Finance Committee  

Inquiry into methods of funding capital investment projects  

Submission from McGrigors LLP

Introduction and Firm Profile

McGrigors is a national commercial law firm with offices in Glasgow, Edinburgh, Aberdeen, London, Manchester and Belfast. We employ 458 people in our Scottish office as part of a total staff of 685 people, including 79 partners and over 300 lawyers across the UK. McGrigors advises clients, including national and multi-national organisations, in the public and private sectors on a wide range of commercial issues. Our Energy and Infrastructure and Project Finance teams have now advised on over 160 PPP projects which have reached financial close, having been involved in this process since the introduction of the private finance initiative. In the calendar year 2007 alone, we closed 14 PPP projects with a capital value of £1.5 billion, ranging from roads projects in Austria and Northern Ireland to hospital and schools projects throughout the United Kingdom. At present, we are advising on 20 projects in various stages of procurement with seven at the preferred bidder stage.

Non Profit Distributing Structures

One facet of our experience which is of particular relevance to the parliamentary enquiry into the funding of capital investment projects is our experience of advising throughout the United Kingdom on non-profit distributing infrastructure financings. The key aspect of the non-profit distributing structures ("NPDs") that have been used in Scottish PPP projects to date is that sponsors' returns over a specified threshold are passed back to the public sector by means of a charitable structure set up at the start of the project. We have no objection in principle to NPDs as a form of financing capital projects, and have developed a high level of expertise in their operation, and this encompasses advising:

- bidding consortia on both the Aberdeen Schools and Falkirk Schools NPD Projects and the funders of a bidding consortium on the Aberdeen Schools NPD Project;
- the European Investment Bank in respect of its role in funding the Argyll and Bute Schools NPD Project which completed in September 2005;
- the vendor and issuer on the Moyle Interconnector NPD Project (a project involving the 100% senior debt financing of the electrical interconnector between the electricity grids of Scotland and Northern Ireland, through a monoline wrapped bond financing);
- Royal Bank of Canada/Team Northern Ireland/Premier Transmission Limited in the implementation of a structure similar to that used on the Moyle Interconnector Project to finance the acquisition of the Scotland Northern Ireland Gas Pipeline;
- Northern Ireland Energy Holdings Limited on the incorporation and structuring of that NPD company and its subsidiaries and acting for that group of companies on the (bond financed) debt financing of the Belfast Natural Gas Pipeline; and
- the Scottish Executive on the grant funding and structuring of the Glasgow Housing Stock Transfer (the largest of its kind in Europe) to a non-profit vehicle and the subsequent structuring in relation to second stage transfers; we are now retained to act for the Glasgow Housing Association on structural issues arising from these transfers.
NPDs offer a number of attractions to public sector procurers including:

- an improved alignment of long term public and private interests with more stability of long term ownership/control as there is no shareholder equity to be traded in the secondary markets;
- greater stakeholder acceptance, in particular on local authority procured projects where there is a perception that returns on equity lead to excessive profits for investors;
- existing standard form PPP documentation can be used with some minor adjustments to reflect the NPD structure;
- surplus cash flows are available for the public benefit via charitable contributions;
- standard PPP risk allocation to subcontractors remains unaffected;
- limited recourse project finance is available; and
- from the stakeholder perspective, there is greater transparency through Independent and Stakeholder Directors sitting on the project company board.

There are also, however, reservations which should be borne in mind. The principal reservation that investors and contractors have in relation to the current form of NPD structure being promulgated by the Scottish Government (and as amplified in the PPP Forum submission to this enquiry) is that junior debt (which effectively replaces shareholder equity in these structures) must be refinanced if and when an independent director decides that it is prudent to do so and without any requirement to recompense the holders of the junior debt for their loss of return over the life of the project. Other issues which we have encountered on projects using these structures include consideration of:

- the appropriate degree of risk transfer and the management of the exposure of the project company to any residual risks in view of the lack of pure equity return;
- refinancing potential and mechanisms for extraction of the project company share of the gain;
- the constitution of the corporate vehicle used as the traditional project company;
- management incentivisation and control (where there is no equity interest it is key to ensure efficient and effective management of the project);
- identification of true "surpluses";
- liquidity and reserving mechanisms to protect the project company from "cost shocks"; and
- treatment of subordinated debt as an element of compensation on termination.

Scottish Futures Trust

We understand that the main objectives of the Scottish Futures Trust ("SFT") are:

1. to encourage additional investment in Scotland;
2. to ensure cheaper costs for future capital investment projects in comparison to projects which use the PFI model; and
3. to operate on Non Profit Distributing Principles.

