

3 Education: Contract Management of Public-Private Partnership Schools

Summary

The school public-private partnership contracts examined during this audit represent a significant financial obligation to the province totaling approximately \$830 million over their 20 year life. The magnitude of such contracts requires a very high duty of care which has not been adequately met by the Department of Education. Comprehensive contract terms and management processes and procedures which ensure services paid for are received are essential to protecting the public interest. Our audit identified significant weaknesses in both of these areas. As a result we cannot conclude on whether key calculations supporting contract payments are correct or whether many services paid for are received. The findings in our report should be carefully evaluated by government prior to entering into complex long-term contracts in the future.

Our audit identified instances in which child abuse registry and criminal record checks, fire safety inspections, and emergency first aid and CPR training were not completed by the developers as required under the service contracts. Contract terms do not address significant areas such as audit access for the Province; measurable levels for all services; monitoring compliance with contract terms including required documentation; and an adequate payment adjustment system when contract terms are not complied with. The Department's reliance on negative feedback to monitor contract compliance is not sufficient to ensure services are received.

Two developers subcontracted their responsibilities under their service contracts for certain schools to the regional school boards. These subcontracts effectively transfer the risks for the operation and maintenance of the schools assumed by the developers in the service contracts back to government. Regional school boards are delivering contracted services at a lower cost than that paid to the developers. Over the 20 year life of the contracts the estimated difference in payments between the developers and regional school boards is approximately \$52 million. In addition, regional school boards need to do a better job ensuring that all money owed to them by the developers is received. We noted instances in which amounts received by the regional school boards did not comply with contract terms; these will result in significant financial recoveries for the Boards.

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Background

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- 3.1 The Province of Nova Scotia constructed 39 public-private partnership (P3) schools. The last 31 were bundled and awarded to three private sector consortia, or groups of companies. For these last schools, development contracts to design, finance and build the schools were signed effective between February 1998 and June 1999. Through service contracts signed effective between May and July 1999, the Province agreed to lease the schools for approximately 20 years and the companies, which we will refer to as developers, agreed to manage, operate, and maintain the schools. The service contracts also define contract payments. Two of the developers signed contracts for each school. Our audit scope includes the service contracts for the last 31 schools. The developers involved are Ashford Investments Inc., Nova Learning Inc., and Scotia Learning Centres Inc.
- 3.2 The Province makes payments related to the capital lease; maintenance and operations; technology refresh; and capital repair and replacement over the term of the contracts. As of March 31, 2009, the Province had paid the following: \$224.7 million for capital leases; \$128.6 million for maintenance and operations; \$14.4 million for technology refresh; and \$6.8 million for capital repair and replacement. As of March 31, 2009, the Province is committed to paying approximately \$210.0 million for capital lease obligations, and has an estimated commitment of \$218.9 million for maintenance and operations; \$18.1 million for technology refresh; and \$9.9 million for capital repair and replacement to the end of the service contracts.
- 3.3 The operating payments made to the developer are based on a combination of utility rates and utility usage volumes plus inflation adjustments. Other payments are made to separate sinking funds and are to be used for technology refresh and capital repair and replacement. These payments are based on a rate per square foot. For March 31, 2009, the following approximate payments were made: capital leases - \$26.1 million; maintenance and operations - \$17.6 million; technology refresh sinking funds - \$1.7 million; and capital repair and replacement sinking funds - \$0.8 million.
- 3.4 The service contracts allow the developers to use subcontracts to fulfill their responsibilities but the developers are not relieved of their obligations to the Province under the contracts. Two developers entered into subcontracts

with the Strait Regional School Board (SRSB), Cape Breton-Victoria Regional School Board (CBVRSB) and Chignecto-Central Regional School Board (CCRSB) for the Boards to fulfill the developer's operating and maintenance responsibilities for 15 schools. The developers remain responsible for capital repair and replacement costs for all three Boards and, in one Board, insurance coverage. The Department of Education continues to pay the developers for their responsibilities under the service contracts and the developers pay the regional school boards for services provided.

Audit Objectives and Scope

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- 3.5 In Spring 2009, we completed a performance audit of the Department of Education's management of school public-private partnership service contracts. The audit was conducted in accordance with Section 8 of the Auditor General Act and auditing standards established by the Canadian Institute of Chartered Accountants.
- 3.6 The objectives for this assignment were to determine whether:
- the Department of Education's contract management processes and procedures are adequate to ensure services detailed in the service contracts are received and payments for services are made in accordance with the contracts;
 - the developers are complying with significant terms of the service contracts focusing primarily on those terms related to student health and safety;
 - service contract terms are adequate to ensure the public interest is being protected; and
 - subcontracts between developers and regional school boards result in government getting value for money.
- 3.7 The objectives of this assignment did not include assessing whether using public-private partnerships for acquiring and operating the 31 schools included in the audit was appropriate at the time.
- 3.8 Generally accepted criteria consistent with the objectives of this audit do not exist. Audit criteria were developed specifically for the engagement using both internal and external sources. Criteria were accepted as appropriate by senior management of the Department.
- 3.9 Our audit approach included interviews with management and staff of the Department, developers, and regional school boards; examination of

contracts, subcontracts and other documentation; and testing compliance with service contract terms. Payment testing covered periods ranging from September 2005 to March 2008 as detailed in the report. Service level testing covered the period from April 2007 to March 2008.

