Capital Law

Inquiry into the Welsh Government's capital funding options

9 May 2019

Introduction

We provide this brief paper in anticipation of giving evidence to the National Assembly for Wales' Finance Committee on 15th May 2019 in relation to the funding sources available to the Welsh Government.

Our approach

"*We see the Mutual Investment Model (MIM) proposal as the only viable tool to provide significant finance to fund ambitious Welsh projects*"

Our observations in this document are targeted towards the way this may be achieved, and are split into three areas:

— Delivering an effective funding strategy
— MIM and value for money; and
— MIM v PPP / PFI

The focus of this inquiry is broad. Therefore, our approach is to concentrate on the specific elements which are relevant to our business.

Delivering an effective funding strategy

"*Best practice in relation to delivering projects is reliant on an effective funding strategy*"

Given our involvement in significant projects (such as the M4 Relief Road and Hinkley Point C) several very clear best practice themes arise in relation to project delivery and an effective funding strategy must be based around these.

An effective funding strategy must have regard to the specific requirements of a project and the maturity of the project. In the most basic of terms the lifecycle of a project has four distinctive steps:

Step 1 **Project Pipeline -** identifying a pipeline of projects around which a strategy can be formulated.

Given that a project pipeline will extend beyond the electoral cycle, the project will require multi-political party support and be in the public interest generally. The Well-being of Future Generations (Wales) Act 2015 facilitates this Step by requiring that that all public sector projects must improve our social, cultural, environmental, and economic well-being.

Step 2 **Project Feasibility –** identifying specific projects within the pipeline for delivery

Once the pipeline of projects has been established the next step is to consider the requirements for delivering a specific project along with identifying and mitigating risks. This step typically revolves around the following:

— **Funding** – identifying at an early stage an appropriate source of funding for delivery of the project.
— **Pooling resources** – there have been several projects throughout Wales that have used a public to public collaborative approach. Local Authorities have worked together with suppliers, to produce efficiency savings in costs and share work practices. In turn, this increases the value of prospective contracts, making them more attractive to the market.
— **Market engagement -** yields benefits in relation to cost estimation, risk management, and ease of delivery.
— **Defining the project and specification** – this is the initial process of defining the project requirements, which will be informed by the other elements of this step.
— **Procurement** – planning and choice of procurement route is crucial at this stage.

Step 3 **Project De-risking -** carrying out the de risking steps and delivering the project.

This is the implementation stage of the strategy and is the process of getting the project "Delivery-ready" and builds on the feasibility step. The key elements here are:

- **Clearly defining the project and specification** – this is a priority at this stage and the outcome should be a clear scope based on up to date market price information. The projects specification must be approached in a way that allows the prospective contractors to price clearly.
- **Early Contractor Involvement** – is a useful tool at this stage to develop the specification.
- **Funding** – any preconditions relating to the project delivery funding should be considered / satisfied at this stage and requirements and obligations incorporated into the specification / procurement process as required.
- **Procurement** – is the final element of this step and must be carried out in a way that demonstrates transparency, fairness, integrity, competition, and accountability. Planning and choice of procurement route is crucial at this stage. Competitive dialogue (where candidates are invited to take part in a dialogue process, during which the nature of the project may be discussed and possible solutions may be developed) has a proven track record for delivering projects and is a good precursor to collaborative working during project delivery.

Step 4 **Project Delivery –** appointed contractor delivers the project in accordance with the specification.

This is the final step and the key here is a project that is delivered on time and within budget and relies on the following:

- **Funding** – ensuring that the funding requirements are satisfied promptly to ensure cash-flow into the supply chain; and
- **Collaborative working** – there needs to be a framework to provide quick decisions on key issues and effective mechanisms to communicate with stakeholders, manage risks, and resolve conflict. Controlling risks is central to this – with the party best placed to handle the risk being tasked to do so.

