Report on Capital Funding Models

September 2024

1.0 Context

The Scottish Funding Council (SFC) published its College Infrastructure Strategy (CIS) in November 2022. SFC are working on the delivery plan for the Strategy, including the funding and financing options for investment in college infrastructure.

SFT, through its role supporting Scottish Government Infrastructure Division was historically involved with the College sector on revenue funding for three major new colleges. The three projects formed part of the wider NPD programme managed by SFT. SFT provided the associated support for the college asset disposals for these projects and a number of additional ad hoc projects. SFT has also worked with SFC where a number of college and universities have undertaken projects through the Non Domestic Energy Efficiency framework for capital funded projects or using financial transactions for energy and energy efficiency related projects.

SFT's Real Estate Team also works with SFC and specific colleges (City of Glasgow, Ayrshire, Inverness and currently Fife College) on disposal strategies for the sale and reuse of surplus assets, reducing ongoing liabilities associated with these and unlocking capital receipts (which can then be reinvested in the sector).

SFC has asked SFT to produce a funding and financing scoping paper to inform SFC's work in developing a delivery plan for the College Infrastructure Strategy. The following paper sets out the Scottish Government funding and financing mechanisms for capital investment in infrastructure, and some high level considerations for SFC to take forward in considering their applicability to the College sector.

2.0 Key principles underpinning the funding and financing of colleges infrastructure investment

Funding

Any asset ultimately has to be paid for (or "funded"), either as it is built or as it is used. Funding for infrastructure assets comes either from public sector budgets, or from "customers" in the form of user / occupier / developer charges. As public bodies, the College infrastructure is ultimately taxpayer funded from public sector capital or resource budgets.

Financing

If an asset is paid for as it is used, a form of “finance” (which comes with an expectation of repayment) can be raised to build the asset. Financing of the asset can be raised either as public sector financing or private financing.

Colleges and financial borrowing powers

Any specific circumstances for colleges borrowing from the Scottish Government would be within the budget set for Colleges by SG and will be set out in the framework arrangements for SFC/College bodies.

Our understanding is that Colleges sit in the public sector, they cannot raise extra finance for capital spending through borrowing. This differs to local government sector who can borrow to finance capital expenditure under the prudential borrowing regime from the Public Works Loan Board, the UK Infrastructure Bank and other commercial banks. This also differs to the universities which are charitable companies and classified to the private sector who can also access external finance. The ability to raise investor finance from by any public or commercial body requires the investor to have confidence at the outset that there will be future income streams that to repay the finance.

Raising finance through income generation

Our understanding is that the governance around generation and retention of income sources from colleges will be covered by the framework agreement between Scottish Government and SFC/Colleges such as realising income from the disposal of an asset (covered further in the report below on asset leverage). The ability to raise income for infrastructure funding in the sector through tuition fees is a policy matter out with the scope of this report. Other sources that public bodies have started to consider are income generation through renewables generation and selling of electricity. This would require specialist commercial input to understand any potential opportunity and vires/classification risk (below) for colleges.

Classification

Colleges are classified as public bodies in Scotland. The Office for National Statistics rules for ‘classification’ impact on infrastructure investment consideration. If the infrastructure investment scores against capital budgets (in other words, is “on balance sheet”), then this reduces funds available to be spent elsewhere in the public sector.

If an college infrastructure investment approach successfully draws in finance from institutional debt or equity in a project, for example through a Special Purpose Vehicle under a Private Finance Initiative style of contract, it is the analysis of the risk allocation, control and ownership

over the infrastructure that will determine classification and not whether the source of finance comes from outside the public sector. For this reason, alternative financing mechanisms to draw in private finance or income from third parties, often seen as an attractive approach by public bodies to increase infrastructure investment, require specialist diligence to consider the classification risk. For example a privately financed project constructed through a special purpose vehicle with private sector equity that demonstrates risks and controls remaining with government such as the appointment of majority of directors on a board, majority risk capital investment, or acting as a guarantor for loan repayments, is likely to still require capital budget cover for the asset.

