

17 September 2018

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The Convener  
Public Audit and Post-legislative Scrutiny Committee  
Room T 3.60  
The Scottish Parliament  
EDINBURGH  
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Dear Ms Marra

### **Weighted Average Cost of Capital**

Thank you for your letter of 1 June 2018 seeking views on Mr Cuthbert's correspondence regarding the evidence I provided at PAPLS Committee on 7 December 2017. As advised to your team, it has taken us some time to reply over the summer given staff resources and the need to extract information from a large number of financial models.

The correspondence relates to the cost of finance, which is one cost component of the NPD and hub programme and we have provided responses to Mr Cuthbert's technical points below.

Firstly, I would like to put that cost component in the context of the full life-time cost of acquiring assets using the NPD and hub Design Build, Finance and Maintain (DBFM) routes. We are keen to maintain transparency of these costs, which are published on the Scottish Government Website<sup>1</sup>. That information provides clarity that the cost of designing, building, financing and maintaining an asset over 25 years has been around 2.7 times the capital value of the asset itself for building projects, excluding the Balfour Hospital which had an anomalous financing arrangement<sup>2</sup>. Whatever measure is used for the cost of the private finance, it remains one component of that total published cost; and is a component which is required in order to deliver the additionality of investment the programmes were established for.

It must always be the case that the life cycle cost of an asset over 25 years, including borrowing costs and the cost of maintaining the asset in good condition, will be higher than simply the cost of building the asset.

SFT has worked with our partners to deliver the best possible life cycle value for money across the programmes by:

- Setting cost and space metrics and sharing of reference designs for schools within the Scotland Schools for the Future Investment programme to demonstrate leading practice in the provision of modern inspiring learning spaces;

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<sup>1</sup> <https://www.gov.scot/Topics/Government/Finance/18232/12308/NPDhubPipelinepayments>

<sup>2</sup> Roads are excluded as they are financed over 30 years, and all figures include a 2.5% RPI inflation assumption

- Benchmarking of capital, life cycle and maintenance costs to support the identification of best value across a range of procuring authorities;
- Introducing different approaches to competition of financing costs across the NPD and hub programmes suited to different project scales and pipelines, and ensuring that project procurers have financial advisors to interrogate financial models and cost of finance at a project level;
- Allocation of funding across local authorities to optimise the use of revenue funding support across local authorities;
- Implementation of a validation approach to provide external challenge at key stages of project development.
- Setting programme level expectations for community benefits and key performance indicators, including for SME engagement across the hub programme

These programme-level approaches have added value and the overall design, build, finance and maintain approach has delivered assets which will be maintained to a good standard for 25-30 years, and the additionality of investment I referred to in my evidence.

The private financing approach adopted was required to deliver additionality of investment, was part of an overall approach designed to optimise life cycle value and was competed and benchmarked to be as keenly priced as the market was prepared to offer.

The weighted average cost of capital (WACC) is the most widely used measure in project finance to provide a snapshot of the overall borrowing rate incurred by a project across the various forms of debt and equity invested. It is relatively simple to calculate and to understand. Therefore, it is the financing metric most readily employed in considering the overall cost of capital and comparing this to other alternative sources. Across the programmes it has been 4.74% as I stated in my evidence.

As Mr Cuthbert identifies, the Project Internal Rate of Return (Project IRR) is a calculation to determine the discount rate that would bring the net annual cashflows across the project life to zero on a net present value basis. Conceptually this can be more difficult to understand. Nevertheless it is also a recognised measure of the cost of capital in a project.

Again as Mr Cuthbert identifies, we can expect the Project IRR's to be higher than the WACC as the WACC is an average at Financial Close and the subordinated debt or 'risk capital' repayment is almost always repaid less quickly than senior debt. It is usually a condition of the senior lender and a feature of the project finance model that a portion of investors risk capital remains in the project company until the very end of the operational period, this provides a level of comfort that the company continues to meet its obligations until handback of the facility. The Project IRR has averaged 5.92% across the hub and NPD programmes.

Neither of these two approaches provide a completely accurate representation of the cost of private finance across the programme for a number of reasons including that:

- In hub, the public sector is an investor in subordinated debt and risk capital meaning that an element of the financial returns accrue to the public sector (rather than going to private investors), and lower the net cost of finance to the public sector;

- In hub, a charity (the Hub Community Foundation) has rights to invest a further 20% into these projects and has used these rights to generate income to fund a charity giving programme. HCF recently announced a £1.3m fund to support 10 charities across Scotland<sup>3</sup>. This public benefit could be considered as an offset to the cost of finance.
- In NPD, surpluses generated over the life of the project will flow to the public sector, rather than adding to private sector profits, thereby reducing the effective cost of finance to the public sector.

Nether of the two measures of WACC or project IRR take account of these effects which serve to lower the overall effective cost of finance for the public sector from the values quoted. However, each is a valid measure in its own right.

In relation to Mr Cuthbert's final point, we do not hold the "weighting factor" suggested and to derive it would require substantial resources. The stated objective is to monitor "whether the differential between the WACC and the project IRR is tending to increase over time" and to that end we propose to update your committee on the average WACC and IRR for all projects in the programme which have reached financial close up to that point in time as part of the regular major projects update. These updates will allow Mr Cuthbert and other interested parties to see whether the differential is increasing, decreasing or static.

Finally, as a part of our commitment to transparency, I would like to draw your attention to SFT's website: <https://contracts.scottishfuturestrust.org.uk/>

This page draws together and publishes the contract documentation for all NPD and hub DBFM contracts, and all of the Financial Models which are outside their period of commercial confidentiality<sup>4</sup>, and states when further financial information will be published.

I trust the Committee finds this response, and SFT's approach to contract publication in the interests of increased transparency, helpful. Please let me know if you have any further queries on this matter.

Yours sincerely,



**Peter Reekie**  
Chief Executive

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<sup>3</sup> <https://www.hcfcharity.org.uk/storage/uploads/hcf-press-release-15-may-2018.pdf>

<sup>4</sup> Scottish Information Commissioner decision 042/2017 upholds SFT's approach of withholding lender rates of return for a period of time.