NPD Model
Explanatory Note

February 2015

SCOTTISH FUTURES TRUST

FOREWORD

In recent years a number of public authorities in Scotland have procured privately financed infrastructure projects using the “non-profit distributing” or “NPD” model. The NPD model was developed and introduced as an alternative to, and has since superseded, the traditional private finance initiative or “PFI” model in Scotland. It has been used in the education (schools) and health sectors and is currently being rolled-out in the transport sector.

The model has been fine-tuned since it was first introduced and so this explanatory note has been prepared in order to clarify and summarise the basic principles that underpin the NPD model (as it will be applied in future privately financed infrastructure projects) and differentiate it from the traditional PFI model.

This explanatory note has been prepared and issued by the Scottish Futures Trust on behalf of the Scottish Government. Any clarifications and queries should be directed to the Scottish Futures Trust at mailbox@scottishfuturestrust.org.uk

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1. THE NPD MODEL: CORE PRINCIPLES AND BENEFITS

1.1 Core Principles

The NPD model is defined by the broad core principles of:

- Enhanced stakeholder involvement in the management of projects
- No dividend bearing equity
- Capped private sector returns.

It is important to note that the NPD model is **not** a "not for profit" model. Contractors and lenders are expected to earn a normal market rate of return as in any other form of privately-financed PPP deal. Rather, the model aims to eliminate uncapped equity returns associated with the traditional PFI model and limit these returns to a reasonable rate set in competition.

These core principles apply to the NPD model across all sectors (e.g. health, education, transport). To the extent that there are any variances in precisely how these principles are implemented, these will be indicated in relevant sector-specific guidance/documentation.

Where the NPD model is to be implemented in a sector for the first time it may need further development to adapt to the specific risks and requirements (e.g. technology, regulation, stakeholder interface) of that sector. Any such development must be done in consultation with the Scottish Futures Trust.

1.2 Benefits

The NPD model retains the benefits of traditional PFI structures, such as:

- Optimum risk allocation
- Whole-life costing
- Maximised design efficiencies
- Robust programming of lifecycle maintenance and facilities management
- Performance-based payments to the private sector
- Single point delivery system, reducing interface risk for the public sector client
- Improved service provision

and also produces the following additional benefits:

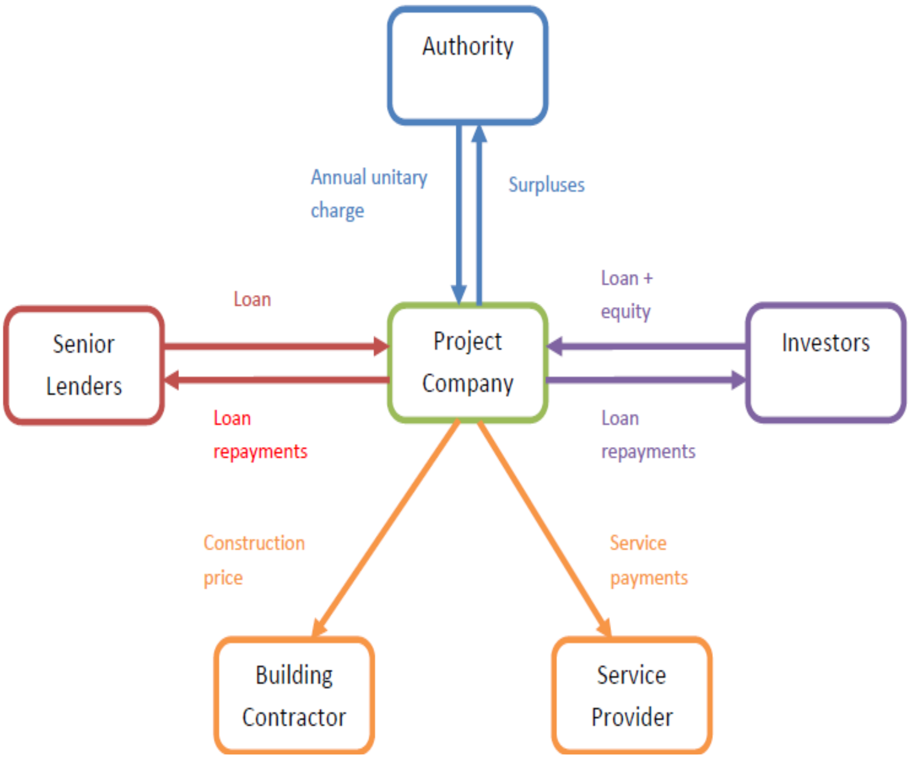
- Capped returns ensure that a "normal" level of investment return is made by the private sector and that these returns are transparent
- Operational surpluses generated by the Project Company are directed to the public sector client or a third party nominated by it

