Glasgow Colleges' Regional Board

Audit and Assurance Committee Meeting

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Paper Title	Audit Scotland NPD
Agenda Item	10
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Responsible Officer	Board Secretary
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Action	For noting

Privately financed infrastructure investment

The Non-Profit Distributing (NPD) and hub models

ACCOUNTS COMMISSION

AUDITOR GENERAL

Prepared by Audit Scotland
January 2020

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- help them to manage their finances to the highest standards
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- government agencies, eg the Scottish Prison Service, Historic Environment Scotland
- NHS bodies
- further education colleges
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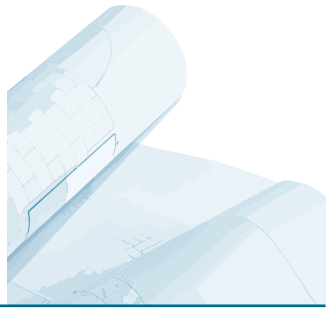

Audit team

The core audit team consisted of: Graeme Greenhill, Martin McLauchlan, Michael Duff, Claire Richards and Karla Graham, with support from other colleagues and under the direction of Mark Taylor.

Links

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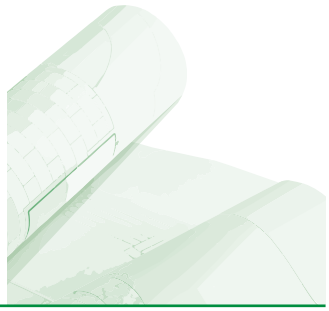
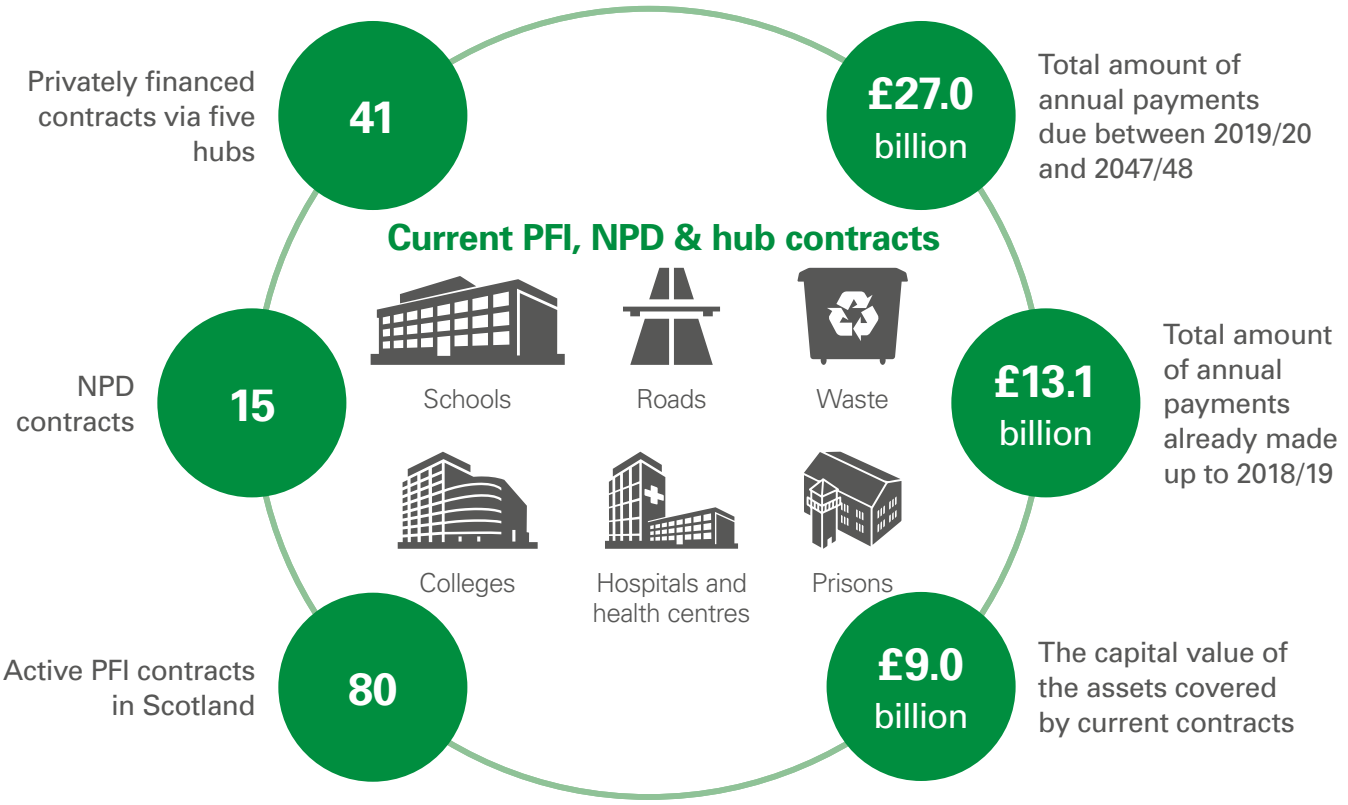
Key facts




Privately financed contracts via five hubs
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£27.0 billion
Total amount of annual payments due between 2019/20 and 2047/48
Current PFI, NPD & hub contracts
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Total amount of annual payments already made up to 2018/19
Colleges
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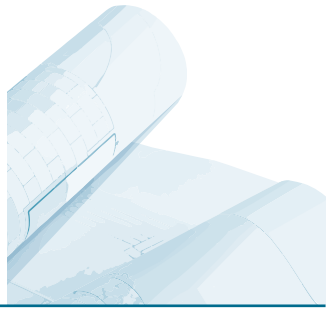
Prisons
Active PFI contracts in Scotland
80
£9.0 billion
The capital value of the assets covered by current contracts

Summary



Key messages

1 Since 2005, Non-Profit Distributing (NPD) and hub private financing have supported £3.3 billion of additional investment in public assets. Another £5.7 billion of investment is also being supported under earlier Private Finance Initiative (PFI) contracts. Private finance costs more than traditional forms of financing, affecting future budgets for many years. The Scottish Government has accepted these costs to enable additional investment to take place. But it is not clear enough how decisions have been taken about which projects will use private finance, or how well this is achieving the best balance of cost and benefits in practice.

2 The structure of NPD removes the ability of the companies involved to obtain dividends. Nevertheless, companies can generate returns by selling their rights to future contract payments. The Scottish Government does not monitor the extent to which this is happening, making it more difficult to know how effective its policy of profit capping has been in limiting overall private sector returns.

3 The hub model has enabled private finance to be obtained for smaller community-based projects, but some aspects of competition are limited. Hub structures and governance are complex, and councils and other public bodies have mixed views about how well hubs are supporting their aims.

4 Changes to the interpretation of national accounting rules mean the Scottish Government has now stopped using the NPD and hub forms of private financing for new projects. To contribute to meeting its National Infrastructure Mission commitment to raise annual infrastructure investment by £1.6 billion by 2025/26, the Scottish Government is developing a Mutual Investment Model (MIM) of private financing. This contains many features of both the NPD and PFI models.

5 Councils have used NPD and hub private financing to improve local infrastructure. This has enabled projects to proceed that would not otherwise have been affordable. But by focusing on affordability, it is not clear how public sector organisations have assessed the value for money of using private finance, or whether the implications of entering into these contracts have been fully considered. A new schools funding model has the potential to continue Scottish Government investment in the school building programme, without a private finance cost premium. It remains to be fully developed and tested in practice.

Recommendations

The Scottish Government is developing its approach to using private finance under the MIM, the replacement for NPD and hub forms of private financing. Our recommendations aim to assist the Scottish Government, the Scottish Futures Trust and the wider public sector as new funding models are introduced.

The Scottish Government should:

- better document and report how decisions on the use of private finance are made at a programme level, and how the overall combination of programme and project funding aims to maximise investment and benefits (paragraph 29)
- better communicate the rationale of project financing and funding decisions to public sector organisations and Parliament (paragraph 32)
- continue to monitor existing NPD and hub projects to review if the models are successfully achieving their original aims, and documenting lessons learned (Parts 2 and 3)
- set out how the MIM will operate, and establish clear criteria for selecting programmes and monitoring risks (paragraph 88)
- develop its public reporting to provide more information on the costs and benefits of using private finance, the management of risks and outcomes delivered, and its contribution to supporting economic policies and growth (paragraph 97).

The Scottish Futures Trust should:

- demonstrate more clearly the links between the financial savings attributed to centralised activity and individual projects (paragraph 52)
- monitor any secondary market transactions in hub equity and NPD and hub Special Purpose Vehicle equity to record ownership and, potentially, to inform the design of future privately financed contracts (paragraphs 58 and 76).

Councils, and other public sector organisations, should:

- systematically assess the implications of participating in the financing and contract approaches led by the Scottish Government, before going ahead with individual projects (paragraphs 30–32)
- clearly report current commitments under privately financed contracts, and the ongoing commitments related to these, as part of their annual budget setting (paragraph 32)
- review all projects and services procured through the hubs to assess the costs, savings and benefits against other procurement options (page 29).

The Scottish Government and councils should:

- continue to work together to develop arrangements for the new schools investment funding model, ensuring opportunities and risks are fully understood and properly managed (paragraph 93).

Background

1. The Scottish Government considers investing in infrastructure assets such as schools, roads and hospitals is key to delivering quality public services and supporting economic growth. Public bodies in Scotland use their day-to-day budgets (referred to as **revenue or resource budgets** (i)) for spending on services, such as paying staff and suppliers, and use capital budgets to invest in infrastructure assets. The Scottish Government and councils can increase the amount of money available for building and refurbishing assets in a number of ways, including, within limits, directly borrowing money to pay for upfront construction costs.[1]

Revenue or resource budgets	Capital budgets
 Spending on services: paying staff, suppliers, etc	 Invest in infrastructure assets

Ways the Scottish Government and councils can increase the amount of money available for building and refurbishing assets:

Directly borrowing	The Scottish Government was granted capital borrowing powers under the 2012 Scotland Act and these were further extended to current levels (£450 million a year annual limit, £3.0 billion cumulative limit) under the 2016 Scotland Act. Councils can borrow under the Prudential Framework.
Enter into contracts with the private sector	During the contract period, the public sector uses its revenue budgets to make **annual payments** (i) to private companies to cover the cost of financing the asset (borrowing and interest), plus associated maintenance and service charges for ongoing services (known as **unitary charges** (i)). At the end of the contract period, typically 25 to 30 years, responsibility for all services and maintenance transfers to the public sector body.
Privately financed and revenue-funded projects: - PFI - NPD - Hub - MIM (Exhibit 1, page 8)	The best known, and most widely used, model for privately financed and revenue-funded projects is the Private Finance Initiative (PFI), introduced by the UK Government in 1990. In 2005, the Scottish Government replaced PFI with the Non-Profit Distributing Model (NPD). In addition, the Scottish Government set up five hub companies between 2010 and 2012 to deliver community infrastructure projects using either traditional capital budgets or private finance contracts to pay for the assets procured through the hubs. In May 2019, the Scottish Government announced that the Mutual Investment Model (MIM) would replace NPD and that it will no longer deliver new privately financed projects through the hub companies. Appendix 1 provides a summary of the development and use of privately financed infrastructure contracts in Scotland up to 2019.

Revenue and Resource Budgets

Councils and health bodies day-to-day budgets are referred to as revenue budgets.

The Scottish Government's and other central government bodies' day-to-day budgets are referred to as resource budgets.

If a privately financed contract is used to build public infrastructure, the annual payments the public sector makes come from these budgets.

Annual payments/ Unitary charges

These are the contractual payments that the public sector makes each year to the company set up to design, build, finance and manage the asset.

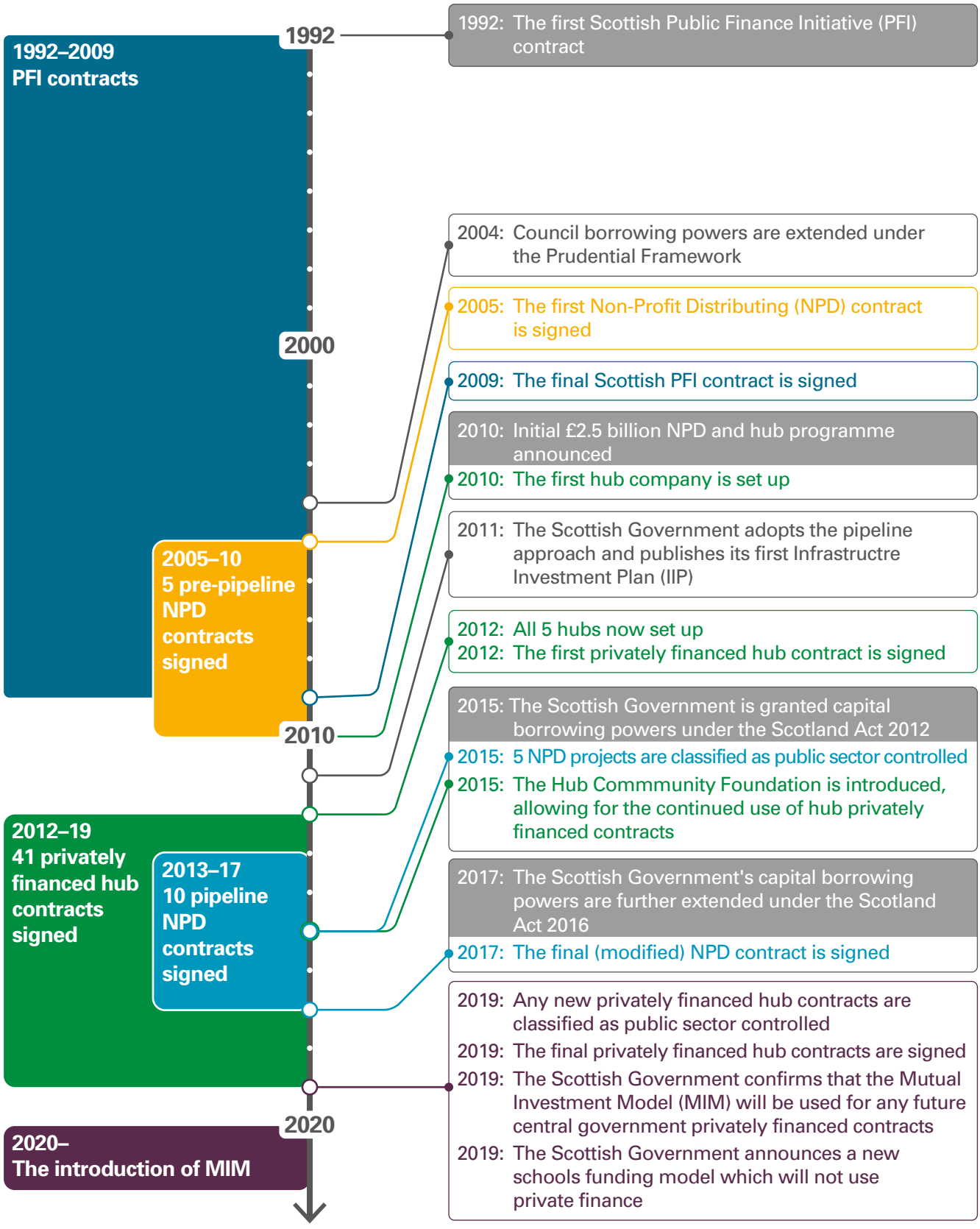
The payments cover:
- interest charges
- repayment of the money borrowed
- ongoing maintenance of the asset
- any other services the company is providing.

