

The Highways Private Finance Initiative (PFI) has been the subject of much interest recently. This is not surprising given the massive scope of the scheme and the impact it will have on the Island's transport infrastructure.

Below we seek to give answers to a number of questions and misunderstandings that have aired recently.

Further questions or comments can be emailed to highways-pfi@iow.gov.uk while more information can be found on the PFI website <http://www.iwight.com/highways-pfi/>

Q. Can you explain the main principles of PFI, what it will mean for the Island and how it is financed?

A. Under the PFI, virtually every stretch of the Island's highways network will be resurfaced along with every footway, pavement and dedicated cycleway. This network will also be maintained to an agreed standard for 25 years. Also included in this major overhaul will be street furniture, a new CCTV network, street lighting and cleansing and roadside verge maintenance.

Together, this work will be the largest engineering project ever undertaken on the Island and will bring the county's transport infrastructure up to an unprecedented quality.

The council was one of three authorities to be granted the PFI grant because for many years it has been obvious that the road network on the Island was not of good quality. Residents have for many years identified the standard of Island roads as one of their greatest concerns and the only way sufficient money can be invested to address this issue is through PFI

We were originally awarded £364 million but the new Government – as a response to the current economic difficulties – asked the authorities to revise their schemes. As a result of this, the council was awarded PFI grant of £260 million. This grant does not have to be repaid by the council. It is wrong to refer to it as a loan or a mortgage.

As part of the PFI, the council will be required to make an annual contribution to support this grant. This annual contribution is currently estimated to be £8.3m but the council will seek to negotiate this figure down though the negotiations we are currently holding with three international companies who are bidding to be our partner in the scheme. More on the financial arrangements involved in the PFI can be found below but this £8.3m is comparable with the amount of money we currently spend on delivering the services that will be included in the new PFI contract.

Q. Can you explain how the value of Government grant has been reduced and does this mean the initial bid was inflated. How does the recently announced grant reduction affect the business case for the scheme and how it will affect the way the council carries out the work?

The Outline Business Case (OBC) is the document used by the council to seek approval of the HM Treasury (HMT) and the Department for Transport (DfT) which is necessary to allow the project to proceed to the procurement stage. The OBC approval was formally received in February 2010 when the quality of the bid was found by HM Treasury's independent reviewers as "exemplar".

However as a response to the financial situation the Government asked all councils with Highways PFI approval to revise their proposals to reflect the reduction in money available. The council had in advance of the confirmation been negotiating with the DfT and the three potential partners on the basis of a 30 per cent reduction for the best possible scheme that could be delivered in accordance with this new budget.

This has successfully been done and the DfT remain happy with the OBC as amended. If it wasn't fully satisfied then, quite simply, the DfT would not have approved a grant of £260 million.

Therefore the validity of the OBC still remains – the scope of the project is still the same and the economic benefits are still huge. In fact, the financial case for PFI, has, if anything, slightly improved as the banking situation continues to improve, and the overall project costs have been reduced.

Q. Was the initial bid in any way inflated?

A. This assumption is based on an entirely false premise. The funding approved for the original OBC approval was 30 per cent higher because the delivery of that particular business case required 30 per cent more funding. It was an even more comprehensive project.

As we have seen, the base funding was cut by 30 per cent and subsequently a new OBC was agreed to reflect that reduced funding.

Both schemes – though of different scale - were approved by the DfT because both offered excellent value for money. Once again the DfT and HM Treasury would not have approved a scheme that had 'inflated' costs.

We, along with our counterparts who were lucky enough to have substantial central grants approved, have simply found ways to focus the spending in key areas and reduce spending in less important areas. This can be done while retaining the original scope of the PFI.

Q. Where could "efficiency savings" be made?

A. Since it was clear the grant would be reduced, the council has looked to see how the available grant should be spent to deliver the best possible scheme for the Island. This has been done by applying most funding to those areas most in need of it. The main area of capital spend on this PFI is focused around carriageways, footways, structures, drainage and street lighting.

The carriageway refurbishment for the roads carrying most traffic (hierarchy 1 roads) will be upgraded to a high standard, with slightly lower standards as we move down in road hierarchy. Hierarchy 4 roads, many of which are farm access roads or country lanes, will be upgraded to a lower standard than originally envisaged; however, all roads under the PFI scheme on the Island will be upgraded to nationally acceptable standards and will be treated at least once in the life time of the project and in some cases twice depending on the level and type of traffic using the roads. All work will be of significantly higher quality than that currently carried out on existing schemes. The type of refurbishment required for each road is stipulated in the agreed contract and the partner will not be allowed to reduce the level of required treatment below this pre-defined level.

