

# Review of Operational PFI/PPP/NPD Projects

**Date : June 2011**

## **1. Introduction**

- 1.1. During 2010/2011, SFT carried out a review of operational PFI / PPP / NPD contracts to assess whether there are value for money savings that can be realised. A key conclusion of the review is that SFT believes that significant savings can be achieved by more effective contract management. As a result of that review, SFT identified in its 2011/12 Business Plan an emerging opportunity to take forward a collaborative approach to PPP contract management on a regional basis across Authorities.
- 1.2. This report sets out the scope of our review and summarises the conclusions reached. It also sets out the steps which we intend to take during 2011/12 to fulfil our business plan objective to implement and manage improved approaches to PPP contract management.

## **2. Background**

- 2.1. There are currently 87 operational projects in Scotland across the schools, health, waste & waste water, transport and other sectors. The total annual unitary charge on these projects is approximately £912m. Government has calculated that the share of Scotland's resource DEL budget used to pay for these contracts will peak at 2.3% in 2015/16 alongside the payments made by Local Authorities. Any savings that can be made will have a significant impact on budgets in the current climate.
- 2.2. SFT engaged with a number of bodies across a range of sectors and reviewed contract documentation and financial models as well as meeting with contract management teams.
- 2.3. Further details on the scope of the review and the work undertaken are set out in the Update Report which SFT provided to the Scottish Government in September 2010 and which is set out in Appendix 1 to this Report.
- 2.4. Infrastructure UK published a draft paper, Making Savings in Operational PFI Contracts, earlier this year. The paper reaches similar conclusions to the SFT review and is available at [http://www.hm-treasury.gov.uk/d/iuk\\_making\\_savings.pdf](http://www.hm-treasury.gov.uk/d/iuk_making_savings.pdf).

## **3. Key Findings**

- 3.1. Many of the PFI/PPP/NPD contracts across Scotland are now run in portfolios by private sector investors and managers with skilled resources dedicated to delivering quality operations efficiently. The private sector contract managers know the terms of individual contracts in great detail and are able to share best practice and efficiency measures between them.

3.2. Our key conclusion is that there are opportunities for VfM savings to be delivered through increased collaboration and commercial discipline in contract management, through the development of a shared service approach. Savings could be delivered from:

- i) Optimising the scope of services in the PPP contract;
- ii) Reviewing the risk transfer and value delivered from transferring some risks;
- iii) Reviewing response requirements and the overall value delivered by high standards of service delivery;
- iv) More robust management of contractual performance standards;
- v) Sharing best practice in relation to cross-sector provisions such as benchmarking of facilities management costs and insurance premium risk sharing;
- vi) Increasing in some cases the hedging against future inflation in some contracts;
- vii) Reducing the cost to the public sector of administering PPP contracts through a shared service approach;

SFT believes that savings in excess of £5.5m per annum could be realised through such a shared service approach, with the opportunity for greater savings existing following a comprehensive review of points above.

3.3. We also found that:

- 3.3.1. Given the current margins in the financial markets there are not significant opportunities at this stage for senior debt refinancing to deliver savings. There could be opportunities as construction phases end in 2011 and beyond for projects that reached financial close at the height of the credit crisis;
- 3.3.2. Given the increase in PWLB borrowing rates for Local Authorities in the UK Comprehensive Spending Review last year, there does not appear to be a good case for replacing elements of project finance debt with Local Authority PWLB borrowing as may previously have been the case;
- 3.3.3. Contract termination could potentially deliver savings in some instances, but the scope of VfM savings that may be available has not been reviewed as termination would bring assets back into the public sector for accounting purposes, and the capital budget required for this is not currently affordable.

- 3.4. As discussed at 2.4 above, Infrastructure UK is reviewing the opportunity to make savings in operational projects in England. SFT will continue to liaise with IUK and identify any areas where a robust strategic commercial approach could be taken with the PPP industry to deliver savings analogous with those required to be delivered in other areas of the public services. This opportunity may not be available with tightly drawn commercial contracts and the movements in the financial markets following the global financial crisis but will remain under review.
- 3.5. A more in depth analysis of our findings is contained in the Progress Update and Initial Conclusions Paper, which we provided to the Scottish Government towards the end of last year and which is set out at Appendix 2 to this Report.