- 3.10 Our audit objectives required that we obtain access to documentation of the developers. We would like to acknowledge that management and staff of all the developers were cooperative and provided us with information in a timely manner.

Significant Audit Observations

Contract Management and Compliance

Conclusions and summary of observations

The Department of Education's contract management processes and procedures are not adequate. Important services are not being received and payment errors were made. For example, significant service contract requirements which impact student health and safety are not being completed such as child abuse registry and criminal record checks, and fire safety inspections. We also identified a number of instances in which we could not conclude whether payments were made or services were provided in compliance with contract terms due to a lack of adequate documentation. The absence of an appropriate system to manage and monitor large complex contracts significantly increases the possibility that services paid for are not received and important contract terms are not complied with.

- 3.11 *Compliance testing for services* – We tested certain service level requirements, focusing on student health and safety for compliance with contract terms. We found the developers were not providing many of the contracted service levels tested and for some services there was no evidence the required service levels were being provided. We are concerned there may be an increased risk to student health and safety due to the lack of compliance with certain contract terms as detailed below.
- 3.12 *Child abuse registry checks* – Developers are required to obtain child abuse registry checks on all contracted staff prior to working in schools. We found 20 of the 40 contracted staff we tested did not have a child abuse registry check completed. For an additional five individuals, there was no evidence to support the completion of a check. For the 15 record checks initially examined nine were not done prior to hire, as required. The time period after hire ranged from six days to 254 days. Subsequent to our audit,

clean record checks were obtained for 14 of the 20 individuals who did not have record checks. Record checks were not obtained for the remaining six individuals. As well, clean record checks were obtained for three of the five individuals for which there had been no evidence to support completion of the checks. Record checks were not obtained for the remaining two individuals. We believe the Department of Education needs to address this issue immediately. Individuals working in schools who have not been appropriately screened pose an unacceptable risk to students.

Recommendation 3.1

The Department should ensure child abuse registry checks are completed prior to hire for all employees working in schools.

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- 3.13 *Criminal record checks* – One of 40 individuals tested did not have a criminal record check completed. For an additional two individuals, there was no evidence that criminal record checks were completed. For the 37 record checks examined, 19 were not done prior to hire as required. The time period after hire ranged from one day to 303 days.

Recommendation 3.2

The Department of Education should ensure criminal record checks are completed prior to hire for all employees working in schools.

- 3.14 *Emergency first aid and CPR training* – 14 of 40 individuals tested did not have the required emergency first aid and CPR training. For one other individual, there was no evidence to support the training was completed.

Recommendation 3.3

The Department of Education should ensure all employees working in schools have required emergency first aid and CPR training.

- 3.15 *Fire Safety Act* – Nine of 13 schools examined did not have all fire safety inspections completed as required by the Fire Safety Act. For the four remaining schools, there was no evidence to support completion of all required inspections. The contracts require compliance with the Fire Safety Act.

Recommendation 3.4

The Department of Education should ensure the developers are completing and documenting the results of all fire safety inspections required under the Fire Safety Act.

- 3.16 *Preventive maintenance* – The contracts require maintenance be completed in accordance with manufacturer's requirements where applicable. The

maintenance work on four of 56 pieces of equipment tested did not meet manufacturers' requirements. For an additional 30 pieces of equipment, there was no evidence that all required work was completed.

Recommendation 3.5

The Department of Education should ensure all preventive maintenance is completed in accordance with manufacturers' requirements.

- 3.17 *Cleaning services* – The contracts for two developers define detailed cleaning requirements including frequency. No documentation, such as checklists signed by staff, was maintained to support the completion of required cleaning procedures. For three of the seven schools examined, cleaning staff indicated there were a few cleaning procedures not completed at the frequency required by contracts.

Recommendation 3.6

The Department of Education should ensure adequate documentation is maintained to support the provision of required cleaning services under the contracts. The Department should review documentation to ensure cleaning is completed.

- 3.18 *Hazardous cleaning materials* – We found all 13 schools tested stored hazardous cleaning materials in a secured area.
- 3.19 *Regular maintenance work* – The contracts do not define the timing of maintenance work to be completed other than noting it must be done promptly. For two developers, we found inadequate documentation to support when maintenance work was completed. As a result we were not able to assess timeliness.

Recommendation 3.7

The Department of Education should ensure the developers maintain adequate documentation to show maintenance work is completed on a timely basis. The Department should review this documentation to ensure maintenance work is completed on a timely basis.

