Response to the Finance Committee of the Scottish Parliament’s Call for Evidence:
Scottish Futures Trust / NPD Programme
Response from Allianz Global Investors GmbH (“AllianzGI”)
Date of Response: 2nd October 2015

Background

The finance committee of the Scottish parliament (the “Committee”) has invited views on the success of the Scottish Futures Trust (“SFT”) in achieving its aim of ‘improving the efficiency and effectiveness of infrastructure investment and use in Scotland by working collaboratively with public bodies and industry, leading to better value for money and improved public services’ (the “Aim”). In particular the Committee has expressed interest in respondents’ views on the following specific topics:

1. The SFT’s role in securing additional investment;
2. The SFT’s role in securing better value for money and improved public services;
3. The SFT’s role in fostering innovation to improve outcomes;
4. The SFT’s role in encouraging collaboration to improve efficiency;
5. The SFT’s efficacy in securing better outcomes including job creation, training and apprenticeships, environmental sustainability, broader community benefits and digital connectivity.

Why we are responding to the call for evidence

AllianzGI was the largest private sector investor in the Scottish NPD programme in 2014. We feel we can make comments directly relevant to topics (1), (2), (3), & (4) based on our experience of investing in the M8/M73/M74 bundle and the Aberdeen Western Peripheral Route ("AWPR"). These projects were procured by Transport Scotland (“TS”) under the umbrella of SFT’s NPD programme; they are the two largest NPD projects to date and are mentioned on page 07 of the SFT Corporate Plan 2014-2019.

AllianzGI’s clients invested almost £370m for over 30 years in these two major Scottish economic infrastructure projects during 2014. The European Investment Bank (EIB) co-invested approximately £450m in loans with the same 31 year maturity as our bonds.

About AllianzGI

AllianzGI is a regulated investment manager owned by Allianz SE, the parent of the Allianz Group, one of the world’s largest insurance and investment management groups.

In 2012 AllianzGI established an investment function dedicated to the sourcing and management of very long-term debt investments in infrastructure projects and companies in the European Union and North America, in response to: (i) demand from our pension fund and insurance company clients for such assets; and (ii) the banking crisis (which had reduced long-term bank lending to infrastructure projects).

Our institutional clients comprise insurance companies and employee pension funds from within the Allianz Group and third party pension fund and insurance company clients of AllianzGI. Third party clients include UK occupational pension funds of both private companies and local government bodies.

The ultimate customers of these institutions are current and future pensioners, life assurance policy-holders and the insured under property & casualty insurance contracts. Accordingly, our clients require high quality, non-speculative, stable, investment grade, long-term investments to ensure their commitments to their pensioners and policy-holders will be honoured in the future. These investments are secured by long-term, predictable, cashflows derived from real infrastructure assets used in the delivery of essential infrastructure services. We invest in both ‘economic infrastructure’ and ‘social infrastructure’ and, as well as economic suitability, all of our investments must meet our high internal standards for environmental and social governance (ESG).
Our Evidence

- **Success of SFT in meeting its overall Aim**

Our investors are free to invest in infrastructure in many countries and regions and enjoy a wide variety of opportunities. Confidence in our public sector counterparties, the public procurement process, the PPP framework, political acceptance of PPP and the overall investment environment in the relevant market (including political and economic stability) are all prerequisite.

We understand that the M8/M74/M73 and AWPR represent key economic infrastructure important to the development of Scotland.

TS attracted a very large investment from our investors in competition with many other investment opportunities during 2014 using SFT’s NPD model.

It is worth noting that this was achieved during a period when there was considerable uncertainty regarding the future political status of Scotland which could have adversely affected investor sentiment especially if other aspects of the opportunity had been weak. The robustness of the NPD model and the relative efficiency of the NPD process were among the mitigating factors that enabled the investments.

The M8/M74/M73 is note-worthy as being one of the first major European PPP transportation projects to be financed since the banking crisis without the use of bank lending (and the attendant risks of mismatching short-term deposit taking with long-term lending and the need to use uncollateralised derivatives to match fixed payments to floating rate debt).

The M8/M74/M73 was one of the first listed PPP bonds featuring multiple deferred debt drawdowns. Deferring debt drawdown to match the timing of construction expenditure serves to lower the amount of interest paid during construction thereby lowering the cost of the project for taxpayers.

