Public Audit Committee

20th Meeting, 2022 (Session 6), Thursday, 30 June 2022

Major Capital Projects

Introduction

1. At its meeting today, the Public Audit Committee will take evidence on the Scottish Government's most recent update on Major Capital Projects (MCP), which covers the six months' period ending March 2022. The update is available here

2. The Committee previously agreed that the focus of today's evidence session will be on the programmes and projects that fall under the 'Driving inclusive economic growth' theme of the Infrastructure Investment Plan (IIP). In particular, the Committee will focus on the transport elements of this theme including—

   - A720 Sheriffhall Junction
   - A83 Access to Argyll and Bute
   - Aberdeen to Central Belt Rail Enhancements
   - A9 dualling
   - Highland Main Line Phase 2
   - Major rail project enhancements

Background

3. The Scottish Government began providing six-monthly update reports to the Session 3 Public Audit Committee on the progress of MCPs in 2009. This was in response to recommendations contained in its report, Major Capital Projects. The Session 6 Public Audit Committee agreed that it wished to continue to receive these six-monthly updates. This is the second update provided this session.

4. At its meeting on 19 May 2022, the Committee took evidence from the Scottish Government on the governance, assurance and oversight arrangements that are in place in respect of public sector MCPs. Follow up information from the meeting of 19 May was provided by the Scottish Government on 23 June 2022 and can be found in the **Annexe.**

5. Further background about the Committee's scrutiny of MCP updates can be found on the Committee's webpage.

Next steps

6. The Public Audit Committee will decide any further action it wishes to take after it has taken evidence from Scottish Government officials.

Clerks to the Committee
27 June 2022

ANNEXE

Major Capital Projects: Accountability and Governance Arrangements – follow up information from the Scottish Government, 23 June 2022

Purpose

1. At the Public Audit Committee session on 19 May, officials provided evidence on the governance and accountability arrangements surrounding major capital projects and agreed to provide further information or clarification on a small number of points:
   - The membership of the Infrastructure Advisory Group;
   - The formula for use of the Non-profit distributing (NPD) model;
   - The formula for the use of the Mutual Investment Model (MIM); and
   - Technical and policy guidance on exiting PFI contracts.

Membership of Infrastructure Advisory Group

2. During the meeting on 19 May Mr Leonard asked who was on the Infrastructure Advisory Group. Andrew Watson noted in the meeting that the IIB brought together senior leaders from policy areas and corporate functions with a role to play in infrastructure delivery. The Infrastructure Advisory Group tends to be at director and deputy director level and membership was drawn from policy makers in the main parts of government.

3. The membership of the IAG is as follows:

Meetings are chaired by the Deputy Director, Infrastructure and Investment. Membership is open to all Directors leading directorates (or their delegates) with an interest in the development of the Government's infrastructure strategy and those responsible for capital spending from the Scottish Government's Budget, in particular:

- Budget and Public Spending
- Energy and Climate Change
- Transport Scotland
- Digital
- Local Government and Communities
- Early Learning and Childcare
- Housing and Social Justice
- Learning Directorate
- Economic Development
- Advanced Learning and Science
- Health Finance and Infrastructure
- Justice
- Planning
- Scottish Procurement & Property
- Directorate for Environment and Forestry
- Directorate for International Trade
- OCEA.

The NPD and MIM models

4. During the meeting on 19 May, Mr Beattie asked if the Scottish Government officials could provide the Committee with a copy of the formulas for NPD and MIM. This information is included in the paper, drafted by the Scottish Futures Trust, which is attached at annex A.

Guidance on exiting PFI contracts

5. During the meeting on the 19 May Mr Leonard asked if the guidance produced in 2020 by the Scottish Futures Trust to support bodies looking to exit PFI contracts could be shared with the Committee. He further asked that current policy guidance on exiting PFI contracts and information on any plans on this issue be shared where possible. The paper provided at annex A (paras 18-20) sets out the current guidance on exiting PFI contracts which are coming to the end of their term. Where there is a proposal to end a PFI contract early, each case is assessed on its own merits, with a particular focus on value for money.