#### **4. Collaborative Contract Management**

- 4.1. SFT is working with public body partners to develop a proposal for a collaborative approach to PPP contract management through a shared service as it considers that this is key to optimising the savings referred to at 3.2 above.
- 4.2. Consolidation of contract management expertise across groups of Authorities could realise savings not only in administrative costs but crucially in better management of the contracts enabling Authorities to realise opportunities to drive out better value through their contracts.
- 4.3. Contract management is required both at an operational level to ensure that the Authority gets the services which it is paying for and pays no more than is due and at a strategic level to drive improved value from the contract and to deal with changing requirements over the life of the contract.
- 4.4. Bringing together a number of Authorities, would provide the opportunity to create a structure involving a range of expertise, levels of skills and experience and could be reinforced by a centre of expertise within SFT.
- 4.5. SFT has already begun discussions with a number of local Authorities in the south east of Scotland to develop an approach to a collaborative working and this will be taken forward over the coming months. Piloting in this area matches the boundaries of the first hub territory to have moved into operation. Managing contracts through a service matching hub territory boundaries makes sense as in future the Authorities within these boundaries will have DBFM agreements with a single partner on common terms that could deliver even greater value when centrally managed.
- 4.6. One area which would be considerably improved by the creation of a collaborative contract management resource is the operation of the insurance premium risk sharing provisions in many contracts. With a view to maximising potential savings in this area, SFT proposes to contact all Authorities with PPP Contracts to recommend that

they carry out a review of the sharing position and will continue to provide assistance on how that could be carried forward.

- 4.7. SFT will also continue to act as a centre of expertise in this area, providing ongoing support on existing contracts.

## **5. Conclusion**

Following its review of operational PFI / PPP / NPD projects, SFT has identified the opportunity for Authorities to realise savings and improve VfM through improved approaches to contract management and we now intend to take forward a pilot project in collaboration with local authorities in the South East of Scotland.

## **Appendix 1:**

### **Operational PPP Projects VfM Review Update 30 September 2010**

#### **1. Introduction**

SFT has undertaken to carry out a review of operational PFI / PPP / NPD contracts, to assess whether there are value for money savings that can be realised.

SFT has written to 22 Scottish public bodies indicating that we should like to engage with them on this exercise. We have requested a copy of all the legal documents associated with such contracts, the financial model and the key contacts within each body to engage with regarding the review. We have reviewed a significant number of contracts, but are at an early stage in discussing the findings of this review directly with the public bodies. Following this, we anticipate an engagement taking place with private sector sponsors and / or FM contractors as appropriate.

By selecting public bodies that have signed a number of contracts, the 22 bodies provides coverage of 56 of the 85 contracts signed in Scotland (66%) and includes many of the older contracts signed in the late 1990s which will generally not have followed the standardised contracts that were developed later on and therefore may have fewer protections included for the public sector, but may also provide some opportunities for savings as well. The 22 bodies also give coverage of every key sector of PPP infrastructure and therefore should expose any issues that are restricted to a particular sector.

#### **2. Areas for Review**

SFT has reviewed a number of areas of possible saving as part of the review. Below are the main areas, along with the initial conclusions reached.

##### **2.1. Debt Refinancing**

We do not consider there to be an opportunity currently to realise savings to refinance the senior debt in existing PPP projects, given the pricing of debt has increased since most of the projects reached financial close. There may be an opportunity to refinance some of the large projects that have recently reached financial close (since March 2009), once these projects have entered the operational period (e.g. Fife Hospital and M80). This will not occur before 2011 and should be considered at this time.

##### **2.2. Short Term Savings**

There are a number of ways in which the short term cash cost of contracts could be reduced, but which are likely to have a longer term adverse impact on the overall cost of projects. Two of these are briefly described below:

- (i) Extension of Project Term – the public sector could agree with private sector contractors to extend the period of the contract, in exchange for a reduction in the annual unitary charge. The cumulative nominal unitary charge payable against the project clearly will increase and even in net present value terms (NPV) is likely to lead to an increase cost to the public purse.

(ii) Back Ending of Debt – agreement with project financiers to defer interest and / or capital repayment over the short term and repay the greater rolled up level of debt that would result later in the project. Such deferred repayment would require an increase in the unitary charge later in the project that is likely to outweigh, in NPV terms, the short term unitary charge savings.

We do not propose to investigate these in any more detail given the likely adverse impact on overall VfM, but could do so in pursuit of budgetary savings if required.

### **2.3. Contract Termination**

It may make sense in selective cases to consider the termination of contracts.

**Voluntary termination** should be a consideration for public sector bodies in circumstances where particularly poor value for money is an ongoing issue and where this would be addressed by voluntarily terminating the contract. For example on a number of the early PFI contracts, it was agreed that the asset did not revert to the public sector at the end of the contract - voluntary termination in some cases may allow control of the asset to be regained by the public sector without a significant increase in the termination liability.