The PFI partner also will have to maintain the average road condition in any given area above a pre-determined level. A similar approach will be taken in the upgrade of structures and footways. We will be maintaining the same refurbishment without any reduction in standard or spend in the upgrade of drainage, because we believe this is not traffic dependent and is key to improving the road condition.

In addition we have brought forward the spend on street lighting to a more efficient LED system which will produce significant savings throughout the contract starting as early as possible. We have also considered some routine activities like grass cutting of the verges and prioritised areas that are important to the Island's tourist image. These areas will continue to be maintained at the highest levels but in some of the more remote and rural locations the frequency of cuts will be reduced in keeping with the surroundings.

All these measures have been discussed to the satisfaction of the DfT.

Q. It is said that under the new arrangements, the PFI service provider will take on the statutory role of the highway authority, thus privatising a major County Hall department and leaving it beyond accountability to the electorate through their elected members, as is now the case. Is this right?

A. This is simply not the case.

The Isle of Wight Council will remain the Highway Authority and therefore hold all the statutory powers and responsibilities for operating a public highway network. However the council does have powers to delegate some or all of its roles to the service provider. This is so that PFI partner can carry out the works and deliver a seamless service without the need to seek the continual approvals of the council for all work.

However the contract will be framed to ensure the PFI partner must operate within policies that have already been approved democratically by the elected members of the council. These policies are listed and agreed before the contract becomes live. The PFI service provider can only work within this framework and will need to seek the

council's approval if they wish to go outside of agreed policies. The council will have a strong contract management team that will also monitor the performance of the PFI service provider through over 500 key targets. If the partner does not comply with the terms of its contract, then, payments will be deducted.

The PFI contract will therefore have financial incentives for the partner to abide by the agreed contract while the council retains overall control. This is a far better delivery model compared to the current arrangements.

Furthermore, the chosen partner will be required to attend regular meetings of the democratically elected council scrutiny panel. Here performance against the agreed contract will once again be scrutinised.

Q. Portsmouth City Council is reported to be asking for a renegotiation of its highways PFI contract after just six years with its contractor. What powers do the IW Council have, if any, to renegotiate the contract during its 25-year lifespan?

A. Our understanding is that that Portsmouth City Council is currently carrying out a Best Value Review – a standard practice in all PFI contracts which is spelled out in the contract at the very start. Because PFI contracts by their very nature are long term ones, periodic review to identify savings is neither surprising nor unexpected. In fact it would be foolish not to build in this procedure to avoid the very accusation made in a subsequent question that this type of contract is a 'straight jacket.'

In the IWC Highways PFI contract, there will be provisions for:

- Refinancing gains – to negotiate new terms if the banking terms change in the future;
- Best value type reviews;
- The sharing of any gains arising through innovation in technology on a basis that is 75:25 in the council's favour;
- To share any third party revenue, again 75:25 in the council's favour;
- The periodic market testing of rates supplied as part of contract to ensure they remain competitive;
- Competing with external contractors if new works need to be included.

There are also provisions within the contract to introduce new terms through what is called a 'change protocol.'

In short, the PFI combines the certainty of a long term contract with the terms of that contract reflecting the fact that we live in a changing world. This fact also explains why so much time and care has to be taken at this time to put into place a deal that is right for the Island.

Q. What measures and safeguards to the tax payer are in place to ensure the cost of maintenance is capped?

A. The Highways PFI contract is a fixed price contract, subject only to uplift by inflation (RPIX) and in a world where nothing changes for 25 years, the tax payers' commitments are totally fixed and hence tax payer liability is capped (this level of assurance cannot be given under the traditional council managed service). The only variation to this contract is possibly resulting from changes to the size of the road network and potential for innovation with time and we have built in the necessary safeguards to protect the public purse.

Q. The OBC estimates inflation at an average of 2.5 per cent over the 25-year life of the PFI. Is this realistic in the light of the current rising rate and the considerable financial uncertainties that lie ahead?

A. The 2.5% inflation is an average across the 25 year period and not based on one or two isolated years. The inflation is a key control mechanism that the Bank of England operates and the Governor reports to the Chancellor of the Exchequer and the 2.5% is HM Treasury's recommended long term inflation rate for use in PFI projects. During the years when inflation is running at a higher rate than anticipated, the project surplus will also gain higher deposit interest, off-setting some of the effects of inflation. It must also be remembered that however a highways maintenance project is procured and whatever the scope of that work, the cost will always be subject to change according to the current rate of inflation.

