

HM Treasury – Reform of the Private Finance Initiative

Evidence from the Scottish Futures Trust

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**SCOTTISH
FUTURES
TRUST**

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Introduction

The Scottish Futures Trust (SFT) is an independent company established by the Scottish Government in 2008 with a responsibility to deliver value-for-money across all public infrastructure investment in Scotland.

For its size and population, Scotland has one of the largest Public Private Partnership infrastructure investment programmes anywhere across Europe. The 2011/12 Scottish Budget gave SFT responsibility to deliver an additional £2.5bn pipeline of projects – to be paid for as they are used from future revenue budgets – in partnership with the Scottish Government, local government, NHS boards and other public bodies. SFT's role is managing the pipeline of projects in the programme, presenting a properly coordinated face to the market across all investment sectors, challenging procurers and sharing best practice to maximise value-for-money and simplifying contracts and processes to save time and cost in procurement and delivery.

Scotland has pioneered capped private sector profits so that profits properly reflect risks taken and deliver better value for the taxpayer. The entire £2.5bn will be delivered under the Non-Profit Distributing (NPD) structure with delivery risks transferred to private partners under capped profit arrangements.

It is in this context that the SFT has submitted evidence in response to HM-Treasury's call. The evidence is published here in full with no redactions.

Further information on the work of the Scottish Futures Trust can be found on our website: www.scottishfuturestrust.org.uk

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Section 1: Role of the Private Sector

Question 1

Do respondents think that the private sector has a role to play in the future delivery of public sector assets? Are there specific sectors where the private sector should not have a role?

The Private sector must have a role in the delivery of public sector assets across sectors. There are core skills sitting in the private sector in relation to asset creation and management that are not core to the public sector, which is rightly focussed on the commissioning and provision of public services. The key to maximising value for money is to:

- use private sector skills and capacity appropriately where they complement and augment public sector skills and capacity;
- Create clarity over what is expected and what the reward should rightfully be for risks taken by the private sector;
- Transfer risks robustly where a private sector party is genuinely able to manage them (as opposed to just where the public customer is not able to manage them).

Across the phases of development of a public sector asset:

Commissioning: Determining the need for the asset and the outcome requirements from it – *public sector responsibility, with an increased focus in the future on joined-up asset planning across public sector organisations to create a sustainable estate fit (in the social infrastructure sector) for joined up service provision. Private sector asset portfolio rationalisations skills have a part to play.*

Specification – At the highest level determining what the form (and potentially location) of the asset to meet the need should be – *public sector responsibility, with an increased focus on addressing “needs not wants” and creating space and cost efficient sustainable assets. Private sector expertise in describing the specification has a part to play.*

Design – The design of an asset to meet the specification – *private sector responsibility, there are some areas of the public sector with in-house design capability and this can be valuable. Public sector can engage private sector designers directly however, early involvement of construction and life-cycle expertise can deliver life cycle cost benefits. Careful consideration of the hand-over point between client-led design and contractor-led design is critical.*

Construction – The creation of the asset – *private sector responsibility procured from construction contractors under a wide variety of models.*

Financing – Infrastructure funding is the primary stream of revenues used to offset the cost of the asset. Financing is the way in which that stream is manipulated to make funds available when they are needed. – *One of the points of this paper overall so covered elsewhere*

Life Cycle maintenance – The management, preventative maintenance and replacement of elements of the asset over time to preserve its condition – *One of the points of this paper. See Q4.*

Reactive Maintenance & hard facilities management – The every-day maintenance of the fabric and systems of the asset to correct faults and breakages – *Again one of the subjects here see S10.*

Soft Facilities management – The provision of non-core services required by the use of the asset for example cleaning, catering, security. – *Public or private. Increasingly SFT sees the public or private provision of these services to be independent of the creation and maintenance of the asset itself. The public sector can deliver these services itself or contract for a private sector provider to deliver them, most likely under a short-to-medium term contract arrangement. See S11.*

Service provision – The delivery of front–line services from the asset if it is social infrastructure, or the use of the asset / provision of the services that run on it (eg rail) or commodities that are run through it (eg information / electricity) – *Separable generally from the provision of the asset itself, but with an important differential as to whether there is a direct user–payment, or payment from general taxation.*

Question 2

Are there other delivery and procurement models used in the delivery of public assets in the UK and internationally that respondents consider work well? What are the key features of these model(s)?

Other respondents will no–doubt discuss the use of Regulated Asset Bases for asset provision and various construction contracting methodologies such as frameworks and early contractor engagement. All of these have their place.

In Scotland, SFT has two particular models that are relevant:

The **Non–Profit Distributing (NPD)** structure is a form of public private partnership for asset provision that like PFI relies on a project finance structure but is very different in respect of key features that are relevant to Government’s aims set out in Section 1.2 of the consultation document. The structure is used for the provision of relatively standard social and economic infrastructure funded from taxation via an availability payment to a provider on a “pay as you use” basis over the life of the asset (as opposed to traditional capital investment where the public sector uses “pay as you build” from capital budgets as the asset is created). As the funding is over the long–term, private financing is used to pay for the creation of the asset up–front. Key features are:

a) A **regulated return** to the private sector limiting the profits from the operation of the asset to a capped level through the provision of risk capital through fixed interest subordinated debt rather than equity. Any excess returns are passed back

to the public sector procurer of the asset. This fixing of the level of return creates a **better balance between risk and reward to the private sector.**

b) A **Public Interest Director** on the Board of the private company established to deliver the assets, with a particular responsibility to represent the interest of the public sector procurer and maximise returns to it. The inclusion of a public interest director, along with changes to contractual provisions on information provision delivers **greater financial transparency**

c) **Simplification of contract provisions** including: amending elements of risk transfer around changes in law, insurance premiums and utilities consumption in particular where the private sector was required under previous models to accept risks that it could not reasonably manage; removing elements of service provision around minor changes to the asset and cosmetic maintenance and harmonisation of payment mechanisms across sectors delivers **accelerated and cheaper procurement processes** as there is a lesser requirement for individual contract tailoring and **can potentially access a wider range of financing sources** as the risks associated with the asset in its operational phase are more predictable and capable of strong investment rating.

