APPENDIX 1

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24 March 2006

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Dear Mr Strang

Schools PFI Project
Final Comment on Value for Money

Purpose and Responsibilities

Securing value for money (together with affordability) are key requirements for public bodies to progress PFI projects.[1] I have examined the analysis provided by the Council's financial adviser and this letter provides South Lanarkshire Council with my comments on the value for money of the Schools' PFI Project. These comments should not be regarded as advice.

South Lanarkshire Council is accountable to the public for the stewardship of funds under its control. It is for the body alone to take decisions about whether value for money is being achieved for any transactions it is considering entering into, after taking whatever advice it deems necessary.

The letter is provided to inform you of my views at this stage as external auditor and for no other purpose. In particular, no responsibility is accepted towards any other organisation or individual who may seek to place reliance on its contents.

Audit Scotland's Code of Audit Practice sets out clearly the nature of public sector audit and the general duties of external auditors operating under that audit regime. The Statement of Responsibilities of Auditors and of Audited Bodies provides further clarification of the respective roles of both parties.

Conclusion

The analysis prepared by the Council's financial adviser demonstrates overall value for money, although I believe that the Council should consider the basis for the PSC estimate of FM costs. This element is significantly different from the cost in the preferred bid. A limited comparison to other projects indicates that the preferred bid cost is reasonable.

[1] Treasury Taskforce Technical Note 1 - How to Account for PFI Transactions and Scottish Executive's draft VFM assessment of PPPs in Scotland

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Changing circumstances

My view as set out in this letter is based upon the information presented to me as at 14 March 2006 in the documents listed in the appendix. If circumstances change, or further information becomes available, then I may have to reconsider my view.

In this regard I would draw attention to the fact that project negotiations are continuing and the risks and costs associated with the project may alter, which could materially affect the value for money assessment. Changes may have a material impact on my comment.

My views are also expressed in recognition of the current underlying guidance including:

- Scottish Executive's VFM assessment of PPPs in Scotland;
- HM Treasury Green Book; and
- HM Treasury Value for Money Assessment Guidance.

Single bidder status

South Lanarkshire Council's Schools PFI project was tendered under OJEU rules on 16 June 2003 and thirty-five organisations registered an interest in participating in it. Two pre-qualification questionnaires were returned and both consortia were considered eligible to proceed to the invitation-to-negotiate stage. Competition has been demonstrated by the existence of more than one robust bid at that stage in the procurement process. The AMEC consortium was selected as the preferred bidder on 2 February 2005. .

Specific circumstances of this project

My comments on the value for money assessment take into account the specific circumstances of this project. These include:

- refurbishment is not considered as a major element (4.1% of capital expenditure);
- the project is a large-sized schools' project; and
- catering, cleaning and janitorial services are excluded.

Adjustments to the public sector comparator/ bid comparator model

As part of assessing value for money in a PFI project, the Council prepares and updates a Public Sector Comparator (PSC) or Bid Comparator Model (BCM). The PSC/ BCM provides quantified evidence that the PFI option is value for money against a shadow PFI/ preferred bidder's model. This comparison demonstrates that PFI procurement represents better value than conventional procurement.

The estimates and adjustments used in the PSC/ BCM are critical elements in demonstrating value for money. Our review of these estimates and adjustments identified the following issues:

Discounted cashflow calculations

The PSC and the shadow bid/ preferred bidder's model present costs using discounted cash flows to derive a net present value (NPV) for each option. It is important that these cash flows are consistent and reasonable.

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I have re-performed the assessment based on the cash flows identified in models provided by the financial adviser. I have used 1 April 2006 as the base date for my NPV calculations and discounted at 3.5% (real)/ 6.09% (nominal). The preferred bidder's model is based on six-monthly cash flows. Both models commence in 2006/2007 and end in 2039/2040.

The NPV of the PSC indicated in the Council's model is £451.4 million. This model assumes that cashflows arise at the end of each 12 month period. This contrasts with the preferred bidder's model which assumes cashflows arise at the end of every six month period. In order to ensure consistency in comparison, I have assumed that the PSC cashflows arise at the end of nine months (average of 6 and 12 month points used in the bidder's model). This adds £4.1 million to the PSC and increases the VFM headroom by the same amount.