- 3.20 *Contract monitoring by Department of Education* – The Department of Education carries out limited monitoring of compliance with the service level requirements of contracts such as completion of child abuse and criminal record checks, emergency first aid and CPR training, cleaning services, preventive maintenance, and compliance with the Fire Safety Act. An appropriate monitoring system is essential to help ensure services paid for are received and that all possible value to the Department of entering the P3 contracts is realized. The Department's failure to adequately monitor

these contracts has resulted in a number of non-compliance issues, some of which unnecessarily increase the risk to student health and safety.

- 3.21 The Department relies primarily on informal feedback received from school board staff working at the schools to monitor whether contracted services are received. If there are no complaints, Department staff assume adequate services are provided. However, school board staff we interviewed were not aware of the detailed service level requirements of the contracts and therefore are not an effective control to ensure services paid for are received.
- 3.22 Department management informed us that they also receive information on services provided by attending Facilities Management Team meetings where school operational issues are discussed. However these meetings are only held for 18 of the 31 schools and are not held regularly in those 18 schools. These meetings may provide some information relevant to contract monitoring but are not effective in ensuring all services are provided as required.
- 3.23 We interviewed the principals at 13 schools. Overall, they were satisfied with the level of services provided. However, the principals were not aware of the required contract service levels and therefore could not comment on whether all contracted services were received, or whether services delivered met contract requirements. There were some concerns expressed regarding the timeliness of completing larger repairs in one developer's schools.

Recommendation 3.8

The Department of Education should establish adequate contract management processes to ensure contracted services are received. These processes should be followed for the remainder of the contracts.

- 3.24 *Contract monitoring for operating payments* – The Department pays the developers for operating and maintenance costs, in addition to technology refresh and capital repair and replacement. Operating payments are made monthly based on estimates. After year end, the developers calculate the actual operating payments due based on changes in the utility rates and usage volumes for utilities, and inflation rates. This is compared to the payments received to determine a balance due to or from the Department of Education. The Department has not attempted to obtain documentation from the developers to support the utility rates and usage volumes. One developer voluntarily provides this support. Another developer informed us they use an estimate for electricity rates and not actual rates in their submissions. Department staff informed us they check the mathematical accuracy of the calculations, verify the inflation rates used, and where applicable, ensure the information is the same as the prior year. However, without adequate

verifiable documentation, there may be over or underpayments to the developers which are not detected.

Recommendation 3.9

The Department of Education should obtain appropriate supporting documentation from the developers for amounts used in calculating operating payments.

- 3.25 *Contract monitoring for capital payments* – The Department makes monthly or semi-annual capital lease payments for each school. Staff ensure the amount paid is the same as the prior period as required by the contracts.
- 3.26 *Compliance testing for operating payments* – We selected a sample of operating payments made between September 2005 and December 2007 and found payment errors based on contract terms. These errors would likely not have occurred if there was adequate monitoring to ensure payments comply with contract terms. Our testing results are detailed in the following paragraphs.
- 3.27 The contracts indicate operating payments will be increased approximately five years from the beginning of the contracts depending on the contract terms. We found this payment adjustment was made prior to, or after, the required time period for 8 of the 11 schools examined. In this instance, the net impact on payments is not significant but without proper monitoring, significant incorrect payments may be made.
- 3.28 The payment increase is subject to an annual inflation adjustment. We found one of the developers has never claimed or received this adjustment. At the time of this report, the developer had not claimed, and the Department had not paid, amounts owing as a result of this error. As of December 2008 the amount owing was approximately \$61,000.
- 3.29 We examined the calculations for operating payments made for a sample of 12 schools where actual utility costs were used. We found the utility costs were adequately supported. We also tested the inflation rates used and did not identify any problems.

Recommendation 3.10

The Department of Education should establish adequate contract management processes to ensure payments made under the P3 contracts comply with contract terms. These processes should be followed for the remainder of the contracts.

- 3.30 *Ability to conclude on certain compliance testing for payments* – During our compliance testing for payments, we found no documentation to support

compliance with contract terms for certain aspects of the payments. As a result, there may be over or under payments which are not detected. These situations are detailed in the following paragraphs.

- 3.31 Annual operating payments are determined using base rates for utilities and salaries, from the start of the contracts. For all but one utility rate for one developer, the Department had no documentation to support whether the proper base rates were used. Since the contracts began approximately ten years ago, staff did not know if support was ever received for the base rates. A copy of information supporting payments made over the life of the contracts was not maintained.
- 3.32 Based on contract requirements, the Department should pay salary increases up to the inflation rate for the year, for non-school board staff, and actual salary increases for school board staff. The Department is paying the base salary costs increased by inflation. Staff did not attempt to obtain information on actual salary costs to determine if payments made comply with the contract terms. Without information on actual salary costs, we cannot conclude whether payments were made in accordance with the contracts and if not, how much of an error was made.
- 3.33 According to the contracts for one developer, an increase in operating payments will be paid five years from the date of substantial completion of the schools. The Department had no documentation to support the date of substantial completion for all schools. As a result, we could not conclude on whether payments were made in accordance with the contracts.
- 3.34 Operating payments are made based on a rate per square foot. For five of the 15 schools tested, staff could not provide support for the square footage used in the calculation. According to the relevant contracts, the square footage used to determine operating payments is to be based on a *"...confirmation of as built Gross Square Footage."* For three of the schools, staff could not provide a confirmation or other support for the square footage used. For the other two schools, the architect had provided an area certification. However, the certificate does not support the square footage used. The initial contracts have been amended but the Department has not kept a consolidated control copy of all changes. As a result we could not conclude whether payments were made in accordance with the contracts.
- 3.35 Similarly, Department staff could not provide support for capital lease payments for 13 schools of one developer. Therefore, we cannot conclude whether these payments were correct.