Infrastructure and Investment Division

June 2022

ANNEX A

Non Profit Distributing & Mutual Investment Models

Using public private partnerships to attract private finance and deliver additional capital investment

1. Both the Non-Profit Distributing (NPD) model and Mutual Investment Model (MIM) are forms of Public Private Partnership (PPP) which allow projects to be funded annually through revenue budgets as the asset is used, rather than upfront capital budget as the asset is built.

2. In contrast to a traditional capital procurement where the public sector pays for the asset as it is being built and is responsible for maintaining the asset, under a PPP the public body does not pay anything until the asset is completed. The public body procures a private partner who establishes a project company (ProjectCo) to design, build, privately finance and maintain an asset such as a college or a road. The public body pays a fixed annual sum (some elements of the annual sum are subject to inflation), often referred to as a unitary charge, for the asset to be maintained and available for use over a contract duration of 25-30 years. If the asset, or a portion of it, is not available for use, the public body does not have to pay the full charge.

3. The total amount paid for an asset through the unitary charge over 25-30 years is significantly higher than the capital cost of the asset because it includes the cost of the finance, running the ProjectCo, and the cost of maintaining the asset in good condition, as well as just for designing and building the asset. The risk of cost changes during construction, and the overall risk of building the asset and keeping it in good condition is transferred to the private sector through the PPP contract.

4. This ‘pay as you use’ arrangement leads to the concept of ‘additionality’ – which is that subject to detailed budgeting rules, investment in assets through PPP can be ‘additional’ to capital budget allocations. No capital budget is needed in the years that the asset is being built, but instead revenue budgets are needed later whilst the asset is being used – albeit over a much longer total period of time. It is this premise of ‘additionality’ which allows investment in infrastructure beyond the capital budgets available that has driven the use of PPP type models.

5. In 2018 the National Infrastructure Mission commitment was announced by Scottish Government to boost economic growth by increasing annual investment in infrastructure by 1% of 2017 Scottish GDP by 2025-26 and to overcome historically lower levels of UK investment in infrastructure. This commitment cannot be met through capital budgets alone. The Infrastructure Investment Plan

2021-22 to 2025-26[1] details how Scottish Government intends to deliver the National Infrastructure Mission.

6. Over time the PPP models used to deliver revenue funded projects have evolved. The most common and well-known form of PPP in the UK is the Private Finance Initiative or PFI. NPD and MIM have evolved to address historic issues with PFI contracts and descriptions and use of these models is detailed in the sections below.

Non-Profit Distributing (NPD)

7. NPD was first developed by Scottish Government under the name NPDO, or non-profit distributing organisation in the early 2000s. SFT took over the model when SFT became operational in 2009 and developed the model for the "NPD Programme" launched in 2010.

8. The principals of design, build, finance and maintain are the same as for most PPPs as described above. However, the ProjectCo in an NPD project does not have dividend bearing equity – so ~~s~~ponsors make a capped financial return which is bid for in competition and still take the same risks of cost increases or failure to maintain the asset properly as the private sector takes in other forms of PPP such as PFI. Any additional profits or 'surpluses' generated by the ProjectCo through the operation of the contract are returned to the public authority, rather than being taken by the private sector sponsors as profit in the form of dividends. There is also an enhanced stakeholder involvement in the management of the project through a requirement for the project company to have a Public Interest Director, appointed by the public sector, sitting as a Director on its board.

Non-Profit Distributing (NPD) – use of model

9. Fifteen NPD projects have been undertaken in Scotland in the Health, Roads, Education and Further Education sectors.[2] Construction has now been completed on all these projects and all are operational with the procuring authorities paying the unitary charge for use of the assets.

10. Whilst there are fifteen NPD projects with concession periods of 25-30 years and therefore they have several years still to run, the NPD model is no longer used for new revenue funded projects. The cessation of the use of the NPD model followed a change in Eurostat statistical rules issued in 2014 which meant that the profit capping used in the NPD model no longer met private sector classification from a Scottish Government budgeting perspective, and instead, capital budget would be required to cover these projects during the construction period, thereby removing the **additionality** of investment benefit. Following this ruling, Scottish

[1] A National Mission with Local Impact: Infrastructure Investment Plan for Scotland 2021-22 to 2025-26 - gov.scot (www.gov.scot)

[2] Details of these projects and annual unitary charge figures can be found on the Scottish Government website in the following publications: NPD projects pre 2010: NPD projects pre-November 2010: unitary payment charges - gov.scot (www.gov.scot) and NPD projects post 2010: NPD/hub programme: unitary payment charges - gov.scot (www.gov.scot)

Government asked SFT to explore profit sharing options to deliver additionality of investment to meet the National Infrastructure Mission and the Mutual Investment Model (MIM) was identified as a potential model to deliver these requirements.