There may also be circumstances where operator performance on the contract is so poor that **contractor default** could and should be enforced. The contractual implication of doing so will vary somewhat for each project, but in most recently signed contracts will require a determination of the market value of the contract and repayment to the project company on this basis. Termination whether voluntarily by an Authority or by contractor default raises a number of questions regarding the future funding and maintenance of the assets – including

- a) Is PWLB an appropriate means of financing termination liabilities for local authorities?
- b) Is there any capacity / appetite to finance termination liabilities where PWLB borrowing is not available?
- c) Does level playing field support remain in place for local authorities, or would capital budget cover be given to bring assets back within public budgets for central government projects?

Amongst these, point c) is of particular significance. SG Finance advise that if a contract was terminated, and termination costs financed through PWLB borrowing in a Local Authority, then existing Revenue Support from SG would become supported borrowing and require capital budget cover. It would not be good business for the Authority to terminate if Revenue Support was not ongoing. Thus, the overall VfM assessment, and even assessment of cash payments made would suggest that termination could be the best option but the capital budget implication for Scottish Government could make termination unattractive in the short term.

As shown in the example below, we are building evidence that the termination route could deliver VfM in some circumstances. Confirmation of whether you would wish us to pursue these with contracting authorities is needed before progressing any further.

## **2.4. Risk Transfer**

There are a number of areas of risk transfer to the private sector which may no longer represent value for money and which may have been included, or retained following changed circumstances in the original contracts principally in order to achieve off balance sheet treatment. These tend to be in areas where the contractor is not in control of the risk and is therefore likely to charge a premium. With the recent change in accounting treatment, this higher level of risk transfer is not required to retain off balance sheet treatment.

The main areas to review in this area are:

- Movements in the general insurance market for insurance premia
- General change in law affecting the costs of the PPP company

There may be an opportunity to re-negotiate this risk transfer on some existing projects in order to achieve a reduction in the unitary charge; albeit with some greater level of risk being taken by the public sector. It will be dependent upon the allowance for risk that has been made within the pricing of each contracts and how any unitary charge savings that result compare with the additional risks being assumed.

## **2.5. Review of the Scope of Services**

There is also the opportunity to explore the scope of FM services provided to operational PPP contracts. These include:

- Re-scoping the services associated with the project – transfer services to the most efficient provider of such services. This could mean bringing additional services into the PPP contract or removing services from the PPP contract and bringing the service back ‘in-house’.
- Reviewing the usage of PPP assets by public authorities to assess whether other public sector services / agencies could use the asset, whether there are surplus assets that should be mothballed or whether there are third party income opportunities.
- Ensuring that any contractual benchmarking / market testing of soft services takes advantage of the current competitive environment for such services.

### **3. Example**

One early contract provides for the private sector contractor to retain the assets at the end of the contract (subject to a right of buy out at market value from the Authority), unless there is a Authority default during the contract in which case, subject to termination payments by the Authority, they regain control of the asset. Our preliminary calculations, based upon the Authority borrowing from the PWLB to fund the termination liabilities and meeting the FM costs and lifecycle costs equivalent to the values allowed for in the project costings, showed a potential annual saving of circa 15 - 20% of the unitary charge from the termination of the contract – albeit that in addition to this a sum to pay for the asset is still due at the end of the contract period.

### **4. Allocation of Savings Made**

Generally in PPP contracts, savings that have been realised historically (such as part of a debt refinancing) have been retained by the local public sector body and no share has been passed back to central government. Generally level playing field support would need to be substantially retained by Authorities to incentivise implementation, although there may be circumstances in which some contribution in the form of a reduction in SG budgetary support would be warranted.

### **5. Conclusion**

1. SFT is at an early stage of discussions with public sector bodies to explore the areas mentioned above. Some areas of potential saving are being identified, but as significant analysis and eventually contract renegotiation would be required to deliver them, it is too early to say whether the level of savings will be significant.
2. A decision from SG is needed on whether to pursue VfM and cash savings through termination which would bring assets back on balance sheet for the public sector.
3. We recommend that in order to maximise incentives, SFT continue to work largely on the premise that savings that are realised will be retained by the local public sector body implementing the change.
4. We recommend that the extension of the term of projects and / or the back ending of debt is rejected as a means of realising short term savings in unitary charge, unless an overall value for money improvement in NPV terms can be demonstrated.