The first two parts of this payment are generally fixed.

Those related to maintenance and other services are often linked to inflation.

Exhibit 1

The use of privately financed infrastructure contracts in Scotland



Source: Audit Scotland

2. All privately financed infrastructure contracts share common features (Exhibit 2, page 10). In particular, they involve:

- a **project company, commonly referred to as a Special Purpose Vehicle (SPV)** (i), set up by the private sector with overall responsibility for delivering and maintaining the asset during the contract period
- one or more lenders providing project finance to allow the asset to be built
- a construction company and a service provider with responsibility, respectively, for building and maintaining the asset. The service provider may also provide other ancillary services such as cleaning
- the public sector making annual payments from revenue budgets during the contract period to the project company, enabling the project company to repay lenders and service providers. Annual payments are dependent upon services being provided as outlined in the contract and the risks and responsibilities transferred to the private sector.

3. Like borrowing, private financing enables the Scottish Government, councils and other public sector bodies to spread the upfront cost of constructing new infrastructure over a longer period. But doing so incurs additional interest and other financing costs. These commitments must be met from future revenue budgets, limiting how future budgets can be used.

4. Privately financed infrastructure contracts are highly complex, incorporating elements that deal with construction, ongoing maintenance and related services alongside financing arrangements. The non-financial provisions are not inherently different to those included in traditionally financed infrastructure contracts, which also involve private sector companies. For example, construction specifications and quality monitoring arrangements must be established and build prices agreed. The key differences relate to the inclusion of financing arrangements and maintenance, and the costs associated with these, as well as the duration of the contract. By including the requirement to maintain assets to a specified standard, the relevant public organisation aims to ensure up-front that they will be kept in an adequate condition.

About the audit

5. Our audit looked at NPD and privately financed hub projects to determine how effectively they contributed to infrastructure investment across Scotland and represented value for money. We examined:

- how the NPD and privately financed hub models differed from the PFI model, and the total public sector commitments under the different contract types
- the roles of the Scottish Government, the Scottish Futures Trust (SFT) (see page 12) and hub companies in supporting councils, and other public sector bodies, to deliver privately financed capital investment projects
- how individual councils and other public sector bodies have managed projects, assessed the costs and benefits of available financing options for projects and demonstrated overall value for money of the amounts spent on private finance.

Project Company/ Special Purpose Vehicle (SPV)

This is a private company set up specifically to deliver the project, and to manage and maintain it over the life of the contract.

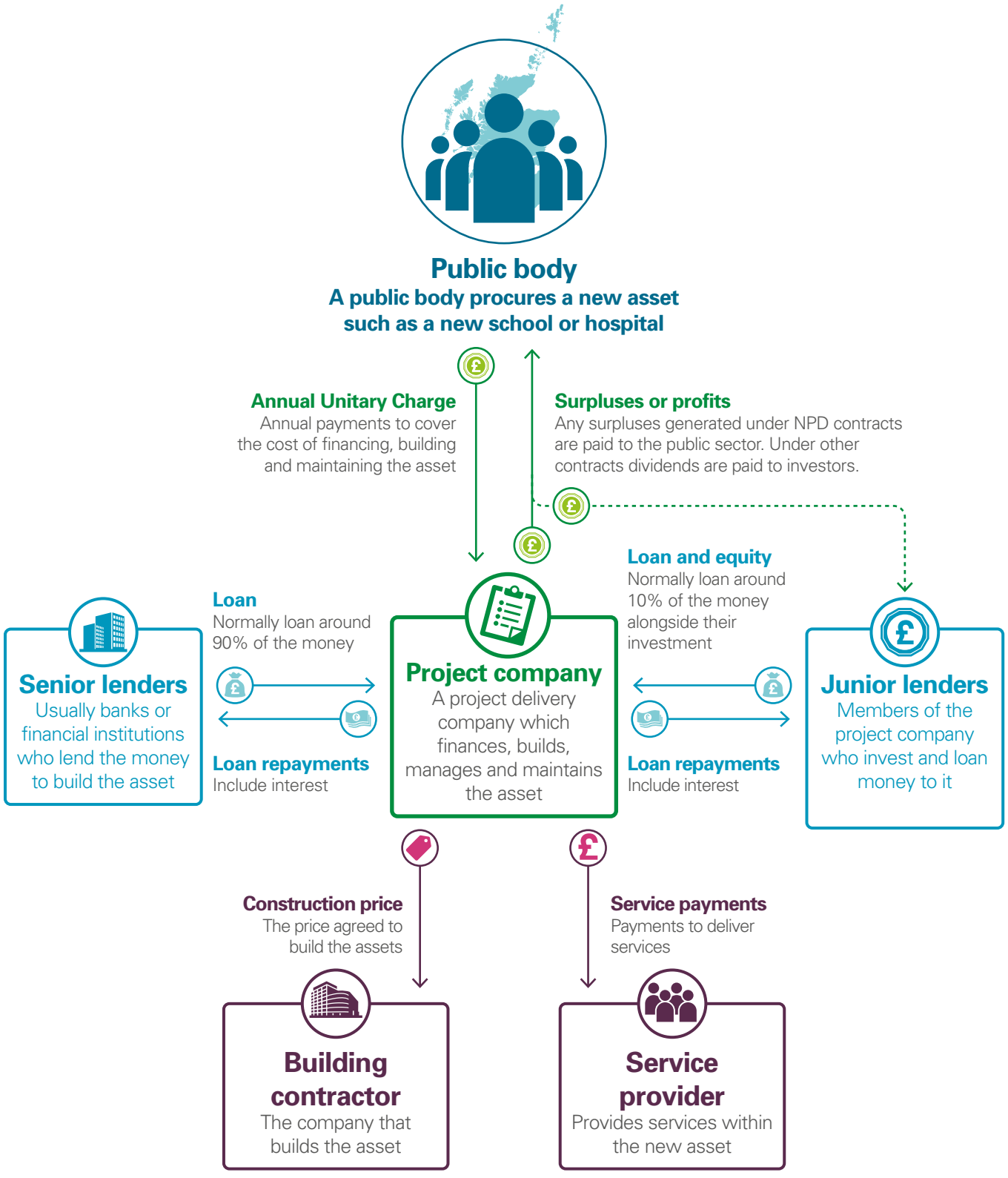
The contract is between the public sector and the SPV, and the public sector pays the SPV.

The membership and shareholding of these companies is different depending on the type of contract used.

Exhibit 2

How privately financed contracts work – a brief guide

All privately financed contracts involve a company being set up, with the public sector paying for the construction, maintenance and financing of the asset over the contract life.



Source: Audit Scotland

6. The report has four parts:

- Part 1 explains how the Scottish Government and other public sector bodies make infrastructure investment decisions, including how projects are to be financed and how value for money is considered during this process. It also looks at the current use of private finance and the financial commitments arising.

- Part 2 examines the NPD model and how this has been implemented in Scotland. This looks at the roles of the various partners involved, the costs of delivering assets through this model compared with other financing options, and the extent to which value for money has been considered.

- Part 3 examines the hub initiative and how privately financed projects are delivered through the five hub companies set up in Scotland. This includes examining the roles of the partners involved, the associated costs of financing and delivering assets in this way, and the extent to which value for money has been considered.

- Part 4 looks at how the lessons from previous private finance models can be applied to the Scottish Government's future capital investment plans and commitments, including the use of the MIM.

7. The focus of our audit is on the choice of financing method, and the costs and benefits related directly to the financing approach applied. This means the audit does not consider:

- wider capital investment and procurement decisions, such as the need for, design of, or quality of materials used in the construction of individual projects

- how well individual privately financed projects have been managed and delivered

- the wider operation and funding of the SFT, which is the responsibility of the Scottish Government; or other initiatives that the SFT manages, including the National Housing Trust and innovative financing mechanisms such as tax incremental financing and the growth accelerator model

- capital projects supported by borrowing or capital grants that are being delivered through the hubs.

8. We looked in detail at a sample of nine projects (four NPD and five hub) as shown in Appendix 2. This also sets out the wider methodology we used to gather evidence, which includes desk research, data analysis and interviews with the Scottish Government, the SFT, councils and other public sector organisations. Appendix 3 provides information on the advisory panel we consulted during the audit.

Scottish Futures Trust

The Scottish Government established the Scottish Futures Trust (SFT) in 2008 as a private limited company wholly owned by Scottish ministers.

The SFT has responsibility for a range of initiatives and operates across all phases of the infrastructure investment cycle, including developing alternative funding models to secure additional investment. It developed and delivered the Non-Profit Distributing model, the hub programme and continues to lead on Scotland's Schools for the Future programme.

The SFT acts as a centre of expertise on infrastructure investment, for example advising the Scottish Government on likely levels of market interest when the pipeline of infrastructure investment is being developed. The SFT's responsibilities, with respect to NPD and hubs, include: developing overall programme approaches for effective delivery, including a set of standard contractual documents; advising on and organising the funding and financing of projects; advising on project delivery; providing project validation through scrutiny and diligence checks; and encouraging collaborative working.

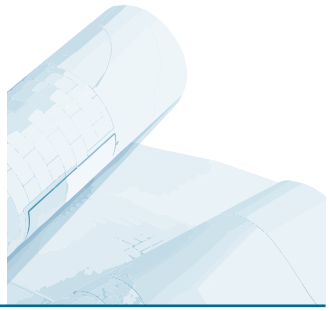
Scottish ministers set the SFT's priorities inline with wider strategic policy objectives, monitor its performance, and are ultimately accountable to the Scottish Parliament for the activities and performance of the SFT.

From 2009, the Scottish Government set a target for the SFT to achieve savings and benefits of £100–150 million each year across all its activities. The SFT's 2014–19 Corporate Plan set a five-year target of £500–750 million. The SFT's 2019–24 Corporate Plan has moved away from this corporate financial target, now focusing on achieving ten outcomes which support the Scottish Government's wider National Performance Framework.

The relationship between the Scottish Government and the SFT is formally defined within the Management Statement and Financial Memorandum signed in 2008. This is currently being reviewed and updated, with proposals for the Auditor General for Scotland to become responsible for appointing the SFT's external auditors.

Part 1

Making public sector investment financing decisions



Key messages

1 Since their introduction, NPD and hub contracts have supported £3.3 billion of additional investment in public assets. A further £5.7 billion of investment is still being paid for under earlier PFI schemes. This investment has come at a significant cost. Annual payments totalling £13.1 billion have already been made under these three types of contracts. This covers the cost of building, financing and maintaining the assets, as well as providing some services. Between 2019/20 and 2047/48, a further £27.0 billion is due to be paid.

2 Private finance costs more than traditional forms of financing, such as public borrowing or capital grants. The Scottish Government has accepted these additional costs as part of its priority of investing in infrastructure to support economic growth and help improve public services. But it is not clear enough about how individual projects are identified as suitable to be financed privately, or how the overall combination is securing the best available balance of cost and benefits. Once the Scottish Government has decided to provide support if a privately financed contract is used, affordability, rather than value for money, is the focus of subsequent decisions taken by public sector organisations.

Private finance has enabled additional infrastructure investment to take place

9. Using private finance contracts has enabled the Scottish Government to fund additional infrastructure investment. This is because using these contracts (such as PFI, NPD or through the hubs) means construction costs are not charged up-front against its capital budget, or met from capital borrowing. This allows capital budgets and borrowing to be used on other projects, or for other purposes. Private finance has therefore provided 'additionality' to the ability of the Scottish Government to fund infrastructure investment, by paying for infrastructure from resource budgets over time.

10. Similarly, where councils deliver a project through a privately financed contract, the Scottish Government is able to meet part of the cost without it affecting its own capital budget.[2] Using private finance therefore enables councils to receive additional funding support from the Scottish Government, supplementing councils' own capital funding and borrowing powers, and allowing them to undertake additional investment to improve facilities or respond to demand pressures.

The Scottish Government outlines the national programme of infrastructure investment projects

11. Since 2011, the Scottish Government has taken a pipeline approach to infrastructure investment, setting out the national programme of major public sector infrastructure investments through its Infrastructure Investment Plan (IIP). The IIP is directly linked to the capital plans and national priorities of the Scottish Government, as well as the local investment plans and capital programmes of other public sector organisations, such as councils and health boards.

12. The IIP allows for a programme of major work to be set out while recognising that, due to annual funding constraints and project slippage, the timing of individual projects within it may change. The adoption of the pipeline approach coincided with the global economic downturn, reductions in capital budgets and a time when the Scottish Government had no capital borrowing powers. The latest IIP in 2015 provides information on major projects, generally those with a capital value of over £20 million, that are currently being procured or constructed. In the September 2019 update on the IIP, the total capital value of the 44 projects listed is £3.8 billion, with £2.3 billion of this making use of privately financed contracts.

13. The Scottish Government considers that the IIP supports development of the construction sector, and therefore growth in the overall economy, by providing certainty of work. Similarly, the inclusion of privately financed projects within the IIP increases the number of public sector infrastructure projects, helping to support the construction industry and ensure capacity to deliver such projects is retained. In order to ensure this is effective, individual projects, and the overall size of the programme, must be attractive to the private sector contractors and to the investors who lend money to pay for construction.

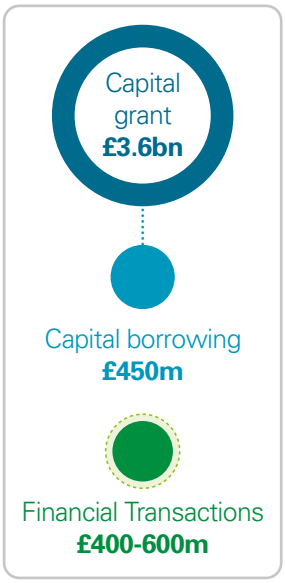
Capital grants remain the most important source of funding for infrastructure investment

14. While private finance has increased the amount available for capital investment, the capital component of the block grant remains the largest source of funding available to the Scottish Government for infrastructure investment:

Block grant – the capital element of the block grant makes up about 85 per cent of the total capital funding available to the Scottish Government. Between 2010/11 and 2018/19, the Scottish Government's capital budget decreased by about 7.4 per cent in real terms, from £3.8 billion to £3.6 billion (at 2018/19 prices).

Capital borrowing – the Scottish Government has had capital borrowing powers since 2015/16, ten years after the introduction of NPD. It can currently borrow up to £450 million each year, subject to a limit on total borrowing of £3.0 billion.