d) **Revised interaction of design and procurement** with a greater level of design work undertaken prior to the launch of a procurement process for the NPD contractor when combined with contract simplification has a further role in delivering **accelerated and cheaper procurement processes** as the period when two or more bidders are expending significant sums on parallel design development can be reduced. There is a potential for some opportunity for innovation during the competitive process to be lost and therefore the quality of the public sector controlled specification and early-stage design process, along with consideration of the design hand-over point is critical.

e) **Payment only for an available asset** retains the **incentive on the private sector to deliver to time and budget**, and to take appropriate **risk on the delivery of services**

f) **Taking the best of change mechanisms** from contracts used across different sectors strikes an appropriate balance between simple changes that the public sector building occupier can make itself, intermediate changes that can be selected

from a pre-priced and transparent price list, and more complex changes where there is a transparent process for costing the change required. This gives **greater flexibility to accommodate change** whilst recognising and making transparent that there is always a cost associated with changing an asset whether that be a sunk cost if the asset was paid for as it was built, or an ongoing cost if it is paid for as it is used.

Taken together, SFT believes that used for assets to which it is suited, the NPD model is **less expensive and uses private sector innovation to deliver services more cost effectively** whilst retaining the key benefits of a “pay as you use” structure. An explanatory note on the NPD model can be found here¹.

The other model adopted by SFT is the **hub** structure which creates an institutional public private partnership including a private sector delivery partner and the key public bodies in a region (eg Health Boards, Local Authorities, blue light) for the delivery of community infrastructure. hub allows for pay-as-you-build delivery using traditional capital budgets or pay-as-you-use delivery under a structure with a similar regulated return to the NPD model. It is based around a set of carefully determined key performance indicators which require continuous improvement in cost performance over time and delivery of targeted environmental and social outcomes such as building energy performance and training and employment opportunities. The regulated return under the hub model is structured with a base return to the private sector, sharing of returns from improved performance between the public and private sectors above the base case in order to incentivise continuous performance improvement, and a capping of return above which 100% would be returned to the public sector asset procurer. Hub sees the public sector investing in projects alongside the private sector and having Directors on the Board to bring a shared interest and further increased transparency. Aside from continuous improvement and the achievement of important key performance indicators in delivery, the hub model promotes joined-up commissioning of assets between the

¹ <http://www.scottishfuturestrust.org.uk/docs/439/Explanatory%20Note%20on%20the%20NPD%20Model.pdf>

public sector participants under the governance of a Territory Partnering Board. This will see an increase in the sharing of facilities between public bodies within a community and asset rationalisation through joined-up estate planning, delivering better services to end users, reduced service delivery costs and reduced overall estates costs.

Question 3

How should the use of private finance be evaluated when considering the best procurement route to deliver a public asset?

In Scotland, the use of private finance for delivering public assets is part of the commitment set out in the Government's 2011–12 Budget² to “explore all possible means to support higher levels of infrastructure investment than would be possible through the capital budget alone.” In recognition that “Capital investment is vital to strengthening recovery and supporting sustainable economic growth” and that “Scottish Government does not have the flexibility to borrow to fund additional capital expenditure”

In measuring the value of private finance, SFT has therefore considered the benefits brought by accelerated investment in infrastructure as compared to waiting until capital budgets become available. A calculation of this benefit, according to a methodology developed in France is set out in our annual statement of Benefits³. The social benefit of acceleration is a key aspect often overlooked.

SFT has not undertaken quantitative value for money analysis on a project-by-project basis comparing the discounted life-cycle cost of public versus privately financed assets as the range of uncertainty in the cost and particularly risk estimates involved in such a calculation are considered to be greater than the

² <http://www.scotland.gov.uk/Resource/Doc/331661/0107923.pdf> pages 36-40

³ <http://www.scottishfuturestrust.org.uk/docs/361/SFT%20Statement%20of%20Benefits%202010-11.pdf> pages 41-41

differential between the results on each side of the equation. Our value for money approach for individual projects⁴ focuses on efficiently procuring the “right” asset specified to sustainably address needs not wants.

With flexibility to borrow, the value of private finance would objectively be evaluated by considering the differential cost between forms of financing, and the differential benefits over an asset life. This could be done at an investment programme level on the basis of exemplar projects rather than by a costly analysis in respect of every individual project.

Question 4

Are there features of the PFI model that should be retained?

There are important features of the availability payment based pay-as-you-use model as embodied by both PFI and NPD that deliver value and should be retained. At the heart of these are:

Integration: Of design, construction and life cycle maintenance to bring a clear and (through whole-life cost competition) incentivised focus to optimising the whole-life cost and operability of the asset.

Diligence: Ensuring that a contract is only entered into for the delivery of the asset when the specification, price, programme and commercial conditions are properly aligned to give reasonable certainty of delivery. This diligence is particularly strong when it is performed for senior funders who have clear incentives not to lose money.

Risk Transfer: There is value in the certainty delivered through transferring risk to a party clearly incentivised and skilled in managing it. SFT has previously said that it “believes fundamentally that there is risk in these projects and that there is value in transferring elements of that risk to another party..... Seeking to finance them at

⁴ [http://www.scottishfuturestrust.org.uk/docs/536/Value%20for%20Money%20Supplementary%20Guidance%20\(Final%20Version%20October%202011\).pdf](http://www.scottishfuturestrust.org.uk/docs/536/Value%20for%20Money%20Supplementary%20Guidance%20(Final%20Version%20October%202011).pdf)

Government's risk-free rate of borrowing does not mean that all risk is abolished. The risk varies through the life of the project, and there is a very valid argument to recognise this and only pay financing costs that involve high risk premiums during the construction phase where the real risk for most projects exists.⁵

Certainty of Maintenance: This is an important and often overlooked feature of PPP structures which means that the condition of the asset after 25 years is good and predictable. The standards set for condition at hand back of the assets could be altered if procurers feel that the condition requirement is too high, but the presence of an up-front contractual requirement to pay for maintenance to an agreed standard has been shown to be perhaps the only way in the public sector budget prioritisation mechanism to ensure budgets for maintenance are prioritised. SFT has said "if you are not prepared to maintain an asset, you shouldn't retain it. It can well be argued that this is the central benefit of PPP style procurement – you contract for the maintenance of the asset as you contract for it to be constructed. It seems to me a false argument to say that the differential is because the private sector is inherently better at looking after assets – most asset managers in the public sector know exactly what needs to be done. It is simply that in the public sector budget setting processes, the only way that we can bring ourselves to make enough money available to maintain assets properly is by contractually committing it to a third party, the moral commitment made when the asset is created seems to simply not be strong enough⁶".