## **Appendix 2**

### **Review of Operational PPP Projects Progress Update and Initial Conclusions**

#### **1. Executive Summary**

SFT is carrying out a review of operational PFI / PPP / NPD contracts to assess whether there are value for money savings that can be realised. There are currently 87 operational projects in Scotland across the schools, health, waste & waste water, transport and other sectors. The total annual unitary charge on these projects is approximately £912m.

SFT is currently working with 22 public bodies, covering 56 of the signed contracts and has reviewed contract documentation and financial models as well as meeting with contract management teams.

The opportunities for releasing savings in these long-term tightly drawn contracts are moderate, and initial findings are:

- a) Given the current margins in the financial markets there are not significant opportunities at this stage for senior debt refinancing to deliver savings. There could be opportunities as construction phases end in 2011 and beyond for projects that reached financial close at the height of the credit crisis;
- b) Given the recent increase in PWLB borrowing rates for Local Authorities in the UK Comprehensive Spending Review, there does not appear to be a good case for replacing elements of project finance debt with Local Authority PWLB borrowing as may previously have been the case;
- c) Contract termination could potentially deliver savings in some instances, but the scope of VfM savings that may be available has not been reviewed as termination would bring assets back into the public sector for accounting purposes, and the capital budget required for this is not currently affordable;
- d) There could be opportunities for VfM savings to be delivered through increased collaboration and commercial discipline in contract management, possibly through the development of a shared service approach involving SFT. Savings could be delivered from:
  - i) Optimising the scope of services in the PPP contract;
  - ii) Reviewing the risk transfer and value delivered from transferring some risks;

- iii) Reviewing response requirements and the overall value delivered by high standards of service delivery;
- iv) More robust management of contractual performance standards;
- v) Sharing best practice in relation to cross-sector provisions such as benchmarking of facilities management costs and insurance premium risk sharing;
- vi) Increasing in some cases the hedging against future inflation in some contracts;
- vii) Reducing the cost to the public sector of administering PPP contracts through a shared service approach;

SFT believes that savings in excess of £5.5m per annum could be realised through such a shared service approach, with the opportunity for greater savings existing following a comprehensive review of points above.

## 2. Introduction

SFT is carrying out a review of operational PFI / PPP / NPD contracts to assess whether there are value for money savings that can be realised. The table below breaks down the 87 projects by sector and the cumulative unitary charge payable.

### Box 1 - Summary Of Scottish PPP Contracts

<b>Sector</b>	<b>No. Of Projects</b>	<b>Annual Unitary Charge</b>
Schools	38	£435m
Health	27	£206m
Waste & Waste Water	12	£151m
Transport	4	£64m
Other	6	£56m
<b>Total</b>	<b>87</b>	<b>£912m</b>

SFT has written to 22 Scottish public bodies indicating that we should like to engage with them on this exercise. We have requested a copy of all the legal documents associated with such contracts, the financial model and the key contacts within each body to engage with regarding the review. We have reviewed a significant number of contracts and have had initial meetings with 9 of these bodies. See Annex A for a list of these bodies.

By selecting public bodies that have signed a number of contracts, the 22 bodies provides coverage of 56 of the 87 contracts signed in Scotland (64%) and includes many of the older contracts signed in the late 1990s which will generally not have followed the standardised

contracts that were developed later on and therefore may have fewer protections included for the public sector, but may also provide some opportunities for savings as well. The 22 bodies also give coverage of every key sector of PPP infrastructure and therefore should expose any issues that are restricted to a particular sector.

### **3. Areas for Review**

SFT has reviewed a number of areas of possible saving as part of the review. Below are the main areas, along with the initial conclusions reached.

#### **Debt Refinancing**

We do not consider there to be an opportunity currently to realise savings to refinance the senior debt in existing PPP projects, given that the margins<sup>1</sup> applying to debt have increased since most of the projects reached financial close. For many years, commercial lenders were prepared to lend long term finance to infrastructure projects at a margin of 1% and below. The credit crisis has seen a re-pricing of this finance to at least double the margins previously charged. Therefore the opportunity for operational projects to take on cheaper debt does not currently exist. For those (relatively few) projects that have reached financial close since the credit crisis and have therefore had to incur these higher margins charges from the start, there may be an opportunity to refinance the debt once they have reached the operational period. This will not occur before mid 2011 and should be considered at this time.

We have also considered whether the partial repayment of debt directly by the public sector could provide value for money for the public purse. Specifically we have reviewed the funding of a capital contribution from the public works loan board (PWLB) to repay a minority of the outstanding debt within a local authority PPP project. This review has not demonstrated value for money as the borrowing rate from PWLB (which since the Comprehensive Spending Review on October 20<sup>th</sup> has increased to 1% above the relevant gilt rate) in general exceeds the interest rate on the project debt it would be replacing. This is illustrated in Box 2 as a worked example.