Recommendation 3.11

The Department of Education should maintain a control copy of all significant contracts, which includes all approved changes and supporting documentation.

- 3.36 *Contract monitoring for technology refresh, and capital repair and replacement funds* – In addition to operating payments to developers, monthly payments are made to six sinking funds for either technology refresh or capital repair and replacement. Three of the sinking funds established are managed by the Department and three are managed by the developers. For those sinking funds managed by the developers, the Department is not currently monitoring to ensure all amounts received from the Department are deposited, interest is earned and reinvested, and only eligible funds are withdrawn in accordance with contract terms. If these sinking funds are not properly monitored, funds may not be spent on intended purposes and value for money may not be achieved. We were unable to determine whether these funds were monitored prior to March 2008 as Department of Education staff had retired and there was no documentation such as a contract management manual detailing processes followed.

Recommendation 3.12

The Department of Education should monitor transactions processed through the sinking funds administered by the developers.

- 3.37 *Contract monitoring related to changes in responsibilities* – Initial service contracts were amended making the Department of Education responsible for technology refresh and furniture, fixtures, and equipment (FF&E) instead of the developers. FF&E funds are part of the capital repair and replacement payments. Since the contract amendments, the Department continues to send payments to the developers in accordance with the original contracts and the developers return a portion of the funds to the Department or to the school board. The Department is not monitoring funds to ensure the correct amount is returned by the developers.

Recommendation 3.13

The Department of Education should monitor funds received from the developers concerning technology refresh and furniture, fixtures and equipment.

- 3.38 *Compliance testing for technology refresh, capital repair and replacement, and FF&E funds* – We examined the transactions processed through the three sinking funds administered by the developers between April 2006 and March 2008 to determine whether funds were properly accounted for in accordance with contract terms. As well, we tested the reimbursement of funds to the Department, for the same period, where changes in

responsibilities resulted in the developers reimbursing the Department for funds received. The results of our testing follow.

- For the three sinking funds administered by the developers, we found the funds provided by the Department were deposited into the accounts except for one account which the developers overpaid by \$1,000 for the period tested. We found interest was earned on the accounts and reinvested. As well, we tested a sample of 26 disbursements from the capital accounts and found all items met the contract definition of capital.
- We tested the reimbursement of funds to the Department in two of the three instances in which contract amendments resulted in the developers returning funds to the Department. We found the correct amounts were returned to the Department.

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3.39 *Contract management manual* – The Department does not have a comprehensive P3 school contract management manual. Two staff responsible for managing the P3 school contracts retired in March 2008. Their positions were not filled until December 2008. Staff responsible for contract management during the interim period, and new staff hired, lacked detailed knowledge of contract terms, were not aware of contract management processes which may have been followed in the past, or what should be done to adequately manage the contracts. A contract management manual would provide guidance to current and new staff helping to ensure there are adequate and consistent contract management processes followed when staff responsibilities change or new staff are hired. Department of Education staff indicated they are in the process of developing a manual.

Recommendation 3.14

The Department of Education should develop a contract management manual for use by staff.

Contract Terms

Conclusions and summary of observations

The terms of the service contracts are not adequate to ensure public interest is protected. The contracts do not address significant areas such as adequate audit access for the Province; measurable service levels for all services; monitoring compliance with contract terms, including documentation requirements; and an adequate payment adjustment system to be used for non-compliance. The lack of these significant contract terms impairs the Department's ability to hold the developers accountable and effectively manage the contracts. In addition, contract terms which are vague may result in negotiated value not being realized.

- 3.40 *Lack of audit provisions* – The contracts do not include a specific audit provision for provincial internal audit or departmental staff. Without audit provisions, the Department may not have access to important information it requires to ensure compliance with contract terms. As a result, incorrect payments could be made or services not provided.

Recommendation 3.15

All significant new contracts between the Department of Education and service providers should include audit provisions for the Province.