Financial Transactions – since 2012/13 the Scottish Government has been allocated between £0.4 and £0.6 billion per year in Financial Transactions. Among other uses, this can be invested in the project delivery companies set up under privately financed contracts. Ultimately, the loans and equity investment in the project companies are repayable to HM Treasury.[3]

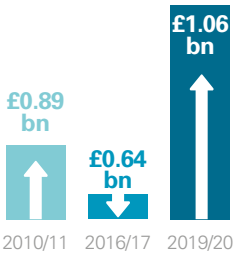


15. Similarly, Scottish Government capital grants continue to be a significant source of councils' capital funding:

- Between 2010/11 and 2019/20, Scottish Government capital grant funding to councils increased from £0.89 billion to £1.06 billion in real terms (19.9 per cent). Annual funding fluctuated significantly over this period, and in six of the nine years capital funding was lower than 2010/11. For example, in 2016/17 total funding was £0.64 billion after the Scottish Government re-scheduled £150 million for payment in 2019/20. This reprofiling reflected the fact that councils, under the **Prudential Code** ⓘ, have more extensive borrowing powers than the Scottish Government.[4] This includes access to the **Public Works Loan Board (PWLB)** ⓘ. They can also use their reserves to support their capital programmes.[5]

- In 2018/19, councils spent £2.8 billion on capital investment, with over a third of this supported directly by grant allocations from the Scottish Government. Elements of Scottish Government capital funding are often ring-fenced for specific purposes, such as supporting the expansion of early learning and childcare provision.[6]

Capital grant funding to councils



Private finance contracts are relatively expensive, and the Scottish Government has set an affordability cap on their use

16. Using privately financed contracts is more expensive than traditional funding mechanisms, such as using capital grants or borrowing powers. This is partly because the private sector is likely to pay more for its borrowing than the public sector and the private sector assumes responsibility for the ongoing maintenance of the asset. Costs are also increased because private finance contracts have at their core a fixed price construction contract, with the contractor bearing more of the risks for any unexpected problems experienced during construction. This has helped transfer some of the risk to the private sector that would otherwise lie with the public sector organisation. The public sector may, however, still require to negotiate a financial settlement where responsibility is disputed and has an ongoing requirement to deliver public services.

17. The premium paid by the public sector reflects the additional financing costs, as well as the transfer of risk, the ongoing cost for the private sector to maintain the assets to a defined standard, and the provision of any other associated services over the contractual period. The SFT calculated in April 2019 that the lifetime costs (construction cost, ongoing maintenance, plus repayment of borrowing) of NPD and hub private finance projects signed under the pipeline approach were on average about 2.9 times the construction cost of the assets. This compares with lifetime costs of 1.5 times the construction cost when using capital grants and between 1.9 and 2.6 times the construction cost when using public sector borrowing.[7] The Scottish Government has accepted these additional costs to allow additional infrastructure investment to be funded.

18. Some caution must be exercised when comparing the relative costs of NPD, hub and PFI projects. As well as differences in the services provided under each, they are also likely to have been affected by external economic factors. For example, because PFI contracts were largely agreed prior to the 2008 economic crash and NPD projects after it, private investors' risk appetite (which affects the returns they are willing to accept) will have changed significantly across this period.

The Prudential Code

Introduced in 2004 as a framework to support councils and help them show effective control over levels of, and decisions relating to, capital investment activity, including borrowing.

This self-regulating approach has enabled individual councils to adopt borrowing and treasury management strategies that fit with their corporate plans and objectives.

PWLB

A statutory body operating within the United Kingdom Debt Management Office, an Executive Agency of HM Treasury.

The PWLB lends money from the National Loans Fund to councils, and collects the repayments.

19. Public sector assets with a combined capital value of £9.0 billion have been, or will be, delivered through current privately financed contracts (Exhibit 3):

- There are currently 80 active PFI contracts, which have been used to build assets with a value of £5.6 billion.
- The Scottish public sector also signed five NPD contracts between 2005 and 2011, with a capital value of £0.5 billion.
- Ten more NPD projects with a value of £1.6 billion have been signed since 2011, following the Scottish Government's introduction of the project pipeline approach to manage infrastructure investment.
- A further 54 privately financed projects, represented by 41 contracts, have been signed through hub companies since 2012, with a value of £1.3 billion.

Exhibit 3

Current PFI, NPD and hub private finance contracts by sector

Revenue-funded contracts that access private sector finance have primarily been used to support investment in schools and health projects.

		Total		PFI		NPD (Pre-pipeline)		NPD (Pipeline)		Hub	
		Contracts	Capital Value (£ million)	Contracts	Capital Value (£ million)	Contracts	Capital Value (£ million)	Contracts	Capital Value (£ million)	Contracts	Capital Value (£ million)
	Schools	66	4,330.6	34	3,037.2	4	369.9	-	-	28	923.5
	Transport	6	1,388.7	4	609.7	-	-	2	779.0	-	-
	Waste	11	609.0	11	609.0	-	-	-	-	-	-
	Colleges	4	295.1	1	8.6	-	-	3	286.5	-	-
	Health	45	2,215.1	26	1,227.9	1	95.0	5	506.6	13	385.6
	Other	2	32.0	2	32.0	-	-	-	-	-	-
	Prisons	2	112.0	2	112.0	-	-	-	-	-	-
	Total	**136**	**8,982.5**	**80**	**5,636.4**	**5**	**464.9**	**10**	**1,572.1**	**41**	**1,309.1**

Contracts Capital Value (£ million)

Note: One further privately financed hub project, the Clydebank Health and Care Centre (estimated capital value £21.6 million), is being added to an existing contract. This is in development and has been excluded from the capital values above.

Source: Scottish Government and HM Treasury data (as at 30 May 2019)

20. The Scottish Government provides different levels of financial contributions to the public sector organisations delivering these projects. For example, the Scottish Government meets all the annual revenue payments of Transport Scotland's transport projects, while it pays a proportion of the annual costs associated with colleges developing their campuses. Similarly, Scottish Government funding to individual councils differs depending on the type of project. For example, the Scottish Government's contribution to the annual costs varies between primary and secondary schools delivered through the Scotland's Schools for the Future programme.

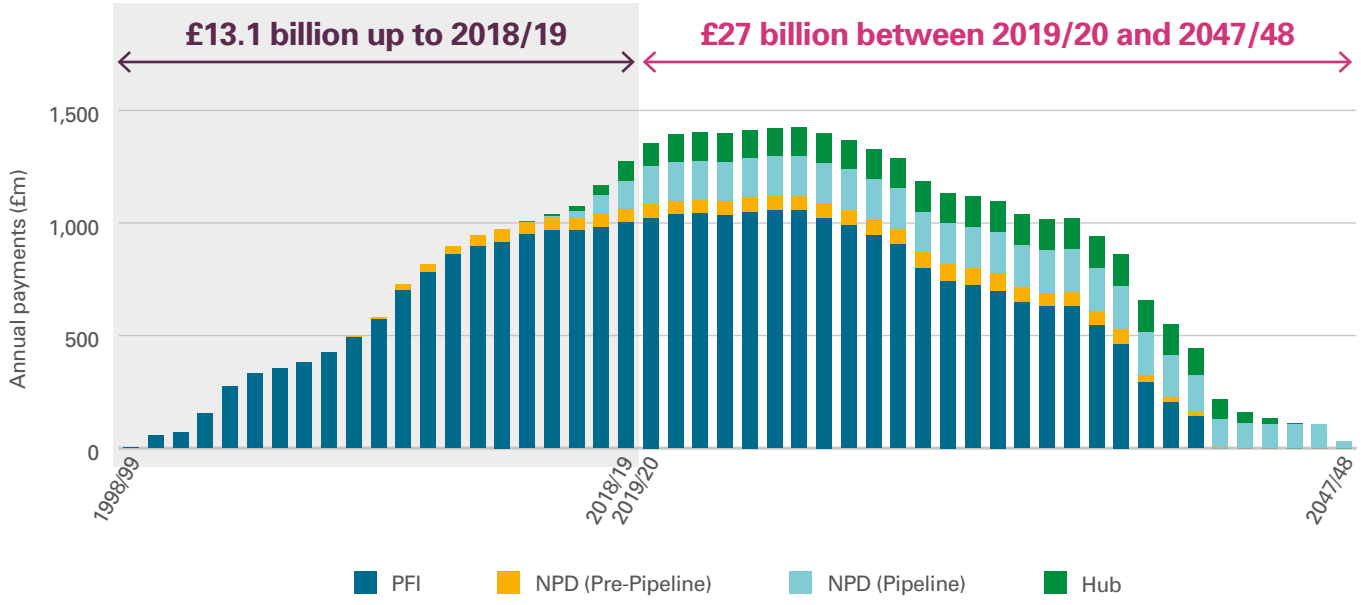
The Scottish Government has committed to spending no more than five per cent of its revenue budget supporting infrastructure projects

21. The Scottish public sector is contracted to pay a total of £40.1 billion in annual payments between 1998/99 and 2047/48 under current PFI, NPD and hub privately financed contracts. This is over four times the capital value of the assets developed. These annual payments cover the cost of financing the construction of the assets, maintaining them to contract specified standards, and the provision of some specific services. The total value of annual payments as a proportion of the construction cost of individual assets can be influenced by a range of factors. These include, for example prevailing market interest rates, inflation and tax rates at the time the contract was signed, the pricing of the risk transferred to the private sector, and the range of services included in the contract. About £13.1 billion has been paid between 1998/99 and 2018/19 and £27.0 billion is due to be paid between 2019/20 and 2047/48 (Exhibit 4).

Exhibit 4

Scottish Government commitments under privately financed revenue-funded contracts

There are significant commitments under current contracts up until 2047/48.



Note: One further privately financed hub project, the Clydebank Health and Care Centre (estimated capital value £21.6 million), is being added to an existing contract. This is in development and future revenue payments associated with this project are not included above.

Source: Scottish Government and HM Treasury data as at 30 May 2019

22. The Scottish Government committed to spending no more than five per cent of its Departmental Expenditure Limit resource budget on annual repayments for capital borrowing and privately financed projects. This was to ensure infrastructure investments funded through these methods remained affordable. In 2019/20, the Scottish Government changed how it makes this calculation, limiting it to five per cent of its total fiscal resource budget, excluding spending on benefits. This approach continues to make a valuable contribution to its overall budget management, providing a clear reference point for its decision-making. The Scottish Government currently forecasts that the repayments will amount to between three and four per cent of its budget each year in the period 2019/20 to 2025/26.

23. The introduction of new tax and spending powers under the 2012 and 2016 Scotland Acts means that the Scottish Government's budgets are much more uncertain and volatile than previously. The Scottish Government's May 2019 Medium Term Financial Strategy (MTFS) models that, because of the increased devolution of tax-raising powers, its budget in 2023/24 could be as much as five per cent more or less than currently forecast.[8] Because privately financed contracts lead to long-term financial commitments, they reduce the flexibility available to the Scottish Government to manage future budget changes. It is critical, therefore, that the Scottish Government continues to keep the extent of these commitments under review as part of its overall approach to budget management.

It is not clear enough how decisions are taken about which projects to finance privately

24. As part of the spending review cycle, and subsequent annual budget setting process, the Scottish Government considers how to allocate its available capital and resource funding across its different portfolios. This is informed by policy priorities and commitments, including the capital investment plans of directorates and proposals from councils and other public sector bodies; with approved business cases supporting these. Once capital budgets are decided at a portfolio level, the investment commitments across each portfolio are examined to identify programmes which may be suitable for privately financed contracts.

25. Broadly, projects receiving Scottish Government funding support will be chosen either to meet specific commitments or to target areas of the overall public sector estate that require investment. For example, health projects will often be aligned to the annual NHS State of the Estate report, which identifies buildings that require urgent maintenance. Similarly, investment in councils' schools addresses commitments around improving the overall condition and functionality of the school estate. Responsibility for delivering each of the projects listed in the IIP rests with the council or other public sector body which is procuring the project.

26. Through its NPD and hub approaches, the Scottish Government has looked to maintain the availability of private finance by making it sufficiently attractive to investors. A key part of this is ensuring that there is a continuing pipeline of projects, and that the overall package of private financing sought remains large enough to attract investment at affordable costs. Because the Scottish Government is looking to maximise investment by combining traditional and private finance, decisions about when to use privately financed contracts are based upon an overall consideration of its capital spending programme. This is essentially a political choice about which projects to fund in any one year, and how to balance investment with other areas of spending.

Lack of transparency means it is difficult to conclude whether the mix of capital and privately financed projects has been optimal

27. The Scottish Government has lead responsibility for deciding where private finance will be used, with input from the SFT and others, such as councils in respect of the schools programme. Assessing the suitability of a programme for support through the Scottish Budget and then ensuring the optimal combination of capital-funded and privately financed projects to maximise investment and benefits, forms a key part of this work. Generally, projects costing less than £20 million are considered unlikely to be suited to using private finance due to the complexity of managing the contracts and the relative size of associated fees. For much of the programme, options about where private finance can be applied are limited, with obvious candidates often straightforwardly identified.

28. The SFT recently highlighted that when selecting a project to use private finance, it is important that project requirements are clear upfront, and unlikely to change over the course of the contract.[9] It has also identified that projects in sectors where technology or legislation changes quickly, that involve complex service delivery or comprise several phases, are much less suitable for private finance.

29. The Scottish Government has applied these broad principles, with learning from earlier projects being used to inform later decisions. But there is a lack of documentation about how the Scottish Government had decided the best way to fund programmes or individual projects within the IIP. This makes it difficult to conclude whether the combination of capital and privately financed projects maximises the overall benefits of the IIP, or the economic impact of the additional investment.

Value for money assessments of individual projects do not consider wider implications of using private finance

30. Once the Scottish Government has decided how to fund specific programmes, it is then the responsibility of individual councils and other public sector bodies to assess the value for the money of projects, as part of the final business case, prior to procurement. SFT guidance states that the public sector body should consider a range of factors such as service design, site selection and community benefits. During our examination of a sample of NPD and hub projects, we found that the SFT's and individual public sector bodies' assessments focused on the benefits to be delivered from the project compared to the costs incurred.

31. Individual councils and other public sector bodies do not consider how projects are financed, because the Scottish Government has already indicated it will contribute to the annual repayments if the project is delivered through a privately financed contract. A council considering building a new asset, for example, is therefore unlikely to consider alternative financing routes as it would have to meet all of the project costs rather than a proportion of them. Scottish Government support therefore makes private financing a more affordable prospect for councils. This means that affordability, rather than value for money, becomes the focus of an individual public sector organisation's decision-making.

32. A consequence of councils and health bodies paying a proportion of annual commitments for their privately financed projects is that these bodies have less flexibility when setting their annual budgets, and potentially less funding available for other services. It is not clear whether the Scottish Government takes into account affordability considerations for procuring bodies, for example the level of

repayments required under existing contracts. In deciding whether to pursue and accept the provision of Scottish Government funding, it is important that councils and other public sector bodies consider the extent of future financial commitments carefully, as well as issues such as contract length and loss of control of the assets, when deciding whether to proceed with privately financed projects.

Procurement has largely been successful at generating competition

33. The SFT focuses on attaining the best privately financed deal for the public sector, through specification and competition at the procurement stage. This includes a wider assessment of value for money, including design quality, outcomes and community benefits, alongside cost. Our analysis of nine NPD and hub projects found there was significant market interest, enabling the public sector to benefit from competition. The four NPD projects received between three and nine applications from the open market, with a minimum of two bids taken forward for final evaluation. The five hub projects received between two and three bids from eligible contractors appointed by the hubs (paragraph 67). Details of these nine projects are shown in Appendix 2.

The Scottish Government is introducing a new model to allow privately financed infrastructure investment to continue

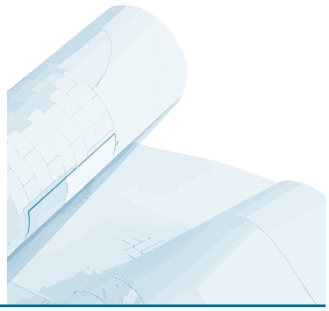
34. The Office for National Statistics (ONS) is responsible for classifying whether privately financed projects are under public sector or private sector control, using guidance prepared by Eurostat, the European statistical body. The construction costs, and associated borrowing, of projects classified as being under private sector control are not added to the UK national debt. If projects are found to be under public sector control, then the full cost of the asset will count towards the UK national debt and also against the Scottish Government's capital budget, reducing funding available for other investment. A private sector classification is therefore key to allowing additional investment to be made.