- The public interest is represented in the governance of the NPD structure, which increases transparency and accountability and facilitates a more pro-active and stable partnership between public and private sector parties.

2. THE NPD MODEL: STRUCTURE

2.1 Illustration of NPD structure

The structure of an NPD project is illustrated as follows:



*NPD Features

- Equity carries no dividend entitlement
- Junior Lender (Investor) return is capped at % interest on loan repayments
- Surpluses paid back to the Authority or its nominee

2.2 Project Company

Whilst there has been no specific company structure requirement, all NPD projects to date have adopted a structure where the Project Company is a special purpose company limited by (non-dividend bearing) shares. The shares are held by the private sector investors with the exception of one "golden share" held by the Authority which increases transparency and accountability and underpins the NPD principle of enhanced stakeholder involvement.

2.3 Funding

There are no stipulations regarding private sector funding solutions provided the “no dividend-bearing equity” principle is upheld. The capital structure on NPD projects to date has comprised senior and junior funding and, although junior funding has been provided exclusively by way of subordinated debt, alternatives would include mezzanine debt, preference shares or a single tranche of blended rate debt. Annex A provides some consideration of the different choices of junior funding.

2.4 Role of the Junior Lenders

One of the cornerstones of the NPD model is the principle that the Project Company should at all times be managed by the parties whose lending is at risk. It follows that, in the absence of dividend-bearing equity, the ownership and control of the Project Company lies with the junior lenders (subject to senior lenders’ step-in rights).

In the absence of equity returns, the junior lenders are incentivised to manage the “equity risk” to protect their investment and secure their forecast return. The junior lenders appoint the majority of the Project Company’s directors (pro rata to their investments of junior debt) to give them the control needed to manage this risk. To preserve this link between investment risk and control, the shares in the Project Company are “stapled” to the junior debt investment so that the ownership and control of the Project Company always transfers with the investment (and vice versa).

Junior funding may come from sub-contractors, senior lenders or third party funds and institutions. When it comes to managing the affairs of the Project Company, conflicts of interest may arise in any disputes it has with funders and sub-contractors, depending on the nature of the investors. Conflict is perhaps best avoided if the investor structure is a mixture of both contractors and funders, although this may not always be possible. The potential for conflicts of interest must be dealt with up-front through the Project Company’s articles of association and provisions to this effect are contained in the standard form NPD articles of association.

2.5 Rate of Return

The investor rate of return, bid in competition, should reflect the level of risk transfer negotiated. It is important that the risk transfer is sustainable and so the risks passed to the Project Company should be evaluated against the cash flows in the NPD model to ensure that, in the absence of equity, these risks can be managed effectively. The sustainability of the proposed risk transfer should be evaluated in a sector-specific context and procuring authorities should seek advice in carrying out such an assessment.

2.6 Contract

The NPD model retains the efficient risk transfer achieved through the traditional PFI model and the contracts for NPD models therefore generally follow HMT’s Standardisation of PFI Contracts Version 4 Guidance.

With a view to the NPD project pipeline, and building on existing standard form contracts and precedent, SFT has produced a standard form NPD project agreement for use on accommodation projects across sectors (i.e. health, schools, further education). Some amendments will be required in other sectors (e.g. transport).

