Finance Committee

FIN(3)-06-08 (p3) Inquiry into Public Private Partnerships: alternative models of PPP

Meeting date: Thursday 10 April 2008
Meeting time: 10.00 – 12.30
Meeting venue: Committee Room 3

Purpose of Paper

1. To describe different approaches that can be adopted to developing PPP/ PFI projects.

Background

2. The attached paper has been prepared by PricewaterhouseCoopers to describe the different approaches that might be adopted in developing a PPP proposal.

John Grimes

Clerk, Finance Committee

April 2008

National Assembly for Wales

Finance Committee Investigation into PPP – Options and Issues

April 2008

Terms of Reference

- Finance committee of the National Assembly for Wales (NAW) has submitted a call for evidence to support its inquiry into the use of public private partnerships including PFI in Wales

- The terms of reference for the inquiry are as follows:

  - *"To examine the scope for drawing on private finance for public sector projects with particular reference to:*

    - *The potential benefits, costs and risks that may be involved;*
    - *Any policy changes (whether to remove barriers or apply controls) that may be needed to realise the optimum outcome; and*
    - *Practical guidance to enable the public sector to strike the most advantageous arrangements within the agreed policy framework"*

Introduction

- Historically, PFI (Private Finance Initiative) has been the primary mechanism used by the public sector in PPP (Public Private Partnership) procurement
- This was due to the concentration of private sector activity into predominantly ‘non-core’ activities in areas that could be more easily segregated into a separate contract
- However, as the role of the private sector in the provision of public services has expanded, so too has the number and type of innovative procurement solutions available for use
- There are now a wide range of approaches to the procurement of capital infrastructure, some of which may have the potential to be delivered in the Welsh context