Mutual Investment Model (MIM)

11. The Mutual Investment Model was developed by the Welsh Government as another form of PPP which shares the characteristics described for PPPs above. It was recommended by Scottish Futures Trust in a 2019 Options Appraisal[3] for Scottish Government into potential privately financed schemes to deliver additionality of investment as part of the National Infrastructure Mission.

12. The MIM model shares the profit-distributing characteristics of PFI, and brings a share of those profits back to the public sector via a public-sector holding of up to 20% in the risk capital in the Project Company established by the winning private sector bidder to deliver the project. Thus, the public sector takes a share in the potential up-side, and a share of the risk of delivering the project alongside the private sector partner.

13. MIM contracts can share a number of the features introduced in NPD to improve the overall value for money of contracts and share the NPD characteristic of having a public sector appointed Director on the board of the project company.

14. The MIM profit-sharing arrangement (as compared to the NPD profit-capping arrangement) has meant that the MIM model, as a policy proposal, has been assessed by ONS as being classified to the private sector under ESA10 statistical rules. Therefore, the MIM model allows for the budgetary additionality of the pay-as-you-use PPP arrangements to be maintained.

Mutual Investment Model (MIM) – use of model

15. Whilst MIM has been identified as a value-for-money option to deliver additionality of investment over and above current capital and public borrowing sources of investment, SFT also noted that “should greater borrowing powers be made available to the Scottish Government, this would provide a lower cost financing option to deliver additionality.” There are other ways of delivering additionality apart from MIM which include ‘outcome based’ funding approaches being used for the Learning Estate Investment Plan delivery[4] and Green Growth Accelerator[5] but these assume access to public sources of investment. Therefore, the MIM infrastructure investment tool is reserved for central government assets where access to borrowing is more restricted and certain characteristics suitable for MIM are met:

    a. new not refurbishment projects

[3] sftoptionsappraisalreportlowres.pdf (scottishfuturestrust.org.uk)
[4] Learning Estate Investment Programme - Scottish Futures Trust
[5] Accelerating green growth - gov.scot (www.gov.scot)

b. projects capable of specification for 25 years
c. technology stable
d. stable legislative environment
e. can sustain transaction costs i.e. project value >£30m

16. Roads and accommodation projects such as colleges lend themselves well to the investment model. Other social infrastructure assets such as prisons, blue light, administration, and cultural buildings could also be delivered. The investment model is less suitable in sectors where technology or legislation changes quickly or there is complex service delivery.

17. To date no MIM projects have been procured, but MIM is being considered for the roads sector, and specifically the A9 project.

Return of PPP projects to the public sector

Public sector buy-out of projects

18. There is no Scottish Government policy encouraging buy out of PPP projects. Any proposal would be considered on a case-by-case basis, such as in the example of East Ayrshire Community hospital which was mentioned at the Public Audit Committee meeting. This would look at the value for money of terminating the contract early and bring the assets into public sector operation.

Handback of assets at the end of the concession contract

19. Where contracts are approaching handback to the public sector we do have clear guidance in place[6]. Challenges to be addressed to ensure a smooth handover of assets and services include:
- Inherent contractual complexity of early PFI Contracts
- Resource and Governance
- Ongoing Contractual Compliance
- Existing relationships
- Alignment of End of Contract Works with organisational, asset and net zero strategies
- Availability of decant accommodation
- Compatibility of systems and databases
- Post End of Contract Facilities Management services provision

20. Portfolios are taking a programme approach to managing the issue and ensuring that the wider service learns from early projects. For example, the health portfolio has a specialist support group which recommends review of the contract at least 7 years from the contract end date.

[6] endofcontractprogrammeapproachfinalsftreporttemplate150420v11.pdf (scottishfuturestrust.org.uk)