The first execution of such a bond required innovation and time, which the NPD PPP framework, administered by TS/SFT, permitted. The structure has been replicated on similar large transport projects in Belgium and Germany but Scotland was where the first of these bonds was issued (and where the cost-saving has been greatest, owing to the higher prevailing rates of sterling interest vs. euro interest rates).

Our comments on the specific topics follow.
(1) **SFT’s role in securing additional investment**

See comments above under ‘Success of SFT in meetings its overall Aim’.

We understand one of the consequences of the current budgetary rules is that ‘revenue-funded’ public infrastructure investment schemes such as the NPD/PPP/Hub are a source of investment ‘additionality’ at a time of constraints on ‘capital-funded’ public infrastructure.

Most economists ascribe some level of GDP-multiplier to essential infrastructure investment, which manifests itself as a small initial increase in GDP arising from the direct impact of the initial construction expenditure (e.g. increased employment in the construction sector) and then a larger longer-term GDP increase arising from increased productivity of those using the infrastructure. For example, in the context of our road investments these longer term benefits arise from reduced congestion and shorter journey times as well as improved safety.

By delivering projects now via these innovative procurement models, it should be recognised that SFT is enabling the receipt of these larger longer term benefits sooner than if it limited annual infrastructure investment to the amount of its capital budget¹, as well as achieving the risk-transfer and through-life value-for-money of PPP/NPD described below.

(2) **SFT’s role in securing better value for money and improved public services &**

(3) **The SFT’s role in fostering innovation to improve outcomes**

*Improved Long-term Outcomes*

The role of PPP to secure better value-for-money by creating incentives for PPP sponsors to minimise the *whole-life* cost of projects for their public sector customers through the competitive procurement of long-term contracts, rather than encouraging a focus on short-term savings to the detriment of through-life asset performance, is well documented. PPP also appears to reduce ‘optimism bias’ in costing and timetable forecasts. For examples, see various reports from the National Audit Office on this topic from 2003 onwards.

Despite the overall positive impact of PPP on infrastructure procurement outcomes, one aspect of the PPP model which has been widely criticised, and to which SFT has developed its own solution distinct from the model applied in other parts of the UK, is the volatility of equity returns. In essence the NPD model caps the return to equity investors in projects by providing a rebate mechanism under which the procuring Authority is entitled to excess cashflow above the level required to achieve the capped shareholder return bid by the PPP sponsors.

¹ In this context we note that SFT, like many other European infrastructure procurement bodies, is now facing new unexpected challenges (and potential delays to otherwise ‘shovel-ready’ infrastructure) arising from Eurostat having changed the evaluation framework used for PPP classification from the risk-based ESA95 assessment to the control-based ESA2010 assessment. We would hope that given other EU level initiatives to promote private sector investment in public infrastructure to augment direct public funding, in particular the Juncker Plan, SFT will receive the clarity it needs from the statisticians on a timely basis to make whatever small modifications to NPD are necessary to achieve the same budgetary classification historically afforded to PPP where the vast majority of construction, availability and operational risk is transferred to the private sector. Given the cost of delayed projects, both in terms of increased procurement cost and delayed implementation, the Committee may wish to enquire what additional resources are being allocated to ONS and Eurostat to expedite assessments and improve guidance to bodies such as SFT to avoid statistical classification delaying essential public works.
From our perspective as a debt investor, the volatility of equity returns in PPP projects is one of the less attractive features of the asset class. While our primary concern is downside volatility leading to a loss of the owners’ economic interest in the ongoing stewardship of these long-term assets (or, in extreme cases, actual insolvency), we recognise the public sector’s primary concern is that excessive upside volatility leads to a perception of poor value for money and/or private sector profiteering. Such perceptions, in turn, can lead to increasingly adversarial relationships between the private sector stewards and public sector customers which can then directly hurt debt investors.

Most political and media attention has focused on upside volatility, in part because it is more newsworthy, but also because most companies active in PPP are keen to highlight their successful projects and down-play the impact of unsuccessful projects leading to a general impression that the sector as a whole is bad value-for-money. Rather than debate here the rights-and-wrongs of this perception (which has been subject to much commentary elsewhere), it is sufficient to note that the NPD model is an innovative attempt to defuse or side-step this issue by giving the Authority an unfunded economic stake in projects. This caps the upside for equity and goes some way to reducing downside for debt and equity investors (but not for the construction and services companies providing fixed price contracts whose risk profile remains unchanged, it must be emphasised), leading to efficiently priced capital.