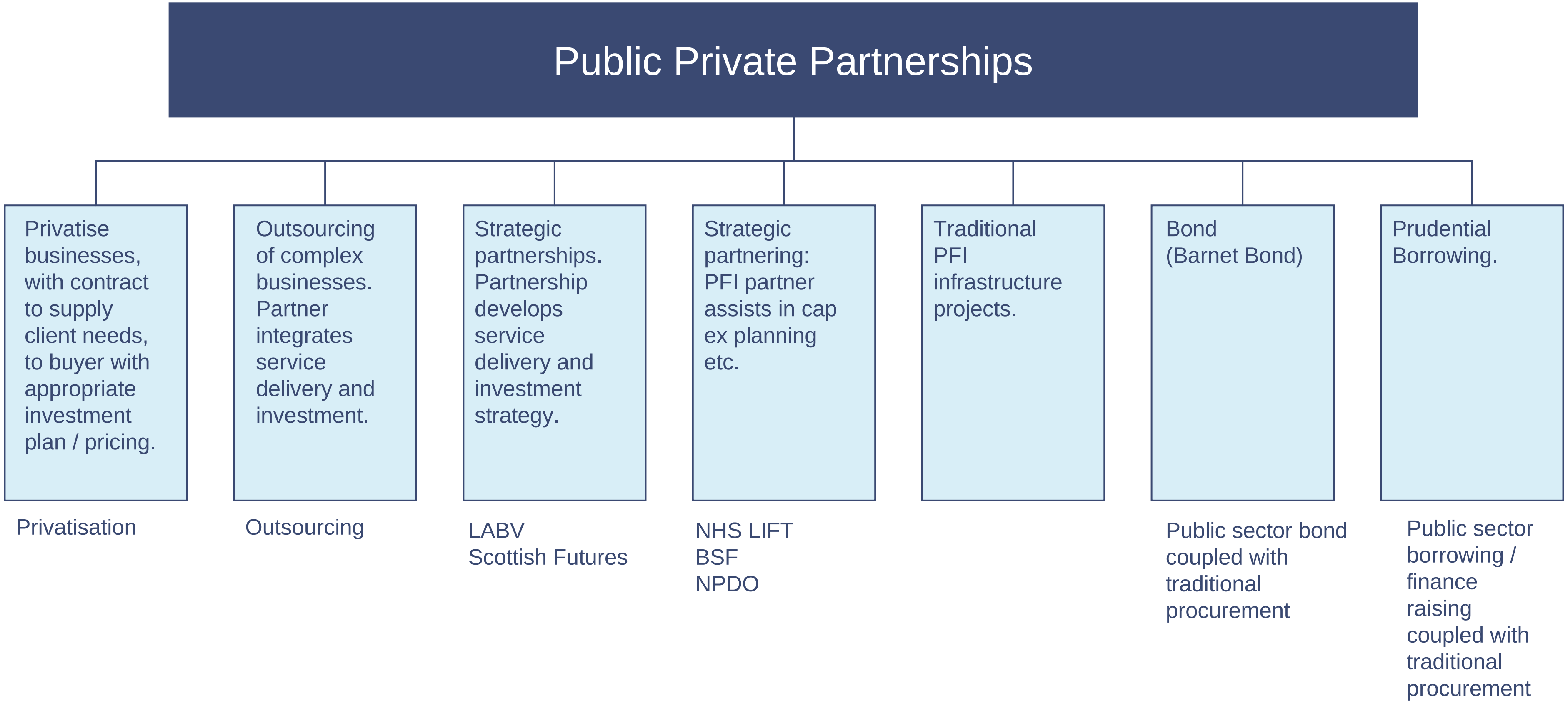
Introduction

- PFI has been a primary method of procuring large infrastructure projects for a number of years. As such, responses to the inquiry have tended to focus on PFI
- However, a number of responses have made reference to alternatives to, and developments of, classic PFI. Models mentioned have included:
  - Local Improvement Finance Trusts (LIFT)
  - Building Schools for the Future (BSF)
  - Local Asset Backed Vehicles (LABV)
  - Non-Profit Distributing Option (NPDO)
  - Prudential Borrowing / Bonds

- The Finance Committee wishes to obtain an overview of these and other alternative models.

Introduction

PPP covers a range of structures. These can be summarised as follows:



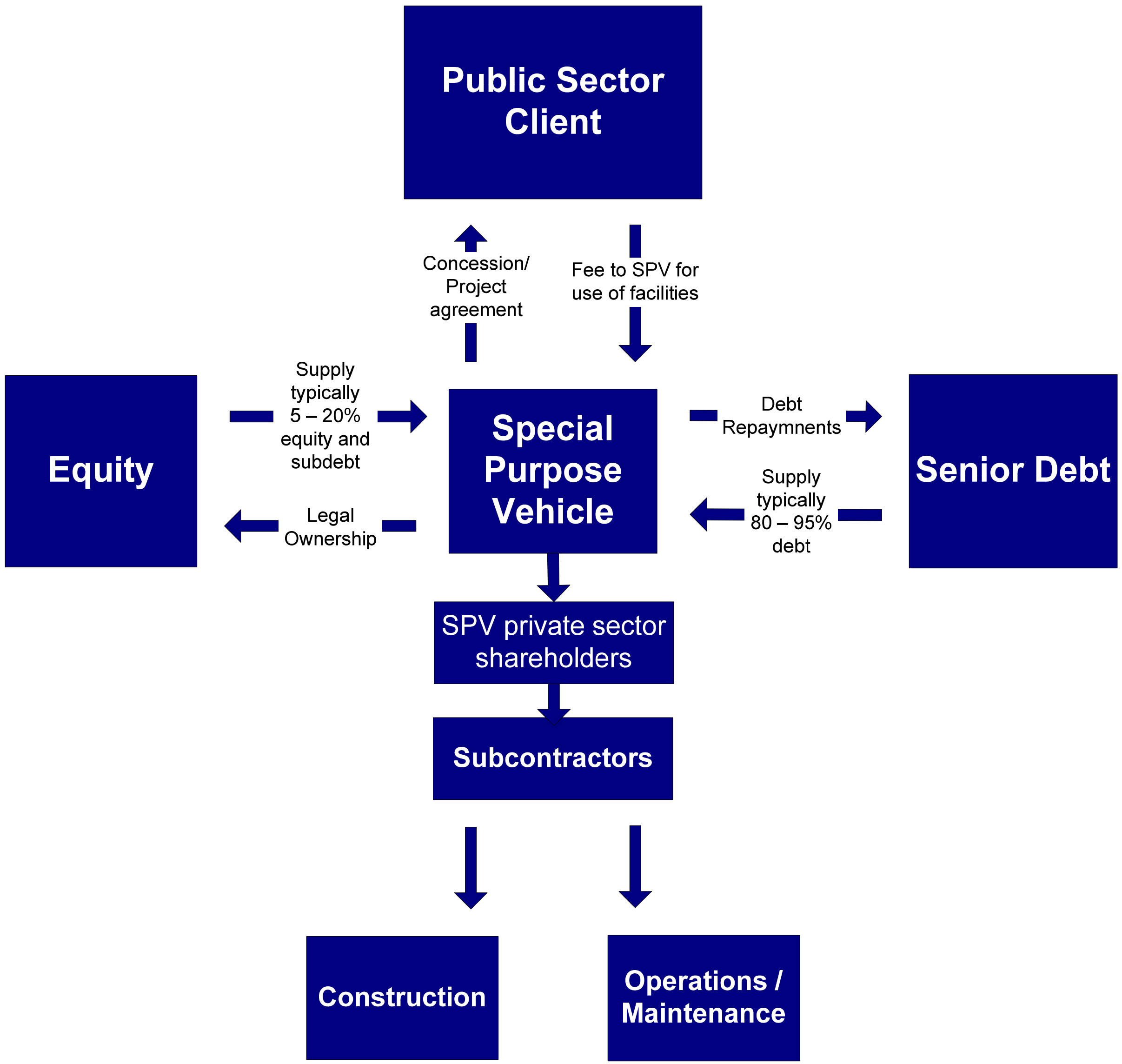
There is considerable overlap between some of the procurement models – there is extensive scope for solutions to be tailored to meet specific requirements

