over such a long-term project the impact of climate change cannot be quantified. The potential for global political, financial and environmental changes may have far-reaching and unforeseen consequence which may impact on the contract. This would not be a risk that the partner would accept.

Issues

28. It is clear that it is impossible to identify all possible risks involved with such a long term contract but failure to maintain and repair the highways infrastructure carries its own risks. For example, the Council presently self insures against claims, and has an extremely successful repudiation rate, but it is considered that the number of claims would be likely to increase as the infrastructure continued to deteriorate. Also, as central Government has set a target of eliminating highways backlog by 2014/15, the Council may incur costs if this work is not completed on time.

Recommendation

29. That it be noted that the total expenditure over the lifespan of the PFI cannot be properly identified.

    Reason: There are too many unknown quantities at this stage in the process.

Implications

30. There are no quantified Financial, HR, Equalities, Legal or other implications associated with the above recommendation.

The cost implications associated with the PFI bid and its outcome

Consultation

31. The Assistant Director (City Development & Transport) presented information on the timetable for the remaining stages of the PFI process – see Annex B. This included information on each stage and the points at which a decision would need to be taken on whether or not to proceed.

32. Information was also presented on a number of procurement risks which could impact on the PFI scheme:

    - Time – the longer the negotiations are, the more expensive the cost.
    - Cost
    - Change of Rules
    - Attractiveness of Contract –the contract must be attractive to bidders otherwise the scheme will be a waste
    - Challenge and Withdrawal – a bidder could challenge the procurement process and withdraw from the negotiations

Information Gathered

33. The Director of Resources presented a summary of the budget for 2007/08 which highlighted expected pressures – see Annex C. It was recognised that a decision to proceed with the next stage of the PFI bid, i.e. submitting an OBC would have an effect on the 2007/08 budget. The summary also recognised that the largest proportion of cost would be likely to be incurred in 2010/11, as the majority of cost occurs in the last few months.

Issues

34. Although there are recognised cost implications associated with a PFI bid, costs would be reimbursed when the PFI scheme commenced. It is clear that the overall cost to the Council of the PFI approach would be less than completing the same amount of work of the same quality and standard via alternative methods. The Council could only finance the same amount of remedial and maintenance works as done through a successful PFI, by putting severe constraints on other budget commitments over the 25-year period.

35. The drawback of the PFI route would be that the Council cannot predict what else may occur during the next 25 years that may result in further budget pressures and once a PFI contract is signed, the Council could not reduce its financial commitment to the repairs and maintenance works to allow the budget to be reassigned. The Council would have little room to manoeuvre with regard to its financial commitments.

36. The current variance is £0.5m - £1.0m, though until detailed calculations have been undertaken, to assess the affordability of the scheme, the actual variance will not be known. It was also acknowledged that the difference between the current allocated budget and the notional budget assumed in the EoI was in the region of £1.25m, and members were concerned that the OBC should identify a means of addressing the shortfall.

37. Members also acknowledged that other unquantified known short to medium term budget pressures (e.g. Waste PFI) exist, and recommended that an holistic view of the financial constraints of the Council will have to be taken.

Recommendation

38. That in the event that the EoI is successful, careful consideration should be given when deciding whether to proceed to each of the following stages of the process.

Reason: To ensure a full understanding of the cost implications.

Implications

39. There are no quantified Financial, HR, Equalities, Legal or other implications associated with the above recommendation.

Acknowledgements

The Committee would like to record its thanks to the various officers who have supported its work. The assistance and advice received has been appreciated, and without this support it is unlikely that the scrutiny could have been completed in the timescale. In particular thanks go to:

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Final Report Approved ✓ **Date** 22 February 2007

Councillor Richard Moore
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Highways Maintenance Scrutiny Ad-Hoc Sub-Committee

Wards Affected: **All** ✓

For further information please contact the author of the report

Background Papers:
Local Government Private Finance Initiative (PFI): CYC Expression of Interest

Annexes
Annex A – Alternative Procurement Options for 2010
Annex B - Timetable of remaining stages of PFI process
Annex C – Presentation on budget Pressures