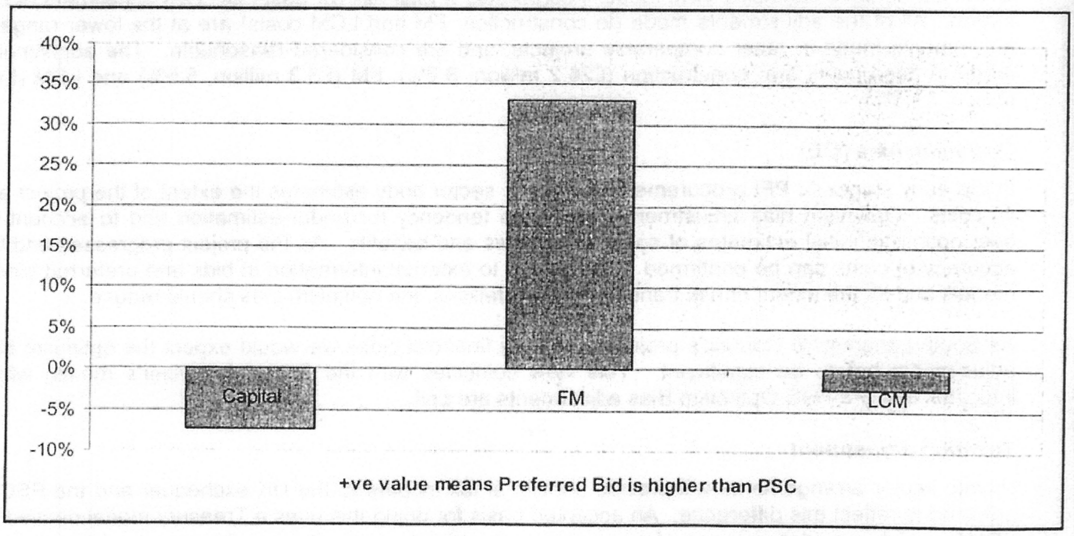
The financial adviser has aggregated the six-monthly cashflows in the preferred bidder's model to derive an annual cash flow model. My analysis has reverted to the six-monthly cashflows and timings taken from the InspirED financial model. This increases the preferred bid model by £6.1 million and reduces the VFM headroom by this amount.

Base Construction/ Life Cycle Maintenance/ Facilities Management Costs

Typically, the base costs of construction in a preferred bidder's model are higher or similar to those in a PSC. Further adjustments are then made to the PSC to represent the additional risks borne by the Council of using traditional procurement).

In South Lanarkshire Council's model, the base construction and lifecycle maintenance costs in the preferred bid, compared to the PSC assumptions are reasonably consistent

Exhibit 1: Preferred bid elements vs PSC



However, the base facilities management cost (i.e. before risk adjustment) contained in the preferred bidder's model (£103.4 million) is significantly higher than the cost in the PSC (£77.8 million - following adjustments by the financial adviser to insurance costs). The procurement process did attract another bid in a competitive environment and this could indicate that the original PSC estimates for FM costs were understated rather than any issue with the competitiveness of the preferred bid. I have further reviewed this issue later in this report after comparing FM costs in other schools' projects.

If the original PSC estimate is low, then any adjustment would improve the VFM headroom.

Land Receipts

The South Lanarkshire project identifies significant receipts that can be achieved through the sale of surplus land. These receipts form part of the PFI contract and are an inherent part of the preferred bidder's financial model (£48.05 million notional). The financial adviser's PSC model takes into account the effect of land receipts and the costs are shown net.

There is a NPV cost differential between the receipts achieved within the PSC and preferred bid model (£42.4 vs 39.4 million). This is attributable to the incorrect discount factor used in the PSC. The nominal amounts included in the PSC model are taken from the preferred bid, but these have been discounted at 3.5% rather than the combined nominal rate of 6.0875%. This has the effect of overstating the net present value of these receipts in the PSC, by £3 million. Adjustment would increase the PSC and VFM headroom by this amount.

Risk Adjustments

A key feature of PFI schemes is that certain risks are transferred to the private sector. This commonly includes construction cost and duration over-runs, where the private sector bears the risk of delivering operational property assets on time and within financial constraints. In order to represent this in the value for money assessment, the PSC is adjusted to reflect risks which are transferred under the PFI agreement.