PPP Models – PFI

Overview

- PFI is an arrangement where the public sector contracts to purchase services, usually derived from an investment in assets on a long term basis (up to 30 years).
- Typical features include:
  - Private sector responsible for design, construction and maintenance of infrastructure and certain support services
  - SPV (special purpose vehicle or company) established for venture – typically owned by project sponsors
  - Private finance used to fund initial capital expenditure
  - Transfer of risk from public sector to the private sector
  - Much of the risk assumed by the SPV is passed to other entities via sub-contracting arrangements
  - SPV is paid via an unitary payment – such payment is reduced if performance falls below required standards
  - Detailed and complex legal documentation required
  - Limited flexibility to deal with changing market conditions
  - Early PFI schemes have, in some cases, resulted in major refinancing gains to private sector – gains now shared
  - Potential transfer of employees under TUPE/ROE arrangements

Typical PFI Contract Structure



PPP Models – PFI

Key strengths

- Opportunity to tap private sector innovation, technical, management and financial resources and expertise
- Key risks can be transferred to the private sector
- Contractors can be immediately penalised via the unitary payment if performance targets not met
- Private sector due diligence processes applied particularly via banking review
- Public sector offered protection in default scenarios
- Historically off-balance sheet funding possible for public sector. Introduction of IFRS will limit this
- Regular maintenance of building and guaranteed condition at expiry

Key weaknesses

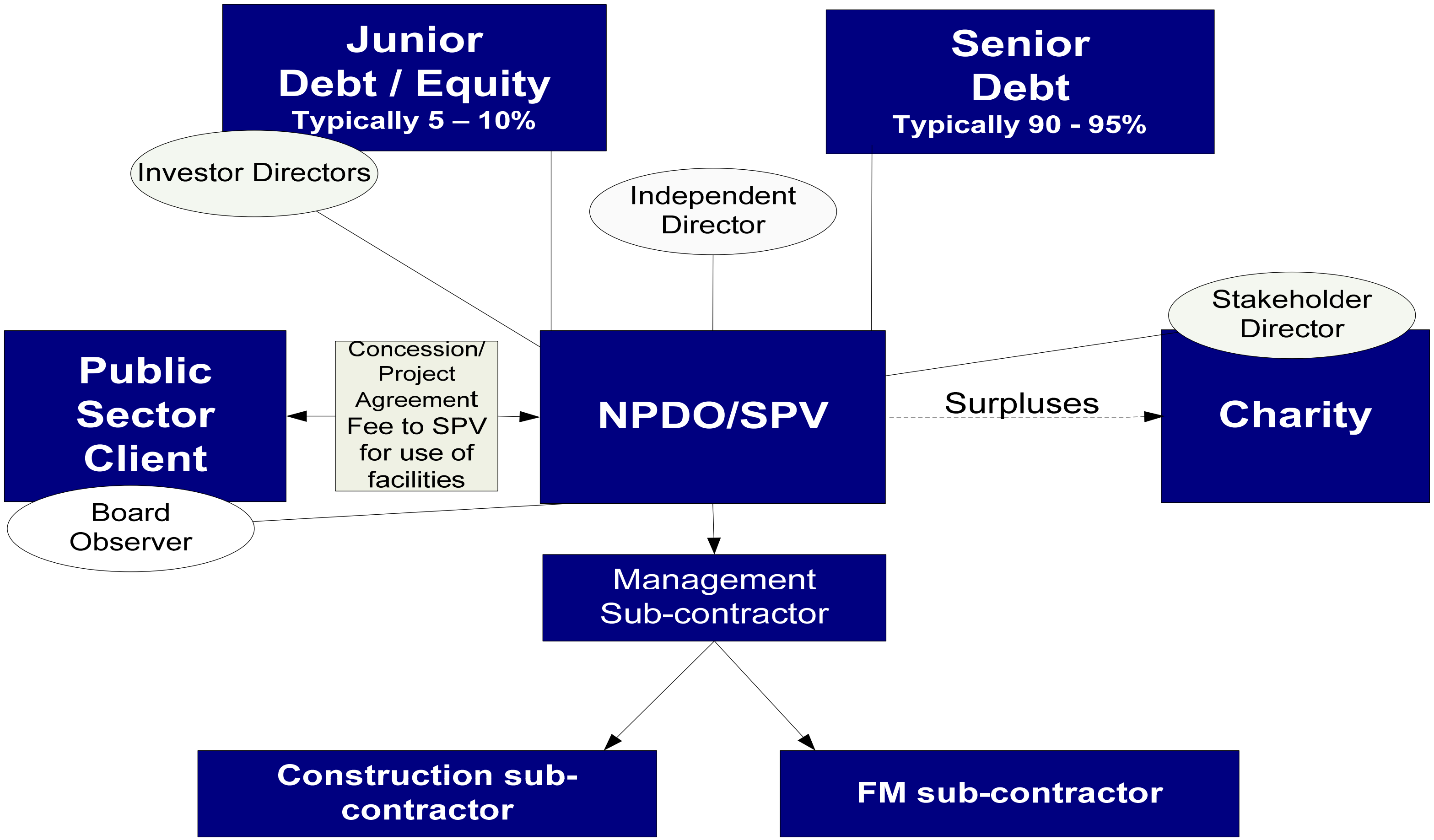
- Risk transfer not always fully effective
- Long length of contracts policy changes may affect the original requirement for the procured assets
- Limited contractual flexibility
- Procurement costs and time
- Private sector return included within unitary charges
- Public sector tied into long term contracts

