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Our ref

TC/SCC/PFI/FV

(sent by post and email)

8th October 2019

Dear [REDACTED]

Sheffield City Council: Audit of accounts for the year ended 31 March 2017 – decision and statement of reason

We are writing to advise you of our decision on your objection to the accounts of Sheffield City Council for the year ended 31 March 2017.

We previously wrote to you on 6th August with our provisional view. We had no response to that provisional view and this letter sets out our final decision together with our statement of reasons for coming to that decision.

Your objection

Your objection is set out in the attachment to your e-mail dated 23 July 2017 and relates to seven Private Finance Initiative (PFI) contracts entered into by Sheffield City Council (the "Council"). Six of the PFI schemes referred to involved the construction or refurbishment of buildings with the seventh PFI scheme being in relation to the maintenance of highways. It specifically asks us to:

- make an application to the Court for a declaration that the related items of account are contrary to law under section 28 of the Local Audit and Accountability Act 2014; and
- issue a public interest report under section 24 of the Local Audit and Accountability Act 2014.

Specifically your objection relates to the following seven PFI contracts. We have noted the key details of each of the contracts below:

■ **Howden House**

- the purpose of the arrangement was to provide initial capital investment into office accommodation followed by ongoing maintenance and the provision of facilities management and support services;
- this is a 30 year arrangement from February 2001; and
- the unitary charge was £4.86m p.a in 2016/17.

■ **Schools Phase One**

- the purpose of the arrangement was to provide initial capital investment into two primary schools and four secondary schools followed by ongoing maintenance and provision of facilities management and support services;
- this is a 25 year arrangement which commenced in the 2001/02 financial year; and
- the unitary charge was £10.77m p.a. in 2016/17.

■ **Schools Phase Two**

- the purpose of the arrangement was to provide initial capital investment into two secondary schools followed by ongoing maintenance and provision of facilities management and support services;
- this is a 25 year arrangement which commenced in the 2005/06 financial year; and
- the unitary charge was £4.20m p.a. in 2016/17.

■ **Schools Phase Three**

- the purpose of the arrangement was to provide initial capital investment into two secondary schools and two primary schools followed by ongoing maintenance and provision of facilities management and support services;
- this is a 25 year arrangement which commenced in the 2006/07 financial year; and
- the unitary charge was £7.69m p.a. in 2016/17.

■ **Building Schools for the Future (BSF)**

- the purpose of the arrangement was to provide initial capital investment into two secondary schools and one specialist school followed by ongoing maintenance and provision of facilities management and support services;
- this is a 25 year arrangement which commenced in the 2008/09 financial year; and
- the unitary charge was £9.38m p.a. in 2016/17.

■ **Bradfield School**

- the purpose of the arrangement was to provide initial capital investment into one secondary school followed by ongoing maintenance and provision of facilities management and support services;
- this is a 25 year arrangement which commenced in the 2012/13 financial year; and
- the unitary charge was £3.19m p.a. in 2016/17.

■ **Highways**

- the purpose of the arrangement was to provide initial capital investment into the improvement and ongoing maintenance of roads, footways, highway trees, traffic signals, street lights, street furniture and street name plates amongst other associated areas;
- this is a 25 year arrangement and became operational during the 2012/13 financial year; and
- the unitary charge was £53.25m p.a. in 2016/17.

Your objection specifically asserts that:

- The decision to enter these PFI contracts was irrational and based on conflicted, for profit advice by audit consultants which was not in the public interest.
- The local authority has not demonstrated how the seven contracts represent value for money in terms of non-performance/delivery and exiting the contract.
- The local authority did not have sufficiently robust governance arrangements during the construction phase of the 6 projects nor are they in place now to ensure that the buildings are safe. We note that this element does not relate to the Highways PFI.

- The local authority is making monthly unitary payments without robust governance arrangements based on self-declared availability and performance reports of the PFI contractors, which is irrational conduct.

Your objection also raised the following two questions, which we have not accepted as part of our assessment as these are requests for information that can be made directly of the Council:

- “Please provide the modelling /methodology behind all fair value assessments of PFI assets and liabilities in 2016/17”
- “Over the course of the past financial year 2016/17, please outline how the authority has been able regularly monitor PFI contract "breakage costs" to determine when it may be advantageous to exit or refinance the PFI contract? Please provide the most recent assessments, carried out during 2016/17, of PFI breakage costs, and the proprietary models or formula relied upon by the local authority upon which regular breakage costs assessments relied upon by the authority are based.”

