OFFICIAL REPORT
AITHISG OIFIGEIL

Public Audit and Post-legislative Scrutiny Committee

Thursday 17 September 2020

Session 5

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PUBLIC AUDIT AND POST-LEGISLATIVE SCRUTINY COMMITTEE
19th Meeting 2020, Session 5

CONVENER

Jenny Marra (North East Scotland) (Lab)
Anas Sarwar (Glasgow) (Lab) (Acting Convener)

DEPUTY CONVENER

*Graham Simpson (Central Scotland) (Con)

COMMITTEE MEMBERS

*Colin Beattie (Midlothian North and Musselburgh) (SNP)
*Neil Bibby (West Scotland) (Lab)
*Bill Bowman (North East Scotland) (Con)
*Willie Coffey (Kilmarnock and Irvine Valley) (SNP)
*Alex Neil (Airdrie and Shotts) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Kerry Alexander (Scottish Futures Trust)
Dr Jim Cuthbert (Independent Statistician and Former Scottish Office Chief Statistician)
Peter Reekie (Scottish Futures Trust)

CLERK TO THE COMMITTEE

Lucy Scharbert

LOCATION

The James Clerk Maxwell Room (CR4)

Scottish Parliament

Public Audit and Post-legislative Scrutiny Committee

Thursday 17 September 2020

[The Deputy Convener opened the meeting at 10:00]

Decision on Taking Business in Private

The Deputy Convener (Graham Simpson): Good morning and welcome to the 19th meeting of the Public Audit and Post-legislative Scrutiny Committee in 2020. We have received apologies from Anas Sarwar MSP, who is the acting convener, and therefore, by popular demand, I will be convening the meeting in his place.

Before we begin, I remind members, witnesses and staff that social distancing measures are in place across the Holyrood campus—the witnesses who are miles away from me have already realised that. I ask that all care is taken to observe those measures over the course of this morning's business, including when exiting and entering the committee room, and I remind members not to touch the microphones or consoles during the meeting.

Agenda item 1 is a decision on taking business in private. Do any members object to taking item 3 in private? If Neil Bibby, Alex Neil or Willie Coffey object, they should raise their hands. I have no objections to that, so that is agreed.

Section 23 Report

"Privately financed infrastructure investment: The Non-Profit Distributing (NPD) and hub models"

10:01

The Deputy Convener: Agenda item 2 is on the section 23 report, "Privately financed infrastructure investment: The Non-Profit Distributing (NPD) and hub models". I welcome to the meeting: Peter Reekie, chief executive of the Scottish Futures Trust; Kerry Alexander, director of infrastructure investment finance and programmes at the Scottish Futures Trust; and Dr Jim Cuthbert, who is an independent statistician and a former Scottish Office chief statistician. I understand that Peter Reekie and Dr Cuthbert wish to make some brief opening comments.

Peter Reekie (Scottish Futures Trust): Thank you for the opportunity to give evidence to the committee today on the report published by Audit Scotland in January. First, I would like to record the fact that I act as a public interest director on the company that is delivering the Aberdeen western peripheral route NPD project.

Kerry Alexander (Scottish Futures Trust): I am public interest director for the project NPD company that runs the Inverness College project. I was also on the advisory panel for the Audit Scotland report.

Peter Reekie: The Scottish Futures Trust acts as the central programme manager for the hub programme, which has delivered more than 130 community infrastructure projects using capital funding as well as the 41 projects delivered by the programme using privately financed approaches, which we are here to discuss today. We also manage the programme of 10 non-profit distributing projects that have been undertaken since 2011. As the report points out, together, the revenue-funded programmes have delivered just under £3 billion-worth of infrastructure investment in Scotland's roads, health and education facilities since 2011.

As the Auditor General has recognised, the programme has delivered additionality of investment in those assets, and the whole-life costs of the contracts have all been published. Those show that the total programme cost is projected to be within the affordability cap of 5 per cent of future departmental expenditure limit budgets set by the Scottish Government, and is below the early estimates of the lifetime costs for the programme.

The SFT has also published all the NPD and hub design, build, finance and maintain contracts and is publishing the financial models, following a period of commercial confidentiality, so that interested parties can undertake their own analyses of these contracts and financing approaches.

The report focused on the choice and cost of financing, and that is a very significant component of an asset's whole-life cost. However, it is just one element of the value. The NPD and hub programmes are early examples of a focus on community benefits. The hub programme alone has delivered more than 1,000 apprenticeship places and more than 6,000 work placements, and more than 80 per cent by value of the subcontracts that have been placed have gone to Scottish small and medium-sized enterprises.

Finally, all those contracts include terms for asset maintenance. The payments made and the contracts signed will keep the building or road in good condition for its users for the whole 25 to 30-year life of the contract. The community benefits that are being delivered, and the assurance of a good standard of maintenance, are something that I am proud of across the programmes. They are not something that we have such good transparency around or assurance of in other forms of procurement.

Kerry Alexander and I will be happy to answer any questions that you have.

The Deputy Convener: Thank you. Jim Cuthbert would also like to say a few words.

Dr Jim Cuthbert (Independent Statistician and Former Scottish Office Chief Statistician): Thank you for the opportunity to give evidence to the committee. The Audit Scotland section 23 report is very much to be welcomed. It confirms the need for better understanding of various points of the private finance model. The report says how that should be achieved and I think that this committee has a potentially important role in achieving better information.

What the committee might be doing or should be doing is, first, identifying the information requirements for this type of scheme and, secondly, making recommendations about the kind of mechanisms that would deliver those requirements. I made some suggestions on both aspects in the note that I put to the committee, and I hope that you will consider them.

The Deputy Convener: I am going to open the meeting up to questions now. First, Dr Cuthbert, can you expand on what you just said? I ask probably for my own benefit, because I am quite new to the committee.