It is clear from the generic lifecycle above that funding is key at each step. This also highlights that the level of funding and the type of funding will vary during a project. For example, Project Delivery will require the highest level of funding but the amount of funding should be clearly definable. Project Feasibility, on the other hand will require a lower level of spend but the extent of the expenditure will be speculative in nature in order to explore mitigation options to ensure price certainty at Project Delivery.

In summary an effective funding strategy depends on multiple sources of funding (ranging from conventional funding to public / private partnership models such as MIM) appropriate to the relevant point within a project's lifecycle.

MIM and value for money

"*The premium paid for finance and delivery of a MIM project does lend itself to the principle of - Something for Something*"

Put simply MIM is a form of project agreement to fund and deliver "off balance sheet" privately financed public projects. Given that WG do not have access to the level of capital funds, the MIM proposal is the only viable tool to provide significant finance to fund ambitious / high value projects. Therefore, the fact that MIM is more expensive than direct funding is a moot point.

However, the MIM model is not necessarily in search of the lowest price but rather best value. Consideration should be given to the ancillary benefits available. For example, those driven by the Well-being of Future Generations (Wales)Act 2015.

For example, in relation to the dualling of A465 (project earmarked for MIM funding), the procurement focus will be on:

- £300 million being spent with Welsh companies (70% of the total spend)
- Creating 140 apprentice roles
- Community benefits.

The comparison with debt funding is not so clear cut. If the MIM project proposed has a clear specification which in turn can be accurately priced the investment risk is minimised. The aim is to provide a project which requires a defined level of funding (i.e. the risk of cost overrun is minimal) which is offset by the annual payments. In effect the aim is for the level of return to be guaranteed – meaning that lenders risk, and in turn its rate of interest, is reduced. This should make the project competitive with the rates of debt funding available.

MIM v PPP / PFI

"The MIM process must be collaborative and have regard to the lessons learnt from PPP/PFI projects."

The MIM and PPP / PFI models have a number of factors in common but MIM has the benefit of hindsight and must have regard to the lessons learnt from PPP / PFI models. The table below provides a comparison of the three models.

	Private Finance Initiatives (PFI)	Private Finance Initiatives (PPP)	MIM
1.	PFI is a form of PPP where a private sector company finances and provides a public service that might include construction, maintenance and operation, for which they are paid by a public authority.	Although PPP technically includes PFI and Concession Contracts (payment recouped via tolls) it is more commonly associated with Institutional PPP where a joint venture company is established jointly by a public authority and a private company to provide a public service	MIM is a form of project agreement to fund and deliver "off balance sheet" privately financed public infrastructure projects. In effect a Public Private Partnership (PPP) – to enable private partners to build and maintain public assets
2.	**Funding** – usually traditional bank debt funding repayable by the authority.	**Funding -** usually traditional bank debt funding repayable by the authority.	**Funding –** combination of equity and debt funding to SPV No direct repayment of debt by the authority but an annual payment for facilities management paid by authority
3.	**Design and construction –** SPV procures the supply chain and is usually asked to take a great deal (if not all) of the project risk from the authority. However, the price will reflect this.	**Design and construction –** as per PFI	**Design and construction –** SPV procures design and construction but the project specification is intended to be de-risked prior to it being handed over to the SPV.
4.	**Facilities management –** anticipated that hard and soft facilities management. This is the main criticism of PFI as costs escalated.	**Facilities management** – as per PFI	**Facilities management** – hard facilities management only (limited to identifiable maintenance) and <u>not</u> soft maintenance (e.g. replacing street lights) this responsibility to remain with the authority.
5.	**Control –** Authority tending to maintain control by being a significant shareholder in the SPV (on-balance sheet risk)	**Control –** Authority has 50 per cent or more share in profits and has veto / approval rights (on balance sheet risk)	**Control** – 15% - 20% equity stake for the Authority with a nominated director to the board of the SPV i.e. limited control (off balance sheet)

Conclusion

The challenge / opportunity will be to advance the project pipeline supported by a robust funding strategy. This will make sure that several ambitious and high value projects are capable of delivery.