Legal background

In respect of the Howden House PFI scheme, this was entered into under the Council's general duty to discharge its functions of providing social services, housing services and education for children. The specific statutory provisions which are relevant to these functions include parts II, V, VI and IX of the Housing Act 1985, Parts VI and VII of the Housing Act 1996, Part I of the Housing Grants, Construction and Regeneration Act 1996, and part I of the Education Act 1996. These statutory provisions are all considered relevant in the context of the Howden House accommodation providing space from which the Council delivers or ensures the delivery of its functions with regards to social services, housing services and education for children.

In respect of the schools PFIs, the statutory powers for councils to enter into arrangements to maintain, build, improve and provide services for schools are contained in section 13A ('Duty to promote high standards in schools'), section 14 ('Functions in respect of provision of primary and secondary schools') and section 16 ('Power to maintain and assist primary and secondary schools') of The Education Act 1996.

In respect of the highways PFI scheme, the specific statutory powers for councils to maintain and manage the Authority's roads and highway assets are contained in sections 41(1), 62, 64, 92 and 97 of the Highways Act 1980. Further relevant powers are set out in section 65 of the Road Traffic Regulation Act 1984; section 89 of the Environmental Protection Act 1990; and sections 49 and 72 of the New Roads and Street Works Act 1991.

In entering into these PFI contracts the Council also relied on section 111 of the Local Government Act 1972, which enables local authorities to do anything which is conducive or incidental to the discharge of any of their functions.

In addition, section 1(1) of the Local Government (Contracts) Act 1997 states that “Every statutory provision conferring or imposing a function on a local authority confers power on the local authority to enter into a contract with another person for the provision or making available of assets or services, or both, (whether or not together with goods) for the purposes of, or in connection with, the discharge of the function by the local authority”.

Approach

Given the age of some of the agreements, not all the contemporaneous documentation setting out the Council’s decision-making and what was taken into account was available. In considering whether there was any evidence to suggest that the Council’s decisions to enter into the PFI contracts that are the subject of this objection were irrational or would be considered irrational or in some other way outside of the Council’s powers we considered:

- the information that was available, including information related to the PFI procurement framework that Councils were required to comply with when these contracts were entered into; and
- the applicable statutory guidance.

Detailed Considerations

Below we set out each of the issues you have raised along with our final view.

The decision to enter these PFI contracts was irrational and based on conflicted, for profit advice by audit consultants which was not in the public interest.

We have identified in the **Legal Background** the legal powers available to the Council.

Our view is that the Council had the legal powers to enter into the PFI contracts that are the subject of this objection.

However, any decision by a local authority must not only be within its powers as conferred by statute, but also be made lawfully in accordance with public law principles. For example, a local authority must take into account all relevant considerations and discount irrelevant considerations, must follow its own decision-making procedures, and not act in a way that no reasonable local authority would ever act (see *Associated Provincial Picture Houses Limited v Wednesbury Corporation* 1 KB 223).

Given our review of the legal basis upon which the decisions to enter the PFI contracts subject to this objection were made, and our observations with regards to compliance

with the Treasury's Green Book (see below), our view is that the Council did not act unreasonably or irrationally in the exercise of its powers.

You also assert that the decision to enter into the PFI contracts was based upon advice from consultants who were conflicted. You have provided examples of advisors to the Council on specific PFI schemes who have also acted as auditors to the equity holders and Special Purpose Vehicles (SPVs) set up to deliver other PFI schemes for the Council.

Given the number of parties involved in these schemes, in various capacities, it is reasonable to expect that firms acting for the Council in an advisory capacity on specific PFI schemes may also have acted as auditors and advisers to entities involved in other Council PFI schemes. You have not provided any evidence that individual firms acted as advisers to the Council on specific PFI schemes whilst at the same time acting as auditors or advisers to entities, or the owners of these entities, bidding for the same PFI scheme. There were rigorous Ethics and Independence Standards in place at the time these schemes were being procured that were designed to prevent firms from undertaking audit or advisory work that could give rise to a conflict of interest under these circumstances.