⁵ http://www.davidhumeinstitute.com/images/stories/Seminars/Reekie_transcript.pdf page 10

⁶ http://www.davidhumeinstitute.com/images/stories/Seminars/Reekie_transcript.pdf page 7

Section 2: Institutional investment

Question 5

What changes to the current approach to the allocation of risk and the procurement and delivery of public facilities and services would increase institutional fund investment appetite, either directly or through intermediary investment vehicles?

Institutional investors themselves will be better placed to respond to this question.

SFT's observation is that where there is a regulated sector and strong elements of direct user charges for the assets (either completely as in the utilities, or partially as in rail or social housing) then a corporate or quasi asset-backed form of financing can work well (eg regulated Asset Base financing), potentially with an aggregating intermediary (such as The Housing Finance Corporation⁷ in the Registered Social Landlord sector). These structures are known to attract institutional investment through the capital markets.

However, where the Government is ultimately funding the asset from taxation, and the asset is specific in nature it is difficult to see such a structure creating a risk profile substantially different from direct government borrowing. If there is any substantial movement away from a risk profile that sees Government making a payment only for an "available asset" (other than potentially as discussed in Q9 and Q13), then the argument for paying for financing separately from general government borrowing is weakened as many of the other benefits discussed in Q4 can be delivered in other ways.

Within the confines of a PPP structure that sees payments made for "available assets" then there are options, such as discussed in 2c. (amended risk allocation and reduced range of services) which SFT believes could increase institutional fund investment appetite. Discussions with market players suggest that strong

⁷ <http://www.thfcorp.com/>

investment grade rating and liquidity are important and options to deliver this are discussed more in Q6 below.

The bundling of assets together to form a portfolio for investors to diversify risk and create an investment opportunity of scale is a potential, but history of bundled PPP deals shows this to be difficult to achieve from within the public sector due to the issues of having multiple client bodies, timing difficulties and inter creditor issues. Private sector side debt aggregators of funds could potentially address this issue and other respondents are better placed to comment.

Question 6

Would alternative approaches to the current typical capital structure of projects be favoured by institutional investors? What constraints currently exist to adopting these approaches, and how could these be addressed?

As above, we respond within the constraints of a structure that sees payment made for “available assets”. SFT is considering a number of options that may be of interest in the review:

- a) Decreasing gearing from the current standard of 90:10 and an increase in senior debt cover ratios would reduce the risk for senior lenders and potentially allow a stronger rating for senior finance, making it more attractive for institutional investors. However, the increased equity (or subordinated debt) tranche would be more expensive and as it would tend to be in place for the whole life of the project would significantly increase overall financing costs.
- b) Introducing a tranche of mezzanine debt (or facility) between risk capital and senior finance would have a similar effect, at a potentially lower cost. It has been discussed by players including the European Investment Bank and other respondents will be able to give more detail.
- c) The reappearance of wrapping has received some coverage of late, and whilst the wrapper’s do not have the AAA rating of pre-financial crisis, there may be a role

for this quasi insurance model of credit enhancement for the entire term of the contract along with the services of information flow and controlling creditor provided by the wrapper. Given e) below, and the limited market available, the value of a wrap during the operational phase would have to be clearly tested against its cost.

d) Separation of construction from operational phase financing could deliver institutional investment in the operational phase and is further discussed in Q13.

e) As discussed in Q2c. above, the simplified contract used in NPD contracts with a clearer allocation of risks that the private sector is able to manage, and a reduced range of services should deliver a stronger rating in the operational phase. Under the NPD model, this can be combined with robust cover ratios without a substantial loss of value to the public sector, as surpluses required in the cash cascade to deliver the required cover ratios can be returned to the public sector to the extent that they are above the fixed subordinated debt coupon. Given a strong investment grade in operation, a different approach to credit enhancement during construction could be considered to properly recognise the difference in risk between these two phases and only pay the cost of the increased risk in the phase in which it exists. The Canadian approach would be to use a security package including a combination of letters of credit, performance bonding and instruments such as sub-contractor insurance from main contractor insolvency to increase the rateability of the senior finance overall. SFT is engaged in exploring this approach which may have been facilitated by the simplification of the operational phase of the contract.

Finally, it has been suggested that investors of scale may be prepared to take a blended view of the risks of providing available assets and adopt an un-gearred structure for a single blended return. SFT has yet to identify investors with the capacity to undertake the necessary origination, up-front diligence and ongoing management; and the interest to provide blended finance at a risk: reward profile that would make it attractive as compared to a geared structure but remains open to any such an approach.

Question 7

Are there other actions that could be taken, by the public or private sectors, to increase institutional investment in public assets and services, and what are these? What would be the expected implications for cost, risk transfer and value for money?

Aside from the points in Q6 and Q13, an increase in origination, diligence and management capability within the private sector investors or investment managers could increase institutional investment through private placements. Other respondents will be better placed to comment on this.

The creation by the public sector of “baskets” of assets, with a portfolio where some assets are core existing assets with an ongoing need (and revenue stream), some may have disposal potential, and there is a requirement for some to be developed (new or redevelopment) could create an investment opportunity for institutional investors with a property portfolio. Where assets are non–specialist and can be leased by public sector occupiers on an operating lease basis and where value can be delivered through rationalisation this could be attractive to both the public and private sectors as in the Local Asset Backed Vehicle (LABV) models. However, where assets are specific to their purpose (eg schools or hospitals) it is likely to be difficult to transfer significant risk to private sector operators under such a structure in order to deliver value form a privately financed solution.