35. In July 2015, the ONS concluded that, because of effective vetoes over key aspects of the project and a share of project surpluses going to the Scottish Government, the AWPR NPD project was under public sector control (Part 2). This meant that the Scottish Government was required to account for the AWPR, along with three other NPD projects, as if they were funded from capital budgets or capital borrowing. Since this ruling, no further NPD contracts have been signed, with the exception of NHS Orkney's contract for the delivery of a new hospital and healthcare facilities in 2017.[10]

36. The ONS accepted the SFT's proposals to change the structure of hub private finance projects such that they remained under private sector control. Eurostat reviewed the revised hub project structure in 2019 and concluded that any future use of the modified hub project structure will be classified as public sector controlled (Part 3). Subsequently, in its May 2019 MTFS, the Scottish Government announced that it would no longer use the hubs to deliver privately financed projects. Instead, it is developing the MIM as a replacement for both NPD and hub private finance projects (Part 4).

Part 2

Using the NPD model



Key messages

1 NPD's use of private sector borrowing to build infrastructure projects is more expensive than using public sector sources of borrowing. A fixed rate of interest is agreed on senior debt, but this is above equivalent public sector interest rates. Significant professional fees also must be paid. Councils and other public sector bodies may have underestimated the additional costs of private finance when decisions were made to proceed with NPD projects.

2 The Scottish Government developed the NPD model to address perceived failings in PFI and increase the transparency and governance of projects. Due to the age and status of NPD projects, the Scottish Government does not yet know how successful this approach has been at limiting overall private sector returns.

3 The structure of NPD contracts means that some of the debt is only repaid towards the end of the contract period, increasing the total interest paid. This has the potential to create a secondary market in project company debt. This creates risks for the public sector, reducing the transparency of the ownership of the project companies set up to construct and maintain the assets that form a significant part of the public sector estate.

The Scottish Government established the NPD model in response to criticisms of PFI

37. The PFI model was subject to widespread criticism because of what was seen as the potential for the private sector to make excessive profits. **Project companies, commonly referred to as Special Purpose Vehicles (SPVs)** ⓘ, were largely financed by loans to allow the construction of the asset. Annual contractual payments were often increased for inflation even where interest rates were fixed, and about ten per cent of the available funding was in the form of equity (shares in the SPV issued to its constituent companies). This meant that if unexpected surpluses were made by the SPV, for example if the agreed annual payments exceeded the SPV's costs of operating and maintaining the asset, then these surpluses would be distributable to its shareholders in the form of dividends.

38. In developing the NPD model, the Scottish Government sought to retain what it saw as the advantages of the PFI model while addressing the criticisms by:

ⓘ

Project Company/ Special Purpose Vehicle (SPV)

This is a private company set up specifically to deliver the project, and to manage and maintain it over the life of the contract.

The contract is between the public sector and the SPV, and the public sector pays the SPV.

The membership and shareholding of these companies is different depending on the type of contract used.

- providing the public sector with increased governance and transparency over the SPV delivering the project, usually through a 'golden share' that gives enhanced voting rights on key issues to a Public Interest Director (PID) who sits on the board of each SPV

- ensuring the SPV has no dividend-bearing equity. Company members provide only loans, and shares are non dividend bearing

- ensuring that any surpluses generated would be used to meet project costs before being returned to the public sector, or to a nominated charitable body, at the end of the contract. This removes the ability of the companies involved to obtain dividends from the SPV during the period of the contract.

A more detailed comparison between PFI and NPD contracts is provided in Appendix 1.

The SFT developed and managed NPD, and sits on project boards, but councils and other public sector bodies remain accountable for investment decisions

39. Under NPD, the organisation procuring the asset is ultimately accountable for the decision to commit public funds and for ensuring money is spent efficiently and effectively. The SFT assisted procuring bodies by producing standardised project documentation, including contracts and wider guidance, and carried out key stage reviews at specific project milestones to ensure compliance. It therefore had a critical role in ensuring that NPD contracts were appropriately transacted, and that projects deliver intended efficiencies and benefits. The SFT was also involved in project procurement and helps with contract management, working alongside the public sector and contractors.

40. The SFT nominates the PID of each SPV. The council or other public sector organisation can only nominate a board observer rather than a director. This ensures a separation of responsibility between purchaser and provider, which limits the scope for conflicts of interest. The principal role of the PID is to bring an independent voice to the SPV's board, ensuring that it complies with good governance practices and that its decisions meet the public interest. The PID holds the power to veto certain board decisions, for example decisions about refinancing and project insurance. It is this level of control, alongside the profit-sharing elements of the model, that resulted in the ONS classifying NPD projects as being public sector controlled.

Using private finance through NPD projects is more expensive than using capital budgets or borrowing

41. Under the NPD model, the successful bidder, which went on to form the SPV and undertake construction of the asset, identified about ten per cent of the funding package as part of its bid. This lending, known as **subordinated debt (sub-debt)** *i*, is borrowed from junior lenders such as construction companies, the senior lenders or other third parties. Normally, the remaining 90 per cent of the lending, known as **senior debt** *i*, was from banks or the capital markets, at a fixed interest rate. Since 2010, senior debt funding was sourced after the appointment of a preferred bidder, and an advisory board (including representation from both the SFT and the procuring body) oversaw the competition for funding. Sub-debt is a riskier investment since repayment of senior debt takes precedence over it. Sub-debt is therefore loaned at a higher interest rate than senior debt.

i

Subordinated Debt (sub-debt)

Provided by the company shareholders or another lender. It is less secure than senior debt. This, in turn, means it is riskier and interest rates are higher to reflect this. Normally this makes up around ten per cent of an SPV's total borrowing.

i

Senior debt

A loan typically provided by a financial institution at a fixed rate. Repayment of this debt takes priority over others. Normally this makes up around 90 per cent of an SPV's total borrowing.

42. We compared private finance interest rates for the 15 NPD projects with other sources of public sector borrowing, such as UK Government gilts and the Public Works Loan Board (PWLB) for councils. For the five NPD projects that preceded the Scottish Government's IIP approach:

- Taking all sources of funding into account, and weighting appropriately, overall financing of NPD projects was between 0.6 and 3.0 percentage points higher than public sector rates available when contracts were signed.
- In the case of senior debt, private finance interest rates (weighted if there was more than one lender) were between 0.2 and 2.6 percentage points higher than equivalent UK Government gilt or PWLB loan rates.[11]
- In the case of sub-debt, private finance interest rates were between 5.2 and 10.1 percentage points higher than equivalent UK Government gilt or PWLB loan rates, with interest rates of between 10.0 and 14.5 per cent.

43. For the nine NPD projects that formed part of the IIP, excluding the NHS Orkney New Hospital and Healthcare Facilities project which used a prepayment model and so has no senior debt (paragraph 35), we found:

- taking all sources of funding into account, and weighting appropriately, the overall financing of NPD projects was between 1.4 and 2.8 percentage points higher than the public sector rates available when contracts were signed
- in the case of senior debt, private finance interest rates (weighted if there was more than one lender) were between 0.9 and 2.3 percentage points higher than equivalent UK Government gilt or PWLB loan rates
- in the case of sub-debt, private finance interest rates were between 6.1 and 8.9 percentage points higher than equivalent UK Government gilt or PWLB loan rates, with interest rates of between 9.4 and 12.4 per cent.

44. The National Audit Office has examined over 700 private finance contracts in England with similar findings. One of the reasons given for the higher private sector interest rates is the degree of risk transfer associated with individual projects. Risk transfer is an essential element of privately financed projects, with the public sector paying a premium for the private sector contractor becoming largely responsible for ongoing maintenance, corrective works and additional construction costs which would otherwise have to be separately funded if they arose. Our detailed examination of four NPD projects showed some transfer of risk, with penalties applied where contractual obligations were not met. But NPD contracts can't protect councils and other public sector bodies entirely from such risks. For example, they may have to step in to protect service provision or to resolve contract disputes in some circumstances.

Interest rates are lower in NPD projects where the European Investment Bank provides some of the debt

45. The European Investment Bank (EIB) is jointly owned by European Union members and lends, at favourable rates, to specific large-scale infrastructure projects that support EU objectives. One of the five pre-pipeline NPD projects benefitted from EIB funding. Following this, the SFT engaged directly with the EIB about investing in the NPD programme. The EIB then provided funding for five of the ten NPD projects forming part of the Scottish Government's IIP. In each instance, the EIB provided about 50 per cent of the total senior debt.

46. We found that the weighted senior debt interest rates for the six NPD projects attracting EIB funding were between 0.9 and 2.3 percentage points higher than comparable sources of public sector borrowing. This generally compares well to NPD projects that did not attract EIB funding. The EIB invested in the final tranche of NPD contracts signed in 2014/15. It is not currently clear if there will be an institution fulfilling a similar role to the EIB once the UK leaves the European Union. In the absence of an alternative to commercial sources of borrowing, it is likely that the public sector will pay more to support any future programme of large privately financed projects.

There are other costs associated with financing NPD projects that influence the total paid by the public sector

47. In NPD projects, the repayment of the sub-debt borrowed usually takes place towards the end of the contract period, and sub-debt is repaid after senior debt. This means that interest costs are paid on the full amount of borrowing during most of the lifetime of the project. This leads to larger interest costs overall than if the borrowing had been repaid throughout. By identifying the **internal rate of return (IRR)** ⓘ built into an NPD contract, the costs associated with this approach can be considered. The IRR approach discounts annual cash flows associated with repayments to reflect the time value of money. Calculation of the IRR establishes the discount rate at which the net present value of the future cash flows (loan repayments) is equal to the initial investment (the amount borrowed to construct the asset). In effect, the calculated IRR is the underlying rate of return that lenders can expect on the project.

48. Our analysis of project information found that when inflation, fees and taxation were excluded, the calculated IRR was between 1.1 and 4.3 percentage points higher than the equivalent weighted interest rates. The IRR was also between 1.3 and 5.7 percentage points higher than if the Scottish Government had borrowing powers available or councils borrowed directly to fund the projects at the time contracts were signed (Exhibit 5, page 25).

49. At the time decisions were made to proceed with NPD projects, despite complying with official guidance, the additional costs of using private finance may have been underestimated.[12] HM Treasury guidance uses a 6.0 per cent discount rate, comprising 3.5 per cent social time preference rate (an allowance reflecting the societal preference for having money now as opposed to at some point in the future) and 2.5 per cent inflation. Since 2012, public sector borrowing rates have generally been below 3.5 per cent plus inflation. The business cases and financial models may therefore have underestimated the real rate of interest that public bodies are paying (**the real IRR** ⓘ) by discounting future cash flows more heavily than would have been the case if the assumptions better reflected prevailing conditions. As the real IRR represents the effective interest rates paid, it also means that the public sector may be underestimating the premium being paid over the lifetime of the project when calculating the real IRR.

50. SPVs also incur significant professional fees when raising finance. Our analysis of the financial models of the Moray Schools, the City of Glasgow College and the AWPR NPD projects indicates that these fees were equivalent to between 1.0 per cent and 4.5 per cent of the total amount of senior debt. Professional fees are not always paid up-front, with elements repaid over the length of the contract as part of annual unitary charges. This increases the overall cost of NPD projects, as payments over the life of the contract attract interest charges.

Internal Rate of Return (IRR)

The interest rate at which the net present value of cash flows equals zero. Internal rate of return is used to evaluate the attractiveness of a project or investment.

In this context, it can be used to measure the rate of return expected to be earned by the private sector investors.

Real

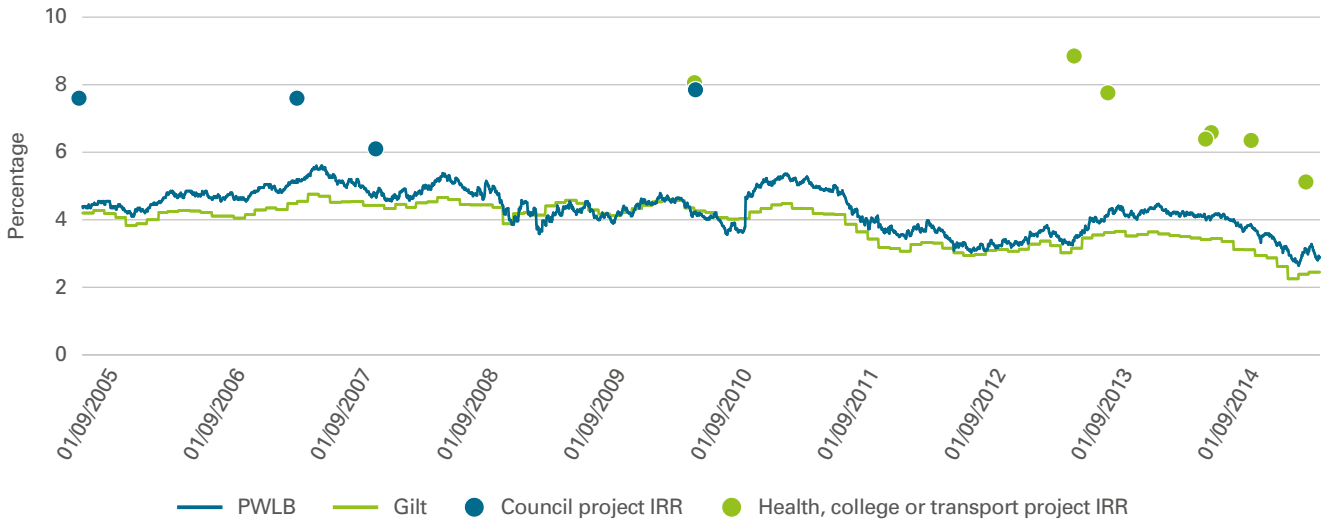
Real terms is generally used to show that figures have been adjusted for inflation.

In this context, we are referring to them being adjusted to take into account both the Social Time Preference Rate and inflation.

Exhibit 5

Private finance interest rates for NPD projects compared with interest rates for public sector borrowing

The IRR of NPD projects is higher than comparable sources of public borrowing.



Note:
1. The Scottish Government had more limited borrowing powers prior to the Scotland Acts of 2012 and 2016.
2. Projects that have not been operational for two years prior to the publishing of this report are included in our analysis of project ranges but excluded from the above chart. This analysis compares the nominal IRR, before fees and tax, with comparable public sector sources of borrowing at the dates contracts were signed.
3. To reflect the length of NPD contracts (25-30 years), gilt rates quoted are simple averages of the close of business redemption yields for each month of the prevailing 20-year (long) benchmark gilts, and PWLB rates are 24.5–25 year fixed rate annuity loan interest rates (secondary price release where appropriate).

Source: Audit Scotland analysis of SFT and UK Debt Management Office data

It is difficult to identify savings attributed to individual projects

51. Efforts to reduce overheads by standardising project specifications, procurement approaches and contract documentation have been a key part of the overall NPD approach. Until recently, the SFT calculated the financial benefits of its work by applying standardised savings factors to the total cost of constructing new infrastructure under its different workstreams. The calculations, which are subject to external review, assume that delivering projects through certain routes will achieve a standard saving or benefit. For example, the methodology calculates that a saving of 25 per cent of total expenditure results from delivering schools through the Schools for the Future programme, compared with building them using private finance outside the programme. Similarly, a ten per cent saving is applied to all NPD projects and all projects delivered through hubs, irrespective of whether they are delivered using capital or revenue funds.