We cannot comment on the adequacy of the risk management processes operated by other firms who have provided advisory services to the Council to ensure that the Ethics and Independence Standards in place at the time these PFI schemes were entered into were complied with. With reference to the work that we (KPMG LLP) carried out for Sheffield City Council, we have identified that:

- We were not and are not advisors to the Council on any of the schemes themselves; and
- The external auditors to the Council during the periods when these PFI schemes were entered into were the Audit Commission and KPMG LLP and neither the Audit Commission nor KPMG LLP were advisors to the entities bidding for, or delivering, PFI schemes at the time of being auditor. We do not believe, and have not been provided with any evidence to suggest, that acting as auditor of equity holders in PFI schemes or SPVs delivering PFI schemes whilst also being auditor of the Council represents a conflict of interest.

We are not aware of any evidence that any of the advisers acting for the Council offered advice which was either biased or lacking in objectivity. In the absence of any such evidence, our view is that we do not accept your assertion that the Council's advisers were conflicted when acting on behalf of the Council.

The local authority has not demonstrated how the three contracts represent value for money in terms of non-performance/delivery and exiting the contract.

For each PFI scheme Value for Money assessments consistent with HM Treasury guidance set out in the Green Book would be carried out prior to commencement of any scheme.

The Treasury's Green Book provides guidance to help public bodies develop objective and evidence-based evaluations of proposals to help inform decision-making. The VfM Assessment methodology is a key component of the Green Book approach. Further to this, the Council's assessments had to go through a relevant submission process in order to secure the necessary PFI credits to help finance the schemes. As the Council subsequently secured the PFI credits for these PFI schemes, it can be reasonably inferred that the Council's assessments were submitted in accordance with the requirements of the Treasury Guidelines and the Green Book approach.

We note the National Audit Office (NAO) report, *PF11 and PF12*, (18 January 2018), repeats criticisms of the VfM Assessment methodology which it made in its report of 2013, *Report of the VfM assessment process for PFI*. The report argues that the VfM assessments 'have features which favour and advantage PFI in comparison to a publicly financed approach'. HM Treasury has disputed the NAO's criticisms and its response is included within the NAO report of 2013. The 2018 NAO report makes further criticisms of the vfm assessment process, including the treatment of cash flow timing and discount rates within the methodology. Criticisms of the PFI methodology led Government to introduce the reformed PF2 arrangements to increase efficiency and flexibility.

We also note that the Council had no influence over the approach adopted in the VFM assessment methodology, which was determined by Government. The Council also had no discretion over the terms of the termination provisions of each contract which are consistent with the standard form of PFI contract. Given that, our view is that the Council did not act unreasonably, in Wednesday terms, in using the PFI to procure these schemes and in so doing, that it acted within existing Treasury guidelines in the decision-making process.

With regards to exiting the contract, the Council's finance team has carried out recent assessments to determine whether refinancing or exiting the contracts would be financially viable or worthy of further consideration. We have reviewed these assessments and they appear reasonable. We further note that in general terms the costs of exiting PFI schemes are significant as the termination provisions are designed to compensate PFI providers for the loss of future income streams, as well as giving the Council surety, as far as reasonably possible, of service provision and costs over the life of the contract. When the costs of termination are combined with the costs of replacing the services provided we are satisfied that the Council has acted reasonably in not seeking to exit its PFI contracts.

The local authority did not have sufficiently robust governance arrangements during the construction phase of the six projects related to buildings nor are they in place now to ensure that the buildings are safe.

This element of your objection specifically concerns the self-certification and sign off of the buildings making up these PFI schemes. We note that the safety requirements in relation to the construction of buildings are governed by the Building Act 1984 and secondary legislation including The Building Regulations 2010 (SI 2010 No. 2214) and The Building (Approved Inspectors etc) Regulations 2010 (SI 2010 No. 2215). We note that the decision to accept self-certification in relation to buildings built further to the PFI projects is consistent with the legislation.

There is no evidence that has come to our attention during the review of relevant documentation that demonstrates the Council deviated from the processes set out in legislation or regulations referred to above.

You have provided some specific allegations related to the PFI schemes that are the subject of this objection with regards to the inadequacy of inspection carried out by the Council to identify any construction or fire safety defects. We consider that this question, specifically in relation to judging the adequacy of safety inspections is not one that is within our jurisdiction as auditor and therefore we have not considered this further.

We have noted both the basis upon which self-certification in relation to buildings is consistent with relevant legislation and, in response to later elements of your objection, the ongoing monitoring and governance arrangements with regards to management of the contract. Below we have summarised the management and governance arrangements in place across each scheme. Our work has identified that the Council and its PFI scheme partners had in place mechanisms that considered construction and fire safety defects/maintenance as part of these arrangements.