Dr Cuthbert: I am particularly interested in the financial aspects of these schemes but, as Peter Reekie said, other things come in as well and I agree that they are very important.

It is welcome that the SFT has taken a fairly liberal approach towards making information on the financial aspects of the schemes available. It has a policy of publishing the financial model two years after the end of the construction period, and that is to be welcomed.

I published a paper through the Fraser of Allander institute that analysed the financial models for three hub schemes and drew some conclusions. One thing to note is that it is not easy to analyse the financial models. That leads to the thought: would it not be much better if, when the project was being tendered for, one of the criteria that were laid down was that certain standard indicators should be produced for each project as a matter of course? That would make it much easier for everybody involved—the SFT; outsiders, when they get their hands on the information; and the public sector client—to understand what was going on.

It is important that there is quite sophisticated information available. It is not just a question of the interest rate being charged on senior debt or earned on subordinate debt. It is also important that there is information available and analysed on the profile of payments through time.

That is where I started to have an argument with Peter Reekie a good long while ago, when he quoted to the committee the weighted average cost of capital, which is just a straight weighting together—90 per cent and 10 per cent, basically—of the costs of senior and subordinate debt. The point that I was making was that, given that the subordinated debt is being paid off much later than the senior debt, for a variety of reasons, the actual cost—the internal rate of return of finance—could be significantly larger than the weighted average cost of capital. That indeed turns out to be the case, as is confirmed in the work that I did and in the Audit Scotland report.

That difference in time profiles means that, potentially, the value of the holdings of subordinated debt to the equity holders, if they came to make a secondary market sale to realise a profit, could be quite large. To understand that, you really need to know what the net present value of the stream of projected payments on subordinated debt is, calculated at a discount rate that a pension company would be looking for if it came to purchase it.

You do not get an understanding of the potential profits that are made by the equity holders unless you have information on the net present value of that stream of payments calculated at an appropriate discount rate. You also do not really know about the opportunity cost to the public sector unless you know the net present value of the overall stream of payments that it is committing to make when it signs the contract, taking out the element that is for on-going maintenance and service and so on, discounted at the sort of interest rate that it will have been paying if it had gone down the national loans fund route.

It is very important that the public sector has an idea of the opportunity cost. One way of doing that is to discount the unitary charge apart from services at the NLF interest rate and potential profit to the private sector, which you get by discounting the subordinated debt payments at the sort of interest rate that a pension had been purchased at. Those are the sorts of indicators that should be being produced. There is no reason why they cannot be calculated from the financial model, although it can be difficult because all financial models are different. There is absolutely no reason why they should not be stipulated as a standard indicator that should be produced, and they should be produced as part of the documentation before the contract is signed. I think that it would be of value to the Scottish Futures Trust, because it would be able to look at those aspects much more easily than it can do at present, and it would be of value to the Scottish Government, obviously.

There is no reason why, after the two-year period of confidentiality is up, those indicators should not be published so that the public has the information. In the shorter term, I suggest that, if there are enough projects, it would be quite possible for the Scottish Futures Trust to aggregate those indicators and publish an average over a year or two years, so that we have an idea of what is going on currently in these projects. That is the sort of suggestion I am making: that there should be those mechanisms, and those indicators should be published.

The Deputy Convener: That was quite a long answer and I think that I should give Peter Reekie the chance to give a response to it.

Peter Reekie: First, I should say that these projects are competed for. The cost of finance is one aspect of the total cost of the project that is paid for by the public sector in the form of the unitary charge over the 25 to 30-year life of the contract. The critical aspect that we have always been really clear and transparent on is: what is the whole-life cost of the design, build, financing and maintenance of the asset through the contract? That is the aspect that is studied in competition and the best value is selected at that stage.

We agree with Dr Cuthbert that there are lots of different ways of measuring the financing cost, different elements of the financing cost and different elements of all the other costs involved in a large and complicated project. We think that the primary one is the unitary charge—the overall cost to the public sector—and that has always been published.

We wrote to the committee in September 2018 with both WACC and the IRR measures across the programme. We said that both the WACC and the IRR are useful indicators. We will happily commit to publishing the WACC and the IRR for contracts signed in the future, if there are any contracts of this nature in the future, because both are important measures. As Dr Cuthbert said, we could do that as an average updated periodically and individually for contracts once the period of commercial confidentiality—which again, as he said, we managed to keep quite tight—has come to an end.

However, we think that the range of other indicators that Dr Cuthbert suggested, including those that include an estimate of a rate that a pension fund might be prepared to invest, are a bit more difficult and they involve an element that different people could take different views on. Therefore, independent researchers or any interested party are probably best off forming their own view of those sorts of measures from the full information that comes in the financial models, as and when they are published.

Colin Beattie (Midlothian North and Musselburgh) (SNP): I am curious about something that Jim Cuthbert said. You suggested that we use the measure IRR. I wondered why you had not considered MIRR, which might give a more accurate figure and would certainly indicate a little lower return against capital at the end of the day, which would have a beneficial knock-on effect, I think.

Dr Cuthbert: What does MIRR stand for?

Colin Beattie: Modified internal rate of return.

Dr Cuthbert: Right. There are a number of variations of internal rate of return, and I am not saying that any one of them should be used. However, to come back to what Peter Reekie was saying, I think that knowing any variety of interest rate is not enough on its own. One really must get at net present value before one understands what is going on.

10:15

I am not convinced by Peter Reekie's view that that might be difficult, in some sense, because choosing what interest rate to work on is a matter of judgment. Obviously, getting a particular interest rate to discount at involves judgment; on the other hand, one only needs to be in an approximate range to get a good idea of what is happening.