52. The SFT does not disaggregate its reported benefits to individual projects. This makes it difficult for councils and other public sector bodies to establish and report the savings delivered by making use of centralised approaches. Public sector participants we spoke to reported that they often had difficulty understanding how the SFT's savings figures relate to the projects they are delivering.

The Scottish Government does not yet know how successfully NPD has limited overall private sector returns

53. A significant criticism of PFI was the potential for the private sector to profit from the subsequent sale of their interests in project companies (known as secondary market transactions). A **secondary market transaction** (i) is where a shareholder of an SPV will sell its interests (both shares and associated sub-debt) to another party who is willing to accept a lower IRR. The original lender may have several reasons for selling its interests, such as to release cash for investing in other ventures or to extract profits earlier, accelerating their returns.

Secondary market transaction

This is when a shareholder sells their shares to someone else. In this context, they are selling their SPV shares and the sub-debt.

The new shareholder is paying them for the right to receive a share of the future payments made by the public sector.

There remain opportunities for companies to generate profits by trading their rights to NPD payments to others

54. The structure of NPD contracts removes the ability of the investors involved to obtain dividends directly during the period of the contract. Nevertheless, there remain opportunities for companies to generate **profits** (i) by trading their rights to future contract payments to others. NPD aims to cap the profits generated directly from the annual contractual payments, although private investors are still expected to be able to earn market rates of returns on their investments. The level of these returns depends on the construction, service and finance costs offered through the tendering process, particularly the pricing of the risk transferred to the private sector. It is likely that bidders will have increased their prices to some extent to reflect the absence of potential dividends, but it is not possible to determine directly the extent to which this is the case.

55. As well as increasing the total interest paid, the effect of repaying sub-debt principal towards the end of NPD contracts also means that the loan principal is more heavily discounted, with the result that the IRR is higher than would have been the case if the principal were repaid earlier. The consequence of this is that an original lender may be able to make significant **returns** (i) by selling their equity holdings on the secondary market, specifically after construction is completed and the risks to returns are lowered. If there is an investor who is targeting a lower IRR than that associated with sub-debt, the original investor can sell their holdings in an SPV for a profit. Some insight into the pricing of risks transferred can potentially be obtained by monitoring secondary trading.

Profits and Returns

In this context, we use profits to refer to the annual profits of the SPV (and the share each investor will receive).

By selling on the secondary market, investors can generate a large profit in a single year. We refer to this as returns.

56. The age and status of NPD contracts, most of which have only recently been completed, means that there has been limited opportunity so far for a secondary market to develop. The emergence of a secondary market would present an opportunity for the initial private sector investors to accelerate their returns, with ongoing contractual obligations remaining with the SPV. There have already been changes in the ownership of both hubs and hub SPVs (paragraph 76). Neither the Scottish Government or the SFT centrally monitor the secondary market, although the procuring public sector organisation (as an SPV member or observer) will be informed of changes in ownership.

57. Secondary market transactions have no impact on the total value or timing of annual payments made by the public sector, or the profits directly available to shareholders under the contract. But changes in the ownership of the companies, and therefore the contractual responsibility for assets being used to deliver services, could have implications for the public sector:

- **Transparency:** the public sector loses an element of control over how assets can be used when entering into a privately financed contract. In the absence of any monitoring, there is no oversight of the ultimate responsibility for, and partial control of, a significant part of the public sector estate. Consolidation of ownership may present risks if significant cash injections into SPVs are subsequently required.

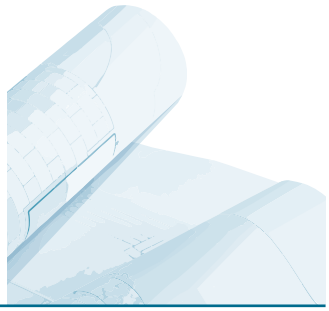
- **Accountability:** secondary transactions can reinforce the separation of services and financing. Service delivery ceases to be the responsibility of the investors involved in setting up the SPV. This can make it more difficult for the public sector to hold investors to account. The emergence of specialised infrastructure investment funds also means that a significant number of equity purchasers in PFI projects are not contractors or service providers, altering the relationship between the public and private shareholders.

- **Commitment and risk transfer:** NPD contracts are based on an assessment of costs across the whole life of the contract period, taking into account construction costs, the ongoing operation of the asset and the provision of specified services. Ownership changes may indicate that the commitments made by original investors are focused on a shorter period than the contract length, undermining the whole-life costing approach.

58. Monitoring secondary market transactions may allow the appropriateness of the original pricing of risks under the contracts, and the level of profits realised through equity sales, to be assessed. It is also critical to determining the extent to which policy aims to restrict returns derived from the public sector payments are realised. Ultimately any profits from equity sales are a private sector gain derived from annual public sector payments. This contrasts, for example, with refinancing gains which would be shared with the public sector.

Part 3

Using hubs to deliver privately financed projects



Key messages

1 Five hub companies, jointly owned by the public and private sectors, have been used to deliver both publicly and privately financed community infrastructure projects, such as schools and health centres, across Scotland. Under the hub model, only appointed suppliers, selected following an initial competitive tendering process and regularly reviewed, can bid for contracts.

2 The hubs aim to generate procurement efficiencies, but some aspects of competition are limited. Several of the companies forming the private sector consortia that are shareholders in the hubs are also on the lists of approved suppliers. Hub supply chains are regularly refreshed, but councils and other public bodies have mixed views about how well the hubs are supporting their aims.

3 Hubs have been successful in obtaining private finance for smaller community-based projects at costs consistent with the larger NPD projects, a key aim of this approach. Nevertheless, there remains significant costs of using private financing in this way and all senior debt was provided by just two lenders. An active secondary market in both hub and hub SPV equity is now developing. No further privately financed projects will be procured through the hub companies.

The hub model was developed to enable private finance to be used for smaller projects and provide wider community benefits

59. Working with councils and other public sector bodies, the SFT set up five hub companies (hubs) between 2010 and 2012 on behalf of the Scottish Government. These were developed to promote partnership working between the public and private sectors. Identifying a pipeline of future work in each area, and across all five hubs, aimed to encourage private sector interest including private finance. Each of the five geographically based hubs brought together local community planning partners, alongside the SFT and private sector partners selected following competitive tendering processes. The hub initiative is used to deliver both capital-funded and privately financed community infrastructure projects such as schools and health centres.

Hubs were expected to deliver a number of financial and non-financial benefits:

Generate economies of scale to enable the use of NPD-style private finance for smaller projects

Seeking funding at hub level, rather than for individual community projects, was expected to encourage the lending market.

Generate procurement efficiencies by reducing tendering and project costs and time

By giving the public sector direct access to a supply chain of contractors, and through the use of standardised contracts. The SFT also uses metrics and benchmarking information to achieve cost efficiencies for hub projects, for example by using cost metrics and reference designs in the Schools for the Future projects, and quality assures privately financed projects through Key Stage Reviews.

Achieve non-financial community benefits

Centred on generating local employment and training opportunities, education and subcontracting to local small and medium-sized enterprises (SMEs).

Promote joint working between the private and public partners and across the public sector

Enabled by the shared equity structure of the hubs, and through strategic asset management and joint working across projects and services.

The hub model reduces procurement costs for individual projects, but some aspects of competition are limited

60. The private sector partners in the hubs are known as private sector development partners (PSDPs) and are typically consortia of companies with expertise in construction, facilities management and finance. PSDPs in each hub were appointed following a competitive tendering process. When they were established, public sector participants (PSPs) held 30 per cent of the equity in each hub company, the private sector partner 60 per cent and the SFT ten per cent. The key features of each hub company are summarised in Exhibit 6 (page 30).

Governance arrangements for hub projects are complex, adding a further layer between purchasers and contractors

61. When working through hubs to procure infrastructure, governance arrangements for privately financed contracts can be complex. For example, public sector organisations cannot simply deal directly with the contractor to resolve issues and also must involve the hub, despite the contractual relationship being between the procuring body and the SPV. Some stakeholders we spoke to were critical of hubs for introducing an additional layer around operations and governance to already complex NPD-style arrangements.

62. Stakeholders across our fieldwork sites offered mixed views about how well hubs add value at a project level. Positive views were expressed about the speed of procurement, the use of standardised approaches and documentation, the support and advice provided by the SFT (for example about contract management) and the focus on community benefits and opportunities for shared learning.

Exhibit 6

Key features of the five hub companies delivering public sector assets

Hubs deliver both revenue- and capital-funded projects, with senior debt competitions being held for groups of projects within each territory.

Territory partnership agreement (TPA)

Sets out how the hub will operate over an initial 20-year period, with an option to be extended for a further five years. The TPA provides the right for the hub to:

- provide partnering services to the public sector for the first ten years
- have the first opportunity to bid for specific projects not in the TDP
- facilitate sub-debt structure and target interest rates for privately financed projects.

For the first ten years of the 20-year TPA, public sector participants offer hubs the first opportunity to put forward proposals to build any NHS primary care infrastructure required over a certain construction value, ranging from £0.75 million up to £3.5 million across the hub territories.

Territory delivery plan (TDP)

Sets out the projects that each hub plans to deliver. TDPs are reviewed annually and refreshed every three to five years.

Territory partnership board (TPB)

Membership includes representatives from each public sector body, the hub and the SFT. The TPB allows collaboration and is the main forum that the public sector can scrutinise the performance of the hub across its activities.

A pre-qualified supply chain

Removes the need to go to the open market for each project. The supply chain is organised into the following three tiers:

- Tier 1 consists of building contractors and facilities management contractors appointed following a tender process when the hubs were established, or through any subsequent refreshing of the supply chain. Tier 1 contractors have the right to bid for individual projects being procured through the hub.
- Tier 2 consists of firms specialising in design and consultancy. Hubs manage both the Tier 1 and Tier 2 contractors.
- Tier 3 consists of potential subcontractors and suppliers, often SMEs. Tier 1 contractors are responsible for managing these subcontractors and suppliers, on a project-by-project basis.

Annual debt framework competitions

Run by the hubs, in conjunction with the SFT, for the right to provide senior debt for hub projects. The successful bidder gets the exclusive right to provide senior debt for specific projects at the winning rate.

Source: Audit Scotland

63. But stakeholders also expressed reservations about whether the standardised approaches fit the operational context, particularly in health projects. They also queried the extent to which hubs have lived up to their objectives to improve joint working and strategic asset management, as well as highlighting a lack of understanding about how value for money for hub projects is demonstrated. Individual councils and other public bodies can also feel less involved in decision making due to the number of other parties involved. The presence of the SFT on both hub and individual SPV boards, combined with its wider role of liaising with funders and contractors, was also cited as a reason these projects can be complex to run.

Once established hubs, and their supply chains, have the right to bid for specific projects that are not openly advertised

64. Tier 1 contractors in each hub were identified through open competition. Once appointed, they choose whether to bid for individual projects. For a privately financed project, the hub company worked with the Tier 1 contractor to develop a costed proposal, inline with SFT costing benchmarks. If the public sector client accepted the hub's proposal, an SPV was then set up. As in an NPD project, 90 per cent of financing was senior debt. The provider of this finance was identified through an annual framework competition covering all privately financed projects within the hub area. The remaining financing is in the form of higher interest rate sub-debt. PSDPs, the SFT and procuring bodies have the right to issue the sub-debt in proportion to their dividend-bearing shareholding in the hub company, earning interest at a level agreed within the TPAs.

65. The hub model has enabled **Financial Transactions** ⓘ to be used to contribute to the financing of infrastructure investment by public bodies. The SFT receives this type of funding from the Scottish Government and uses it to invest in SPV equity and issue sub-debt (ten per cent of the equity and ten per cent of the sub-debt, that is one per cent of the total project funding). Financial Transactions must be repaid to HM Treasury but are not interest-bearing and are issued to the SFT as repayable grants. The SFT retains any subsequent profits from their SPV shareholdings and under agreement with the Scottish Government, uses them to offset its operational costs and reinvest in other projects.

66. The PSP also receives a return on any sub-debt it issues, effectively earning a return on debt issued to build an asset that it will use. This offsets some project costs and facilitates further investment. But it also limits the extent to which hub privately financed contracts transfer financial risk to the private sector because the public sector is providing a share of the riskier sub-debt lending.

Several companies involved in PSDP consortia are also approved Tier 1 contractors

67. The PSDP consortium for each hub comprises between two and four private companies. Each hub also has between two and ten Tier 1 contractors. Several companies have Tier 1 roles for more than one hub. For example, BAM, Morrison Construction and Kier Construction are Tier 1 contractors for three hubs, and Ogilvie Construction and Morgan Sindall have Tier 1 roles in two hubs (Exhibit 7, page 32). Companies such as Kier Construction, Morrison Construction and Morgan Sindall are Tier 1 contractors and are also part of the PSDP consortium in the same hub or are in the same company group as a PSDP partner.

Financial Transactions

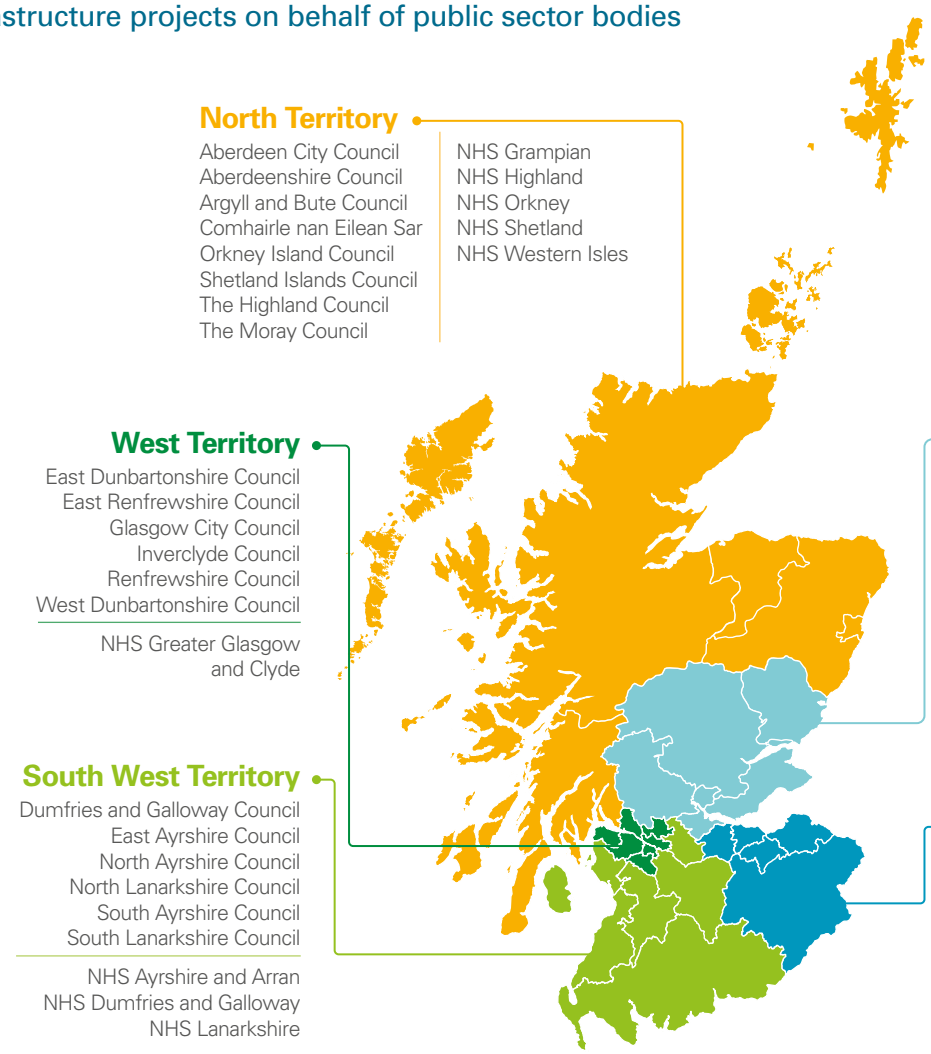
A form of capital funding the Scottish Government receives that can only be used to support equity or loan schemes beyond the public sector.