PPP Models – Variations on PFI

- Recognising some of the limitations/weaknesses of a traditional PFI contract, a number of variations on PFI have been developed in recent years, including the NPDO model e.g. Argyll and Bute

- Strategic Infrastructure Partnerships models e.g. LIFT and BSF which involve:
  - Long term partnership between public and private sectors; and
  - Mixture of PFI and conventional procurement over time
- Public sector usually holds a minority stake in the delivery vehicle’s shares, this conferring some degree of control

PPP Models –
Typical Non Profit Distributing Contract Structure (PFI)



PPP Models – NPDO Model

Key strengths

- As classic PFI, plus:
  - Ability to retain SPV surpluses for community purposes
  - Greater political / community acceptability

Key weaknesses

- As classic PFI, plus:
  - Added legal complications

PPP Models – Strategic Infrastructure Partnerships / Joint Ventures

Building Schools for the Future (BSF)

- BSF - a £9 billion schools infrastructure upgrading programme currently operating in England as a public / private partnership. Some 50% of approved projects are procured via PFI and 50% under conventional design and build procurement.

NHS Local Improvement Finance Trusts (LIFT)

- NHS LIFT is a vehicle used in England for improving and developing primary and community care facilities. NHS LIFT is delivered by Community Health Partnerships, an independent company owned by the Department of Health which has established joint ventures between itself, the NHS and the private sector partners. These joint ventures are known as LIFT companies and they enter into agreements to build, own, maintain and operate primary care buildings which are then leased to NHS providers under a PFI type arrangement

PPP Models – Strategic Infrastructure Partnerships / Joint Ventures

Key strengths

- Suitable for where there is certainty over the kind of infrastructure to be procured, but uncertainty over the timing of project phases
- Opportunity to achieve synergies through 'bundling' similar types of projects
- On-going relationship between public and private sectors

Key weaknesses

- Potential complexity of managing a multi project procurement process
- Potential conflicts of interest for public sector between equity investors and client roles

PPP Models – Scottish Futures Trust

Overview

- The Scottish Government has recently published proposals for a new PPP model for infrastructure and housing procurement. It is proposed that new procurements will be managed via a ‘Scottish Futures Trust’ (SFT)
- The SFT is expected to be a private limited company ‘with a public sector ethos’ run on non-profit distributing principles. Funding will be obtained from bonds, commercial banks, and other private sector investors. Profit gains would be captured for recirculation
- The SFT would design, build and operate facilities, with public authorities paying a unitary charge as per current PFI schemes
- Public sector off balance sheet financing could be retained under IFRS rules
- The SFT will be able to consider a range of procurement methods, with the potential to bring private sector expertise into the public sector

PPP Models – Scottish Futures Trust

Key strengths

- Public sector has potential to retain SPV profits for community purposes
- Potential aggregation savings in terms of accessing debt finance at favourable rates
- Potential to ‘pool’ expertise through an integrated approach to procurement
- Off balance sheet funding for public sector may be maintained
- Potential for procurement flexibility
- Attraction of private sector expertise into SFT