#### **Box 2 – Project Example**

In one project we have reviewed, £74.3m of senior debt was outstanding, with an interest rate swap rate of 5.23% and a margin of 0.66%. The senior debt was repayable over the remaining 23 years of the project with an average life of just over 11 years. The LIBOR and PWLB rate for this duration were 3.3% and 4.5%. Therefore any borrowing of funds from PWLB to repay debt would incur interest at 4.5% and would make a saving of interest of 3.96% (LIBOR rate of 3.3% plus the margin 0.66%). The saving is not greater than this as the interest rate swap remains in place, which means that the project company has to pay to

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<sup>1</sup> While margins have increased the underlying interest rate at which debt is available has decreased. However in most cases the underlying interest rate movement was hedged at the time of financial close and cannot therefore provide a gain in a refinancing.

the swap counterparty the difference between LIBOR (3.3%) and the swap rate (5.23%). The swap can only be broken by paying an upfront charge equivalent to the stream of expected payments to the swap counterparty. Therefore replacing existing senior debt with PWLB funds does not provide a saving but would add a cost. Pre PWLB cost increase, when the cost of PWLB funds was nearly 1% less, then PWLB at a cost of approximately 3.5% could have replaced existing senior debt at a cost of 3.96% realising a saving. This would have meant some transfer of risk back to the public sector but this was not examined further as the PWLB shift made this irrelevant.

### **Financial Re-engineering**

There are a number of ways in which the short term cash cost of contracts could be reduced, but which are likely to have a longer term adverse impact on the overall cost of projects. Two of these are briefly described below:

- (i) Extension of Project Term – the public sector could agree with private sector contractors to extend the period of the contract, in exchange for a reduction in the annual unitary charge. The cumulative nominal unitary charge payable against the project clearly will increase and in net present value terms (NPV) is likely to lead to an increase cost to the public purse.
- (ii) Back Ending of Debt – agreement with project financiers to defer interest and / or capital repayment over the short term and repay the greater rolled up level of debt that would result later in the project. Such deferred repayment would require an increase in the unitary charge later in the project that is likely to outweigh, in NPV terms, the short term unitary charge savings.

Given the negative overall VfM affect of these approaches, we have not considered them any further.

### **Contract Termination**

There could potentially be a case for selective termination of contracts, either in circumstances where particularly poor value for money is an ongoing issue and where this would be addressed by voluntarily terminating the contract, or where operator performance on the contract is potentially so poor that contractor default could be enforced. If contracts were terminated, all risks associated with the assets would fall back to the public sector, termination compensation would be payable, and the value of the assets would become classified as public sector for national accounting purposes.

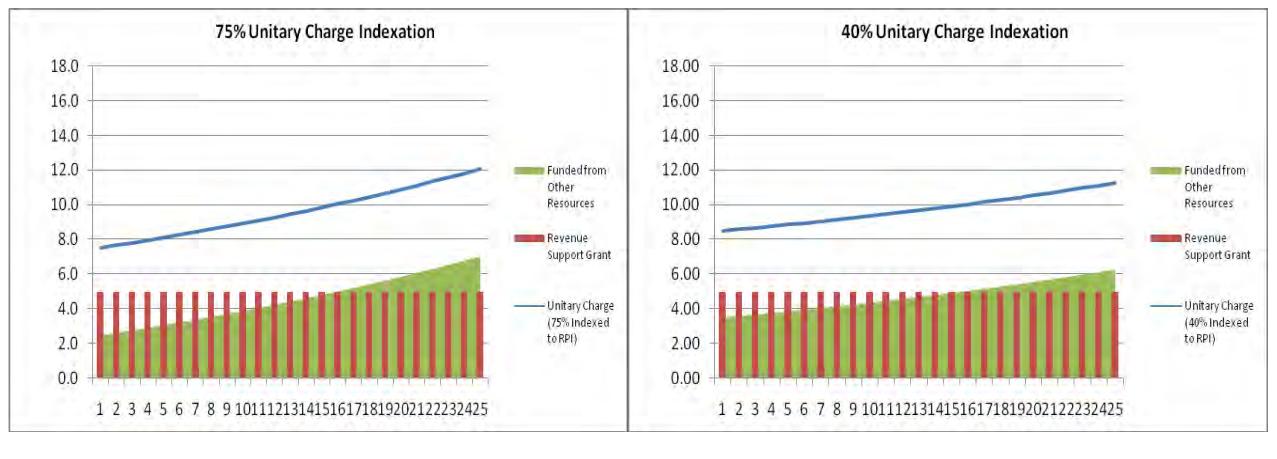
If local authorities borrow from PWLB (to fund termination liabilities) on the basis of level playing field support to be received from SG, then this would be considered to be supported borrowing and hence would create a call on SG's capital budget in the year in which the