I remember a "Panorama" programme on the private finance initiative that looked at the interest rates involved and the IRRs that were being earned on subordinated debt in PFI schemes. The programme contacted the head of one of the major PFI finance companies and asked what interest rate he was getting. I think that he said that it was about 15 per cent, which was in the range that the Treasury regarded as being acceptable at that time. We said to "Panorama" that it should ask what interest rate was being looked for—the target interest rate of the secondary market investors, which we had thought was around 8 per cent—and he came back and said that it was about 9 per cent. That really made no difference; whether it was 8 or 9 per cent made no difference to the basic calculation. Whether you discounted at 8 per cent or around 9 per cent, the return that was being got on capital was multiples of the original capital that was being put in.

You do not need to know the exact interest rate in the secondary market as long as you have a good feel for what it is approximately, and you can do the calculation at that value. Net present value at some realistic interest rate is a much more informative measure than any version of IRR or a specific interest rate.

The Deputy Convener: Thanks for that. I am going to ask about the section of the summary that deals with transparency around how we decide what form of financing to use for individual projects. It says:

> "it is not clear enough how decisions have been taken about which projects will use private finance, or how well this is achieving the best balance of cost and benefits in practice."

I guess that this is a question for the SFT. How would you respond to that comment?

Peter Reekie: In our report on the mutual investment model, which could be used in future, we set out a number of characteristics of projects that make them either more or less suitable to be delivered in that way. Those characteristics include, first, the scale of the project, which needs to be a reasonable size of at least £20 million to £30 million. Secondly, the model works very much better for new-build projects than for any form of refurbishment. There are certain classes of building and other assets where it has been well tried and tested, such as education buildings, with colleges in the NPD programme, health buildings such as hospitals and health centres, and roads.

There is a set of known characteristics that make projects more suitable, but the decisions on which projects to finance by different routes is a decision that is made by the Government. ,I think that Audit Scotland's recommendation on the need to increase transparency was a recommendation for the Government in that decision-making process.

The Deputy Convener: Are you saying that it is entirely the Government's choice and that you have nothing to do with it?

Peter Reekie: We set a set of characteristics and we are able to help analyse projects that are priorities for investment against those characteristics. The decisions that are made against that background—which projects are financed in different ways—are final decisions that are made by Government.

Alex Neil (Airdrie and Shotts) (SNP): A lot of this is highly technical and probably way beyond many of us in terms of the arguments about specifics, how you measure the internal rate of return and so on. I would like Jim Cuthbert's and Peter Reekie's comments on this. The key issue for the committee—and I think probably the key issue for the Auditor General—is that we need have the information and the appropriate measurements in place to ensure that the taxpayer is getting value for money and is not being ripped off.

The concerns all started big time with Hairmyres hospital, which was a PFI project that predated the Scottish Futures Trust. We paid for that something like four times over. In the meantime, the people who were originally involved in the PFI contract have gone off and made hundreds of millions of pounds profit from the sale of their shares, as it were, in that hospital.

How do we make sure not only that we get value for money today but that we are not going to be ripped off, with other people walking away having made massive profits from selling on their participation in the programmes?

The Deputy Convener: That was directed at both the witnesses—you both get a shot, but please keep your answers as brief as possible.

Kerry Alexander: I will take that one first. Certainly, the NPD contracts cap profits to private sector investors, so the value that is locked in when the project is signed is the value that is locked in. There are different points during the transaction, however. The primary investors take the upfront bidding risk in a project and they see it through the risky construction phase. Sometimes, when they are coming out of that end and into the operational phase, a secondary investor looks at the project and considers that there is real value in long-term income coming through—I am thinking of pension funds or infrastructure funds, which tend to be backed by pension funds. The secondary investor will pay a premium to receive that future set of cash flows. It has the same value that is in the contract; it is just about the shape of when the return is taken out, relative to the riskier phase or the longer, steadier operational phase.

Dr Cuthbert: I do not want to repeat myself, but you cannot tell what potential profit will be taken out unless you do an appropriate NPV calculation at an appropriate discount rate. It is perfectly obvious from the financial projections themselves, which are available before the contract is signed, what the potential profits are, assuming that the build goes through as planned.

If, after three or four years, a private investor is taking out two, three or sometimes four times their original equity investment, surely that should be ringing alarm bells early on that perhaps there is undue fat built into the contract. You cannot rely upon the competitive process alone getting that fat out, because the process is not all that competitive and what is happening is obscure. There is information that is readily available and readily recognisable, and it should be looked at—I would say that it is essential to look at it.

The original flaw with PFI was that the Treasury said that a return of 15 per cent or so in relation to equity would be fine in the conditions of the day. It did not realise that that return was projected to be paid towards the end of the contract period—it was very heavily end loaded. The Treasury did not realise the effect of that: when you discounted at a discount rate of around 8 or 9 per cent, you would get back multiples of your original capital, so the potential profit was huge.

It is not good enough just to look at the unitary charge and say, “We can afford that. It looks to be value for money”. You do not really have any idea of the potential profit that is there. You might say that the profit is capped, but if the profit exists through a potential sale in a secondary market, you cannot cap that in any meaningful way unless you know exactly what the net present value is at a reasonable discount rate.

Alex Neil: Basically, I take it from those two answers that we are agreed on the need to cap excess profit. The question is whether the existing arrangements give us the ability to do that. From what Jim Cuthbert is saying, the answer is no, and we need to go further, add value and so on. I think that that is the real issue for the committee and the Auditor General. Our job is to make sure that the taxpayer is not taken for a ride. If the proposition is that we need to put in additional measurements and additional conditions to ensure that the taxpayer is not taken for a ride, it seems to me that that is reasonable, although I would like the Auditor General’s advice on precisely what those additional measures would be.

I have other questions, but at this stage that is the only point that I wanted to register, because it is very relevant to the introductory remarks from Jim Cuthbert and Peter Reekie.

