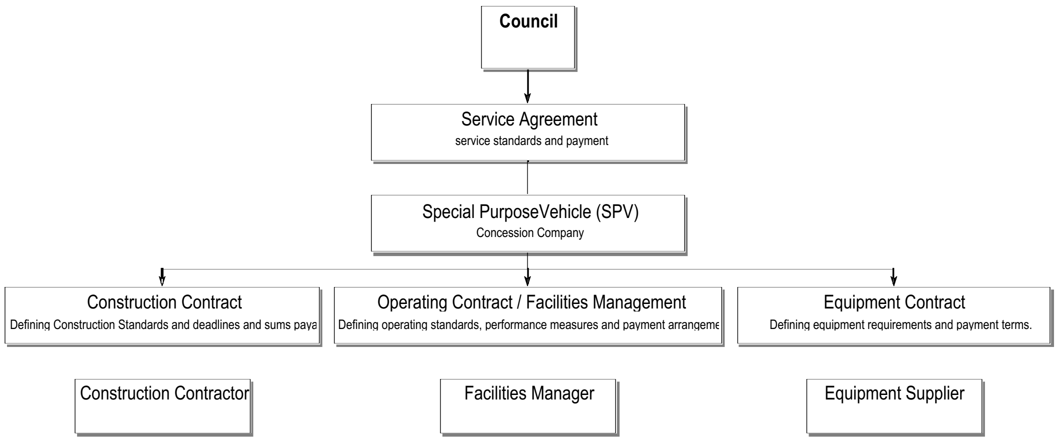
Appendix 2

PFI/PPP Model

Under a typical PPP approach, a capital project is not implemented directly by the Council, but by a private sector partner operating within the terms of a Service Agreement signed with the Council. The private sector partner will normally establish a special purpose vehicle (SPV) as the project Company charged with the responsibility for designing, building, financing and operating schools facilities to serve the Council.

The Contract Structure

A traditional PPP contract structure is shown below –



In a conventional procurement the Council executes various contracts for all the works required for service delivery.

Under a PPP service agreement this is not the case. The Council executes a Service Agreement with a private sector concession company. Under the terms of the Service Agreement, the Council will pay a charge for the agreed services as and when they are delivered.

The Concession Company is responsible for executing and paying for all the contracts necessary to deliver the service, including construction and facilities management (FM) contracts. In some cases elements of the FM contracts may remain in-house and the provider (DSO) will be subject to a separate Service Agreement with the Council.

The risks and responsibilities associated with the design, construction, financing and operation of any assets required for service delivery are thereby transferred from the Council to the Concession Company.

The Council seeks to achieve its goals contractually through the medium of the Service Agreement entered into between the Council and the Concession Company without the Council having any formal involvement in the SPV. The Council's role is to organise the tender process, select a preferred partner and negotiate a detailed Service Agreement setting out the required service scope and standards. The Council's interests, and those of its stakeholders, are protected by the Service Agreement, and the performance management system enshrined in the agreement.

Thereafter the Council's role is to administer the contract and monitor service delivery against the contractually agreed standards.

SPV Financing

Special Purpose Vehicles (SPVs) set up to deliver services under PPP contracts often have high leverages financing structures underwritten by stable cash flows. SPVs are typically funded by 10% equity and subordinated debt (of which typically ½ to 1% is pure equity) and 90% by senior debt.

The reason for this high gearing is that, whereas equity shareholders seek a high return, with the current market rate on PPP equity for schools' partnerships approximately 13.5% in real terms, or 16% nominal after allowing for inflation, senior debt is much cheaper. Current rates for senior debt are around 5%.

The funding costs of an SPV are, therefore, minimized by a funding structure that is heavily dependent on debt.

Conclusions

In conclusion, the key issues regarding the PPP model are:

This method of procurement has been used by councils throughout Scotland since 1997;

During this period, considerable refinement has taken place with regard to the details enshrined within the Service Agreements to protect the public interest;

It has been demonstrated to provide value for money.