It is important to remember that the underlying volatility in equity returns arises because it is in the interests of the procuring authority to maximise the contribution of debt to the funding of project costs because, all else being equal, debt is cheaper than equity. In the parlance of financial markets the ‘leverage’ of PPP assets (i.e. the value of assets controlled by every pound of equity) is very high at around 10:1 compared to ratios in other investment grade private companies (including other infrastructure businesses such as utilities), which may be anywhere between 2:1 and 7:1. Such high leverage is sustainable in the PPP sector only because of its, generally, very limited revenue risk. However, the high leverage means that the effect on equity return volatility of relatively modest changes in operating or capital costs over the 30 year life of the asset (or changes in the cost of debt or even just the timing of actual equity distributions vs. forecast) are magnified much more than would be the case in companies employing a more traditional ratio of equity to assets.

We note that the Welsh devolved administration is reported to be seeking to employ aspects of the Scottish NPD model in PPP procurements expected to occur in 2017-18.

**Improved Short-term Outcomes**

Leaving aside long-term outcomes, it is also worth noting that NPD’s use in connection with the two aforementioned PPP road projects was very timely as it addressed concerns about their potential ‘financeability’ at the early stages of their procurement arising from the impact of the banking crisis on the availability of project funding. So, by this measure, the innovation may have already improved outcomes.

One effect of the NPD structure is to create an additional economic buffer for debt, at a lower cost than simply increasing the equity commitment of the private sector by a similar proportion.

This extra buffer allowed one of the credit rating agencies to ascribe an ‘A-’ rating to the projects whereas typically for projects of this nature one would expect a lower (‘triple-B’ range) rating (at least during construction and the early years of operation before the company had proved it could operate to
a single-A standard). While AllianzGI does not price project credit risk based solely on external credit ratings because of the perceived lack of consistency in project rating methodologies (both between different agencies and temporally within certain individual agencies), a higher rating is a valuable marketing tool for investment banks seeking to sell project bonds to a generalist investor base rather than pre-placing them with specialist investors such as ourselves. The ‘A-’ rating made the idea of a public distribution of the bonds a much more credible competitive alternative to selling the bonds to AllianzGI than would have been the case if they had been rated ‘triple-B’. This was reflected in our agreeing more competitive pricing than we may otherwise have felt necessary to offer in order to win.

Even before the funding competition, the ability to structure the bond to an ‘A-’ rating standard is likely to have encouraged potential bidders for the underlying projects to have had greater confidence in the ‘financeability’ of the project and thus made them more willing to take on the costs of bidding.

(4) The SFT’s role in encouraging collaboration to improve efficiency.

We would note two behaviours in response to this question:

- **General engagement with the investment industry.** SFT representatives are very visible within the infrastructure financing community, addressing and participating in events beyond specific Scottish projects and ensuring high visibility of forthcoming Scottish infrastructure projects to ensure maximum participation in competitive processes such as funding competitions.

- **Collaboration between TS and SFT appeared strong from our perspective during the execution of the two road investments.** We were never aware of a topic under discussion where there was an ‘SFT view’ distinct from a ‘TS view’. Either no conflicts arose or they were resolved between TS and SFT without giving visibility to debt funders of differences within the public sector. Either way we would suggest this is evidence of ‘good collaboration’ leading to ‘improved efficiency’.

(5) The SFT’s efficacy in securing better outcomes including job creation, training and apprenticeships, environmental sustainability, broader community benefits and digital connectivity.

We are not able to offer direct evidence about the efficacy of SFT’s work with respect to these topics.

We would note that the projects in which we invested did contain express obligations on the companies providing the infrastructure covering a number of the broader topics mentioned in this question, including (i) environmental compliance, (ii) community benefits, (ii) apprenticeships, (iv) sustainability, energy and carbon management and (v) community liaison.

In addition, EIB’s involvement in a project is generally seen as an indicator of robust environmental conditions and, as we noted above, EIB co-funded both of the projects in which AllianzGI invested.

As debt funders we would observe that these obligations were included in the projects’ terms without creating incremental credit risk that increased the cost of debt capital.

We are not able to comment on the overall efficacy of these provisions with regard to their direct objects or the impact, if any, on the cost of non-financial contracts of the inclusion of these additional obligations, to the extent they exceeded the statutory minimum conditions with which the companies would, in any event, be bound to comply.