South Lanarkshire Council's VFM model incorporates a total risk (or post-FBC OB) adjustment of £34 million. All of the adjustments made (to construction, FM and LCM costs) are at the lower range of adjustments made in other comparable projects, and are considered reasonable. The adjustments made to base costs are: construction (£26.2 million, 8.2%), FM (£3.3 million, 5.5%) and LCM (£4.5 million, 11.1%).

Optimism bias (OB)

In the early stages of PFI procurement, the public sector body estimates the extent of the project and its costs. Optimism bias adjustments reflect the tendency for under-estimation and to account for over optimistic initial estimates of costs, timescales and benefits. As the project progresses and the accuracy of costs can be confirmed by reference to external information in bids and preferred bidder models and as the extent of risk transference crystallises, the optimism bias should reduce.

As South Lanarkshire Council's project is nearing financial close we would expect the optimism bias adjustments not to be significant. This view coincides with the financial adviser's model, which indicates that pre-FBC Optimism Bias adjustments are £nil.

Taxation adjustment

Private sector arrangements will provide additional tax income to the UK exchequer and the PSC is adjusted to reflect this difference. An accepted basis for doing this uses a Treasury model derived by KPMG, which provides a range of percentage adjustments depending on the nature of the scheme and private sector accounting treatment proposed.

The level of adjustment is in accordance with a basic adjustment under the KPMG model of 5%. The financial adviser adjustment is based on the costs in the preferred bid.

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VFM headroom

The VFM model from the financial adviser shows that the total NPV of the PFI is £43.7 million or 9.7% less than the PSC comparator, indicating that value for money has been achieved. As noted in the preceding paragraphs, I have identified potential adjustments and these are summarised in Exhibit 2:

- Use of Preferred Bid six-monthly cash flows;
- Adjustment to PSC cashflow timing to nine-month point; and
- Removal of land receipts differential, due to discount rates.

Exhibit 2: Summary of potential adjustments

Potential adjustment	**£ million**
Revert to Preferred Bid model six-monthly cashflows	-6.1
Take PSC cashflows to December (9 month point)	4.1
Correction of discount rate on land receipts	3.0
Total adjustment	**1**

Applying these adjustments indicates that the VFM headroom increases slightly, but the overall adjustment is not significant

Comparative costs per square metre

A number of projects of this type are being undertaken by other councils and this provides the opportunity for a comparative assessment of value for money achieved by the PSC. The following graph represents the base NPV cost per square metre derived from the financial models of preferred bidders in five current schools schemes.

Exhibit 3: Costs per square metre – NPV (Scottish Schools' Preferred bidder models)