We have found that the Council acted consistently with relevant legislation in accepting self-certification with regards to construction and fire safety. The Council also has a number of governance arrangements in place with regards to monitoring safety of buildings. We therefore consider it outside of the auditor's roles to consider further the adequacy of the inspections, whether independent or otherwise, that these arrangements encompass.

For those areas considered, our view is that we do not accept your assertion that the Council did not have sufficiently robust governance arrangements during the construction phase of the six projects nor are they in place now to ensure that the buildings are safe.

The local authority are making monthly unitary payments without robust governance arrangements based on self-declared availability and performance reports of the PFI contractors, which is irrational conduct.

We have reviewed the Council's arrangements for managing each scheme and have briefly outlined these below.

Howden House

The Council employs officers who work closely with the external facilities manager/service provider to ensure that the Output Specification is being delivered. This monitoring is formally carried out and documented through monthly Service Operations Board Meeting where performance and contractual outputs are monitored and discussed.

Quarterly Management Operations meetings are also held with more senior officers of the Council and the service provider in attendance. These are utilised to highlight any risks to the contract and issues are tracked.

Where issues are identified and not resolved accordingly there is a mechanism in place to deduct an amount from the unitary charge.

We note that during 2016/17 there were no performance issues that resulted in a deduction from the unitary charge. We did not identify any evidence to suggest this was inconsistent with the performance of the service provider in delivering the contracted services.

Schools PFI (Encompassing Schools Phases 1-3, BSF and Bradfield School)

Whilst encompassing 5 separate contracts the contract monitoring and management across all 5 of these contracts is largely similar and is managed by the same team within the Council.

On top of regular day to day communication, each of the schools has a 6 weekly performance interface meeting, including representatives from the relevant Special Purpose Vehicles, schools and the Council.

In addition a monthly operational meeting is held with the above representatives and Facilities Management providers, which address contractual performance monitoring. Where performance issues are identified the Council will make deductions to the unitary charge according to the contract.

We note that during the 2016/17 period deductions totalling £13,957 were made against three of the five schools PFI contracts. We did not identify any evidence to suggest this

was inconsistent with the performance of the service providers in delivering the contracted services.

Highways

The monitoring of this contract is carried out according to the structure stipulated in the contract itself. This includes the use of a monthly Service Operations Board; monthly Management Board; and Quarterly Strategic Boards.

In addition we have seen evidence of a number of sub team meetings that take place for specific service areas e.g. street lights.

These meetings are all attended by members of the Council, SPV and AMEY and include review of performance, service concerns, deductions and outputs of inspections.

Performance issues or supplier failures are identified through the above governance processes and payments are adjusted accordingly as per the payment terms/methodology outlined in the contract.

We note that during 2016/17 such issues resulted in deductions from the unitary charge of £1,371,006. We did not identify any evidence to suggest this was inconsistent with the performance of the service provider in delivering the contracted services.

Given the arrangements described above our view is that the Council had adequate governance arrangements in place and did not act unreasonably, in Wednesbury terms, in making unitary payments to the operator based on the monitoring arrangements set out in the PFI contracts.

Summary of Decisions

Decision not to make an application to the court for a declaration that an item of account is contrary to law

Section 28 of the Local Audit and Accountability Act 2014 gives auditors the discretion to decide whether or not to apply to the Court for an Order in relation to unlawful items of account. Based on the above considerations and assessments, we are satisfied that there is no information to suggest that the PFI projects in question were entered into unlawfully such that there are no related items of account contrary to law.

As we have not identified any items of account contrary to law, the discretion whether or not to seek a declaration from the court under section 28 of the 2014 Act does not arise.

Decision not to issue a public interest report

We have also decided that we will not issue a public interest report. There is no statutory requirement to provide a reason for this decision, although my reasons would be the same as for my decision above.

Right of appeal

You have a right to appeal our decision not to apply for a declaration under section 28(3) of the Local Audit & Accountability Act 2014. Should you wish to do so, you must issue your appeal to the courts within a period of 21 days beginning with the day after you receive this statement of written reasons.

Should you wish to appeal this decision, we strongly recommend that you seek legal advice.

We have copied this decision to the Council.

Yours sincerely



Tim Cutler
Partner

For and on behalf of KPMG LLP

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