The Deputy Convener: Okay. Thanks for that. I completely agree that this is about getting value for money for the taxpayer. Peter Reekie wants to come back in on that.

Peter Reekie: We agree that it is about getting value for money for the taxpayer. Our view, and the view that has always been taken in the procurement of projects, is that the way to get value for money is by having an open tender process and a competitive procurement and accepting the best combination of quality and cost to meet the user’s requirements. The cost in an NPD contract or a hub design, build, finance and maintain contract is the unitary charge over the life of the contract. All the tenders are based on that type of competition to obtain that measure of lifecycle value for money for the asset.

We also agree that that includes the cost of finance, with financiers having a fixed stream of future income that comes from a project and which is part of the unitary charge. Where we have a difficulty is that we know that different financiers will trade that future stream of income at different points in time because of different views of risk and of the markets.

We do not think that there is a measure of value in relation to the opportunity for future trading that debt instrument, because, at the outset, the competitive market will give us the best deal on offer at the time. We find it a little difficult to think about what we would do differently in a competition that is about delivering the best unitary charge if we had that further information. As Jim Cuthbert has said, it is possible to calculate lots of things at that stage. However, we do not necessarily see how that would enhance the value that we would get as the best lifecycle cost for the asset, which is the unitary charge summed over the life of the contract versus the quality of the asset and the service that is delivered from it.

The Deputy Convener: I want to bring other members in. Bill Bowman is next, and then I will go to Colin Beattie. I remind members who are not present in the room that if they want to come in, they should let me know through the chat function.

Bill Bowman (North East Scotland) (Con): Good morning. I always remember being taught that money has a time value and that net present value gave a good indication of that. I would also like to mention—as I think that I did in our original discussion with the Auditor General—that, as far as I understand, there is nothing illegal about the secondary market. It is just part of the way the system works.

Exhibit 2 in the Auditor General’s report, if you are familiar with it, is about how privately financed contracts work. It shows the parties involved, and I am sure there are some very smart brains in the various lenders and contractors. I will borrow Alex Neil's phrase: who is responsible for making sure that the public are not taken for a ride? I do not see the governance overview in this.

The Deputy Convener: Who is that question directed to?

Bill Bowman: Both witnesses, please.

Dr Cuthbert: In a sense, I think that everyone is responsible. The public sector client, who will ultimately sign the contract, has a responsibility to understand what is in the contract before they sign it. If all that they have is the complicated financial model, they will not be able to understand that easily because it takes several weeks' work to understand what is going on in that model. I think that the committee and the Scottish Government have a responsibility to set up the systems that will make the system work better.

10:30

As I said, in the original days of PFI, the Treasury specified an interest rate of about 15 per cent as being a reasonable return on the subordinated debt and risk capital in a project. However, it did not look to see how that was being earned. The Treasury assumed that it would be earned on a flat profile and it argued quite vehemently with us, saying, "Oh, no. That's paid on a flat profile. It's like a mortgage. It's fine." If you had looked at the financial projections, you would have seen that it was not being paid on a flat profile and that potentially huge secondary market returns were being built in. That should have been obvious before the contracts were signed.

All that I am saying is that some indicators should be produced. They will be approximate indicators, but they will give a very good idea to everybody concerned whether there are potentially huge secondary market returns.

There is nothing wrong with the secondary market itself. In fact, it was regarded as one of the good aspects of PFI to begin with, because it would enable the private sector investor to get their capital out at an earlier stage and mean a more liquid market. There is nothing wrong with that logic, provided that the potential returns that are being picked up are not obscenely large—and they were obscenely large in the early days of PFI.

The projections for hub projects are fairly large for hub projects. When I was looking at the model that I analysed, I reckoned that there was probably a return of something like 8 per cent of capital on a sale early in life of a project that was going well.

Bill Bowman: This is the point that I am trying to get at. You say that we all have a responsibility, which is fair enough, but if there is not one point of responsibility for a project, shared responsibility will mean that we all tick our boxes, but that we do not necessarily get the right overall answer. I am trying to identify who should be looking at the whole project and taking responsibility for everything working.

Dr Cuthbert: I think that it is about responsibility for different aspects of the system. The committee and the Scottish Government have a responsibility to make sure that the mechanisms are there, so that appropriate indicators are available at an early stage before the contract is signed. It is then up to the public sector client and the SFT to look at those indicators and say, "No, that smells wrong. It looks like there is excess return here. We will not sign for that."

Bill Bowman: You are saying the public sector client and maybe—

Peter Reekie: In any of these projects, the public authority that signs the contract is the one that follows the public pound and has the duty to get the best value. We support that absolutely. We have standard forms of contract that make it easier to procure these things and we provide some central support.

As Jim Cuthbert suggested, we have published a lot of the models. We have also helped authorities to procure the right advisory support. As people have said, these are quite complicated financing, legal and technical arrangements, and it is important that any authority that is entering into such an arrangement is properly advised by financial, legal and technical advisers who understand what is going on and who are able to analyse properly the tenders that come back and the financial models associated with those tenders.

That is the responsibility of the procuring authority primarily, supported by the right advisers. We are absolutely there to help them get in place and to support them with standard documentation through the programme.

Bill Bowman: Does that work?

Peter Reekie: I think that it does, yes.

Dr Cuthbert: I must say that I am a bit sceptical. Peter Reekie was talking about the benefit of competition and almost, I think, relying on competition to ensure a reasonable deal. The market is actually thin. The SFT's document on the MIM model says, more or less, that we must have large, complex projects to attract bidders at all. If you are in the business of having large, complex projects, you are not going to have many bidders, and it is very difficult to understand what is going on and what is concealed. Therefore, you cannot rely on competition to make the process work. It did not work with PFI and I do not think it will work with things such as NPD and MIM.