They can be used to invest in SPVs because they are private companies.

The funds must ultimately be repaid to HM Treasury.

Exhibit 7

Five hub companies, covering specific geographic areas, have been set up to deliver public sector infrastructure projects on behalf of public sector bodies



Private Sector Development Partners (PSDP)

North Territory	West Territory	South West Territory	East Central Territory	South East Territory
GTI Galliford Try Investments Ltd	MSG Morgan Sindall Investments Ltd	E Equitix SW HubCO Limited	Amber Investment Holdings Ltd	GTI Galliford Try Investments Ltd
E Currie & Brown Equitix Ltd	MSG Community Solutions Management Services (Hub) Ltd	GTI Galliford Try Investment Ltd	RCP Robertson Capital Projects Hub Investment Ltd	Dormy Hub Investments LLP
	Apollo (Hub West) Ltd	GIP Graham Investment Projects Ltd	FH Forth PPP Ltd	
		K Kier Project Investment Ltd		

Tier 1 partners

Ogilvie Construction	MSG Morgan Sindall	K Kier Construction	BAM Construction	GTI Morrison Construction
Balfour Beatty plc.	BAM Construction	GTI Morrison Construction	Marshall Construction	GIP Graham Construction
GTI Morrison Construction		GIP Graham Construction	RCP Robertson Construction	BAM Construction
K Kier Construction		MSG Morgan Sindall	K Kier Construction	
RCP Robertson Construction			Ogilvie Construction	
Arthur McKay & Co Ltd.			Maxi Construction	
GTI Galliford Try			Muir Construction	
Mears Group FM			Hadden Construction	
RCP Robertson FM			FH Forth Electrical Services FM	
BAM FM			RCP Robertson FM	

Source: Audit Scotland

XX = Corporate links between PSDPs and Tier 1 contractors

68. Having a pre-qualified supply chain reduces the need to openly tender for each project, saving time and the cost of individual procurement processes. The downside is the limited choice of contractors, with only a relatively small number of firms having access to this market. Stakeholders across our fieldwork sites expressed concern about the potential for conflicts of interest and a lack of transparency over how Tier 1 contractors are appointed for individual projects, particularly when the selected Tier 1 contractor is also a member of the hub's PSDP consortium.

More projects than originally advertised are being delivered through hubs

69. To encourage companies to bid to be appointed PSDPs and Tier 1 contractors, each hub company's TDP set out a pipeline of projects to be delivered in the first ten years, and over the 20-year lifetime, of the TPA. When advertising for PSDPs, the TDPs were used to provide an indicative value for the projects to be delivered through each hub. In all five hub areas, the capital value of committed projects has now exceeded the value of projects identified for delivery in the initial ten-year period. In four hubs, the estimated 20-year values have also been exceeded. Hub South-west, the final hub to be advertised, has yet to exceed its 20-year value, as this was set at £1.0 billion (compared to £0.4–0.6 billion for the other hubs).

70. This shows that hubs have been able to procure the level of investment planned, including from privately financed sources. But it also raises a risk that firms outside the hub supply chains could challenge further appointments under EU procurement regulations for awarding contracts if these significantly exceed the totals set out in original TDPs. The SFT identified the risks surrounding exceeding advertised estimates as a potential reason for discontinuing the use of hub privately financed contracts.[13]

Following a series of competitions, only two lenders provided senior debt for hub projects

71. The SFT and Scottish Government intended that securing funding at a hub level would allow more scope to identify projects, or bundles of projects, suitable to be privately financed by increasing the number of projects meeting the minimum value considered suitable. Setting out a pipeline of work in the TDPs, was also intended to encourage greater interest and competition by increasing the overall size of the investment, allowing more advantageous rates on senior debt financing to be obtained.

72. Prior to 2014, senior debt was competed on a stand-alone basis for two pilot projects in Hub North. In subsequent years, each hub held framework competitions for groups of projects up until 2018, when funding competitions were held for individual projects.[14] Seven institutions elected to bid under the first framework competition but the number of bidders decreased in later competitions. Aviva and Nord LB have exclusively provided senior debt for hub projects. The EIB elected not to invest in hub projects – its investment within the UK has typically been focused on larger infrastructure projects, such as those delivered through NPD.

The cost of hub privately financed projects is similar to NPD projects

73. Hubs have been successful in obtaining private finance at costs consistent with the larger NPD projects, which was a key aim of this approach. Our analysis of 41 contracts, delivering 54 projects, indicates that the costs of accessing private sources of senior debt for hub privately financed projects were broadly comparable with the rates secured for NPD projects:

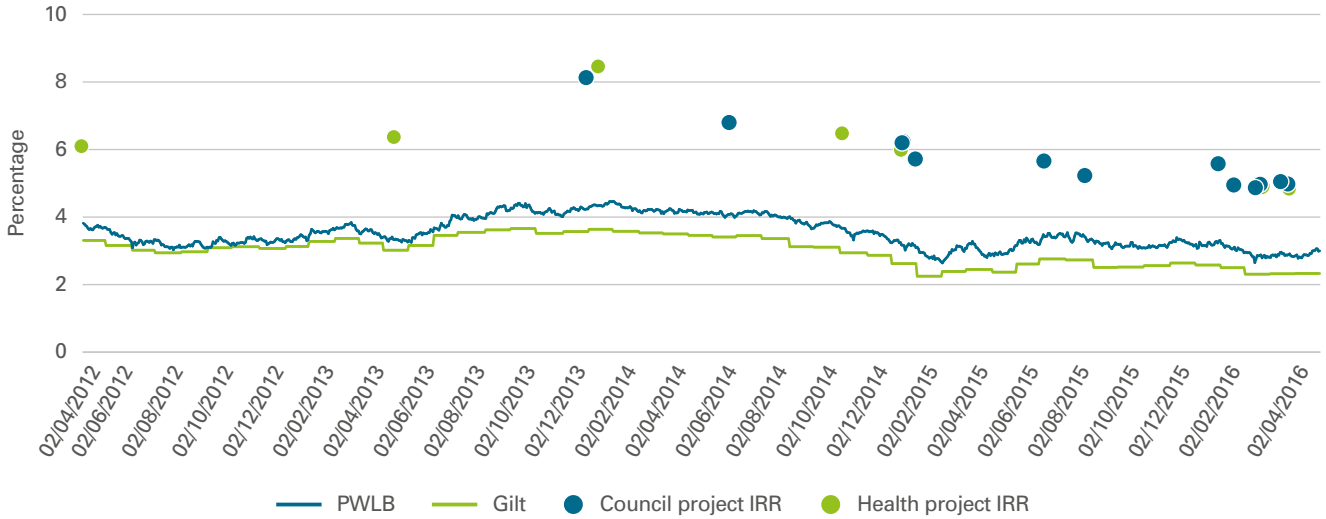
- Taking all sources of funding into account, and weighting appropriately, our analysis shows that overall financing for hub privately financed projects was between 1.2 and 2.5 percentage points higher than public sector rates available when contracts were signed (NPD pipeline: 1.4–2.8 percentage points).
- For senior debt, rates were between 0.5 and 1.8 percentage points higher than comparable sources of public sector borrowing (NPD pipeline: 0.9–2.3 percentage points).
- Target interest rates for sub-debt were set during procurement of PSDPs at between 9.5 and 11.5 per cent within the TPAs, and ranged from 9.8 to 10.9 per cent across projects (NPD pipeline sub-rates were all within the range 9.4 to 12.4 per cent).

74. Using IRR (excluding inflation, fees and tax) as a measure of project interest rates, hub privately financed projects ranged from 4.4 to 8.5 per cent. For all projects this was between 1.9 and 4.8 percentage points above public sector sources of borrowing, again broadly comparable with NPD projects (1.3–5.7 percentage points above public sector rates when contracts were signed) (Exhibit 8).

Exhibit 8

Private finance interest rates for hub projects compared with interest rates for public sector borrowing

The IRR of hub projects is higher than comparable sources of public borrowing.



Notes:
1. The Scottish Government had more limited borrowing powers prior to the Scotland Acts of 2012 and 2016.
2. Projects that have not been operational for two years prior to the publishing of this report are included in our analysis of project ranges but excluded from the above chart. This analysis compares the nominal IRR, before fees and tax, with comparable public sector sources of borrowing at the dates contracts were signed.
3. To reflect the length of privately financed hub contracts (25-30 years), gilt rates quoted are simple averages of the close of business redemption yields for each month of the prevailing 20-year (long) benchmark gilts, and PWLB rates are 24.5-25 year fixed rate annuity loan interest rates (secondary price release where appropriate).

Source: Audit Scotland analysis of SFT and UK Debt Management Office data

Financing fees remain significant for hub projects

75. The hub structures have enabled interest from investors in smaller projects but fees for accessing private financing remain significant. These include additional sub-debt arrangement fees and professional fees associated with using the hubs' partnering services. When these fees are capitalised, they can represent a significant cost to the public sector. Our analysis of the financial models of five hub projects indicates that fees for accessing financing were equivalent to between 1.3 and 3.1 per cent of the total senior debt, similar rates to individually financed NPD projects. The funding competitions have not captured any additional economies of scale to reduce financing fees beyond the market rate for larger individual projects.

An active secondary market in hub projects is developing

76. Repayment profiles for hub projects are similar to those for NPD and PFI projects, with the majority of sub-debt principal repayments being weighted towards the end of the contracts. An active secondary market trading in shares of hub SPVs is already emerging. Neither the Scottish Government nor the SFT currently monitors secondary market trading in the hubs or project SPVs. The onward selling of debt has no effect on the public sector because annual repayments are largely fixed at the point the contract is signed. But an active secondary market in hub project company equity may expose the public sector to the same increased risks as under PFI and NPD (paragraphs 54–58) and may indicate the extent to which returns are available to the private companies involved.

The establishment of a charitable foundation allowed hub privately financed projects to continue for longer

77. The Scottish Government paused the signing of new hub revenue contracts in 2015 while waiting for the ONS to publish its findings in respect of the AWPR (paragraph 35). The ONS subsequently agreed to Scottish Government and SFT proposals to reduce the level of public sector control over hub SPVs by establishing a charity, the Hub Community Foundation (HCF), to take over some of the equity that the public sector previously held. This also meant that some of the risks associated with projects transferred to the HCF. This meant that planned investment could continue for a time, and facilities continue to be built, without affecting the Scottish Government's capital budget or the UK national debt.

78. The shareholding in newer hub SPVs now comprises 60 per cent by the private sector, 20 per cent by the HCF and ten per cent each by the SFT and the public sector participant. Commensurate with its shareholding in SPVs, the HCF also holds the right to subscribe 20 per cent of the sub-debt for each project (two per cent of total project funding). The HCF does not exercise any operational influence over the projects it invests in.

The establishment of the HCF reduced the returns available to the public sector, effectively increasing the cost of projects

79. As a registered charity, the HCF is regulated by the Office of the Scottish Charity Regulator. Its charitable objectives are broadly consistent with the hubs' aims to deliver community benefits, and it is for the Board of Trustees to decide how to generate income to meet these objectives. The hub PSDPs and the SFT are eligible to nominate a trustee, but there is no specific right for the wider public sector to be represented.

80. To raise funds to deliver its objectives, the HCF has invested in individual hub privately financed projects. It has also sold on its investment rights in some projects to third parties, allowing these third parties to provide sub-debt lending to the SPV in return for a payment to the HCF. In their first three years of operation, to 31 December 2018, the HCF:

- borrowed £9.4 million from the private sector to invest in the sub-debt of specific projects
- generated £4.1 million by selling on its right to issue sub-debt for other projects.

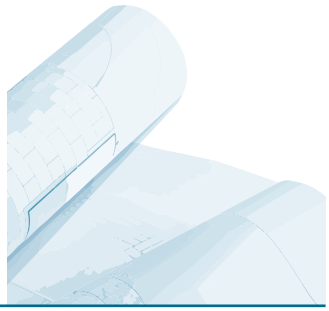
81. As at 31 December 2018, the HCF had £3.2 million of unrestricted funds available to support charitable activities. Although charities will benefit from the establishment of the HCF, and public sector risks were also reduced, reducing the public sector participant's right to invest sub-debt from 30 per cent of the total sub-debt to ten per cent means that less interest on sub-debt will be available to offset its project costs (paragraph 66). Similarly, the HCF will also generate lower returns from the SPV than the public sector participant under the previous arrangements. This is because the HCF is unable to access public sources of borrowing and has to use private sources to fund its lending to SPVs. The interest it receives on its lending is offset by the interest it pays on its borrowing from the private sector.

Eurostat reclassified projects as public sector controlled in 2019 meaning the hubs can no longer be used for privately financed projects

82. In May 2019, Eurostat issued a ruling that the HCF should be classified to the public sector for the purposes of national accounts. This means that any further hub revenue-funded contracts would be classified as public sector controlled. The Scottish Government has now decided that hub revenue-funded contracts will no longer be used to provide infrastructure investment (Part 4). Capital funded investment projects will continue to be procured through the hubs, in line with TDPs and exclusivity arrangements.

Part 4

Future investment



Key messages

1 The Scottish Government has committed to increasing annual capital investment by £1.56 billion between 2019/20 and 2025/26. Unless capital funding from the block grant grows substantially, revenue funding, including the use of private finance, will be required to meet this. A new type of private finance contract, the MIM, is expected to replace NPD and hub privately financed contracts for central government projects. MIM is designed to maintain additionality, but exposes the public sector to a greater risk of project losses than NPD.

2 The Scottish Government is also introducing a new funding model to support the next phase of school investment, providing additionality without using private finance. Councils will fully fund construction from their capital budgets, through borrowing or other means. The Scottish Government will make annual payments if specific outcomes are met, including buildings being maintained to specific standards. The Scottish Government expects this to be less expensive for the Scottish public sector than using privately financed contracts, but the approach remains untested.

3 The Scottish Government needs to learn from the use of NPD and hub programmes when introducing these new financing and funding models. It should also further develop its public reporting on the use of public finance. Better information would enhance transparency and scrutiny of how value for money is considered as part of decision-making, the costs and benefits of using private finance, and the management of risks and outcomes delivered.

The Scottish Government is planning to increase infrastructure investment and to make use of a new private financing model

83. In its September 2018 Programme for Government, the Scottish Government committed to increasing infrastructure investment, including direct investment in schools, hospitals and transport projects. The Scottish Government expects to publish a refreshed Infrastructure Investment Plan by June 2020, following recent recommendations from the Infrastructure Commission for Scotland on infrastructure investment priorities.[15]

84. The National Infrastructure Mission sets out the Scottish Government's commitment to increase capital investment by an equivalent of one per cent of 2017 Scottish gross domestic product each year. This equates to an extra £1.56 billion of annual capital investment planned for 2025/26, compared to 2019/20 levels. To meet this commitment continued use of privately financed contracts could be required unless there is a substantive change to UK fiscal policy, and capital funding through the block grant grows significantly. Such contracts will be used alongside other funding mechanisms such as Financial Transactions funding, borrowing and forms of innovative financing.