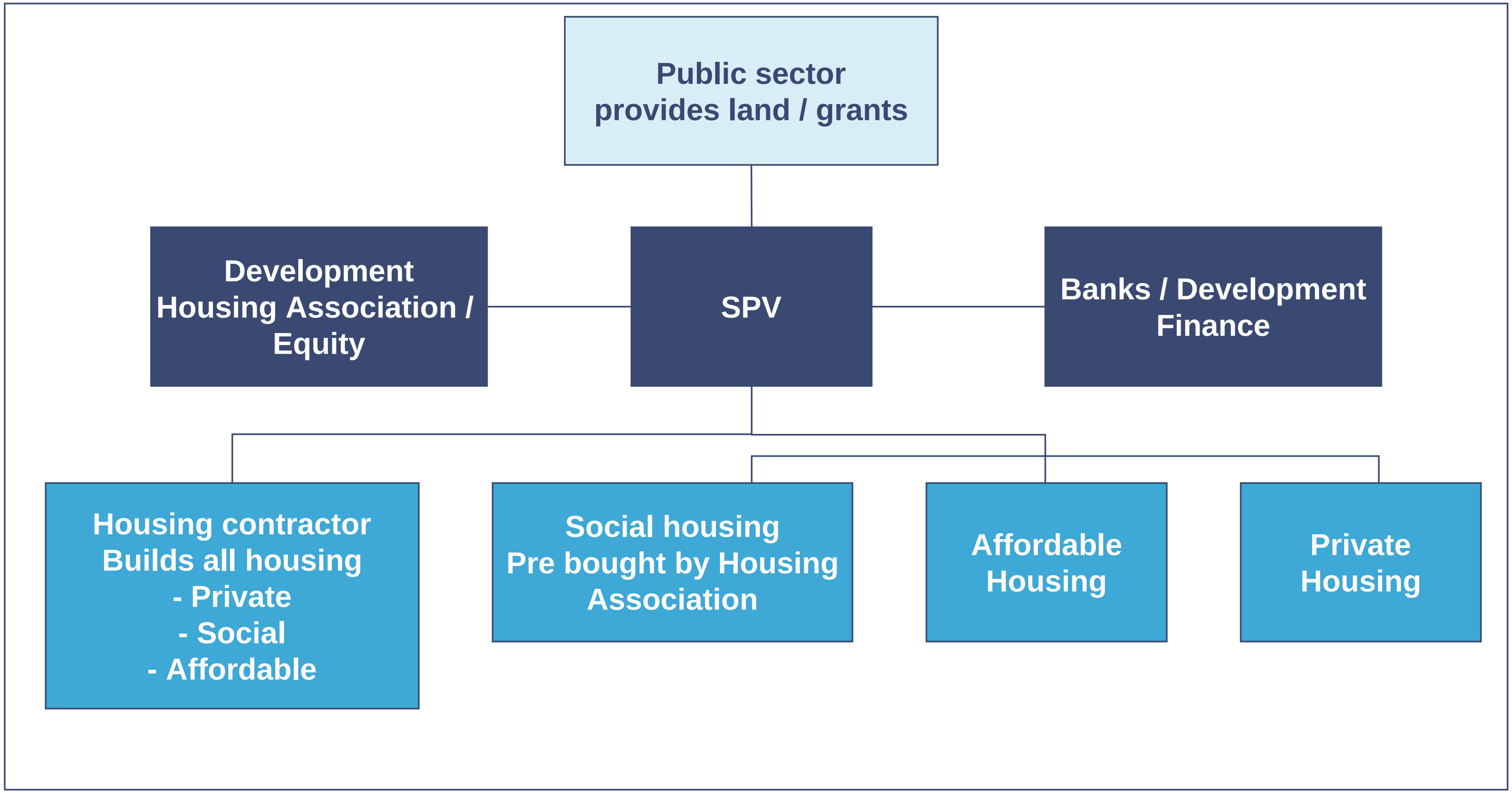
Key weaknesses

- ‘Non profit’ does not apply to private sector sub-contractors providing facilities
- May be difficult to instil a ‘public sector ethos’ in the private sector SFT
- PFI issues in relation to risk transfer and cost of private sector debt would still apply
- Concept still not proven, particularly funder appetite

PPP Models – Innovative Housing Model

- A flexible housing model can be used to develop mixed use residential sites (private, affordable and social housing)
- Can involve a shared ownership public / private SPV with private sector responsible for project risk and delivery and the public sector providing land with planning consent (and potentially existing housing stock in need of redevelopment / refurbishment)
- Private sector takes development risk
- Competition structured to maximise social / affordable housing (ie London wide initaitive sponsored by English Partnerships)