Collaboration

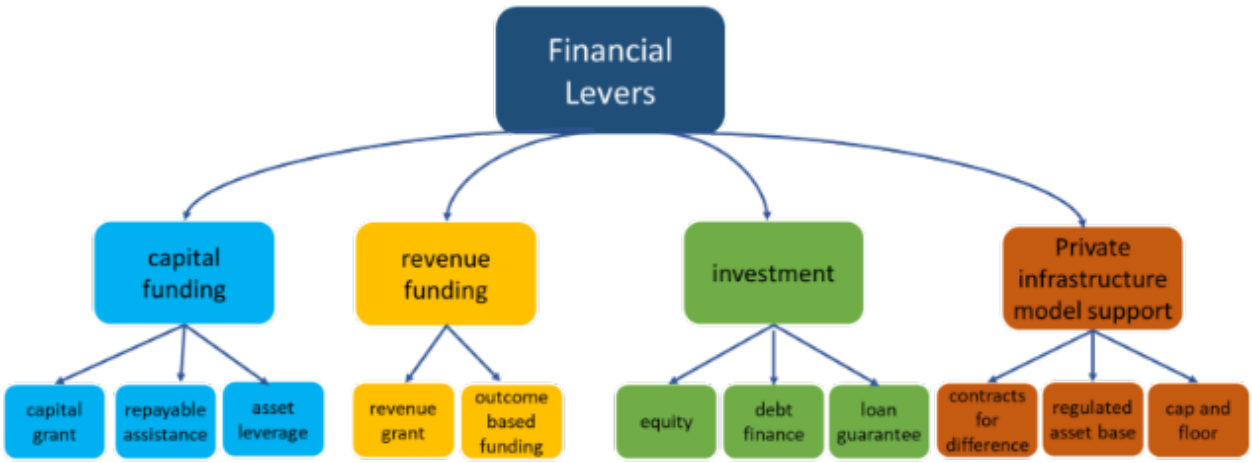
The focus of this report is funding and financing levers. Many organisations are facing similar infrastructure challenges. The opportunity to collaborate with other organisations in 'places' may also provide a route to leverage such as sharing of assets to reduce the overall cost of infrastructure to the public purse. The significant opportunity to do this might with other public buildings in an area owned by the local council offices, schools, community facilities, blue light services or health facilities.

Colleges along with health facilities and schools and community facilities may also create demand loads for EV charging or heat networks in an urban area which alongside other private or third sector organisations could provide innovative ways of developing a demand case to support the roll out of heat networks. Whilst not the focus of this report, the ability to develop the relationships with other local owners and tenants is a useful first step towards innovation around the investment and use of infrastructure in a place.

3.0 Commercial models/levers for Infrastructure Investment

The diagram below illustrates a broad range of investment models/levers that are used by the Scottish Government for infrastructure investment. Each model has risks and opportunity costs and therefore consideration of the key principles above are required as well as considering the underlying business case for investment. Not all of these levers will be applicable to the college sector although they are often referenced in relation to infrastructure and therefore included for completeness.

Where a model is less applicable for public bodies such as Colleges, this is also noted below.



3.1 Capital Funding

3.1.1 Capital grant

Capital grant through Scottish Government CDEL award is well understood as the primary method for paying 'taxpayer' funded infrastructure such as Colleges.

Scottish Government uses its block grant from UK Government as well access to its borrowing powers to fund CDEL awards. The governance for infrastructure investment in Scotland including allocation of capital grant to portfolios sits with Scottish Government.

In addition to the allocation of capital to the portfolio there have been some capital grant funds which can also be accessed by public bodies for decarbonisation which may support the Colleges infrastructure investment planning. These include the Green Public Sector Estates Decarbonisation Fund and the Non Domestic Energy Efficiency Fund (NDEEF). These are managed through the Scottish Government Heat Division team as part of the Energy and Climate Change portfolio. It is worth noting that the NDEEF closed in March 2024 and is currently being reprocured. (Public sector decarbonisation - Energy efficiency - gov.scot (www.gov.scot))

3.1.2 Repayable Assistance

Repayable Assistance is the delivery of capital grant by Scottish Government with performance related conditions and is more typically used to pump prime privately or jointly owned infrastructure where future revenues generated might enable some repayment eg for heat network schemes.

The Heat Network Fund (Public sector decarbonisation - Energy efficiency - gov.scot (www.gov.scot)) that is managed by government's Heath Network Support Unit (Home - Heat Network Support Unit) is a current example of grant funding to pump prime privately or jointly owned infrastructure for heat network schemes with contact details at the addresses included.

3.1.3 Releasing value from the existing college estate

Releasing value from the existing college estate – the sale of surplus assets (either resulting from investment elsewhere in the estate/new facilities or changes in the college delivery model) provides an opportunity to reduce ongoing costs and liabilities and also to unlock capital receipts from the sale of sites/buildings to the private sector or potentially other public bodies.

The value of these will vary considerably across the college estate linked to issues such as scale, location, potential for conversion or redevelopment, market appetite and planning context. An early assessment of the potential of sites and the associated steps (including potential up front work) and timescales associated with realisation of value is a key requirement. There may also be specific opportunities for colleges to use their assets as leverage to bring private sector investment into their estate without the need for additional revenue funding.

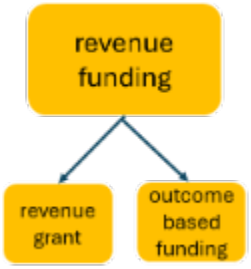
Applicability to the College Sector

The SFC assumption for this paper is that Colleges remain in the public sector and therefore **capital funding** will remain the primary route for infrastructure investment in the college sector.