Colin Beattie: We have been talking about monitoring, reporting and so on, but what consideration has SFT given to any indicators that could assist it with the quality of monitoring?

Kerry Alexander: We look at that in a number of different ways. We have talked already about the published unitary charges, which show the annual cost and the procurement information. We also publish the contract models. In addition, since the Audit Scotland report was published, we have taken on board its recommendation about monitoring and recording the changes in ownership. We have now published on our website the list of investors and funders in each of the hub DBFM projects and the NPD projects. Those are just a couple of examples of the information that is published and tracked.

Colin Beattie: Audit Scotland said that the monitoring of secondary market transactions would help in assessing whether value for money has been achieved. How feasible is it to carry out on-going monitoring of secondary market transactions?

Peter Reekie: As Kerry Alexander has just said, we monitor and publish the equity ownership of all the projects annually, so we update that. We cannot get the detailed commercial position behind any of the transactions that have gone on in the change of ownership, because that is a matter between the buyer and the seller of those instruments at any point.

Colin Beattie: All that you are really able to do is to track the ownership.

Peter Reekie: Yes.

Colin Beattie: There is no way to find out what the levels of returns are in the market.

Peter Reekie: As you know, there is a lot of complexity in the investment market, with different owners at different levels. Ultimately, as we have said, quite a lot of the investments are held by pension funds. Pension funds buy into different infrastructure funds, or funds of funds, so there are lots of levels at which transactions are occurring in the chain to the ultimate owners and the beneficiaries, who may be pensioners in the end, frankly. We cannot access the commercial details of all the levels of those transactions.

Colin Beattie: Does that not create a difficulty? Jim Cuthbert talked about having established levels of returns for investors in the secondary market. How do you manage to achieve that?

Dr Cuthbert: I think that it is fairly well known in the market roughly what people are paying in the secondary market, within a percentage point or two. There seems to be general knowledge of what is going on.

The Deputy Convener: Sorry to jump in. There may be general knowledge, but where can we find out the information? People such as you may have knowledge of it.

Dr Cuthbert: I am saying that you do not need to have an exact idea. As I said in the example that I gave on early PFI, we were working on the assumption that the pension fund would be paying about 8 per cent and I think that the PFI investment company was assuming that it would be 9 per cent. That difference is irrelevant for working out the order of magnitude of the return multiple that the investor will be getting when they make a secondary market sale.

My other point is that it is not that useful to monitor secondary market sales as they occur because that will probably happen four years after the contract is signed. You can get an idea before the contract is signed of what the likely profit would be in a secondary market sale. That would enable you to decide whether to sign the contract. That is worth doing. Monitoring secondary market sales will enable you to say, “Gosh, we got it wrong.”

Dexter Whitfield, an academic, looked at PFI secondary market sales and worked out that the average annual return on PFI schemes on secondary market sales being made was 28 per cent. It is good that he could do that, but that is after the event. You can say four or five years down the line, “We were wrong with that policy”, but you could have said before the contract was signed what the potential level of return was going to be and you could have done something about it then. To my mind, it is essential that you do your indicators and the calculations beforehand. Guddling around afterwards just tells you that you went wrong four or five years ago.

Colin Beattie: If you are going to base a policy or financial decision on anything, you will base it on hard facts and on a source that you can rely on and understand. Unless I am misunderstanding you, you are saying that you find the market level from contacts in the market as opposed to having an indicator that you can look at, get your hands round and use.

Dr Cuthbert: All that I am saying is that you can look at the contract for a scheme. Let us suppose that the protected return is 10.5 per cent, which it would be in a hub scheme. You can then ask, “Supposing that, on completion of the construction phase, the subordinate debt investor were to sell that in the market for 7 per cent, what sort of multiple could they make on their original capital? Does that look excessive or not?" You are not saying it will be 7 per cent, but you are getting an idea of the potential return they could make, and you can form judgments on that.

Your judgment might be, "Well, it doesn't look as if the competitive process is working very well here", and you might not sign that contract or go back out. You might make a judgment more broadly about the whole policy and say, "If that is the sort of potential return that people are making, maybe we'll go ahead with that scheme, but we'll reconsider this whole private finance policy." You should be able to makes those sorts of judgments on the basis on indicators that you can calculate fairly readily from the available information.

Remember, the financial projections are serious documents. That is a serious view by the person undertaking the project and risking their capital on what it will look like if things go well, so you can found a lot on them.

Colin Beattie: I come back to the SFT. Information was promised to this committee on the weighted average cost of capital and the internal rate of return. We do not seem to have received that. Is it possible for it to be provided along with the major capital projects updates?

Peter Reekie: Yes. We wrote to you in September 2018 with the information that we believed had been requested at the time. I apologise if the committee feels that the information—

Colin Beattie: My understanding is that an update was promised.

Peter Reekie: We have said that we will publish the weighted average cost of capital and the IRR—the average figures and scheme by scheme—for the projects that are out of the confidentiality period. We would be very happy to send a copy of that on to the committee.

Colin Beattie: Thank you.

Kerry Alexander: I can give you the updated figures now. When we last reported, it was 4.74 per cent for the weighted average cost of capital and 5.93 per cent for the project IRR. Those averages have moved on since a number of further deals, and the final deals have contracted, so the weighted average cost of capital is 4.69 per cent and the project IRR is 5.86 per cent.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): I want to look ahead to the mutual investment model that the Scottish Government is considering using. I suspect that a lot of the discussion so far will still be applicable to this issue. As I understand, the Welsh Government is using that model. What are your impressions of the application of that model, Peter Reekie and Jim Cuthbert? How successful has it been in Wales? Will you discuss the relative merits of MIM as you see it?