PPP Models – Innovative Housing Model



PPP Models – Innovative Housing Model

Key strengths

- Increased return to public sector through share of development gain
- Private sector provides finance and takes development risk including private house sales
- Public sector can retain ownership and source funding using future guarantees returns
- Opportunity to refurbish / redevelop existing stock

Key weaknesses

- Deferment of land sale proceeds
- More complex structure than straight forward land sale
- Higher professional costs
- Potential conflict of interest re priorities / split of private and affordable housing

Housing Collaboration – An Example from Wales

University of Wales Swansea / Gwalia Housing Association partnership

- 2 collaborative schemes for student / key worker accommodation
- University granted 30-year lease to Gwalia – Gwalia sub-let back to University
- Gwalia borrowed against security of lease
- Gwalia as experienced developer and property manager built/maintains facility
- If University opts to end head-lease after 30 years and get freehold back, pays balance of any remaining debt (or could agree extension of term until paid)
- Cheaper borrowing because of (a) security against lease (b) Gwalia's track record (c) University assumption of risk if debt not repaid after 30 years
- Registered social landlord ethos, and non-distribution of profits

PPP Models - Integrator

Overview

- Under the integrator approach, the public sector authority contracts a project delivery organisation (an integrator) to carry out procurement activity
- The contracting authority defines project scope and objectives. The integrator manages the procurement of the underlying assets and services and then integrates them to provide an overall service to the contracting authority
- The underlying packages can include both PFI and non-PFI elements
- An example of an integrated project in the MoD UK Military Flying Training System

PPP Models - Integrator

Key strengths	**Key weaknesses**
- Increases overall competitive pressure on the supply chain - Performance, availability and price risk being transferred in whole or in part to the integrator - Clear allocation of risks and responsibilities between the private sector and the contracting authority	- Potential lack of public sector control over the procurement process - Potential high cost of integrator services - Still being tested

PPP Models - LABVs

Overview

- Local Asset Backed Vehicles (LABVs) are funds combining locally-owned public sector assets and equity from institutional investors, established to finance the delivery of regeneration and related schemes
- These vehicles tend to have their own boards and management teams, and are constituted as limited partnerships, on a 50/50 ownership basis between the public and private sectors
- Projects are delivered under a business plan with returns made by the LABV shared between the partners on an agreed basis
- Examples include the Blueprint initiative, where the East Midlands Development Agency contributed a £25 million portfolio of sites and premises that was used to lever in private sector funding from Morley

PPP Models – LABVs

Key strengths

- Potential to lever significant private sector assets
- Flexible structure of partnership frameworks
- Ability to maintain public sector influence via a shared ownership structure

Key weaknesses

- Reluctance of authorities to release assets
- Uncertainty over how alliance models such as LABV may interact with other regeneration vehicles

Prudential Borrowing

Summary

- Introduced in Wales in 2004, Prudential Borrowing allows Councils to borrow without specific governmental consent, as long as they remain within their own affordable borrowing units
- Funding is targeted on capital investment schemes. Future revenue streams are used as security for loans, with transport and housing being major areas of investment under Prudential borrowing
- Schemes are managed through the use of future key indicators – affordability, prudence, capital expenditure, external debt and treasury management

Prudential Borrowing

Key strengths

- Potential to obtain loans at relatively cheap interest rates when compared to other sources of finance
- Flexible model that can be used in a wide variety of procurement scenarios
- Allows authorities to ‘invest to save’ where expenditure will be repaid from future revenue savings