An ongoing understanding and monitoring of the government's governance for infrastructure investment remains necessary to best position the college sector.

There may be some bespoke opportunities for leverage in the existing estate where value can be identified in the estate and a route to realising the value within the sector as set out.

3.2 Revenue Funding



3.2.1 Resource Grant

Resource Grant, in the context of funding college infrastructure investment, is used to fund the investment over the period of use of the asset.

Under public private partnership arrangements for infrastructure investment, such the Non Profit Distributing model, resource grant is used to fund the monthly payment to a private sector partner over a period of approximately 25 years. The performance related monthly payment is for the delivery of a maintained building to a specific service specification. The payments are inclusive of the private partners design, financing, delivery and maintenance costs for the asset.

The NPD model, and its predecessor the Project Finance Initiative are no longer in use by the Scottish Government as options for delivering infrastructure and funding investment through revenue funding.

The successor delivery model which shares similar characteristics is the Mutual Investment Model. The Scottish Futures Trust report on MIM and the characteristics of projects suitable to MIM is here options-appraisal-model (scottishfuturestrust.org.uk)

Scottish Government adopted MIM as part of its infrastructure investment toolkit in 2019. The model has not been deployed to date. Whilst further diligence on market interest and size/nature of a pipeline of investments would be required, MIM would theoretically lend itself to replacement or new standalone college buildings (as NPD did for City of Glasgow, Ayrshire and Inverness Colleges). MIM is less suitable for refurbishment projects due to the risk profile.

The Welsh Government are currently using MIM to deliver a road, a health project and learning estate infrastructure. In addition to a small number of schools projects, there is currently a College in Cardiff under preparation for delivery using the Welsh version of the MIM model.

3.2.2 Outcomes based funding

Outcome based funding is also a resource grant based mechanism for infrastructure investment delivery. It has been used to both deliver tax payer funded infrastructure and as a lever to encourage private investment. Typically this mechanism has been used by public bodies who

can access finance upfront to deliver the outcomes and unlock funding. Noting that colleges cannot raise finance outside of SG, there would still be a capital grant requirement to cover the upfront investment in college assets to unlock additional outcomes funding delivered by the assets.

Example 1

Infrastructure Investment in the public sector – Learning Estate Investment Programme

Under this approach the Scottish Government awards resource grant for the achievement of outcomes in relation to ongoing good condition of learning facilities, energy efficiency, digital connectivity, economic growth and embodied carbon. The outcomes are achieved by the local authority delivering the underpinning infrastructure investment and performance to achieve the outcomes and receive the revenue payments. The upfront investment can be funded by capital reserves or through the local authority raising finance eg via Public Works Loan Board.

Example 2

Infrastructure Investment in public/private sector – Growth Accelerator Model

The local authority invests in a range of infrastructure assets to attract additional private investment alongside in infrastructure such that economic outcomes can be delivered. SG awards resource grant for the achievement of these outcomes which are bespoke to the project but could include increased employment, training opportunities, targets for increased passenger numbers in a port. The upfront public investment can be funded by capital reserves or through the local authority raising finance eg via Public Works Loan Board and is alongside the private sector investment. Examples include the Dundee Waterfront, the St James Quarter, Stornaway Deep Water Terminal.

Example 3

Tax Incremental Finance

Local authorities borrow to pay for enabling infrastructure that will catalyse private sector development and unlock additional future business rates. Local authorities are granted the right to retain incremental business rates, which are ring-fenced over a 25-year period and used to repay the initial borrowing. Local authorities therefore accept the risk of private sector development occurring (upon which the hypothecated incremental tax revenues depend).

Applicability to the College Sector

OBF appears less relevant for the sector as it would not provide ‘additionality’ over capital budget given Colleges are unable to borrow therefore capital would still be required upfront to deliver outcomes.

For new build college assets, **revenue funding** through the use of the Mutual Investment Model could provide additionality over the current available capital grant for investment in colleges. MIM requires a long term commitment to government repayment (pay as you use). The use of the MIM is governed by Scottish Government who has not confirmed whether it will deploy the model.

3.3 Investment

This section focuses on financing mechanisms rather than funding. In all options, the funding to repay the investment tools or meet a potential call on a guarantee should be considered.

3.3.1 Equity and Debt Finance

Scottish Government capital funding can also be used to invest in infrastructure indirectly through equity and debt finance. Investment differs from grant as Scottish Government in its investor capacity would seek to make a return on an investment through some combination of interest received, dividends and fees.