Peter Reekie: I will start off and Kerry Alexander may jump in. Last year, we published advice to the Scottish Government that the mutual investment model, as adopted in Wales, would be the most appropriate form of privately financed infrastructure investment, should that be needed to deliver the additionality that the Scottish Government is looking for in overall infrastructure investment.

The model has been used in Wales. I know that it has been challenging for the teams to go through the process with Eurostat in order to get classifications for the projects, which is critical in allowing it to deliver the additionality. However, they are through the procurement process on the projects on roads and schools, on which I think that the Welsh Government has preferred bidders. Kerry Alexander might know more about the detail of the implementation of that.

10:45

Kerry Alexander: Both the project on schools and the roads project are now at the preferred bidder stage. We spent a lot of time talking to the Welsh Government about MIM, as it has gone through the development process, to understand how it approached it, and we have discussed the contract with colleagues in the Welsh Government and with the Office for National Statistics. That helped to inform the options appraisal that we published in 2019 on a technical solution to fit with the current Eurostat rules and how that would work for private finance, should the Scottish Government choose to use that route for investment.

Dr Cuthbert: I have no knowledge of how it is operating in Wales. When the SFT published its options appraisal of MIM, it agreed that it would be more expensive than conventional public sector procurement. I published a note—I think that the committee has a copy—on the SFT document, in which I argued that it had probably understated the extra costs that would be associated with the model. There were a number of reasons for that, one of which was the likely lack of competition on MIM projects. As the SFT document said, they would have to be fairly large and complex projects to attract any interest in the market, but large and complex projects are an opportunity for the tender to build in excess fat.

One other aspect that I did not like about the SFT appraisal was that it assumed a flat profile of payments on subordinate debt. That is extremely unlikely—it is likely to be end-weighted. For that reason, the SFT is likely to have understated the potential secondary market return for MIM investors. I think that MIM will be more expensive, but is likely to be significantly more expensive than was conceded in the original SFT document.

Willie Coffey: That is very interesting. When are we likely to see the impact of the first MIM project? Are we likely to approach the process in that way? Will we appoint one particular project, for example, and see how it goes, or will we throw all our eggs into one basket and finance a number of projects using the model? How is it likely to pan out, in reality?

Peter Reekie: As was the case for the projects that I discussed previously, the decision on financing for individual projects is for the Government. We have done analysis that demonstrates that that route, should we need to use private finance to deliver additionality, would be best. We have said what sorts of project it would be suitable for—they would be similar to the ones that I talked about. As Jim Cuthbert said, larger projects are better for that sort of financing.

The way we compared the costs of different procurement routes had some simplifications, but the overall factor that we think is important for everybody to understand is the whole-life cost of an asset being paid for using the route by which it is bought and financed. In the report—Kerry Alexander will have the numbers to hand—we said that it is about the ratio between how much you must pay over the asset's whole life compared to its cost.

Kerry Alexander: We were keen to set out—in a way that we have seen reported in the press—the whole-life cost of that route versus the capital cost. Such figures have been quoted before. Let us say that paying for the capital—paying for the asset up front—is 1 times the cost. Our analysis showed clearly that paying for the asset with Government capital but maintaining it as you would had it been privately financed under a design, build, finance, maintain contract, would be 1.5 times the original asset cost. If you were to use public finance, such as through the Public Works Loan Board, that would cost between 1.9 and 2.6 times the original cost of the asset. That range is to take into consideration changes in interest rates. Use of private finance would mean that the cost would be between 2.6 times and 3.3 times the original cost of the asset.

As Dr Cuthbert said, we all recognise that the private investment option costs more, taking into account the cost of private debt and the lifelong risk and maintenance cost across the piece.

The Deputy Convener: Are you saying the MIM costs more?

Kerry Alexander: I am saying that private finance costs more, rather than that the MIM costs more than previous routes for private finance.

The Deputy Convener: Are you saying the MIM is cheaper?

Peter Reekie: MIM is broadly analogous with the cost of non-profit distributing or hub DBFM. The ratio is about the same for all the different routes, but all of them are more expensive than public finance would have been, had it been available to deliver the project.

Dr Cuthbert: To repeat a point that I have made, I note that I argue in the paper—which I think the committee has seen—that the SFT underestimated the actual costs that attach to the MIM.

The Deputy Convener: We have seen that paper.

Willie Coffey: I am listening very intently. For clarification, can any control over profits ultimately be taken under the MIM?

Peter Reekie: The MIM is a profit-sharing approach, whereas the non-profit distributing model is a profit-capping approach.

Willie Coffey: That sounds to me as though there is no control.

The Deputy Convener: Between whom is profit shared?

Peter Reekie: Under NPD there is an absolutely fixed return to investors across the lifetime of the project. That is one of the things that was found by the Office for National Statistics and Eurostat to be incompatible with the "private" classification that we need to deliver additional investment. Therefore, the MIM, which we have suggested will be the best available route in the future, does not absolutely cap the return to investors. Projects are still bid for in the market, in competition, and any increased profits in the future would be shared between the public sector party that invests and the private sector majority investors in the MIM project. There is no absolute cap, as there is under NPD; there is a sharing of returns between the majority private sector investor and the minority public sector investor.

Willie Coffey: Are there any other models out there that we could embrace? Is the Scottish National Investment Bank a possibility for funding such projects, or is this the only game in town?

Peter Reekie: There is definitely a hierarchy of costs, as we have set out. I would expect the Government first to use its capital budgets and the borrowing powers that are available to it. There are arrangements that we have developed for schools for the future, using the local authorities' borrowing powers through the Public Works Loan

Board to finance projects. Then, there is the private financing approach.

The Scottish National Investment Bank—you might have touched on this in the previous evidence session—must lend to private sector entities, so it is not best suited to delivering public infrastructure. It might well be able to invest in private infrastructure and housing assets, for example, but it is not best suited for investment in roads, schools, hospitals and things that are primarily public sector assets. Obviously, the Scottish National Investment Bank's investment priorities will be set up in line with its mission.