borrowing takes place, due to the UK budgeting rules under which SG operates. Given the scarcity of capital resources, it is not a priority to make capital budgets available to fund this supported borrowing even if a long-term value for money case existed, unless there is a persistent and significant underperformance issue to be addressed. Due to this general unaffordability of termination, we have not explored this option any further.

**Box 3 – Funding Structure – Local Authority Schools Project**

The graph below sets out the funding structure for a local authority schools project. In both examples below a fixed level (in nominal terms) of revenue support grant is committed from the Scottish Government (£5m), leaving the local authority to fund the remaining unitary charge due from their other resources. The authority can elect to grant either a higher level of unitary charge indexation (left graph – 75% indexation) and therefore reduce their early years unitary charge (UC) and funding requirement (in this example £7.5m UC and £2.5m in the first year), but require a higher UC and funding requirement at the end of the project (£12m and £7m respectively in example) or a lower level of indexation (right graph – 40%) and increase their early years UC and funding requirement (£8.5m and £3.5m respectively) but require a lower UC funding requirement at the end of the project (£11.2m and £6.2m respectively in example). Both scenarios assume a 2.5% inflation rate throughout the project term.

The example in the left hand graph exposes the authority to greater inflationary risk. If the average inflation rate during the project end up being 4% not 2.5%, their funding requirement by year 25 increases from £7m to £11.3m. Whereas the same increase in inflation on the right hand graph would increase the funding requirement from £6.2m to £8.8m.



**Contract Management**

Our review has suggested that the approach to contract management varies considerably across public sector bodies, both in the amount of resource and the targeting of this resource. Overall there are 50 different public sector bodies managing 87 contracts. In sectors where: (1) the whole service is being delivered via the PPP contract as well as the assets (such as waste water treatment contracts delivered by Scottish Water and custodial services delivered by the Scottish Prison Service); and (2) several contracts are under one management team, a larger and more specialist resource is dedicated to contract monitoring and the management

of the contracts is more consistent. Where the core service is provided in house by the public sector (such as in schools PPP and health PPP) the management of the contract can be more diverse and have less specialist resource dedicated to it. We believe that greater value (a combination of lower cost and increased level of service) can be extracted from these contracts from a more consistent and strategic approach to their management. We believe that the optimum way of delivering this would be for greater collaborative working and shared services of contract management across public bodies. This approach would more easily allow investment in resource and training and to reduce the overall cost of contract monitoring. It would also provide the opportunity for greater transparency and consistency in the reporting of financial and operational performance across projects.

SFT's review has highlighted the following areas in which greater attention needs to be applied:

**Optimisation of the scope of contract services and Improved Application of the Contract**

1. Re-scoping the services associated with the project – transfer services to the most efficient provider of such services. This could mean bringing additional services into the PPP contract or removing services from the PPP contract and bringing the service back ‘in-house’.
2. Reviewing the usage of PPP assets by public authorities to assess whether other public sector services / agencies could use the asset, whether there are surplus assets that should be mothballed or whether there are third party income opportunities.
3. Ensuring that any contractual benchmarking / market testing provision for services is applied and it takes advantage of the current competitive environment for such services. At times these provisions are seen as an opportunity by PPP contractors to increase their profit margins and therefore management from the public sector needs to take place to prevent this.
4. Improved management of the change process. Public sector bodies require at times to make changes to their contracts. Experience of implementing this within many public sector bodies is slight and we believe better value for money can be obtained by a focus on this area.
5. Improved monitoring of operational performance. Greater consistency of approach to checking that the contractor is meeting his contractual obligations including a targeted use of the right of audit. There are times in which savings are not being realised by public bodies due to a lack of understanding of the contract provisions.