The route for infrastructure investment would typically be through a Special Purpose Vehicle. The vehicle holds the project assets and sub contracts the delivery and maintenance of the asset. They allow for project assets and risks to be isolated within the vehicle, and for investors to target their investments into specific asset classes with a risk/return profile consistent with their investment criteria. SPVs are usually established as companies limited by shares, though other corporate vehicles can be used.

There are a number of reasons why public sector bodies may wish to become investors in an SPV – whether wholly owned by the public sector or jointly owned with the private sector. Becoming an investor in an SPV provides a degree of control (proportionate to the shareholding held by the public sector body), and therefore an ability to influence, via the entity's governance structure, the strategic direction of the company. It also carries the right to share in profits made by the company, and the risk of losing some or all of the public body's investment in the SPV. Scottish Government can invest in SPVs, either directly, or indirectly via an investment fund established for this purpose).

In the College sector, under the NPD programme route for delivering college buildings, all equity and debt finance in the Special Purpose Vehicles established was owned by the private sector. Under the Mutual Investment Model, SG would own up to 20% (most likely <15%) of the equity and debt finance in the SPV holding the project assets.

Financial Transactions

In recent years, the Scottish Government has received sums from the UK Government known as 'Financial Transactions' (FTs). This is a form of Debt Finance available to the Scottish Government for investment. FTs can be on-lent to a private sector entity owning and / or developing assets as all or part of its financing structure for the project.

In general this finance would have to be lent or invested at a commercial rate of return in order to satisfy Subsidy Control rules. As public bodies it is our understanding the Colleges cannot on lend FTs however these have been used in the university sector. FTs are the main source of capital for Scottish National Investment Bank (SNIB) who lend to the private sector aligned to their missions.

3.3.2 Loan guarantee/Leasing

A Loan Guarantee can be offered by Scottish Government to provide a guarantee over debt repayments to a bank or other finance provider. The guarantee could cover the whole loan or a proportion of it. The intention is to lower the cost of capital for the borrower (e.g., asset developer / investor) sufficiently to allow them to make an investment and potentially to enable access to loans which otherwise, due to the risk profile of the investment, would not be available.

A Loan Guarantee generally has limited budgetary and accounting implications at inception, as long as the risk of it being called upon is low. This will continue to be the case until such time that it becomes likely that it is to be called upon. There are, however, Subsidy Control considerations arising from the provision of a guarantee to a private sector supplier.

The UK Infrastructure Bank operated the UK Guarantees Scheme, which has been used on three projects in Scotland (shale gas import and storage at Grangemouth, Speyside CHP plant and Countesswells Housing development).

Typically loan guarantees have been used for privately owned infrastructure.

An example of guarantees in the college sector was the financial guarantee from government to sit behind the potential default of a college on the payment of its NPD unitary charges to the private partner.

Leasing

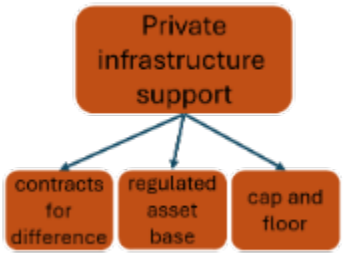
In recent months SFT has seen institutional funders offering structures with loans to public bodies where the public body uses the loan to make the infrastructure investment (ie procuring and delivering the asset using private finance). The investor seeks a long term guarantee for the loan repayments backed by government. Whilst the guarantee itself (should it pass Subsidy Control rules) may not score to the balance of Scottish Government, a call on the guarantee would. Furthermore, the structure would see almost all risk and controls over the asset sitting with the College/Scottish Government and therefore the asset being classified to the public sector and requiring capital budget cover.

It is our basic understanding that the asset would be 'paid for' through a monthly lease cash payment but the accounting and budgeting would see capital required upfront for the value of the asset and revenue budget over the lease period for the interest element. This is in addition to any budget requirement such as the fee for the guarantee at SG level.

Applicability to the College Sector

Linked to the release of value from the existing estate, some of the financial levers for investment described here may be applicable for the college sector. These are likely to form part of a bespoke commercial structure rather than a widely used instrument for college infrastructure investment and should be considered on a case by case basis with professional advice and consideration on the government balance sheet (classification) position.

3.4 Private Infrastructure Investment Support



This section covers several of the most commonly used, business model support mechanisms for private or regulated infrastructure in the UK such as telecoms, water, electricity where powers are reserved.

These types of infrastructure investment support levers are not exhaustive and not considered relevant to infrastructure investment in the college sector. They may have an interface should they be subsequently used by government to support heat infrastructure assets and hence referenced briefly above.

SFT note to recipient

This scoping paper has been prepared by Scottish Futures Trust on a non-reliance basis and thus is not advice.

It does not absolve any recipient or user from its responsibility to conduct its own investigations and procure its own advice as to the validity and viability of the funding and financing concepts contained.

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