- 3.41 *Measurable service levels* – The service contracts require the developer to manage, operate, and maintain the schools in accordance with an operating and maintenance plan and manual. These manuals define certain measurable service levels required. They were approved after the service contracts were signed. Agreeing on the cost of services before determining service levels does not help achieve value for money in a contract.
- 3.42 Measurable service levels were not defined for all services required under the contracts. It is not possible to demonstrate that value for money is being achieved if measurable service levels are not defined for monitoring developer performance. The following are some services for which measurable service levels were not defined.
- Cleaning standards were not defined in the contract with one developer.
 - The contracts require all maintenance be addressed promptly and for two developers there is a requirement that operational issues concerning health and safety be a priority. However, promptly and priority are not defined.
 - Two of the developers have contracts that define maintenance requirements but do not specify the frequency for all of the requirements, such as monthly or annually.
 - The contracts require the submission of a capital repair and replacement plan. However the level of detail required and time period to be covered by the plan are not included.
 - The contracts define the type of insurance required but not the amount. Department staff indicated an amount for comprehensive general liability insurance was subsequently determined but could not provide a documented contract change to support this comment.

Recommendation 3.16

The Department of Education should define measurable service levels for all services in future contracts and these should be included in the contracts prior to signing.

- 3.43 *Monitoring and payment adjustments* – The contracts do not describe the process to monitor performance, including supporting documentation requirements. As well, the contracts do not address what mechanisms the Department can use when developers are not meeting defined service levels in the contracts, other than mandatory mediation and arbitration. The contracts contain a payment reduction for defaults but the developer is only in default if the school cannot be used as a school. A clearly defined monitoring system, including documentation requirements and sanctions such as payment adjustments for non-compliance, reduces the risk of non-compliance with contract requirements. It also ensures the service provider is aware the Department plans to monitor compliance with contract terms, knows what documentation is required to demonstrate compliance, and is aware of possible sanctions for non-compliance.

Recommendation 3.17

The Department of Education should ensure future contracts describe the contract monitoring process, including documentation requirements and sanctions for instances of non-compliance.

- 3.44 *Child abuse registry and criminal record checks* – The service contracts require completion of child abuse registry and criminal record checks for staff working in schools, prior to hiring. However there is no requirement to update those record checks periodically subsequent to hiring. The objective of a screening process is to identify individuals who may not be suitable to work in a school environment as they may pose an unacceptable risk to student safety. We are concerned there may be employees working in schools whose record checks are outdated.

Recommendation 3.18

The Department of Education should work with the developers to assess the risk of not completing periodic record checks subsequent to hiring, determine the appropriate frequency of rechecks, and amend contract terms accordingly.

- 3.45 *Clarity of payment terms* – We identified three payment terms in the contracts which were not clear. As a result, we could not conclude whether payments were made, or would be made, as intended when the contracts were negotiated. Unclear contract terms increase the likelihood that disagreements will arise and could result in costly mediation, arbitration, litigation or negotiated amendments which reduce the value the Province would have received from the contract had the terms been clear. When developing payment terms in future service contracts, the Department should ensure all terms are clear. The details of the three contract terms are discussed in the following paragraphs.

- 3.46 The contracts define how the developers' annual operating payment is determined. The contracts with two developers include a clause which states that operating payments will only be adjusted for increases or decreases in heating fuel costs if the change is greater than 5% as determined annually by rolling averages. The time period for the rolling averages has not been defined in the contracts. According to Department of Education staff, the Department agreed to pay the actual cost of heating fuel each year as it was not clear what the payment calculation should be.
- 3.47 The contracts stipulate withdrawals from the capital repair and replacement funds should relate to capital repairs. The original contracts for two developers define capital repair and replacement costs as "*...any expense or expenditure that is reasonably necessary to maintain, repair, rehabilitate and replace the Learning Centre in accordance with the terms of this Agreement, whether expensed or capitalized under GAAP and is not an operating cost.*" The contracts do not define operating costs. Effective November 2000, the contracts for one developer were amended to more clearly define capital repairs. According to the other developer they follow the definition of capital in the amended contract noted above but there was no evidence of an amendment to their own contracts. The original definition is incomplete, which increases the risk for disputes over the contract term.
- 3.48 Under all of the service contracts, at the end of the initial contract term, the province has the option to purchase the schools, extend the contracts, or terminate and vacate. For the contracts with one developer, the purchase price is determined based on 50% of the fair market value of the properties at a point in time. However, the contracts do not define the appraisal method which can have a significant impact on the purchase price. If the appraisal method that is used results in a high purchase price, the province may not realistically have one of its options available (to purchase the properties) at the end of the initial contract terms.
- 3.49 *Inflation on technology payments* – The contracts define how payments for technology refresh are determined. The contracts of two developers require that the total base operating payment be increased annually for inflation. The developers are required to deposit a fixed amount into a technology refresh sinking fund from the total base operating amount received. However, the amount deposited by the developer does not include the inflation adjustment. There may have been an argument that the developers earned some, if not all, of the inflation adjustment when they were managing technology refresh. However, there have been contract changes which shift responsibility for technology refresh to the Department. We do not know what value, if any, is being received by the Province for allowing the developers to keep the inflation adjustment for technology refresh. Since contract changes, the developers have received \$174,100 for the inflation adjustment up to December 2007. Over the term of the contracts, they

could potentially receive another \$394,000, assuming a 2% inflation rate, for a total of \$568,100.