### **Optimisation of Risk Transfer**

There are a number of areas of risk transfer to the private sector which may no longer represent value for money and which may have been included, or retained following changed circumstances in the original contracts, principally in order to achieve off balance sheet treatment. These tend to be in areas where the contractor is not in control of the risk and is therefore likely to charge a premium. With the recent change in the approach to classification (See Box 4 below), this higher level of risk transfer is not required to retain off balance sheet treatment at National Accounts level and therefore to impact on Scottish Government capital budgets

#### **Box 4 – Change to System of Accounting and Classification**

Until recently, public sector bodies were required to account for PPP transactions under UK accounting standards. Judgements as to whether the PPP contracts were recognised on the public sector body's balance sheet was made in accordance with FRS5 and whether the operator of the asset bore risk with regards to variations in profits or losses on the property. This was determined under a number of different tests – particularly important in achieving off balance sheet treatment was to demonstrate the operators was taking the risk on changes in property related costs and penalties for the unavailability of the asset.

From year ended 31<sup>st</sup> March 2009, public sector bodies are now expected to account for PPP transactions under international accounting standards (IFRS). Each body needs to assess whether its PPP projects fall within the definition of a service concession under International Financial Reporting Interpretation Committee 12 (IFRIC 12). All service concessions which the public sector body controls both the services the operator must provide and the residual value of the asset must account for these assets as a tangible fixed asset on its balance sheet. In practice the vast majority of Scottish PPP projects fall within this definition.

However the Scottish Government budgeting for PPP costs follows HM Treasury's consolidated budgeting guidance which follows the treatment of these assets in the National Accounts under the European System of Accounts (ESA95). ESA95 classifies PPP projects as non government assets if they have transferred construction risk and either demand risk or availability risk. The vast majority of Scottish PPP assets fulfil this criteria and are classified as non government assets.

The main areas to review in this area are:

- Movements in the general insurance market for insurance premia
- General change in law affecting the capital costs of the PPP company

There may be an opportunity to re-negotiate this risk transfer on some existing projects in order to achieve a reduction in the unitary charge; albeit with some greater level of risk being

taken by the public sector. It will be dependent upon the allowance for risk that has been made within the pricing of each contracts and how any unitary charge savings that result compare with the additional risks being assumed. The savings that result from the removal of these risks may need to be shared with the private sector. Such changes to the risk transfer are best agreed alongside other variations being made in a contract (e.g. benchmarking / market testing exercise) in order to minimise the transaction costs associated.

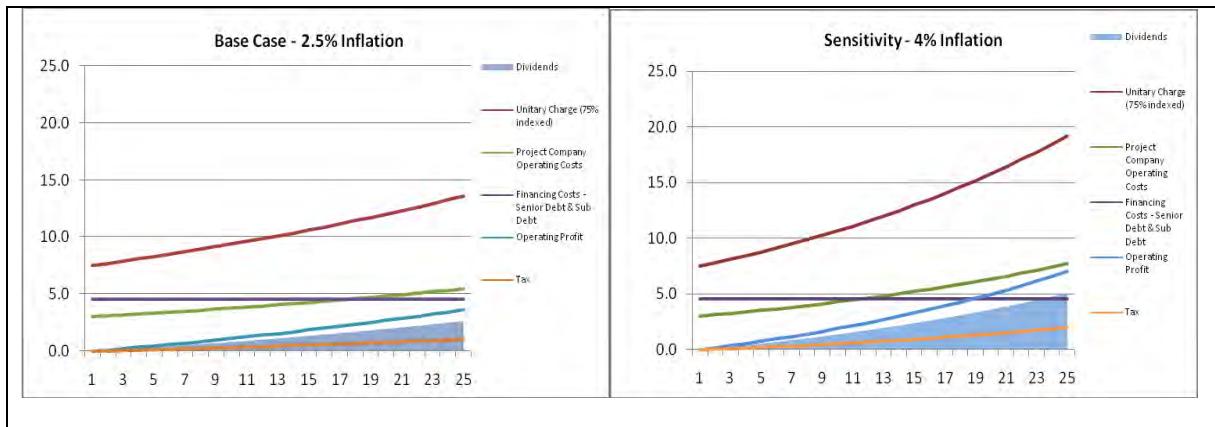
### **Inflation Hedging**

Our review of some project financial models indicates that there are likely to be a number across Scotland in which there is a level of unitary charge indexation in excess of that required to cover the operating costs of the project company. This ‘excess indexation’ could be hedged using an RPI swap, which will produce an additional project revenue stream and hence provides the potential to allow a reduction in the unitary charge. However this hedge could only be introduced with the agreement of the shareholders in the project and therefore the benefit would probably require to be shared with these parties. The number of projects which involve ‘excess indexation’ are expected to be relatively small and therefore the size of the potential public sector benefit is expected to be small.