85. In April 2019, the SFT carried out an options appraisal to compare various forms of private finance schemes to replace NPD, considering additionality, value for money and affordability.[16] The shortlist of options included the MIM originally developed by the Welsh Government, an evolved version of PFI and also NPD (for comparison).[17] In the Welsh version of MIM the public sector has a 20 per cent shareholding in the SPVs set up to construct and manage assets. The ONS has reviewed this structure against Eurostat guidance and has classified it as being under private sector control. This allows investment to be funded from revenue without impacting upon the Welsh Government's capital budget.

86. In May 2019, the Scottish Government accepted the SFT's recommendation to adopt a Scottish version of MIM, based on the Welsh model, confirming that MIM would replace the use of NPD and hubs to fund central government infrastructure projects from revenue budgets (Exhibit 9, page 39).[18] This is contingent on the ONS similarly classifying the Scottish version of MIM as private sector controlled to ensure it provides additionality.

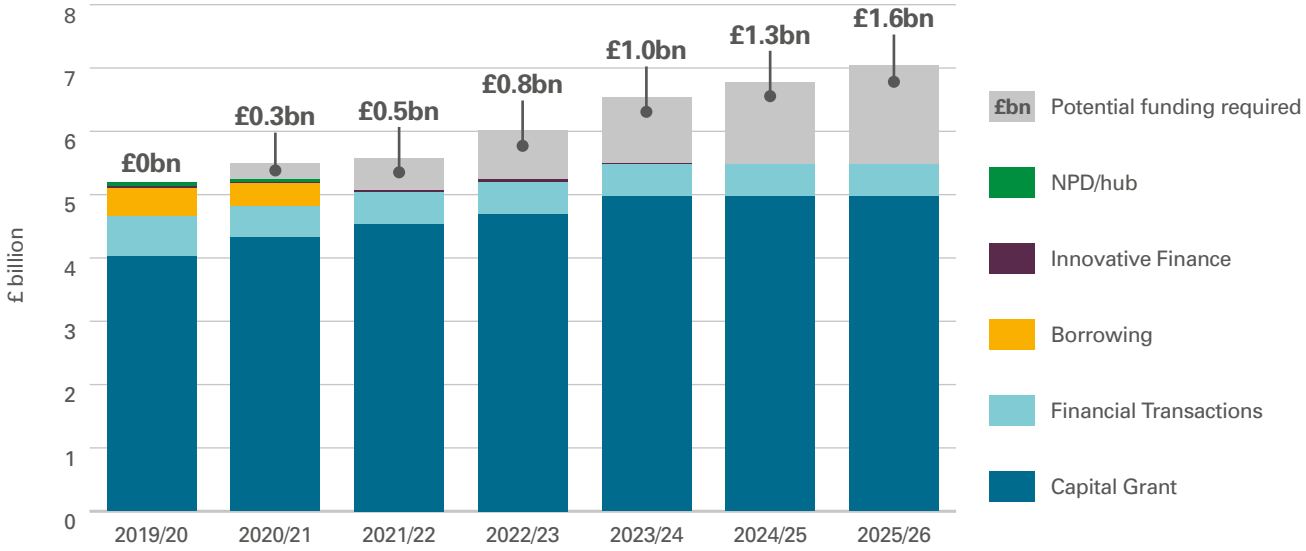
87. The financing costs associated with MIM are likely to be more expensive than alternative options for capital investment, such as capital grants, borrowing and some forms of innovative financing. The Scottish Government's May 2019 MTFS set out the Scottish Government's assessment of different capital funding options, including value-for-money considerations and a framework for how funding options will be considered. It stated that MIM will only be used by central government where borrowing is more restricted, and only after capital grants, borrowing and innovative financing options have been considered.

88. The SFT's options appraisal paper sets out some of the characteristics that make projects suitable for MIM, such as projects valued at over £30 million and those where project requirements are unlikely to change over the 25-year contract period. Using a framework to set out relevant criteria that projects must fulfil to make them suitable for different funding procurement routes would support effective and transparent decision-making about how different funding is deployed. Documenting funding decisions against clear criteria, and effectively reporting and communicating the basis for them, would allow the Scottish Government to better demonstrate how overall value for money is being assessed, considered and achieved at a programme level than is currently the case (paragraphs 27–29).

Exhibit 9

The current trend in capital budgets, 2019/20 to 2025/26

The Scottish Government may need to use a variety of funding sources, potentially including private finance, to meet its target to increase investment in line with the National Infrastructure Mission.



Note: Our analysis uses the National Infrastructure Mission Baseline from the Scottish Government's 2019 Medium Term Financial Strategy (MTFS), based upon its modelled central scenarios until 2023/24 (and thereafter kept level). This provides projections of the capital grant and Financial Transactions funding, as well as expenditure on innovative financing schemes, over the seven-year period 2019/20 to 2025/26. In line with the MTFS, our analysis assumes no NPD/hub investment after 2020/21 and does not forecast the levels of capital borrowing after this point (current powers allow the Scottish Government to borrow up to £450 million each year). The Scottish Government committed in the MTFS to 'steadily increasing' infrastructure investment by £1.56 billion between 2019/20 and 2025/26 but goes into no further detail as to how this will be profiled or achieved. We have used the Scottish Government's baseline figures and then assumed that this increased investment will take place in equal annual increments of £0.26 billion of additional investment (year on year) between 2019/20 and 2025/26. This allows annual investment levels, and the additional funding that may be required to meet the National Infrastructure Mission's commitment, to be estimated. With no changes in the baseline projections, this will need to funded through capital borrowing, MIM or by other means.

Source: Audit Scotland

The MIM retains elements of the NPD model but weakens public sector controls to allow additional investment to continue

89. The Welsh Government launched MIM in March 2017, with the initial wave of projects currently in procurement or development. As with other forms of private finance, under the MIM private partners set up a project company to build and maintain the asset. The public sector then makes annual payments covering the cost of construction, maintenance and financing of the project, and takes over the maintenance of the assets at the end of the contract. The MIM retains elements that the Scottish Government considers are key features of the NPD model but with differences designed to ensure a private sector classification to enable additional investment:

- The public sector will now be able to invest in the SPV responsible for delivering the asset. Under MIM, the investment is limited to 20 per cent of the SPV's shareholding. Under NPD the public sector did not invest in the SPV.

- Senior debt is expected to continue to be 90 per cent of the total debt funding, with sub-debt forming ten per cent. Under MIM, public sector bodies will be able to provide up to 20 per cent of the total sub-debt, equivalent to their shareholding in the SPV.

- The public sector will also continue to be able to appoint a PID, but with more limited powers than under NPD.

- The SFT will continue as a centre of expertise, providing support to the public sector and providing central oversight of investment decisions and monitoring activity.

- The MIM will continue to use standardised contracts, assurance processes and other project documentation.

90. The MIM scheme reintroduces some features of the PFI scheme that were removed under NPD. This is required to achieve a private sector classification and additionality. The public sector will be unable to veto decisions made by the SPV, including those around refinancing. It will not provide the public sector with as much control over the level of profit that the private sector can make as the NPD model does. Instead, through the shared equity structure, the public sector will share any profits generated and, equally, any losses suffered. Appendix 4 provides a high-level comparison of capital funding and the main private finance models utilised in Scotland (including the MIM).

The Scottish Government is introducing a new funding model for the next phase of investment in schools

91. In September 2019, the Scottish Government announced it would support a further £1 billion capital investment in the school estate, once the current Schools for the Future programme is completed in March 2020. It is developing a new funding model for schools, in consultation with councils (via COSLA), to support this next phase of investment. The proposed model has been designed to allow additional investment in the schools estate without the use of private finance contracts. This has the potential to provide better value for money.

92. The Scottish Government proposes that a combination of council capital investment and annual grants will be used from 2020/21 onwards to fund investment in the schools estate. Councils will use their capital grants, borrowing powers and other resources to fully fund the construction costs associated with the school capital investment programme. The Scottish Government will then pay an annual revenue grant if the council meets specific outcomes. This includes outcomes relating to energy efficiency and the condition of their school estates. This is intended to allow the Scottish Government to make payments to support improved outcomes and ongoing maintenance without affecting its own capital budget.[19] By enabling councils to make use of public sector sources of borrowing, or other available capital funding, the Scottish Government expects that financing costs will be lower than privately financed contracts, reducing the overall cost to councils, the Scottish Government and the Scottish public sector as a whole.

93. The model is as yet untested, and the risks need to be fully considered and properly managed. As councils will likely need to borrow to fund their part in the programme, increasing their overall borrowing levels, they need to make informed decisions relating to the risks of participation. The Scottish Government and councils will need to continue to work together to fully develop funding arrangements, including agreeing the mechanisms for monitoring the outcomes and what happens if they are not met, and ensuring associated risks are properly managed. The first phase of the new programme is based on a small number of projects, providing an opportunity for further review.

Increased transparency over the costs and benefits of using private finance would allow improved scrutiny

It is not clear enough how commitments made by Scottish Government and councils under NPD and hub, relate to the wider financial position of the Scottish public sector

94. The Scottish Government and HM Treasury publish a range of information about current privately financed contracts in Scotland (paragraph 19), including the value of the assets, their progress status, and the annual payments committed under the length of the contracts (including outturn against the Scottish Government's five per cent affordability cap). This information is provided in a number of different documents and formats. In the absence of easily accessible, aggregate information in one place, it is difficult for the Scottish Parliament, taxpayers and others to get a full understanding of total spending commitments under privately financed contracts, and of the longer-term implications for public finances.

95. A single set of consolidated accounts for the Scottish public sector, showing revenue-funded commitments alongside total public sector assets and liabilities, would increase the transparency of the overall financial position of the Scottish public sector. The Scottish Government has committed to producing this, but the Auditor General recently reported that the pace of its development needs to increase.[20]

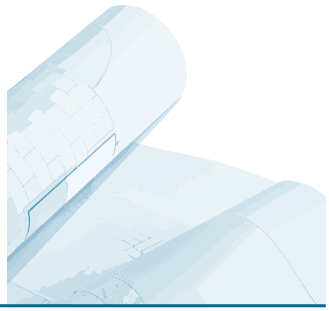
Better information is needed about how well the Scottish Government is achieving the best balance of costs and benefits in practice

96. The Scottish Government currently provides six-monthly updates on major capital projects to the Scottish Parliament's Public Audit and Post-legislative Scrutiny Committee, including those involving private finance. The updates provide high-level information about projects, outlining contract values, the dates of works being advertised and construction beginning, when the asset is operational and updates on progress. Since March 2018, it has also provided an additional annual overview report summarising the Scottish Government's approach to infrastructure investment, including information on total unitary charges. The report is useful in providing high-level information about the progress and capital value of individual projects.

97. Alongside this reporting on progress of the projects and wider infrastructure programme, there is a need for a more regular assessment of the contribution that the use of private finance is making to the Scottish Government's overall aims, including its impact on economic growth. The introduction of MIM provides the opportunity for the Scottish Government to develop better reporting on how it is achieving aims in areas such as attracting investment, encouraging competition and reducing overheads and transaction costs. Aligning this assessment with the SFT's option appraisal for the use of new private financing approaches would help the Scottish Government to demonstrate how well its chosen approach is providing the best available balance of costs and benefits in practice.

98. The introduction of new funding models represents an opportunity for the Scottish Government to learn from the NPD and hub programmes. Alongside the funding hierarchy outlined in the 2019 MTFS, there is also an opportunity for more comprehensive and transparent information to be made publicly available on how the new funding models will operate in practice, how they represent value for money and the risks associated with them.

Endnotes



1 The Scottish Government was granted capital borrowing powers under the 2012 Scotland Act and these were further extended to current levels (£450 million a year annual limit, £3.0 billion cumulative limit) under the 2016 Scotland Act.

2 Under HM Treasury's annual Consolidated Budgeting Guidance, if the Scottish Government was to help councils directly meet the annual costs associated with borrowing to finance construction of a specific asset, such as a school, the full construction cost would be classified as Scottish Government capital expenditure.

3 HM Treasury allocates Financial Transactions to the Scottish Government. They cannot be used directly to build infrastructure such as roads, schools and health projects. They can be used only for the provision of loans or equity investments outside the public sector (including universities, housing associations and project delivery companies).

4 *Borrowing and treasury management in councils*, Accounts Commission, March 2015.

5 All figures are taken from Audit Scotland's analysis of Local Government Finance Circulars and have been adjusted to take into account inflation and the reorganisation of police and fire into national services.

6 *Local government in Scotland: Financial overview 2018/19*, Accounts Commission, December 2019.

7 *An options appraisal to examine profit sharing finance schemes, such as the Welsh Mutual Investment Model, to secure investment for the National Infrastructure Mission and best value for tax payers*, Scottish Futures Trust, April 2019. The SFT calculations were based on the cost of building a £50 million community campus and maintaining it to a comparable standard as specified in a 25-year privately financed contract.

8 *Scotland's Fiscal Outlook: the Scottish Government's five-year financial strategy*, Scottish Government, May 2019.

9 *An options appraisal to examine profit sharing finance schemes, such as the Welsh Mutual Investment Model, to secure investment for the National Infrastructure Mission and best value for tax payers*, Scottish Futures Trust, April 2019.

10 The NHS Orkney hospital contract to replace the existing Balfour Hospital was structured so that the public sector provided a large proportion of the construction cost. Annual payments are largely made to cover services provided, rather than being used to meet the finance costs of construction.

11 Gilt rates are representative of the rates at which the UK Government (and now the Scottish Government) can borrow. Councils can borrow from the PWLB using their prudential borrowing powers. PWLB rates reflect underlying gilt rates. Within this report we are comparing council project information with PWLB rates, and all other projects with gilt rates.

12 *The Green Book: appraisal and evaluation in central government*, HM Treasury, April 2013 (last update March 2019).

13 *An options appraisal to examine profit sharing finance schemes, such as the Welsh Mutual Investment Model, to secure investment for the National Infrastructure Mission and best value for tax payers*, Scottish Futures Trust, April 2019.

14 No senior debt framework competition was held in 2015 because the development of hub privately financed projects was halted while ESA classification issues were being considered.

15 *Phase 1: Key Findings Report: A blueprint for Scotland*, Infrastructure Commission for Scotland, January 2020.

16 *An options appraisal to examine profit sharing finance schemes, such as the Welsh Mutual Investment Model, to secure investment for the National Infrastructure Mission and best value for tax payers*, Scottish Futures Trust, April 2019.

17 Three versions of the MIM were assessed involving the public sector taking up a 20, 30 and 40 per cent share of the SPV capital, respectively. Hubs were not considered because they were specifically set up to deliver community assets so cannot be used to deliver all projects, for example roads.

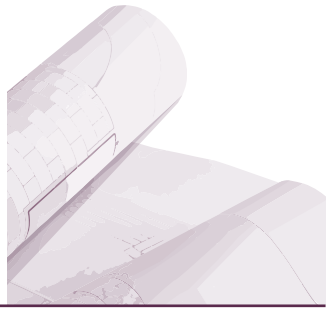
18 *Scotland's Fiscal Outlook: the Scottish Government's five-year financial strategy*, Scottish Government, May 2019.