In terms of source of funds, the assumption we make in terms of funding is that it is unlikely that the Scottish Government will be able to finance infrastructure investment itself in every event and project finance or other external/private sector funding will therefore be one key component. We also refer to the PPP Forum Submission to the Finance Committee of the Scottish Parliament
dated 7 December 2007 in respect of the enquiry into the funding of capital investment projects in Scotland and the continuing role for private sector finance in meeting the Scottish Government objectives for the successful provision of future infrastructure. We also note that HM Treasury issued on 12 March a paper entitled “Infrastructure procurement: delivering long-term value”, which sets out the next steps the UK Government is taking to secure value for money in its procurement of assets, infrastructure and long-term service provision.

We reiterate in broad terms the following comments made in our written submission to the Finance Committee which encompasses what we consider to be the three key facets which the Scottish Futures Trust should enshrine:

1 **Encourage additional investment**

To date, Scotland has been a market leader in infrastructure programmes and is recognised as a centre of excellence for the delivery of PPP/PFI projects since the inception of PFI. Scottish advisers (legal, financial, technical and other) are sought after in the international markets. For example, Partnerships UK is heavily involved in demonstrating to and educating other jurisdictions on PPP markets and structures which can be employed. The Financial Partnerships Unit of the Scottish Government itself has been integral in this process, helping other jurisdictions develop expertise.

However, there is a risk of a decline in interest in investment in infrastructure projects in Scotland due to the lack of certainty around the SFT, new structures being promulgated and the lack of stability in the market. This industry may decline significantly and/or be exported elsewhere if the Scottish infrastructure programme is not implemented.

With SFT committed to encouraging additional investment in Scotland, we believe the key issue is to develop a full, well managed, predictable stream of infrastructure projects both in social and economic infrastructure which will not only assist the development of infrastructure in Scotland directly but also importantly through the multiplier effect of spending in the economy to boost the Scottish economy. This is more important for economies such as Scotland than it is for other economies given the relative remoteness of people from each other and the remoteness of Scotland from major financial and business centres. It is not just about the direct effect good quality schools, hospitals, roads, etc. can have on the economy but also the knock on effect these quality assets have on the rest of the economy and also in ensuring and encouraging people to live and work in Scotland (the relative decline of the working age population in Scotland witnesses the importance of that).

One needs to recognise that the infrastructure market is not a geographically constrained market but is an international market where countries, municipalities and governments compete with each other for available contractors, developers, investors and lenders. Last year alone the infrastructure finance sector worldwide accounted for US$322 billion of investment. That investment is mobile globally and will look for the best quality, most politically stable, most predictable and best returning projects that are available.

Many other countries in Europe and further afield are adopting the PPP/PFI model. There is a significant deal flow outside the UK now and for the first time about a year ago, more PPP/PFI projects were concluded outside the UK than were concluded within the UK. Active markets include but are not restricted to the US, Canada, Australia, France, Germany, the Baltic States, Italy, Spain and Eastern European jurisdictions. This trend is very likely to continue. Indeed a project has just been concluded in Singapore.

The challenge then for Scotland is to develop a programme which competes in this market place. To date it has been successful in doing so but competition is greater now than ever before.

2 **Ensure cheaper costs for future capital investment projects**

We suggest that the main focus of the SFT should be to encourage greater and deeper competition in the market rather than putting in place challenging contractual structures which make the market in Scotland less attractive for contractors/investors. It would be preferable to encourage more
competition and therefore drive down the price the public sector needs to pay for infrastructure assets as a result of there being increased competition rather than as a result of awkward contractual structures.

3 Procurement structure

When competing internationally it is important that investment opportunities and the opportunities for contractors bear many similarities to those found in projects available elsewhere – it is unlikely that the contractors or investors will be inclined to take the time to spend money to familiarise themselves with new structures and enter into a market which looks markedly different from those markets they are accustomed to in other countries.

For this reason we are of the view that any structures introduced through the SFT process should bear a resemblance to PPP/PFI (and the risk allocations now accepted by the market) albeit, with the maturing nature of the market, moderated to ensure that no windfall returns are available to investors/lenders.

We believe that the Scottish Government has committed to this process already by successfully closing three projects which operate on non profit distributing principles and via the various workshops being run by the Financial Partnerships Unit with both the public and private sectors. We consider however that as well as continuing to educate the market in this way the Scottish Government also requires to listen to the market and develop any NPD model in conjunction with that market to ensure first it understands the model, i.e. because it is similar to the PPP/PFI model in terms of risk allocation; or that it uses standard project documentation recognised in the market that has been developed by that market and works; and secondly that any NPD model is competitive for the reasons set out above.

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We believe that there should not be a "one size fits all" approach to the NPD or other models employed. Different infrastructure assets probably merit different structures. In particular, we think that a model including less risk transfer, but lower cost of funding, should be considered (such as the Moyle Interconnector financing structure employed by Northern Ireland Energy Holdings Limited and subsequent similar financings). These projects help generate surpluses to invest in future projects as referred to in the consultation paper.

We look forward to discussing these issues with the Finance Committee.

McGrigors LLP
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