Subcontracts with Regional School Boards

Conclusions and summary of observations

Regional school boards, under subcontract arrangements, are delivering contracted services at a lower cost than that paid by the Department to the developers. Over the 20 year life of the contracts the estimated difference in payments between the developers and regional school boards would be approximately \$52 million. In addition, any value government achieved through the transfer of risks for the operation and maintenance of the schools by signing the service contracts, was not realized because those risks were transferred back to the government. Cape Breton-Victoria Regional School Board's subcontract arrangements with one of the developers resulted in the Board incurring a deficit of approximately \$21,000 under the subcontracts for the two years covered by our audit. This is equivalent to government paying the \$21,000 twice, as the developer has already been paid by the Department to provide this service, and CBVRSB is required to fully fund the deficit from funds available for other services. Regional school boards need to do a better job of ensuring they are receiving all amounts to which they are entitled under their subcontracts with the developers. At the end of the service contracts, the Province has the option to purchase the schools, renew the contracts, or terminate and vacate. A decision must be made four years (three years for one contract) before the end of the contract. The Province should carefully consider the information highlighted in this Report when considering which course of action is appropriate.

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- 3.50 *Background* – After the original service contracts between the developers and the Department were signed, two developers negotiated contracts with some regional school boards (RSBs) to deliver the services outlined in the original service contracts. One developer subcontracted all of their P3 schools back to the RSBs. We were informed that the RSBs were interested in such arrangements for several reasons including possible significant negative impact on RSB budgets and workforce by having schools maintained by a third party.
- 3.51 We acknowledge that under the Education Act the RSBs have the legal authority to enter such contracts, but we are concerned with the unusual nature of these arrangements. The Department of Education entered into significant 20 year contracts with third parties to provide a service. Those third parties subsequently contracted with government-funded entities (RSBs) to deliver these services. Under these arrangements RSBs may

potentially incur deficits to fulfill their contract obligations, while the Department has already paid the developer to deliver those services. These deficits could reduce the funds school boards have available for other areas such as classroom educational services and transportation services. In addition, any value government achieved by transferring operation and maintenance services risks to the developer through signing the initial contracts, was not realized because those risks were transferred back to government through the subcontracts.

3.52 *Regional school board surplus/deficits* – We examined P3 school financial data to assess whether deficits related to the subcontracts were incurred. Any deficits realized by the RSBs equate to government paying the deficit amount to operate and maintain the schools twice and clearly does not represent value for money. The developers have already been paid to provide these services and RSBs have to take money from funds available to provide other services to cover the deficits. The financial data provided by the RSBs was reviewed for reasonableness but was not audited by our office. The results of our analysis are summarized below.

- Cape Breton-Victoria Regional School Board operated at a total deficit of \$251,000 for the 2006 and 2007 calendar years. This deficit was fully funded by the Board during those years. Contract payment errors discovered reduced the total deficit to \$20,745. CBVRSB's subcontracts do not represent value for money to government.
- Strait Regional School Board and Chignecto-Central Regional School Board were able to operate at a total surplus of \$183,000 for the 2006 and 2007 calendar years, and 2007 and 2008 school years respectively. Contract payment errors discovered will increase the total surplus but at the time this Report was written the amount of the increase was not known.

3.53 *Comparison of contract terms and payments* – We examined payments made under both the original service contracts and the RSB subcontracts. For the 2006 and 2007 calendar years for one developer and the 2007 and 2008 school years for the other. Based on our discussions with management of the developers and our review of the contracts, the services to be delivered by the RSBs under the subcontracts mirror those detailed in the developers' service contracts with the Department. The substance of this arrangement is that the operation and maintenance risks assumed by the developers in their contracts with the Department have now been assumed by the RSBs. The exception is that the developers are required to provide for capital repair and replacement costs. However, a separate capital refresh fund has been created and funded by the Department, limiting their risk in this area.

3.54 Our analysis for the two year period indicates that the two developers who subcontracted services to the RSBs will receive approximately \$5.2 million

more from the Department than they will pay the RSBs for providing the same services during that period. This represents a gross profit margin to developers of approximately 34%. The significant difference in the payments is due to the negotiated contract terms. There are differences in the initial base rates negotiated; subcontracts do not include a clause which requires an increase to the base rate after five years similar to the developers' contracts with the Department; and inflation adjustments received by the developers are either not required to be passed on to the RSB or are passed on based on a lower rate per square foot. Using \$5.2 million as an average for the two years, over the 20 year life of the service contracts, the estimated difference between payments made to the developers and the RSBs under the subcontracts is approximately \$52 million.