#### **Box 5 – Excess Indexation**

Where a public body has granted a higher level of unitary charge indexation than is required by the project company to meet its (indexing) costs and no form of RPI swap has been put in place (‘excess indexation’), then the equity return will tend to improve, if inflation turns out to be higher than the base case assumption (generally taken to be 2.5% - as in the example below). Conversely if inflation turns out to be lower than the base case assumption, then the equity return will be lower than expected. The link between higher inflation and higher equity return is shown in the graphs below. The left hand graph would be the expectation of returns at the financial close of the project. (in this example it shows cumulative nominal dividends of £29.7m), given a base case inflationary assumption of 2.5%. The right hand graph shows the impact on dividends from a rise to a 4% average inflation rate, which leads to an increase in dividends to £53.9m. A fall in actual inflation to a 1% average would reduce cumulative dividends to £10.5m.

Therefore excess indexation leads to greater variability in equity returns linked to the actual level of inflation. There may be merit to include an RPI swap to both increase the stability of the project and bring in a additional revenue stream to the project which could be used to bring a unitary charge saving to the public sector, which would have to be shared with investors.



The total level of unitary charge payable under all Scottish PPP contracts in 2011 / 12 is estimated to be £912m. If Scottish Water, Scottish Prison Service and transport projects are excluded, the revised figure is £634m (or largely health and local authority projects). On average about 40% of the Unitary Charge cost is for operating costs (FM , lifecycle, insurance, project company costs) – coming to a total of £254m. We believe that 2% is a conservative estimate for savings and benefits that could be realised from improved contract management – equating to around £5m per annum. In addition to this we believe there may be an additional opportunity to realise savings with regard to both the staffing cost for contract monitoring through a shared service approach and from greater levels of inflation hedging. In total therefore we estimate a potential saving of at least £5.5m per annum from this area of activity should be realisable.

### Commercial Approach to Project Investors

The developers of PPP projects in many cases have ongoing links with the public sector through their wider group companies. It is not unusual for a project developer to also have a construction company or a facilities management company as part of their group. As part of government relationship with firms it may be possible to apply pressure to achieve more favourable terms. However many operational projects have been sold by their original owners and have transferred into the ownership of different infrastructure funds. Such funds have bought the projects from the original developers and are remote from other day-to-day engagement with the public sector.

As the investors work across the UK, SFT have been liaising with Infrastructure UK and will continue to develop approaches to the private sector which recognise the budgetary position in the public sector across the UK and seek to maximise value from existing contractual arrangements.

### 4. Conclusion & Next Steps

SFT has reviewed a selection of contracts from the majority of the 22 public bodies from whom we have received documents to date. A number of savings proposals have been

considered and rejected as either impractical for classification / budgeting reasons or uneconomic and these are described above.

What is clear is that the opportunity for significant financial re-engineering is limited. The combined effect of: interest rate swaps; contractual terms; PWLB cost increase; and government accounting rules provides limited room for manoeuvre. While there have been some proposals from the private sector to restructure debt the initial review of these shows that they do not offer value for money.

There are a number of opportunities to make savings – on a widespread basis this is primarily through improved contract management, which we believe could realise at least £5.5m per annum.

SFT will proceed with some pilot projects to test the value for money of taking back insurance risk and capex change in law risk.

SFT will assist public sector bodies with any moves towards a shared services model of contract management, including both training of staff and advice in the implementation of the areas of savings and benefits highlighted above where appropriate.

Projects that closed at financial crisis margins in 2008 may start to be refinanced in 2011 and SFT will monitor and support these transactions to ensure maximum value for the public sector.

SFT will work directly with the relevant local authorities regarding the implementation of savings opportunities identified from the early NPD projects.

## **Annex A**

### **List of Public Sector Bodies Approached**

Falkirk Council  
Fife Council  
Perth & Kinross Council  
Scottish Prison Service  
Scottish Water  
NHS Lanarkshire  
City of Edinburgh Council  
Renfrewshire Council  
North Ayrshire Council  
East Renfrewshire Council  
Argyll & Bute Council  
Glasgow City Council  
Midlothian Council  
Angus Council  
Stirling Council  
West Lothian Council  
The Highland Council  
Aberdeenshire Council  
NHS Greater Glasgow  
North Lanarkshire Council  
Transport Scotland  
NHS Lothian

### **Bodies with Whom Initial Meetings Have Taken Place**

Falkirk Council  
Fife Council  
Perth & Kinross Council  
Scottish Prison Service  
Scottish Water  
NHS Lanarkshire  
City of Edinburgh Council  
Renfrewshire Council  
North Ayrshire Council