David Beckett
Office for National Statistics
Government Buildings
Cardiff Road
Newport
NP10 8XG

Room: 1.264
Tel: 01633 456980
Email: David.Beckett@ons.gsi.gov.uk
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Mr. Alistair Brown
Director of Financial Strategy Finance Directorate
Scottish Government
Victoria Quay
Leith,
Edinburgh EH6 6QQ

Dear Mr. Brown,

Classification of the Dumfries and Galloway Royal Infirmary (DGRI) and Royal Hospital for Sick Children (RHSC) Non-Profit Distributing (NPD) projects

As you are aware, the Scottish Government contacted the Office for National Statistics (ONS) to request a classification decision on the above health projects.

ONS has now completed assessment of the classification, and as these projects are being delivered through a Public-Private Partnership (PPP), ONS is required to identify the economic owner of the assets (ie the hospitals) and to establish the nature of the project companies.

The ONS has thoroughly analysed the documentation provided for the DGRI project, culminating in a meeting of the Economic Statistics Classification Committee (ESCC) on 19 October 2016. This meeting considered classification of the project in the context of the internationally agreed rules laid out in the European System of Accounts 2010 (ESA 2010) and the accompanying Manual on Government Deficit and Debt (MGDD). In line with ESCC policy, the meeting considered the rules in the 2014 Manual on Government Deficit and Debt (MGDD 2014) as this was the version of the manual being followed when financial close for the above projects took place (11 March 2015 and 13 February 2015 respectively).

The Scottish Government has also indicated that they would expect to apply the classification decision reached for the above hospital projects, to be applied to the Scottish National Blood Transfusion Service project. This project followed the same model and reached financial close on 8 October 2015.

Following a long and detailed discussion, which included the Committee assessing the similarities and differences between this revised NPD model and the original NPD model that was used for classifying the Aberdeen Western Peripheral Route (AWPR) in July 2015, the Committee reached the following conclusions:

1. That High Wood Health Project Co. Ltd (DGRI ProjectCo), High Wood Health HoldCo and High Wood Health Finance Co (the Issuer), on balance, be treated as a single institutional unit for practical purposes ("the Obligator"). This is due to the "stapling arrangement" and the sharing of directors between the legal units, which means that they cannot take decisions independently of each other.

2. That although a number of public sector influences exist (through the Authority) these are insufficient to indicate public sector control and the Obligator should be classified as a captive financial institution controlled by the private sector. As such, it should be recorded as a Private Financial Corporation – see ESA 2010 2.65 (f).

3. The decision in 2. above was primarily arrived at due to the lack of The Authority/Scottish Ministers' control over the corporate policy of the Obligator. In the original NPD project model, used for AWPR, the ProjectCo (the SPV) was deemed to be controlled by the Authority through vetoes over key aspects of its activity and was subsequently classified as a Central Government unit - see ESA 2010 2.27. However, in the case of DGRI and RHSC, an Independent Expert (not employed by, or providing services to the Authority, Scottish Futures Trust or any shareholder in HoldCo) will be appointed to exercise the vetoes instead of these being controlled by the public sector. Even though the ProjectCo Articles still retain the key objective for the directors to achieve maximum sustainable profits available for surplus payments to the Authority through reduced unitary charges, the Committee decided that this objective was not supported by actual Authority management controls (like the vetoes) over the Obligator's implementation of this objective. Moreover, the Committee noted that the relevant Article was part of the conditions of the contract being offered, and could therefore be understood as an implementation of the requirements of the contract.

4. That the assets involved (the hospitals) should be recorded on the government balance sheet. This is because, as with the AWPR project, certain rewards associated with economic ownership of the asset accrue to The Authority. Specifically, all surpluses generated by the ProjectCo SPV are passed to the authority, as well as a significant share of any senior debt refinancing gains. Furthermore, Clause 7 of the SPV Articles expressly provides that an objective for the directors is to "achieve the maximum sustainable profits available for making surplus payments" which go to The Authority, through abated unitary charges, and it is foreseen that such surpluses will be generated. This was taken as a clear indication of the Authority commanding a share of the economic rewards related to the ownership and operation of the asset. In addition, the Authority can claim a stated proportion (in all cases above 50%) of any refinancing gains from the project. While, unlike in MGDD 2016, the applicable MGDD 2014 guidance does not specifically identify this as an indicator of a PPP's assets being on the government balance sheet, it is still captured within the general category of economic rewards from the asset. As a result, ESCC judged that the private sector did not have economic ownership of the asset and so the asset should be recorded on the government balance sheet.

Limitations to this advice

This advice relates only to this case as outlined and understood by ONS at this time. If there are any changes to the project structure, or if additional Authority controls are added, please ensure that ONS are notified.

Eurostat has the right to review any ONS classification decisions and PPPs are of particular interest to them at this time. As such Eurostat may decide to perform its own assessment and could reach a different decision.

I trust this provides sufficient explanation of the decision reached. Please do get in touch if you have any questions or comments.

Yours,

David Beckett