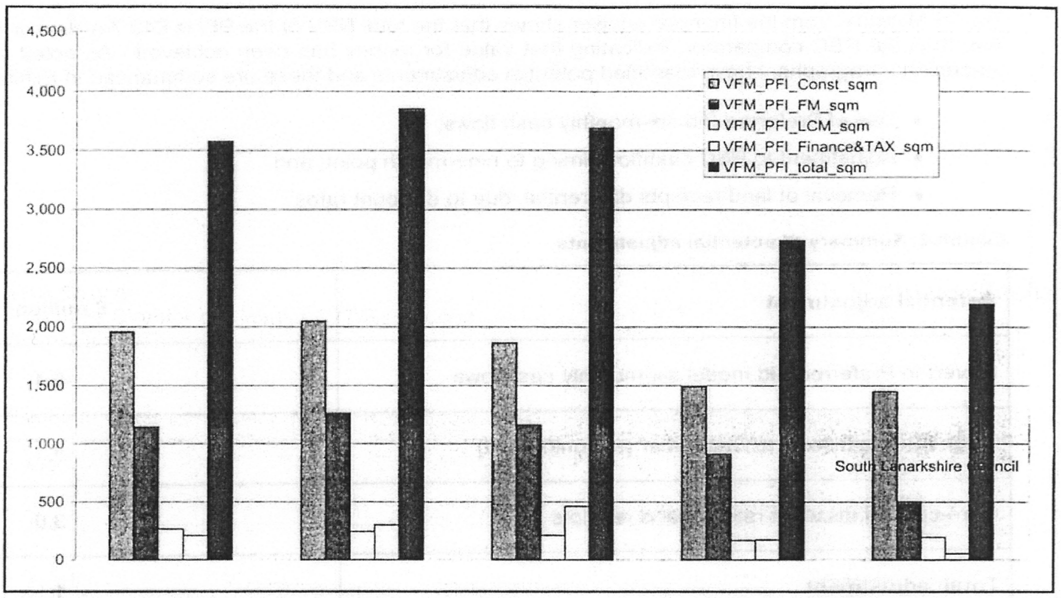


Exhibit 3 shows that the South Lanarkshire Council project has the lowest overall, construction and facilities management costs per square metre, compared to five recent projects. Given the size and scope of the project it is not unexpected that South Lanarkshire Council has achieved such low comparative costs. The project is twice the size of recent schools' projects and this helps to absorb the fixed cost elements of the bid and financing process. Additionally, the extent of FM services in the project is less than other projects. The comparison shows that the total cost of South Lanarkshire's Schools PPP project is £2,196 per square metre (including unitary charge and land receipts). The nearest equivalent is also a central-belt schools' project with a total cost of £2,736 per square metre.

The nature of the South Lanarkshire schools' project is unusual as it excludes most soft FM services that are usually contained in similar PFI projects (particularly cleaning and janitorial services). This means that the average FM cost achieved in other recently concluded Scottish schools projects of about £1,100 per square metre (whole life NPV), is not a good indicator of the expected costs in South Lanarkshire. However, we have limited data that identifies between 53% and 39% of total FM costs in another project may be attributed to the remaining FM services (ie excluding the same soft FM services as the South Lanarkshire project). This indicates that the South Lanarkshire cost of £501 per square metre is reasonable.

Exhibit 4: FM Costs per square metre – NPV (Scottish Schools' Preferred bidder models)

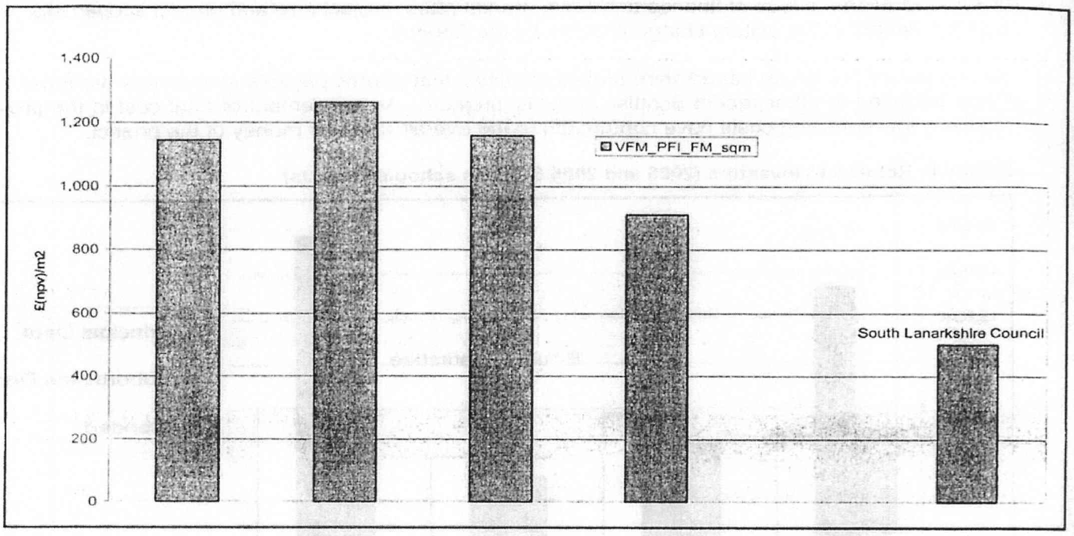
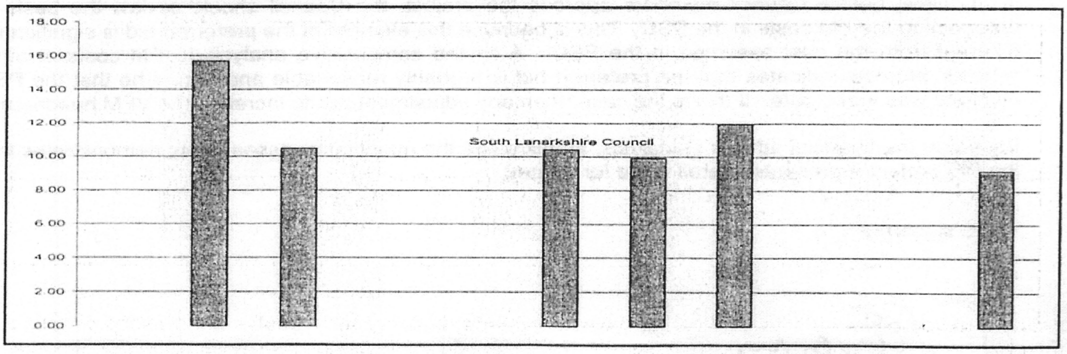