Neil Bibby (West Scotland) (Lab): I want to ask about the learning estate investment programme and the changes to that, with councils funding the construction costs and the Scottish Government picking up maintenance and upkeep costs. What information is available on how the Scottish Government payments for maintenance will be agreed? Will agreed maintenance costs cover the full 25-year period of a school's life cycle? How can costs be predicted for such a long period, and what account is taken of factors such as inflation and energy costs?

Kerry Alexander: The learning estate investment programme is funded up front by councils. The Scottish Government will provide revenue funding over 25 years, which will be paid out on evidencing of delivery of outcomes that are consistent with the national performance framework and the learning estates strategy. That revenue funding will support buildings being kept in good condition, energy efficiency towards our net zero target, digital enhancement and community benefits. Although it has been described in the question as being linked specifically to payments for maintenance over the years, the funding is targeted to support a much bigger basket of outcomes.

There is a lot of evidence and information about whole-life costs from the types of programmes that we have been talking about today. The programme was designed very much around the whole-life costs and paying for a maintained building over time, rather than being designed simply around the up-front cost of the asset. The mechanisms for the level that that should be set at, and how the cost is tapered down should outcomes not be delivered, have all been set in discussion with the Convention of Scottish Local Authorities and with local authorities in the group that designed the learning estate investment programme.

Neil Bibby: Who would bear the risk if maintenance costs, for example, are higher than anticipated? Would it be the councils or the Scottish Government? Alternatively, could the council redirect funds if maintenance costs were lower than anticipated?

Kerry Alexander: The risk for delivering the outcome sits with the councils, which includes maintenance. That mechanism has been discussed and agreed with COSLA and local authorities.

Neil Bibby: There is obviously a need for transparency. What information will be made public to support scrutiny of the schools investment programme and its outcomes?

Kerry Alexander: The programme has announced its phase 1 projects and is in the process of setting the funding arrangements for those. I was determined not to talk about Covid, but because of it the attention of councils and the Government has been on other things, so there is still work to be done on exactly what information will be made available. It is something that we will come back to at a later stage.

Alex Neil: The intervention of Eurostat over the past two or three years has been crucial in changing various things—from the status of housing associations to how the SFT works. Will the rules still apply after we leave the European Union at the end of this calendar year?

Peter Reekie: We are uncertain what rules and situations will apply to a whole bunch of things after the end of the financial year. We expect that the Office for National Statistics will use a set of rules that are very similar or identical to those that have been applied in the past. In the first instance, at least, we will look to ONS, as we do now, for guidance on such matters.

Alex Neil: It is "Wait and see", is it?

Peter Reekie: I do not know the answer, at the minute.

11:00

Alex Neil: Clear messages are coming out here. One is that the cheapest way to fund investment is through the use of capital, the second-most expensive way is to borrow the money through the Public Works Loan Board, the national loans fund or the Bank of England, where the United Kingdom Government is borrowing at 0 per cent interest, and the most expensive way to do it is by involving private capital in the projects.

Given the limitations on our borrowing powers and our taxation powers, for the time being we are probably going to have to continue to use the MIM powers on whatever projects we move forward with. Two questions arise. First, do we know where we are with the planned increase of £1.6 billion a year in infrastructure investment and how much of that will be raised through the Scottish

Futures Trust across all its programmes? I will come to my second question after I have had an answer to that one.

Peter Reekie: The Scottish Government has not yet published its infrastructure investment plan, which we expect to be published some time in September.

Alex Neil: So you do not yet know how much of that you are expected to raise.

Peter Reekie: We will not know which projects will be procured under which approach until the infrastructure investment plan has been published, and some more analysis of individual projects might be needed following the publication of that.

The Deputy Convener: I think that the plan will be published next week.

Alex Neil: My second question is wider and relates to the hub and non-profit distribution. Although the MIM is based on a shared approach between the private sector and the public sector, if the private sector partner decides to sell its share of the business to a third party, will the public partner have any say in principle over whether it can do that and, if so, on what terms and conditions?

Peter Reekie: We do not expect the public sector to be able to control the ownership of the private sector's share, because control of what happens in the project companies is something that the classifiers are very interested in. If the private sector investor decides to sell its investment on in the secondary market—we have talked about that already—that will be a matter for it.

Alex Neil: That comes back to the point that the mutual investment model does not solve the problem of how we prevent excess profits from being made in relation to selling into the secondary market. It seems that we have two basic options, which are not mutually exclusive. We can go down Jim Cuthbert's road of building in some additional calculations at the beginning, so that we know up front what the financial parameters are for selling into the secondary market, or we can include something in the contract that puts a cap on excess profits being made if the private sector sells into the secondary market.

I know that the SFT does not think that it is necessary or desirable, but we know that we could adopt Jim Cuthbert's proposal in principle, which seems perfectly sensible to me. It would not cost us anything and it could save us a lot of money. Under the legislative framework in which we are operating, would we be able—through the SFT or in any other way—to have some kind of contractual arrangement as part of the contracts with the private sector partners whereby a cap could be put on any excess profits being made in selling into the secondary market or a share of those excess profits would have to be paid back to the public purse?

Peter Reekie: We do not think that that would be possible, because the classification rules do not allow the profits to be controlled or capped in that way. The cost of the finance—as part of the cost of designing, building, financing and maintaining the asset—was set at the outset in competition. If a party that takes the higher risk at the early stage sells to a party that wants and values the longer-term stable cash flow that is associated with the operational phase, that is a market operating; we call it the secondary market.