Q. What is the rationale behind tying an infrastructure like highways into a 25-year deal with these and other, unforeseen, circumstances bound to have an impact on road use?

A. A project to completely overhaul the entire road network on the Island is of such a scale that the public sector could never afford to undertake it using conventional financing methods. The PFI is the only way the council will ever unlock the money required to undertake such a massive project.

The contract is not a straightjacket, far from it. The contract will be future proofed, it will have mechanisms to allow for change and it will encourage innovation. The Council will share in the benefit of any innovation both in terms of direct savings and the lion's share of any on selling of the innovation to others. For example, should the contractor introduce a new technology which improves efficiency and generates income for the contractor, the Council will receive 75% of the saving generated on the contract as well as 75% of the income generated.

Long term contracts allow the PFI partner to invest in efficient machinery, to plan operations and resources meticulously and efficiently and to establish long term partnerships with suppliers. These all add up to help the partner achieve significant savings in delivery costs thereby increasing efficiencies and ultimately delivering a far better service to the public when compared to traditional delivery by the public sector. Whilst there are the borrowing costs encountered by the partner, the PFI

delivery model has to be cheaper than the traditional public sector model before the funding will be considered by HM Treasury. In our case, the PFI is approximately 14% cheaper than the council's own delivery and it is likely that figure will increase further as we complete the negotiations.

The 25 year contract provides the council and residents certainty of service, funding and a higher quality scheme for a longer period. It is not a straight jacket or neither party would sign up to such an arrangement.

Q. Will the IW Council lose control of highways under PFI?

A. As explained before, the council will be in full control of this contract through monthly reporting of over 500 targets which are linked to payments. In addition the partner is required to provide daily and weekly report through a real-time Management Information System. The partner's performance will be published on a monthly basis on the council's website along side the performance requirements. This will make the whole process uniquely transparent and open to public scrutiny in a manner not currently possible. The contract, its specification and payment methodology will also be published on the council's website once the contract is signed, save for the commercially sensitive elements. The contract will be scrutinised by the Highways PFI Board and an annual report will be submitted to the Council's Cabinet each year.

The management and reporting regime is, in fact, a lot more rigorous and transparent than the traditional public sector delivery model.

Q. With the highways PFI budget in the hands of a private company, how can Island tax-payers be sure they are getting best value for money?

A. The Highways PFI budget will rest firmly with the council. The authority's contract management team has to provide approval as set out in the contract before the service provider can commence, complete and seek payments. Value for money will be established by 30 months of intensive negotiations with three bidders who are in competition with each other. The bids are compared with our own "shadow model" to ensure the bidders deliver value for money and where we feel that they are not meeting our required criteria, we negotiate further until we gain an outcome that we feel offers best value for money.

With the additional provision repeatedly to test the market, refinancing gains, best value reviews etc, the Island residents can be assured that the Highways PFI provides the best possible investment that they can expect on their roads and that the commercial deal is being negotiated hard in order to achieve the highest value for money.

Q. Who will decide which roads are upgraded first? Who will determine the priorities and schedule of work?

The Island's 800+ km of roads are surveyed annually to establish the condition and we have been consistently doing this to establish trends, areas of needs, types of treatments needed etc as part of the preparation work. We have built a refurbishment model including a detailed costing for the upgrade of the Island's roads. When the bidders make their technical submissions, we will compare their refurbishment model with ours to ensure the upgrade agrees with our own thinking.

The Service Provider will produce a 7 year Core Investment programme during which period the whole of the Island's roads should have been brought to the required condition. This programme will be approved by the council before the contract is signed. The partner will then submit a yearly programme which will be implemented only after the council's approval and following consultation with elected members and town and parish councils.

Q. If work is found not to be up to standard, what comeback does the IW Council have?

A. As explained earlier, payment is linked to achieving required standards and the first seven years of upgrades have to be certified by an Independent Certifier before payments can be made. In addition, the Service Provider has no come back against the council – any faulty workmanship has to be rectified at its own cost and also pay penalties to the council for not meeting the milestones. It will also be charged "availability charges" for occupying the road network longer than agreed.

Q. The DfT press release states: "The projects can now continue their procurement processes and, *subject to approval of a final business case*, be able to award the service contracts." The IW Council press release implies it is a done deal: "The Department for Transport has indicated that the IW Council's PFI scheme *is to be given £260 million...*"

A. The Outline Business Case has been approved as has funding of £260m. We are now in the procurement phase of the project which takes over 30 months and various new approaches will result from the commercial negotiations. These are likely to be different from the council's own assumptions at the Outline Business Case stage and the costings will also be different. These changes have to be reflected in the final business case, whilst still remaining within the grant funding allocated. The submission will be based on the selected Preferred Bidder's tender and the approval of the final business case allows the funds to be released to the council.