Section 3: Government's role in project funding

Question 8

What if any role should public sector capital play in the financing of the construction or operational phase of public assets and services? How and when might public sector capital be best used to improve investor/lender appetite and pricing without adversely affecting risk transfer and performance incentives? What constraints should apply to the quantum of public sector capital grants?

See Section 14 for a discussion of a wholly public capital financing structure.

SFT considers that up to 50% of the financing requirement can be met by public capital whilst maintaining the diligence and performance incentives that a “payment for asset availability” structure places on the private sector delivery partner and financiers. Generally this financing should be applied at construction completion, or clear milestones of partial completion in order to clearly transfer construction risk. Public capital injection is a feature of SFT’s model for the delivery of schools through the hub model, where local Authorities are considered likely to want to want to make a capital injection for their (<50%) share of the cost of the asset under the funding arrangements agreed with Scottish Government.

Question 9

What if any role should public sector risk underpinning or guarantees play in partially de-risking the construction or operational phase of public assets and services? In which areas could underpinning or guarantees have a beneficial impact on investor and/or lender appetite and pricing? What are the constraints to this approach, with particular regard to risk transfer and performance incentives?

SFT considers that an underpin or guarantee of up to 50% of the financing requirement could be made whilst maintaining the diligence and performance incentives that a “payment for asset availability” structure places on the private sector delivery partner and financiers.

Other respondents will be better placed to give a view on the extent to which this (and indeed public sector capital injection) will alter pricing of private finance as there is significant detail in the tranching of any guarantee and it seems that different views are taken (in particular in different jurisdictions) on any pricing differential on the unguaranteed proportion due to an increased credit risk alongside reduced quantum of equity buffer.

Question 10

If public sector capital grants are made to part-finance the construction phase of projects, what constraints should apply and what impact would a level of capital contributions in excess of the current 30% be expected to have on equity and debt investors' investment appraisal and pricing, and on risk transfer and performance incentives?

See Q 8 above

Question 11

If public sector loans are made to part-finance the construction or operational phase of projects, what impact would this have on equity and debt investors' investment appraisal and pricing, assuming pari-passu ranking with senior debt? What approach should be taken to lender voting rights and what other constraints or procedures would be relevant?

Other respondents will be better placed to give a view on this point.

As a generality, if the Government itself lends into "payment for availability" structures then the value of risk transfer is proportionately diminished, and if Government is the majority (or even sole) lender, then the value in the structure is largely lost. See Section 14 for an alternative proposal.

Section 4: Debt finance

Question 12

What alternative approaches to the debt finance of projects should be considered that would address regulatory pressures on the market, while maintaining current benefits of lender due diligence and risk monitoring – thinking about both bank finance and capital markets solutions?

See Q6

Question 13

What is the view of respondents to an approach which financed the construction period of projects separately from the operational phase?

There could be enhanced value in separating construction from operational phase financing and SFT has considered this within the bounds of a “payment for available assets” structure.

One approach to effectively separating the financing is through a mini-perm senior finance structure with either short term senior loan maturity requiring a refinancing before the end of the contract term (hard mini-perm) or strong incentives such as margin ratchets and cash sweeps for a refinancing (soft mini-perm). Under each of these structures the public sector pays a premium for the uncertainty in the future cost of finance. Under a hard mini-perm structure equity has to be able to take the risk of increased cost of finance at refinancing and must be remunerated accordingly and the senior funders must be persuaded that the risk is very low that they would have to roll beyond the contracted maturity to avoid default if refinancing was not possible. Under a soft miniperm structure the public sector tends to pay the high cost of finance dictated by ratchets and only benefit from a proportion of the saving if that is reduced in a refinancing (due to refinancing gain sharing mechanisms).

An approach favoured by SFT is to take a 100% share for the public sector of any increase or decrease in the cost of finance at a refinancing post construction completion through an adjustment to the unitary charge. The cost of finance can be split into two elements – broadly the underlying interest rate and margin. It could be possible to maintain the hedge in long-term interest rates for the full contract term from the outset, but the issues associated with a long swap and short debt are likely to make the cost and complexity of this (if indeed it was available in the market) outweigh any benefit in cost certainty. Government (though perhaps not individual public sector bodies) is well used to accepting the risk that the underlying cost of long term finance varies through time from its own gilt issuance programme as well as having taken the risk at the time all PPP projects are first signed up to. The other element is the margin risk in debt pricing (either from banks, or more likely the capital markets) at a refinancing. Here there is a need to separate any effect of poor project performance from general market pricing. One way to do this would be through the pre-rating of the stable operational phase prior to signing the contract, it could then be re-rated in stable operations (a set period following construction completion) and any difference in rating would be to the cost of equity (and ultimately the incumbent senior financier), with the marginal cost of finance at the originally anticipated rating being to the account of the public sector.

An inability to refinance due to diminished rating would be a contractor default, and an inability to refinance due to market unavailability of originally anticipated tenor and rating of debt would be likely to represent a form of public sector default. SFT considers that such a structure could transfer availability risk to the private sector and retain the incentive to long-term diligence and cost management on behalf of both equity and the funder who would be reliant on a strong operational rating to be held whole at their exit.

It may additionally be possible to refinance a portfolio of assets at the same time in stable operation, potentially through an aggregation vehicle into a larger scale tap of the capital markets.

SFT recognises that such a structure requires further development, not least in refining the separation of finance cost and operational risk, and in controlling creditor issues in the operational phase, however it is considered to have significant merit worthy of that further consideration given that it places two things: (1) short

term risk and diligence with banks; and (2) long term stable cash flows with institutional investors; in what many would perceive to be their natural homes.

Question 14

What impact would a shorter term debt finance approach be expected to have on financing costs? What if any implications would there be for the lenders' due diligence approach and for the transfer of asset design, construction and maintenance risk? What factors would enable the transition from bank debt funded projects to capital markets refinancing?

See Q13 above

Question 15

What factors are relevant to consideration of the appropriate allocation of refinancing risk between the public sector authority and the contractor? Is it possible for project performance and credit factors to be separated from market factors when allocating refinancing risk?