Exhibit 5 considers the floor area per pupil (design capacity) and compares the result to other Scottish schools' projects, where we have data. The total floor area per pupil, at 10.41m^2, is consistent with other Scottish PFI schools' projects.

Exhibit 5: Floor area per pupil - (Scottish PFI Schools)

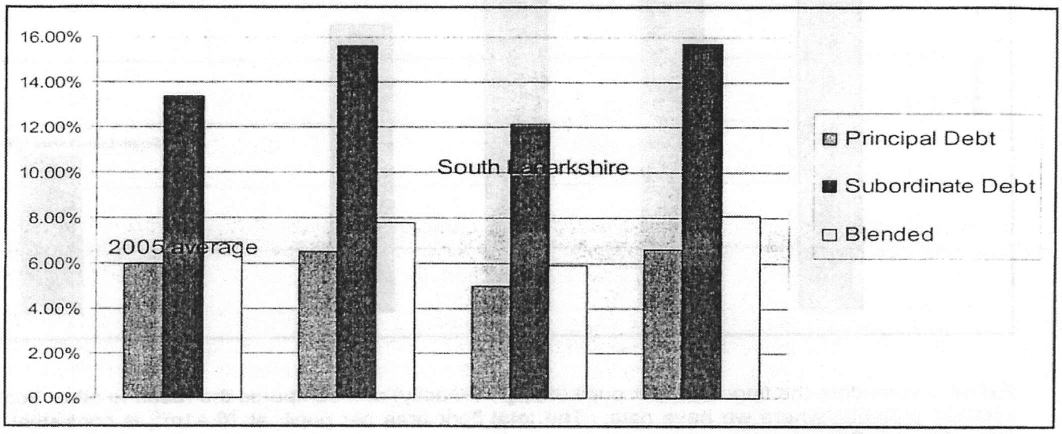


Investor returns/ application of unitary charge

PFI projects are financed by private sector institutions. In return for their capital investment, investors receive interest, principal repayments and dividends. The total investment can be divided into three elements: principal debt (largest proportion of the funding – usually 90%), subordinate debt (8-10%) and equity (perhaps £50,000). The level of risk borne by each investor (to their return and capital) varies from principal debt providers (lowest risk and return) through to equity investors (highest risk and return). The overall weighted return to investors (the blended return) provides an indication of the cost to the operator of financing the project. The cost of financing a project can depend on many factors including the type of finance achieved, market rates, project size and project scope/risks. This cost is reflected in the unitary charge payable by the Council.

An analysis of the South Lanarkshire project identifies that returns payable to investors are lower than those achieved in other recent Scottish schools' projects. As an element of total cost in the project, relatively low financing costs have contributed to the overall value for money of the project.

Exhibit 6: Returns to Investors (2005 and 2006 Scottish schools projects)



Overall Conclusion

In my view, before Council members approve the project, the Council should review the basis of determining the FM costs in the PSC. This is because this element of the preferred bid is significantly different from the cost assumed in the PSC. A limited comparative analysis to FM costs in other schools' projects indicates that the preferred bid is probably reasonable and it may be that the PSC estimate was inaccurate. If this is the case, then any adjustment would increase the VFM headroom.

Based on the financial adviser's analysis, at this stage the quantitative assessment demonstrates that the PFI project represents overall value for money.

Yours sincerely

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Appendix 1

Nature of document	Prepared by	Date
Public Sector Comparator (SLC VFM Summary FBC Final 140306.xls)	Grant Thornton	14 March 2006
Risk & Optimism Bias Summary (SLC VFM Summary FBC Final 140306.xls)	Grant Thornton	14 March 2006
Preferred Bidders Model (Copy of SL-040106-CIBC - rev2 (sent to ST for GT))	InspirED	January 2006