Q. What benefits will PFI bring to the Island?

A. The PFI will bring to the Island £260million in Government grant to improve the council's road infrastructure. This is not a 'mortgage' or a 'loan' that has to be repaid. It is money that the council is being granted in recognition of the poor state of the Island's roads and the innovative solutions we have provided to address that issue.

Residents have repeatedly told us that the state of roads is a primary concern for them. The PFI will address that concern bringing the network up to a standard never seen before and maintained that way for 25 years.. As explained above, the scheme is wider than just highways improvement meaning it will also provide services such as street lighting, CCTV, street cleansing, street furniture, and verge maintenance in a way that is more efficient and effective than at present. The PFI will also enable refurbishment of bridges, 150 drainage schemes and 17 capital schemes.

Such massive investment on what is the largest ever engineering scheme undertaken on the Island will also provide huge opportunities for local commerce and employment. The scheme will present local firms with the chance to offer their goods and services to the PFI service provider whose bid will have been underpinned by the need to use sustainable supply chains.

Exactly how much benefit the PFI will bring to the local economy depends to some extent on how ready the Island is to engage with the scheme. That is why the council is keen to correct the current misinformation that is being circulated and is acting as a link between local business and the organisations currently bidding to be a partner in the scheme.

It is estimated that up to 500 jobs will be created by the PFI from civil engineers, designers, technicians and geologists to ground workers, machine operators, masons and drainage workers.

The council is absolutely committed to letting residents and businesses know the facts of the scheme and also about what they can do to tap into the opportunities provided by this huge investment.

For more information, please visit <http://www.iwight.com/highways-pfi/> or email highways-pfi@iow.gov.uk

Q. Can you explain more about the council's contribution to the PFI?

A. The annual contribution will come from a dedicated budget that has already been built into the medium term financial strategy. This annual contribution is currently estimated at £8.3 million although we will seek to reduce this further through negotiations with the prospective partners. The £8.3 million is comparable to the sum we currently spend on providing the services to be included in the new contract. Rolling these various services into one new contract under PFI means we will be able to provide each more effectively and efficiently than at present. Because this contribution is budgeted for in the approved medium-term financial strategy, it is not new or additional funding.

This £8.3 million contribution should not be compared solely to the 'annual highways budget'. This is because the PFI will include services beyond the scope of those accounted for under the budget heading of highways. For example, substantial elements of the PFI such as street cleansing and the improvement and management of the CCTV network are both funded from different budgets to that of highways.

31-Mar-11

HIGHWAYS PFI OUTLINE BUSINESS CASE (OBC) ASSUMPTIONS AND CURRENT BUDGET

REVENUE SPEND PFI In Scope areas	OBC Assumption	2009-10 Gross Budget	2010-11 Gross Budget	2011-12 Gross Budget
Structures	160,000	165,698	335,487	346,864
Highway Maintenance	2,300,000	2,641,995	3,343,586	3,124,930
Street Lighting	890,000	897,758	837,386	841,768
ROW Cycleways	10,000	11,459	11,338	11,744
Network Management	160,000	722,730	668,756	681,567
Traffic Strategy	480,000	0	242,251	244,192
Highways Design	430,000	582,903	159,977	160,500
Business Management	130,000	249,181	251,477	243,064
Street Cleansing	1,400,000	1,355,397	1,695,097	1,695,097
Public Realm	490,000	503,300	300,935	290,000
CCTV - Control Room	280,000	295,702	305,961	305,961
Central Service Support Costs	370,000	266,291	206,710	206,705
Budget Growth in areas in scope*	720,000	720,000		
Additional contribution EOI	500,000	500,000	500,000	500,000
Total	8,320,000	8,912,414	8,858,961	8,652,392

* The £720k reflects the following agreed during the 2009-10 budget setting process and which now forms part of base budgets:

Highways Maintenance Increase	200,000	Dealing with historic overspends in this budget
Winter Maintenance Increase	300,000	New contract let resulting in increased costs

Street Cleansing Increase	280,000	New contract let resulting in increased costs
Grounds Maintenance	140,000	New contract let resulting in increased costs
Public Realm	<u>-200,000</u>	Saving
	<u><u>720,000</u></u>	

The 2011-12 Gross budget excludes the recently announced £800k for pothole repairs