See Q13 above

Question 16

What are the views of respondents on the effectiveness of preferred bidder debt funding competitions? Could a wider application of debt funding competitions enable more effective access to the debt markets and what role should the public sector play in this, at a local or central level?

SFT considers that preferred bidder debt funding competitions are likely to have their place in an increasingly complex interplay of procurement and financing of projects during a period of financing market volatility. However, consideration must also be given to:

- a) Opportunities to increase liquidity between bidders by removing or limiting the ability of sponsors to require exclusivity from financiers in order to support them at tender stage, recognising that there is commercial sensitivity at this stage but that it is an approach that has been applied in other jurisdictions;
- b) The need to recognise the value of differential financeability between (in particular) different construction contractors, and the impact that the cost of different security packages that funders may require on overall value for money;
- c) The value that can be brought through innovation when sponsors are required to arrange and price in competition a financing package can be substantial and may well be lost if finance is fitted after a preferred bidder is selected.

Finally, it is not clear that procurement risk is avoided with a preferred bidder debt funding competition, as there could be a differential in the way that bidders would have approached any changes needed to the commercial structure of their offering given the requirements of financiers brought in through a separate competition.

Question 17

What alternative approaches could be considered to inflation risk and interest rate risk management, taking into consideration trade offs between budgetary certainty and operational flexibility?

SFT is clear that inflation linking of unitary charges should follow the “natural hedge” with the indexing proportion matching indexing costs to the provider. Over indexing of unitary charges and the use of inflation swaps or index linked financing has left public bodies with significant budgetary pressures at a time of relatively high inflation and reducing budgets, though it remains to be seen how these payment profiles will appear over the longer term. A prudent approach to managing long-term obligations to pay is to have a low proportion indexing such that the real payment decreases over time. As such, the use of embedded inflation derivatives will not be permitted in the NPD programme.

At a central level, it is arguable that some form of long-term inflation linked investment opportunity is a good match for the liabilities in pension funds in particular. It could be a good investment for the central authorities, with a greater ability to manage budget implications over time, to offer. A large scale investment opportunity could be used kick-start a CPI linked market as opposed to the wider spread RPI link.

More broadly, individual public bodies as procurers are not well placed to deal with the budgetary uncertainty of floating interest rates. Central government which, as discussed in Q13 takes interest rate risk regularly may wish to consider centrally the cost / certainty tradeoffs implied. This is particularly the case in respect of long-term financing and flexibility requirements where the cost of breaking long term swap instruments in the event of the need for significant change is a major factor. In Scotland, a central top-slice of revenue budgets is used to pay the element of asset-availability charges that relate to the creation of the asset thereby separating these cost elements in respect of infrastructure investment from the ongoing operational costs of different departments / bodies. Such a budget structure allows a clearer centralised consideration of hedging arrangements.

Section 5: Equity return

Question 18

Would a regulated asset model be more economically efficient than the PFI concession model?

A Regulated Asset Base (RAB) model clearly implies a greater structural change than simply on equity returns. In the regulated utility model, where customers pay for the provision and maintenance of the assets by a naturally monopolistic operator, the RAB model is a way of passing the cost of finance risk directly to customers in line with the regulatory cycle, in return for the low cost of finance delivered by the implicit guarantee of financeability.

The operator holds the assets in a broad and relatively diverse portfolio as part of a business model in perpetuity. The operator requires itself to maintain the assets in serviceable condition in order to deliver services over them and to meet legal / regulatory requirements. Given the diversity of the asset pool, and the charging regimes in place the failure or unavailability of any particular element of the asset base is likely to only have a very limited impact on profitability let alone debt service. Furthermore, at any point in time, the assets under construction are a very low proportion of the total asset base, with the risks associated with construction outturn borne by equity within their overall returns in so far as they are not transferred to contractors. The economic regulator takes a view on efficiency improvements in maintenance and asset creation but is generally hands-off in terms of specific assets and the renewal / expansion programme.

Most of these characteristics are quite different from a programme of investment in social infrastructure, or even roads (setting aside tolled roads) where the Government itself (or public sector bodies) pays for the assets and has a direct role in setting requirements to quite a detailed level and prioritising investment. Given the proximity of the specification and payment for these assets to Government, and the requirement for an implicit guarantee of financeability in RAB, it isn't clear that borrowing through RAB for such assets would be materially different from using

Government's own borrowing and contracting robustly for construction and possibly maintenance activities.

In respect of assets where there is a strong element of user payment, for example directly tolled roads, there could be more of a role for a RAB financed "in perpetuity" model. One issue to be considered would be how to "seed" the RAB, or whether such a structure could be created from a zero-asset base.

Question 19

What are respondents' views on an approach that capped equity returns or that provided for public sector sharing in returns achieved above a specified level? What impact would this be expected to have on investor appetite and pricing and on project performance? At what level should any cap or sharing threshold be set?

As discussed in Q2, Scotland employs the NPD and hub models both of which have a regulated, or capped return structure. Market appetite has been strong for projects procured under this model with recent OJEU advertisements attracting competitive fields of potential bidders.

Caps and sharing thresholds have been set through the competitive process and their value brought in to evaluation through a quantification of the value of surpluses to the public sector procurer, albeit at a higher discount rate than unitary charge payments recognising their uncertainty. On recent procurements in the hub programme, bidders have tendered sharing and cap thresholds at levels highly competitive compared to the history of the PFI marketplace.

Question 20

Should the public sector limit the transferability of PFI equity? What nature and quantum of limit would not adversely impact on investment appetite and pricing, and on project performance?

The transfer of Equity from primary investors (in particular contractors) following construction completion is valuable to all parties, allowing contractors to recycle equity and deliver a pipeline of projects. It is possible that any attempt to limit transferability could deliver little or no benefit to the public sector, whilst unnecessarily constraining private sector investment.

Question 21

Should the public sector share in gains on sale of PFI equity, and what impact would this have on investment appetite and pricing?

SFT believes that the differential pricing of equity (including subordinated debt) between the primary market (new projects) and the secondary market (generally equity changing hands on projects in their operational phase) is too high. The returns tendered in the primary market do not appear to be commensurate with the level of risk being taken. The opportunity to make significant and in our view to a real extent unwarranted, profit from a sale in the secondary market where investors have become comfortable with a significantly lower return broadly commensurate with risk taken remains.