Key weaknesses

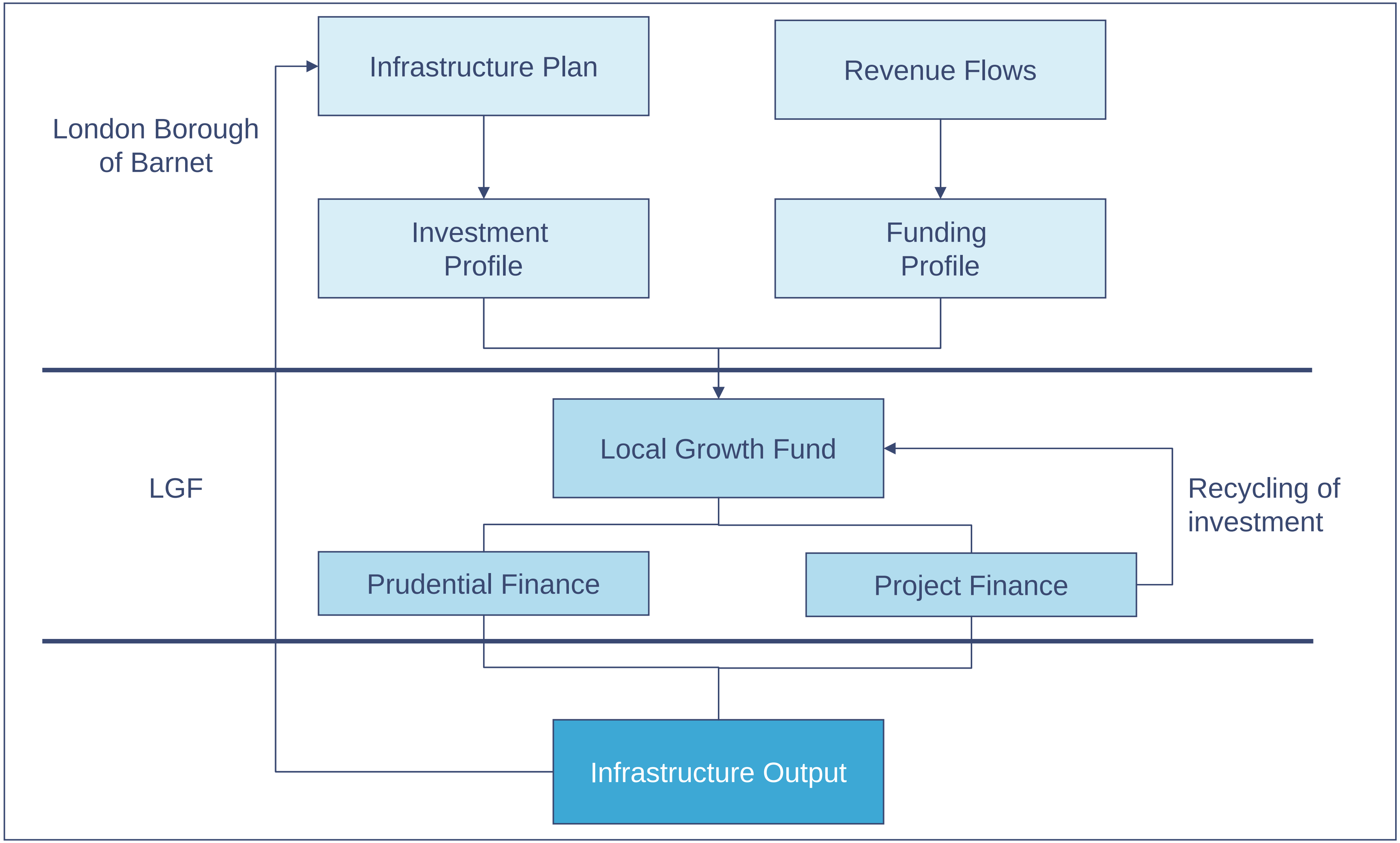
- Cost of loan repayment
- When used for transport schemes, authority may be committed to above inflation rises in fares to repay capital and interest
- Burden on future council tax payments if revenue streams are lower than projected
- Public sector responsible for procurement with limited private sector due diligence

PPP Models – Bond Issue (Barnet Bond)

Summary

- Bonds are essentially debt – sourced from capital markets, rather than banks
- Bonds have been used extensively by states in the US, but have yet to be issued by public sector organisations in the UK (with the exception of central Government)
- The London Borough of Barnet is currently considering the feasibility of issuing its own bond, potentially to be worth some £360 million, to fund an expansion of transport, schools and housing. The bond will be repaid from extra income created by an increased level of council tax and business rates, generated from infrastructure financed by the bond proceeds

PPP Models Bond Issue



PPP Models – Bond Issues

Key strengths

- Relatively low cost of capital
- No specific restrictions on use of funds raised by this method

Key weaknesses

- Future cost of capital and interest repayments
- Unproven in the UK
- Agreement with HM Treasury on critical path

Community Interest Companies (CICs)

New potential vehicle for delivering local-based partnerships:

- Limited Liability company designed specifically to benefit community
- Can be partnerships between local authorities, businesses and other stakeholders
- Can enfranchise local service users (eg by giving them a share/right to vote)
- Assets are “locked” within co and cannot be distributed at less than market value
- Profits either retained or subject to a cap on dividend payment
- Regulated by the independent CIC Regulator – “light touch” approach
- Currently being considered in a number of health/social care partnership schemes