19 As per endnote 1: The Scottish Government was granted capital borrowing powers under the 2012 Scotland Act and these were further extended to current levels (£450 million a year annual limit, £3.0 billion cumulative limit) under the 2016 Scotland Act.

20 *The 2018/19 audit of the Scottish Government Consolidated Accounts*, Auditor General for Scotland, September 2019.

Appendix 1

Privately financed infrastructure investment in Scotland



The Private Finance Initiative (PFI)

The UK Government announced the introduction of PFI as a means of funding infrastructure investment in 1992. The first PFI project in Scotland was the construction of the Skye Bridge, which opened in October 1995. Under the PFI model, the private sector formed a project company, commonly referred to as a Special Purpose Vehicle (SPV) to build, finance and operate the asset on behalf of the public sector. The public sector body makes annual payments, referred to as unitary charges, to the SPV for a period of 25–30 years.

Unitary charges under PFI contracts generally cover:

- the repayment of capital and interest on the loan the lenders made to the SPV to finance the construction of the asset
- the facility management company's costs for operating and maintaining the asset once it was operational, plus an element of profit.

The UK Government saw the main advantages of the PFI model as being the following:

- it allowed the construction of new and refurbished assets to take place at a time when spending constraints were acting as a brake on public sector infrastructure investment
- the private sector borrowed money to build the assets, so this did not count as public sector borrowing or contribute to the UK national debt
- it transferred construction and operating risks to the private sector
- it provided certainty to the public sector regarding the scale and timing of unitary payments to the SPV
- it ensured that the asset was well maintained up until the end of the contract period.

The Non-Profit Distributing (NPD) model

The Scottish Government introduced the NPD model as a successor to PFI in 2005, primarily in order to address specific criticisms that has been levelled at PFI. NPD is not a 'not-for-profit' model. Although dividend payments are not payable, contractors and lenders are still expected to earn a normal market rate of return (as in the PFI model). The responsibility of SPVs to repay loans and ensure the asset is maintained in line with contract conditions is similar under both the PFI and NPD models, although NPD contracts generally exclude elements of services and maintenance that were covered under PFI contracts.

These changes were intended to lessen the ability of the private sector to generate excessive profits through securing efficiencies. The public sector client, or its nominated recipient, is also entitled to any surpluses left in the SPV available during, or at the end of, the contract.

The NPD model compared with the PFI model

There are greater attempts to fix private sector returns at the start of NPD contracts than under PFI.

Features of the contracts	PFI	NPD
The SPV is set up to build, manage and maintain the assets over the lifetime of the contract	The private sector formed the SPV. Members held dividend-bearing shares in the company, meaning they could receive additional income when the company was profitable, or a surplus was being held. The private sector exercised total control of the SPV with no public sector involvement.	The SPV shares are non-dividend bearing. This means the private sector cannot generate additional profits by issuing dividends and is investing only what it lends. The public sector is represented on the SPV board by a Public Interest Director (PID), who has voting rights. The PID also holds veto rights over certain board decisions.
Surpluses generated by the SPV	Surpluses generated could be paid out as dividends to the SPV shareholders.	Surpluses are unlikely to be distributed until near the end of the contract and are not to be paid out until a range of project costs are met. Any surpluses at the end of the contract go to the public sector or a designated charity. This means that direct private sector returns are agreed when the contract is signed.
Repayment of loans	A source of private sector returns, alongside dividend payments. The majority was issued as fixed rate senior debt.	The main source of private sector returns, the majority of which is issued as fixed rate senior debt.
Private sector profits	Varied depending on the ability of the SPV to generate surpluses and pay out dividends.	Capped and agreed at the outset of the project when the debt is issued.
Refinancing gains	Refinancing decisions were taken by the project company.	The PID has effective control over refinancing decisions and any gains would be shared by shareholders, including the public sector.
Common features that contribute to effective contracts	Risk allocation: transferring appropriate risk to the private contractor. Whole-life costing: ensuring contracts and payments take into account the capital cost, as well as operational, maintenance, repair, upgrade and disposal costs. Performance-based payments: ensuring that the public sector receives specified services.	

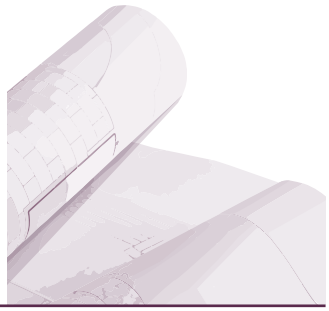
Source: Audit Scotland analysis of the Scottish Futures Trust's NPD guidance documentation

Hub companies

The SFT set up five hub companies (hubs) between 2010 and 2012, developing them on behalf of the Scottish Government. Scotland is divided into five geographical hub areas, each bringing local community planning partners together with the SFT and private sector partners that were selected following competitive tendering processes to form a hub. The hub initiative is used to deliver both capital- and revenue-funded community infrastructure projects such as schools and health centres. Revenue-funded contracts through the hubs involve the public sector body, SFT and one of the hub private sector partners investing in a project company and receiving dividend payments in line with their shareholdings.

Appendix 2

Audit methodology



Our objective:

- To assess whether revenue-financed projects (NPD and via the hubs) are providing value for money, and how effectively they are contributing to the delivery of infrastructure investment across Scotland.

Our audit questions:

- Do the NPD and hub models of revenue financing provide advantages compared with other ways of financing infrastructure investment (including previous methods of revenue-funded infrastructure financing such as PFI)?
- How much use has been made of the NPD and hub models of revenue financing in Scotland and what are the long-term public sector financial commitments relating to all revenue-financed infrastructure projects?
- How well have the Scottish Government, the SFT and the hub companies worked together to deliver value for money from the NPD and hub programme of revenue-financed infrastructure investment?
- To what extent have individual NPD and hub revenue-financed projects been managed well and can they demonstrate that they are value for money?

Our methodology:

- Analysing national data (published by the Scottish Government and HM Treasury) and project financial information (provided to us by the SFT).
- Analysing information from audited public sector accounts and financial returns from public bodies to the Scottish Government.
- Interviews and meetings with senior staff from the Scottish Government and the SFT.
- Interviewing staff and reviewing project documentation in relation to nine case study projects. During this work we:
  - reviewed project documentation (including business cases, project agreements/contracts, project reviews and financial models)
  - met senior staff from public bodies, including senior finance and project management staff, and engaged with wider stakeholders, including hub company representatives.

Our nine case study projects were:

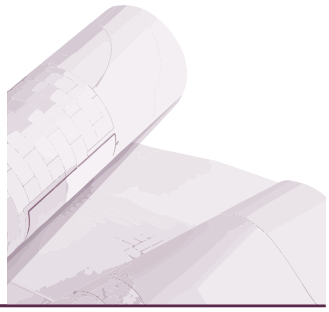
Project	Procuring body	Financing	Status
Moray Schools New Elgin Academy including community facilities. New Keith Primary School on a single rather than a split site.	Moray Council	NPD	Operational December 2012
City of Glasgow College New twin site campus replaced four colleges split over 11 separate sites.	City of Glasgow College	NPD	Operational August 2016
NHS Orkney New Hospital and Healthcare Facilities New hospital and healthcare facility including two GP practices, a public dental service, NHS24 presence, the Scottish Ambulance Service Orkney base and a clinical support services building.	NHS Orkney	NPD (pre payment variant)	Operational July 2019
Aberdeen Western Peripheral Route/ Balmedie Tipperty New 46km dual carriageway with connections to the A90 south of Aberdeen at Stonehaven, to the A92 at Charleston, to the A96 at Craibstone and to the A90/ A92 north of Aberdeen at Blackdog. New 9km dual carriageway with 3km of online dual carriageway improvement from A90/92 north of Aberdeen at Blackdog to the A90 Ellon roundabout	Aberdeen City Council (as an agent for Scottish ministers represented by Transport Scotland)	NPD	Fully Operational February 2019 (discrete phases opened September 2016, June 2018, August 2018 and December 2018)
Wishaw, East Kilbride and Kilsyth Health Centres New community health centres in East Kilbride, Kilsyth and Wishaw.	NHS Lanarkshire	Hub South West	Operational April 2015
Dalbeattie Learning Campus New build learning campus comprising nursery, primary school, secondary school and community facilities.	Dumfries and Galloway Council	Hub South West	Operational November 2017
William McIlvanney Campus New learning campus, bringing two academies and two primary schools together with early years provision and a Gaelic language development centre.	East Ayrshire Council	Hub South West	Operational April 2018
East Lothian Community Hospital New East Lothian Community Hospital to provide integrated health services in East Lothian.	NHS Lothian	Hub South East	In construction (part open)
Inverurie and Foresterhill Health Project Integrated health and social care hub within the existing Inverurie Hospital. New Foresterhill Health Centre incorporating two GP practices, allied health professionals, a retail pharmacy and the Health and Social Care Integrated Team.	NHS Grampian	Hub North	Operational July 2018

Project	Capital Value covered by contract (£m)	EIB contribution (£m)	Total unitary charge payments (£m)	Ratio of capital value to total annual payments	Operational period of contract
Moray Schools	43.9	0.0	171.7	1:4	31 years
City of Glasgow College	193	83.2	603.0	1:3	25 years
NHS Orkney New Hospital and Healthcare Facilities	64.1	0.0	57.2	1:1	25 years
Aberdeen Western Peripheral Route/ Balmedie Tipperty	469	271.2	1,397.7	1:3	30 years
Wishaw, East Kilbride and Kilsyth Health Centres	38.9	0.0	108.0	1:3	25 years
Dalbeattie Learning Campus	24.8	0.0	60.6	1:2	25 years
William McIlvanney Campus	42.4	0.0	107.4	1:3	25 years
East Lothian Community Hospital	70.4	0.0	173.6	1:3	25 years
Inverurie and Foresterhill Health Project	21	0.0	51.9	1:3	25 years

Information on capital values and total unitary charge payments are taken from Scottish Government data and represent the position at the time contracts were signed. These figures may differ from the current figures held by public sector organisations, and therefore from disclosures within their audited accounts. There are various reasons for this including, for example, assets subsequently being revalued; or the rate of inflation differing from initial assumptions when annual payments were indexed; and the cumulative impact of rounding in the Scottish Government's data.

Appendix 3

Advisory panel members



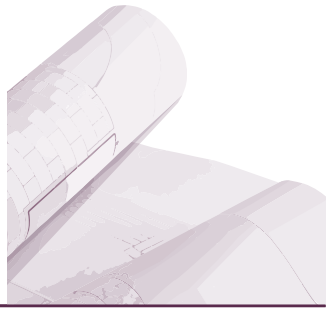
Audit Scotland would like to thank members of the advisory panel for their input and advice throughout the audit.

Member	Organisation
Rachel Gwyon	Scottish Government
Scott Mackay	Scottish Government
Helen Carter	Scottish Government
Kerry Alexander	Scottish Futures Trust
Michelle Rennie	Transport Scotland
Hugh Dunn	City of Edinburgh Council, representing CIPFA Local Government Directors of Finance (Scotland)
Mark Hellowell	University of Edinburgh
Nicola Hudson	Scottish Parliament Information Centre
Neil McCormick	Robertson Capital Projects

Note: Members sat in an advisory capacity only. The content and conclusions of this report are the sole responsibility of Audit Scotland.

Appendix 4

Investment models



The main ways of funding public sector infrastructure investment:

	Capital budget	
	Capital budget	**Capital borrowing**
Status	✓ In use	✓ In use
History	-	-
Description	The Scottish Government's capital budget mainly allocated as part of the Block Grant. This is shared across public bodies as part of the Scottish Budget.	The Scottish Government can now borrow up to £450 million per year, up to a total of £3 billion, to supplement its capital budget. Councils can borrow from the Public Works Loans Board (PWLB) and commercial sources under the Prudential Code.
The cost to build the asset and maintain the asset[1]	1.5 times the asset value	1.9–2.6 times the asset value
Equity stakes in delivery company (SPV)	n/a	n/a
Equity returns	n/a	n/a
Financing	n/a	n/a
Public sector role on delivery company	n/a	n/a

Note:
1. An options appraisal to examine profit sharing finance schemes, such as the Welsh Mutual Investment Model, to secure investment for the National Infrastructure Mission and best value for tax payers, Scottish Futures Trust, April 2019.

Revenue budget				
	PFI	**NPD**	**Hub revenue**	**MIM**
Status	⊗ No longer in use	⊗ No longer in use	⊗ No longer in use	✓ To be used from 2020/21
History	Introduced in 1992. Replaced with NPD in 2005.	Introduced in 2005. Last project signed off in 2015, except for one modified contract signed in 2017.	Introduced in 2010-12. In April 2019, the Scottish Government announced it will not be used for revenue projects after 2020/21.	In May 2019, the Scottish Government confirmed that a version of MIM will be an option to deliver some central government assets.
Description	The private sector finances construction and manages and maintains the asset, typically for 25–30 years. During this contract period, the public sector uses its revenue budgets to make annual payments to the private sector, covering the cost of financing the asset, plus associated maintenance and service charges. At the end of the contract period, ownership of the asset transfers to the public sector body. A Special Purpose Vehicle (SPV) is established to build, manage and maintain the asset over the lifetime of the contract. Annual payments are performance related. The Scottish Government is committed to spending no more than 5 per cent of its revenue budget on the annual repayments associated with privately financed revenue-funded infrastructure projects.			
The cost to build the asset and maintain the asset[1]	-	2.6–3.3 times the asset value		
Equity stakes in delivery company (SPV)	100% Private sector	100% Private sector The public sector has a single 'golden share' giving it voting rights.	Older projects: Private sector (60%), SFT (10%), public sector (30%) Newer projects: Private sector (60%), SFT (10%), public sector (10%) and Hub Community Foundation (20%).	The public sector (Scottish Government) will invest a maximum of 20%.
Equity returns	Dividend bearing shares.	No dividend bearing shares. Capped profits to private sector at pre-agreed level.	The public sector shares the project's profits alongside other members of the SPV in line with their equity share.	The public sector will share the project's profits alongside other members of the SPV in line with their equity share.

Note: 1. An options appraisal to examine profit sharing finance schemes, such as the Welsh Mutual Investment Model, to secure investment for the National Infrastructure Mission and best value for tax payers, Scottish Futures Trust, April 2019.

Revenue budget				
	PFI	**NPD**	**Hub revenue**	**MIM**
Financing	90% senior debt, 10% subordinate debt. Sourced from capital markets (private sector).	90% senior debt, 10% subordinate debt. Sourced from capital markets (private sector).	90% senior debt, 10% subordinate debt. The right to issue senior debt was subject to an annual competition within each hub area. Shareholders issued subordinate debt as per their shareholding (eg, 10% of sub-debt was invested by the SFT).	90% senior debt, 10% subordinate debt. Senior debt will probably be sourced from capital markets (private sector). Shareholders will issue subordinate debt as per their shareholding (ie, 20% of sub-debt could be invested by the Scottish Government).
Public sector role on delivery company	None	A Public Interest Director (PID), nominated by the SFT, sits on the delivery company board. The PID has voting rights and a veto over some operational decisions.	The SFT and public sector are represented on the boards of each hub company. The procuring body is also represented on the project delivery company (SPV).	A PID will sit on the delivery company board. The PID has voting rights but will not have the power to veto operational decisions.

Privately financed infrastructure investment

The Non-Profit Distributing (NPD) and hub models

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