Taking a share of gains from equity sales would be one way to counteract this situation. For future projects it would be possible to implement such a sharing albeit that the provisions required may become complex given that equity is often sold in portfolios. For existing projects it is very unlikely to be applicable retrospectively as the party making the gain is almost by definition not part of the project any more. Prospective application on existing projects would potentially be possible by way of a voluntary code with industry but the level of benefit to be gained overall from that would be likely to be minimal with the majority of projects that are likely to change

hands for the first time following construction completion, having done so already. Gains in further sales are likely to be significantly lower.

In SFT's view, the best way to address this issue for new projects is at source – by regulating (through the contract) the level of equity returns on projects and having these bid competitively as part of the procurement. This return will always be a market decision, but in our view steps can be taken to allow investors to take a new and different view of primary returns:

- a) The NPD structure requires bidders to properly consider the equity return required rather than allow it to be driven by bank cover ratios. As discussed in Q6e, the return of surpluses to the procurer means that not all “free cash” has to go to equity after the cover ratios have been met. This allows lower returns to be modelled whilst meeting senior funder requirements.
- b) Risks have been re-allocated such that investors are not required to price in margin for risks that they are not reasonably able to manage;
- c) The shortening of procurements, with a lesser requirement to invest heavily in design work in the bidding phase means that bidding costs are reduced and margins to make up for the cost of lost bids should not need to be so high.

Together with a highly competitive market, these steps should allow the gap between primary and secondary returns to be lowered (by lowering primary returns) such that any gain on sale may reasonably be considered as a proper reward for taking (in many cases) bidding risk, and the higher risk of construction and handover phases.

Question 22

What views do stakeholders have on public sector co-investment or joint venturing alongside private sector equity? What quantum or terms of public sector equity stake would not adversely impact investment appetite and pricing, and on project performance?

SFT's hub model sees public sector investment in the HubCo public private partnership of up to 40%. Of this, 30% can come from the participating public sector bodies (local authorities, health boards, blue light etc) and 10% from SFT. This equity participation, where there is an alignment of interest in the partnership for successful development of the company to deliver a pipeline of known, and currently unknown projects we see as valuable. The structure also allows (though does not require) pro-rate investment by the public sector in individual financed projects delivered by the hubco.

In terms of quantum it is considered important that the private participant has the clear controlling interest in the hub company and therefore public equity participation has been maintained to well under 50% overall.

For individual stand-alone projects it is less clear that there is value in the alignment of interest and the balance in the tension (which exists in the hub structure as well) between being a client and an investor is considered to fall the other way. A public sector nominated Director on the board of the delivery company as part of the NPD process brings transparency and some influence over key matters where there could be conflict of interest but we have not considered to date that public sector equity participation would bring great value.

Section 6: Risk allocation

Question 23

In what areas do respondents consider that a change to the conventional PFI risk allocation as between the public sector authority, sponsors, funders and suppliers could reduce costs and/or improve the flexibility while still offering value for money?

The following is an extract from SFT's contract user guide⁸ which sets out changes made from previous standard PPP contract forms. SFT believes as discussed elsewhere in this response that these will deliver better value for money for the public sector:

The following material changes have been made to the risk transfer:

- o Title risk (other than the risk of compliance with disclosed title information and/or Reserved Rights) is taken by the public sector (Clause 9 and Schedule Part 6).
- o Risk of capital expenditure arising from unforeseen change in law during the operational period is retained by the Authority (Clause 32).
- o Energy usage and price risks are retained by the Authority, but service standards have been added to incentivise the service provider to do those things that significantly influence energy consumption and are within its control.
- o Insurance premium risk sharing in relation to market-related changes has been dropped so that insurance premiums become mainly a pass-through cost, but measures have been added to ensure that the project insurances are procured on terms that represent best value for money for the Authority (Schedule Part 14 and Schedule Part 15).

⁸ <http://www.scottishfuturestrust.org.uk/docs/440/Standard%20Project%20Agreements%20User's%20Guide.doc>

The changes to risk transfer have been made to improve value for money in the belief that historically either little or no risk transfer was achieved in practice or else the risks transferred were being fully priced by the private sector and, therefore, paid for by the public sector whether or not the risk actually occurred.

Changes of approach have also been adopted in relation to other risks:

- o Energy efficient design will be a design requirement and will be managed through design review, monitoring during construction and testing by appropriate completion tests prior to handover.
- o Vandalism (in schools) will be a public sector risk although the service provider will still provide the reactive maintenance to rectify damage due to vandalism, subject to reimbursement of costs.
- o Internal decoration, window cleaning (and floor coverings) and Authority equipment are excluded from the maintenance service. The Authority will have minimum periodic maintenance obligations for these items. The service also excludes PAT testing of the Authority's electrical equipment.
- o Variations are regulated by a version of the Change Protocol developed for the BSF programme in England. The SFT intends to use experience from projects to produce a standard catalogue for Low Value Changes that it will provide as supplementary guidance in due course. The Change Protocol includes an option that allows the Authority to carry out certain very minor classes of changes for itself.

Question 24

Are there other ways in which the conventional contractual framework could be simplified in a way that would enable the private sector to price more cost effectively?

SFT has reviewed the contractual framework within the bounds of a "payment for available facilities" contract and has made simplifications considered reasonable without significantly perturbing market expectations.

In some sectors, where ultimate return of the asset to the public sector may be considered less important (eg potentially waste) then a more radical simplification into something more akin to a long-term fee for service contract could be considered.

Section 7: Procurement and contract management

Question 25

What further improvements could Government consider to the standard approach to PFI procurement in order to streamline the process and reduce costs, while meeting wider objectives for effective competition, accessing bidder innovation and maintaining a robust contractual framework?