Community Interest Companies

Key strengths

- Set up for benefit of community
- Quick and relatively simple to set up
- Asset lock and cap on dividends
- Independent regulation
- More flexible than a charity
- Can borrow funds
- Can grow via share issues

Key weaknesses

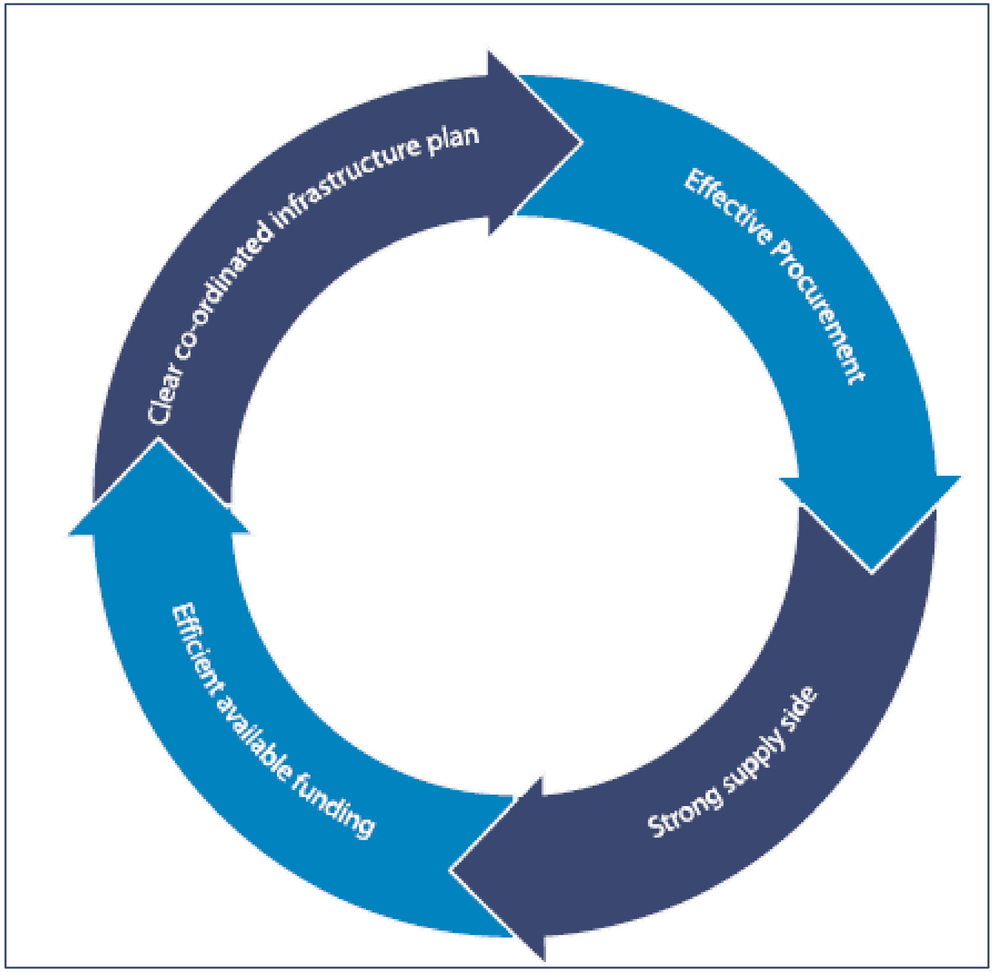
- Limited to providing community benefit
- Profits must (subject to capped dividend) be retained
- On wind-up or redemption of shares, members can't receive more than they paid for shares

Whatever Model Used - Smarter Procurement Needed

- Clear specification of the output required is absolutely key
- New procurement methods (competitive dialogue) give opportunities for more competition but need to be managed carefully to avoid excessive cost
- Simpler / more standardised legal documents
- Adoption of partnering (including some assumption of risk where public sector best placed to manage it) can reduce cost of borrowing and deliver better outcomes
- Inclusion of social and environmental objectives can deliver added value for Wales, eg
  - Recruiting/ training long-term unemployed
  - Engaging with supported business/social firms
  - Including targets for emissions reduction, energy efficiency, recyclables in specifications
- Harnessing private sector can increase impact of social/ environmental initiatives

Conclusions

- What elements should successful procurement involve?



Conclusions

- The range of procurement tools and approaches available has evolved, giving both the public and private sectors the ability to leverage the knowledge and experience accumulated from PFI and elsewhere

- These emerging alternatives to both conventional procurement and PFI may offer more effective and efficient means to build the next generation of infrastructure and provide increased levels of public service delivery

- The important first step is to identify policy objectives and constraints. The choice of tools and model should follow on from that