- 3.55 Department of Education management advised us they believe this difference includes a significant capital lease payment component. They feel this occurred because a portion of capital lease payments were allocated to the operating lease payments at the time the initial contracts were signed, in order to reduce the capital lease costs.
- 3.56 *Cost of living adjustment for Strait Regional School Board*—When examining operating payments to the Strait Regional School Board (SRSB), we found that the Board was not receiving cost of living adjustments required under the subcontracts. The developer is entitled to a cost of living adjustment under its service agreement with Education and the subcontract states “...the Developer agrees to pay any adjustment it so receives to the Board for the term of this Agreement.” The developer received \$864,000 in cost of living adjustments from Education for the two year period we examined. Prior to this audit the Board had not enquired about or received any cost of living adjustments from the developer since the beginning of the subcontracts.
- 3.57 The terms of the subcontracts requiring cost of living adjustments to be paid to the SRSB are vague. The subcontracts do not clearly stipulate how the adjustment amount is to be determined. As a result, we could not precisely determine the amount of the recovery due to the SRSB although we believe that the recovery will be significant. We tested two years of the nine years elapsed to date. The maximum amount that the Board could receive for the two year period we tested is \$864,000. This is another example of lack of clarity in a contract term which could have significant financial consequences depending on interpretation.
- 3.58 When this report was written the SRSB was engaged in negotiations with the developer as to the cost of living adjustment which is payable to the Board. SRSB was also consulting with legal counsel to determine whether the developer was in breach of its contracts for not paying the Board when an adjustment had been received by the developer. Such a breach would require that the developer pay interest on past due amounts and could

further increase the amount recovered by the Board. It should be noted that this error would have continued to increase annually to the end of the contract if not detected.

- 3.59 Management and staff involved in the management of these subcontracts should have a detailed knowledge of the contract terms to ensure all money due under the contract is received.

Recommendation 3.19

Strait Regional School Board should ensure all money due under its contracts with the developer is received.

- 3.60 *Cape Breton-Victoria Regional School Board contract payment errors* – While completing our audit work, we noted two calculation errors in determining the year end settlement amount due to Cape Breton-Victoria Regional School Board (CBVRSB). These errors related to electricity and salary costs and had been occurring since the beginning of the subcontracts. However, settlements were not calculated and claimed until 2009. CBVRSB staff informed us they were aware of these errors prior to our fieldwork. The Board claimed an additional amount of approximately \$403,000 under the terms of the subcontracts. The following paragraphs provide further details of these errors.
- 3.61 The developer and the Board are entitled to actual electricity rate increases from base rates based on the terms of the contracts. The Board has been claiming and receiving an estimate for rate changes as opposed to actual rate changes. The Board claimed an underpayment of approximately \$52,000 for the error.
- 3.62 The developer and the Board are entitled to actual salary cost increases from the base salaries based on the terms of the service contract and subcontracts. The Board has been claiming and receiving actual salary cost increases from the developer but only the increases from the prior year as opposed to increases from the base salaries. As a result, in 2009, CBVRSB submitted a claim to the developer totaling approximately \$351,000.
- 3.63 The developer's management acknowledged that the amount claimed by CBVRSB as electricity and salary cost increases as part of year end settlements should be the same amount the developer claims from the Department according to the terms of the contracts. The developer indicated it identified the payment discrepancies and notified the Board. We believe the Board should explore whether the developer should pay interest on the differences noted.

- 3.64 Management and staff involved in the management of these subcontracts should have a detailed knowledge of the contract terms to ensure all money due under the contract is received.

Recommendation 3.20

Cape Breton-Victoria Regional School Board should ensure all money due under its contracts with the developer is received.

Options at the End of the Service Contracts

EDUCATION:
CONTRACT
MANAGEMENT OF
PUBLIC-PRIVATE
PARTNERSHIP
SCHOOLS

- 3.65 At the end of the contracts, the Province has the option to purchase the schools, renew the service contract for a term not less than 10 years at fair market rent, or terminate and vacate. The contracts require that the Province give four years notice (three years for one contract) of the option selected before the end of the initial contract term. The first deadline will occur in 2016. The Department of Education should consider the information highlighted as a result of our audit when determining which option to accept and what terms should be negotiated if the contracts are renewed. Considerations should include:

- the likelihood deficits could be incurred by RSBs through subcontracts;
- whether there is an appropriate allocation of risks between the province and the developers under subcontracts;
- whether contracting with developers for services traditionally provided by RSBs represents value for money to the province; and
- if service contracts are renewed, how weaknesses in current contract terms and management processes and procedures will be addressed.

Recommendation 3.21

The Department of Education should consider the information highlighted in this Report when assessing its options at the end of the service contracts.

- 3.66 The Department of Education's response to our audit report follows this Chapter. In its response the Department disagrees with a number of the findings detailed in the Report. The Department has declined, upon request from our office, to indicate whether or not it agrees with our recommendations and what, if any, action it plans to take to address them.

Response: Department of Education

The Department of Education appreciates the opportunity to respond to the Auditor General's review of the contract management of public-private partnership schools.

Subcontracts with Regional School Boards

In this Report, the Auditor General suggests that two private developers will profit from their agreements to enter into service contracts with regional school boards by an estimated at \$52 million over a 20-year period.