SFT considers that there are 4 significant areas for improvement:

- a) A revised interaction between design development and procurement. Greater public sector design prior to procurement commencing will save time and cost during the tender process. The tension is that some bidders will feel constrained and unable to offer maximum innovation to meet a requirement truly described by outputs. In general, the time and cost benefits of undertaking high-quality design in the public sector including building layout, adjacencies and room sizes prior to starting the procurement is considered to outweigh the potential cost of lost innovation. In adoption such an arrangements it is important to properly consider what the design cut-off point should be, how to specify negotiable and non-negotiable elements during the procurement and the use of the design team through the procurement process in order to maximise the benefits that can be gained. Within the public sector led design, there could then be more use made of appropriate standardisation between projects to drive further efficiency and sustainability.
- b) Contract simplification and further standardisation of elements such as service specification should lead to reduced time and cost in contract negotiation and discussion.

Both of these areas, if combined with pragmatic bidders who equally want to see quick progress should reduce the time scale for the competitive dialogue stage of the procurement in particular.

- c) Further streamlining and harmonisation across sectors of Prequalification documentation should lessen the investment requirements of bidders when the competition is still very wide;
- d) Improved public sector governance arrangements and approval processes can significantly reduce time scales as the time allowed not just for evaluation, but also for approval of short listing, mid dialogue down selection, preferred bidder appointment and full business case approval can add significantly to time scales and cost.

Question 26

Are there particular ways in which the private and/or public sector approach to contract management can be improved in order to manage contracts more cost effectively?

SFT considers that a shared-service approach to contract management across public sector bodies could lead to more cost effective, and commercially effective contract management. This would in some ways mirror the efficiencies that have been driven on the private sector side through aggregation of individual projects into portfolios for management by specialist groups or companies.

Section 8: Balancing innovation and standardisation

Question 27

What is the right balance of output based versus standardised specification, when considering the twin objectives of accessing greater contractor innovation and reducing costs?

See Q25a – that response was given in particular relating to relatively standard social infrastructure assets. However, we do not consider that a universal approach can be applied. For example in roads procurement it may be that a significantly earlier contractor involvement before detailed routing and major civil engineering decisions have been taken could bring benefits, though the challenges of interacting such an approach with the legal frameworks for project promotion could be substantial.

Question 28

Could a different approach to the engagement of contractors in the procurement process access greater private sector innovation?

Others respondents will be better placed to respond on this point.

Section 9: Soft facilities service management

Question 29

Should soft services continue to be included within the contractual model alongside the delivery and finance of the public facility?

As discussed in Q1, SFT is not promoting the inclusion of soft services within contracts for asset delivery. Many contracts where such services have been included in the past have included benchmarking and / or market testing provisions and retention of pensions and or employment cost risks meaning that there is no cost certainty over the contract period. It is also the case that these services may well see a higher impact on their delivery from changes in law / standards or the detailed use of the facility. Conversely, it has been the case that some contracts including soft facilities management have brought significant innovation, for example the robotic services at the Forth Valley Royal Hospital and it has to be recognised that some innovation may be lost through this approach.

On balance, and in particular in terms of financeability and flexibility, SFT believe that the benefit of excluding soft services outweighs any benefit of including them.

Question 30

Are there alternative approaches to the contractual framework for soft service delivery for a long life facility that could result in a better balance of risk transfer, flexibility and competitive pricing?

Others respondents will be better placed to respond on this point.

Question 31

What impact would the separate contracting of soft services be expected to have on equity and debt investors' view of the project's risks and rewards?

The removal of peripheral services will mean that senior finance faces lower risk from "all-costs" sensitivities and should be capable of a higher rating. It should also provide easier to manage SPVs and a more flexible form of contract management.

Other respondents will be better placed to respond in detail on this point.

Section 10: Hard facilities management

Question 32

Under the current PFI model, how effectively has the party who holds hard facilities management and lifecycle risk been able to price those risks?

Others respondents will be better placed to respond on this point.

Question 33

Reflecting on the long term nature of the contracts and changing approaches in maintenance contracts, for example improvements in technology that drive greater efficiency, how could the public sector have better confidence in the ongoing value for money achieved from hard facilities management and lifecycle risk transfer?

In any long-term contract of this nature, it is possible to sit the life-cycle risks within the operating company (SPV) or pass them down to a facilities management sub-contractor. Under the NPD model, there could be enhanced value for the public sector in retaining these risks at the SPV level where, if risks do not materialise and there is a surplus in the lifecycle fund it would be returned to the public sector procurer.

Others respondents will be better placed to respond on other aspects of this point.

Section 11: Insurance

Question 34

Are the insurable risks of PFI projects most appropriately dealt with (a) by the private sector with a fixed cost passed through to the unitary charge, (b) by a premium risk sharing mechanism or (c) by the public sector? Please specify reasons for your choice.

See question 23 for SFT's approach to insurance premiums. The private sector project sponsor cannot control the risk of "market" movements in insurance premiums and should not therefore be required to price for that risk (or even an element of it). SFT has considered implementing a public sector portfolio insurance structure, or procuring authorities' general insurance / self-insurance arrangements but has considered the interaction of these with a "payment for available assets" contract would be complex and has not pursued in more detail.

Question 35

Are changes in insurance costs that are attributable to project-specific factors (eg claims-history, poor security, quality of build material, installation of sprinklers, security arrangements, etc) most appropriately borne by (a) the private sector, (b) the public sector, or (c) borne on a shared basis? Please specify how.

Others respondents will be better placed to respond on this point

Under SFT's model of the public sector taking "market" movements risk, each party bears its own risk around claims history through the sharing arrangement set out in the Payment Mechanism.

Question 36

Are there (a) certain types of project (eg housing, office accommodation, specialist accommodation, highways, street lighting, equipment etc) and (b) certain types of risk (eg negligence of the contactor/supply chain, business interruption cover for banks, officer's liability, statutory cover, third party liability, vandalism, construction phase cover, property damage all risks), which are more/less suited to coverage by the public sector. If so, which are they and why? What are the concerns, constraints or procedures that would be relevant or required for any such public sector self-insurance?

Others respondents will be better placed to respond on this point

Question 37

If the public sector provided cover for insurable risks for any future PFI projects, what incentives or penalties would be needed to promote a private sector interest in managing risks effectively to reduce/avoid claims?