What concerns me is that we would judge the overall cost—the unitary charge that is paid over the life of the asset—to be the most important factor in competition, and I am not sure that we would be in a position to make a judgment as to what an excess profit might be in a secondary market transaction, or what we would be able to do about that at the bidding stage, when we are focused on the best value to the public purse, which is the whole-life cost of the asset that is paid through the unitary charge.

Alex Neil: The point about the value to the public purse is that if you did Jim Cuthbert's exercise before you signed the contract and it showed that, as the proposal stood at that stage, you could reduce the price to the public sector to prevent excess profits but still allow the private sector partner to make a reasonable return if it sold into the secondary market—that is the whole point of Jim Cuthbert's proposal—you would have the information to make that decision if you desired to do so. Your concern might be that people might walk away from the bidding and you would be left with nobody to do the job, but at least you would then know what the options were. Is that not the point of Jim Cuthbert's proposal?

You are saying—and I fully accept this—that once you have signed the contract, there is no way that you can control the sale into the secondary market and the making of excess profit, however you define excess. However, there is a way of preventing that if you have the additional information that Jim Cuthbert is proposing as part of the consideration of whether to sign the original contract or not. You at least know what you are getting yourself into.

Peter Reekie: My view on that is that the cost of finance is one element of the cost of designing, building, financing and maintaining the asset that leads to the whole-life cost. We evaluate that as the total cost of the asset over its life cycle. Some bidders might have a higher cost of finance and a lower cost of construction, some might have a higher cost of construction and a lower cost of facilities management. The important bit for obtaining value for the public purse is the unitary charge over the whole life of the asset. That is what the competition for such projects is generally based on, along with an analysis by financial advisers of the financial models that looks at all the aspects of the cost of finance and by technical advisers of the other costs involved. I am not sure that another digit, which would be an NPV number, would assist in the assessment of the life-cycle value that we need to do at the stage of a procurement.

Alex Neil: But surely the Government does not want people to make excess profits out of taxpayer investment, as has happened on occasion in the past. I am not saying that it is necessarily the crucial factor in deciding whether to sign the contract, but surely it is useful to at least have the information. If I was still the infrastructure secretary, I would be very uncomfortable about consciously signing a contract under which people could, in effect, make a killing from the taxpayer.

Dr Cuthbert: What Peter Reekie is saying sounds awfully like the original heresy of PFI. With the original PFI, the public sector did not want to know too much about the detail of the contract, because it felt that the private sector had a sort of magic, and that if you probed too deeply that magic would disappear. That was proved to be an utterly disastrous policy.

I see no reason why you lose by having extra information; in fact, you gain. It can be done at no cost. In fact, it can probably be done at a saving, because if you specify that a certain indicator should be produced, it saves the public sector the cost of having to analyse those contracts itself. Detailed analysis of a financial projection is a costly and time-consuming exercise. I see no downsides to having that extra information but plenty of upsides. It potentially strengthens the bargaining hand of the public sector, which it has not been able to exercise in that way in the past.

Alex Neil: I was going to make a similar point to the one that Jim Cuthbert made. If the private sector partner knows up front that you are looking at the potential for excess profits and that it will be a factor in your consideration, does that not incentivise it not to build too much fat in so that it can make excess profit in the secondary market? If you are explicitly not looking at the issue and not taking it into consideration, the private sector partner might well think, “We’ll get a bit of fat in here. We’ll build in a bit of extra profit and make a real bob or two after the construction period, because they’re not going to be bothered with the excess profit.”

Peter Reekie: I do not think that I said that we did not look at the cost of finance as part of the overall package. The procuring authorities and their advisers and the SFT look at the total cost of finance as part of the DBFM package, and all the information that we can get about that is useful. The financiers are incentivised to offer the lowest possible cost of the financial package as a whole because it leads to the lowest possible cost of the DBFM, which is what we evaluate. Therefore, all those market incentives are there.

Collecting data is useful, but I am not sure that the proposed measure would allow us to make any decisions during a procurement that were different from those that we would make if we did the generality of the analysis that is already done by the advisers and the authorities as they go into the procurement phase. That is a really important phase and that analysis is really important, and a lot of it is done by the financial advisers and the procuring authorities on every contract.

Kerry Alexander: One point that I do not think has come up during the discussion is that the project financing structure, which is over 25 years, means that, in order to secure long-term debt from the market and ensure that the investors are right the way in and are incentivised to perform to the contract that they are performing for the client, their capital must be in right to the end. There is a natural part of this structure and the length of it that incentivises the risk investors to be there right the way to the end and to be ready to hand back, and to make sure, should there be any kind of issue with the facility and so on, that the investment is there to be drawn on. Part of the structure itself is why the return is in there until the end. It has not come up that there is a natural part of the structure that is to keep it in until the end. You hold the contractors’ and the investors’ toes to the fire to make sure that they perform to the contract to the end.

Dr Cuthbert: That is nonsense, because if the equity has been sold to a pension fund that is looking for 6 or 7 per cent, their risk capital is not in until the end. Secondary market sales remove the risk capital and put it in the pockets of the original investors.

Kerry Alexander: The contract has not changed, the performance has not changed and the investor is still there. If the investor does not perform, it will lose its investment.

Dr Cuthbert: The idea that a pension fund that thought—

The Deputy Convener: It would be useful if you could stop having a private ding-dong.

Alex, have you finished your questions?

Alex Neil: I think so, although it would be useful for us to get a list of the NPD hub contracts where investors have gone to the secondary market—I know that we will not necessarily know the detail of what they sold their share for—since it was introduced, as that would allow us to see how widespread the practice of going to the secondary market is. I do not think that we have had that information.

Peter Reekie: We publish that information, and we will happily send it to the committee.

The Deputy Convener: Members have no further questions.

It has been a very interesting and useful session, and I thank the witnesses: Jim Cuthbert, Peter Reekie and Kerry Alexander.

11:15

Meeting continued in private until 11:46.

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