3. THE NPD MODEL: KEY FEATURES

3.1 Public Interest Director

The traditional PFI/PPP model gives little visibility for the public sector over the governance and management of the Project Company. The appointment of an independently nominated Public Interest Director (known on the early NPD projects as the "Independent Director") to the Project Company's board is a feature that is specific to the NPD model. The principal roles of the Public Interest Director are:

- Monitoring the Project Company's compliance with the core NPD principles and good governance practices
- Bringing an independent and broad view to the Project Company's board
- Bringing the Project Company board's attention to opportunities for refinancing
- Bringing the Project Company board's attention to opportunities for realising cost efficiencies and other improvements in the Project Company's performance.

It is anticipated that SFT will nominate a Public Interest Director for each NPD project.

The Authority will be entitled to appoint an "Observer" to attend and participate (but not vote) at the Project Company's board meetings. The Observer role has been a feature of traditional PFI/PPP projects in Scotland to date and has been retained in the NPD model.

3.2 Surpluses

The likelihood of surpluses being realised for payment to the Authority (or its nominee) depends on the financing structure and the junior debt return. It may be that the base case financial model for the project does not forecast the generation of any surpluses other than towards the end of the project once the senior funders are repaid and they release the project from their cash reserving requirements. In this case surpluses will only arise naturally during the life of the project if the Project Company performs more efficiently than expected. Another possibility is for the base case financial model for the project to generate an annual flow of surplus cash, as the cashflows required to satisfy lender covenants are greater than required to meet junior debt service.

Authorities will expect bidders to submit their best priced bids (i.e. lowest unitary charge) which fall within the affordability envelope for the project and which satisfy financiers' return requirements and covenants. Hence surpluses should be viewed as a consequence of the structure rather than an up-front requirement. A bid with a low unitary charge and a low level of surpluses will score better in evaluation than one with a high unitary charge and equivalent higher level of surpluses, as the ultimate distribution of surpluses remains uncertain. However, where a certain level of unitary charge is required to meet lender covenants, and the resultant cashflows are more than sufficient to meet the servicing of junior debt, this should result in annual surpluses becoming available for payment to the Authority (or to its nominee). Such surplus payments during the term of the contract will be evaluated positively.

Further guidance on how surpluses are defined is included at Annex B.

ANNEX A: Junior Investment

On NPD projects banked to date, junior finance has only been provided by way of subordinated debt. It is for the bidders on each project to present solutions that best fit the individual project circumstances. These solutions may include alternative finance structures such as mezzanine debt.

Subordinated debt solutions create an “equity-like” structure. The subordinated debt is not counted as debt in the calculation of lenders’ ratios (e.g. the debt service cover ratio) which results in lower levels of cash reserve requirements in the financial model. It is priced akin to equity and is therefore likely to have a higher coupon than other forms of junior debt, leading to a higher weighted average cost of capital.

Mezzanine debt may in some structures be treated as a “debt-like” instrument and therefore be included as debt in the calculation of lenders’ ratios (e.g. the total debt service cover ratio). A financing structure such as this may lead to a lower weighted average cost of capital but may have greater reserving requirements.

Which solution results in a lower unitary charge will depend on whether the impact of any inclusion/exclusion from lenders’ ratios and cash reserve requirements outweighs any higher/lower cost of capital.

ANNEX B: Surpluses

The suite of standard form documentation produced by SFT will define surpluses in cash terms as this ensures greater transparency than, for example, an accounting measure of distributable profit. The financial commitments of the Project Company will have the following order of precedence:

- Normal project expenditure (e.g. payments to sub-contractors)
- Payments to senior funders
- Cash reserve requirements under the funding agreements
- Payments to junior funders
- A cash buffer
- Payment of surpluses

The Project Company will be entitled to retain a level of cash (over and above funders' reserves) and will be required only to pay out surpluses above that buffer. This gives the Project Company a contingency for dealing with any unexpected events that may arise during the life of the project.

Surpluses (if there are any) will be payable every 6 months provided that payment would not put the Project Company in breach of any legal or contractual obligations or the directors in breach of any of their legal duties.

The Project Company's share of any Refinancing Gain and of any savings generated by a Project Company Change will not be caught by the surplus payment provisions but will be payable to the investors.