Others respondents will be better placed to respond on this point

Question 38

Would you favour the establishment of a framework of insurers for PFI contractors to use (with the use of mini-competitions)? If so (a) should the use of the framework be mandatory and (b) would it lead to better value for money for the public sector compared with contractor-led portfolios?

Others respondents will be better placed to respond on this point

Question 39

Do you consider that the ratio of premium income to claims paid for PFI projects indicates that (a) commercial insurance does or does not represent good value for money and (b) the commercial insurance market is or is not operating efficiently in this area? Please specify reasons for your view.

Others respondents will be better placed to respond on this point

Section 12: Flexibility

Question 40

Should there be more and/or earlier break points in contracts and what would be the expected pricing impact for the public sector? Are there specific points that break points should be linked to?

The interaction of break-points and long-term certainty of financing costs is a complex one, and the costs of breaking any long-term swaps would be a significant impediment to value for money. Should the public sector take underlying interest rates risk, then an approach with earlier breaks could be considered.

Question 41

What are respondents' views on the current approach to determining voluntary termination compensation, are there alternative approaches that should be considered, in particular should there be differentiation in compensation amounts reflecting the point at which the termination arises?

Others respondents will be better placed to respond on this point

Section 13: Transparency

Question 42

What degree of financial transparency should be adopted for future privately financed and delivered assets and services?

SFT considers that greater financial transparency should be a feature of future projects and has included a restricted list of commercially sensitive information that can be withheld in Part 26 to the Schedule of the Standard Agreement and timescales for its sensitivity⁹. This includes (for example) for protection of a Financial Model only for two years following completion of the asset.

Furthermore, SFT considers that ongoing routine publication of financial and performance information in the form of performance reports received from the provider should be more widespread within public sector client organisations.

Question 43

What are respondents' views on the potential extension of project information requirements to periodic financial reporting and disclosure from project sub-contractors and shareholders, including sub-contractor out-turn costs, project equity transfers and achieved project and equity returns?

The level of transparency should rightly follow that in other areas of contracting between the public and private sectors. To the extent that a construction contractor delivering an asset under a fixed price "Design and Build" contract is required to disclose out-turn profitability so should the sub-contractors in this form or

⁹ [http://www.scottishfuturestrust.org.uk/docs/434/Standard%20Form%20Project%20Agreement%20\(NPD%20Model\).doc](http://www.scottishfuturestrust.org.uk/docs/434/Standard%20Form%20Project%20Agreement%20(NPD%20Model).doc)

contract. With respect to the investors, NPD arrangements deliver transparency of maximum returns at the equity / sub-debt level.

Question 44

Would a different approach to project governance improve transparency? What if any role should be played by the public sector in the governance of privately delivered and operated projects?

As discussed in Q2, the NPD structure sees a Public Interest Director appointed to the Board of the private sector delivery company to increase transparency, represent the interests of the public sector “surplus” and act in the event of conflict of interest between the private sector directors and that surplus.

Under the hub model, the public sector has two directors in each hub company, one from SFT as the central investor, and one representing the participants. The presence of these Directors on the Board has brought a significant improved mutual understanding of the interest of the public and private participants in the hubCo and a greater transparency to the public sector of the operation of the delivery partner.

Section 14 – Other

Please use this box to include **views on other issues that you consider are important** that are not covered by the questions in chapter 2 of the Reform of the Private Finance Initiative. You can **also use this box to capture alternative proposals or you may want to submit these in a separate attachment.**

Given the key benefits of a “payment for available assets” structure discussed in Question 4, SFT has given some early consideration to whether these could be delivered without the use of private finance.

Integration: The benefits of integrating “whole life thinking” including constructability of the design, maintenance costs, life cycle costs of significant building and systems elements and environmental sustainability are clear. They could however be delivered to a large extent through a clarity of their importance at the specification stage, whole life costing, application of sustainability measures and appropriate diligence without wrapping the whole life into a single contract. Any consideration of whole-life contracting without a financing element would not give as strong a risk transfer as current structures due to the lack of capital at risk during the operational phase.

Diligence: Is generally delivered by financiers, but through the skills of a small group of in-house and contracted individuals. It would be possible, and has shown to be so through high-profile programmes such as the Olympics infrastructure to deliver this diligence in the public sector. What is critical is that the governance arrangements in place properly empower and incentivise the diligence team to give certainty.

Risk Transfer: To an extent would naturally be lost through self-financing in the public sector but equally it is possible to question the value that has really been gained from it given the low level of losses by financiers under this structure. Significant construction risks can be transferred through robust building contracts as has been shown on many successful public sector projects and could (if required)

be further enhanced (at the expense of some private sector costs of finance) through bullet payment on completion.

Certainty of Maintenance: As discussed, this has proved difficult to deliver in the public sector, but a clear ring-fencing of budgets at a high level outside the service delivering organisation could go a long way towards it.

SFT has made a high-level suggestion along these lines in a speech to the David Hume Institute in Edinburgh¹⁰:

“Another option would be an independently operated “Building Scotland Fund”. Borrowing powers, or indeed traditional capital budgets could be used to invest in the fund. The fund would be mandated to act transparently in calculating future repayment obligations, thereby contributing to the first discussion point this evening of considering repayment obligations in aggregate when deciding on a sustainable level of investment to make. It would then be asked by procuring authorities to finance projects identified as priorities – again potentially following the enhanced processes discussed.

The managers of the fund would undertake due diligence and would not agree to finance the project unless they could see a reasonable level of certainty in whole-life costing with robust construction contracts in place. At the outset as well, there would be an agreement to an ongoing annual budget allocation to the fund for life cycle maintenance of the asset. It would have the effect of making properly transparent, if not contractual the financial commitment to the moral obligation of maintaining the asset.

The purpose of this example is not to make a concrete proposal to be leapt upon or rejected, but to illustrate how a considered debate may take us if we can agree that in a fiscally tight environment, and with new powers for Scotland coming along, business as usual is not an option and an increasingly pragmatic approach to risk and real sustainability is going to be required.”

¹⁰ http://www.davidhumeinstitute.com/images/stories/Seminars/Reekie_transcript.pdf