The Department asserts that this conclusion is based on a fundamentally different interpretation of the lease arrangements than was originally intended. Compensation to the developers for the construction and operation of the schools in question is provided for through two lease payments: the first being an operations/maintenance component and the second a capital component.

The objective of the day was to negotiate agreements with private developers that would enable Government to build needed school structures while minimizing the effect of significant, one-time capital expenditures on the Province's financial statements. Thus, the original arrangement was structured to meet the requirements of an operating lease, which enabled expenditures to be spread out over a 20-year period.

This approach placed limitations on the portion of lease payments that could be designated as capital. At the same time, Government recognized the need to compensate developers for their risk in undertaking these projects, as well as a profit on the building structures themselves and costs associated with potential abandonment of the buildings at lease-end. As a result, the developer compensation package for the entirety of the project was set up to be delivered through the operating portion of the lease.

The reality is that there was a shared understanding at the time the agreements were signed that the operating portion of the lease would cover both operating and capital repayment components. The Department maintains, therefore, that it is not appropriate to isolate the operating component of the total lease agreement, and use it as the basis for calculating gross profit on the developers' service agreements with the Boards.

In its review of these private-public partnership agreements in 1998, the Auditor General's office ruled that – irrespective of how the documents were structured – they jointly comprised what was in substance a capital lease arrangement. Following standard audit protocols, the test of a capital lease is whether the risks and rewards of ownership have been effectively transferred to the contracting party, in this case the Province of Nova Scotia.

The Auditor General's judgment at the time was that this in fact had occurred, and the agreements were recognized as capital leases on the Province's financial statements.

The Department would also like to note that the Auditor General's calculation of gross profit on the service agreements with the Boards is based on an extrapolation of maintenance costs associated with the first half of the contracts. As the schools age, there is an increasingly high likelihood that major repairs and replacements – such as a new roofs – will be required. And while there is a small fund set aside in anticipation of these costs, it does not fully protect the developer's risk in this regard.

Risk Transfer

In addition, the Department has a different understanding than the Auditor General of the notion of risk transfer as it relates to the developers' service contracts with school boards. The significant risk variables of the operating lease agreements – fuel and salary costs – are covered by escalator provisions built into the contracts so developers are fully compensated for any rise in prices. In effect, there is no significant risk associated with the caretaking and day-to-day maintenance of the schools, and there was no substantial risk transfer element contemplated in those areas as a component of the lease agreements.

In fact, given that the Auditor General concluded in his 1998 review that the Province had not successfully transferred the risks of ownership to the public-private operator, it does not follow that the public-private operator could at any point thereafter transfer the risk on to the school boards.

Contract Management and Compliance

The Auditor General has identified service contract standards in the areas of criminal record checks and first aid training of school employees that, despite reasonable efforts, have not been met in all cases. The Department acknowledges these gaps and will work with the relevant school boards to ensure that all checks and training are done in advance of employment within school facilities.

The Auditor General also suggests that the Department of Education's contract management processes and procedures as they relate to cleaning and maintenance services are inadequate. The Department maintains that, in fact, it simply employs an alternate and equally effective method of ensuring that standards are met.

The Department believes that service in these areas is best assured through awareness of school-based staff and oversight by Board-based property service divisions. This is the approach taken for all publicly-owned and managed schools. It relies on regular inspections and clearly identified steps for escalating issues identified by on-site staff.

This is a system that we believe works. When interviewed by Auditor General's Office staff, school principals stated that, "Overall, they were satisfied with the level of services provided."

The Department is committed to ensuring a high level of cleaning and maintenance services at all its schools. Current practice identifies issues on a timely basis and provides a clearly understood and efficient path for remediation with the developer. Furthermore, there are costs associated with the development and management of documentation and monitoring protocols as suggested by the Auditor General. The Department believes that its current practice strikes the appropriate balance between cost and benefit, representing good value for the Province of Nova Scotia.

Contract Terms

The Department acknowledges that the Auditor General's suggestions re contract terms can be considered as a part of any future public-private partnership agreements.

Response: Strait Regional School Board

Recommendation 3.19

Strait Regional School Board should ensure all money due under its contracts with the developer is received.

The SRSB agrees to implement the recommendation. In relation to the expected time frame for implementation, we are now in the process of collecting monies due under our subcontract with the developer.

Response: Cape Breton-Victoria Regional School Board

Recommendation 3.20

Cape Breton-Victoria Regional School Board should ensure all money due under its contracts with the developer is received.

Management is in agreement with the recommendation. Invoices for the incremental amounts owed from the developer have been issued and are being followed up on regular basis. Per discussions with developer staff, payment should be received by the end of the 2009 fiscal year. Management will continue to monitor these receivables and have discussions with the developer until payment is received. The possibility of charging the developer interest on the outstanding receivables will be brought to the CBVRSB Senior Staff for consideration.

RESPONSE:
STRAIT REGIONAL
SCHOOL BOARD
AND
CAPE BRETON-
VICTORIA
REGIONAL
SCHOOL BOARD