SCOTTISH HOSPITALS INQUIRY

Provisional Position Paper 10

Term of Reference 2: The Contractual and Funding Structure Relating To The Royal Hospital for Children and Young Persons/ Department of Clinical Neurosciences Project

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Glossary

Bouygues	Bouygues Energies & Services FM UK Limited, the facilities management contractor appointed by IHSL. See section 6.
CAMHS	Child and Adolescent Mental Health Services. One of the units for the provision of such services by NHSL, known as the Melville Unit, is located in RHCYP.
Capital expenditure	Spending by a public authority from its own financial resources that produces or enhances an asset such as hospitals, schools or roads. Also referred to as "capital spending" or "spending from the capital budget".
CIG	Capital Investment Group. The Scottish Government Capital Investment Group oversees the approval process for business cases across NHS Scotland where the value of the capital project is greater than the Board's delegated limit.[1]
DCN	Department of Clinical Neurosciences
FBC	Full Business Case; see section 5
IHSL	IHS Lothian Limited, the SPV/ Project Company established to carry out the RHCYP/ DCN project.

[1] For further details see here: https://www.pcpd.scot.nhs.uk/Capital/Approval.htm.

MSFM	Management Statement and Financial Memorandum of Scottish Futures Trust; see paragraph 3.3.3.
Multiplex	Brookfield Multiplex Construction Europe Limited, the construction contractor appointed by IHSL. See section 6.
NHSL	NHS Lothian Health Board
NPD	Non-Profit Distributing. See fuller discussion in section 3
OBC	Outline business case. The Outline Business Case identifies the preferred option for implementing a strategic / service solution, demonstrating that it provides value for money and the supporting commercial and management arrangements to be put in place to successfully implement that option. It is a key stage in the approvals process for projects.[2] See section 4.
PA	Project Agreement – the agreement between NHSL and IHSL dated 12 and 13 February 2015 for the design, build, finance and maintenance of the new RHCYP/ DCN building at Little France.
PFI	Private Finance Initiative – see paragraph 3.2.1
PPP	Public Private Partnership - see paragraph 3.2.1

[2] Further details can be found in the Scottish Capital Investment Manual: https://www.pcpd.scot.nhs.uk/Capital/scimpilot.htm.

Revenue expenditure	Expenditure by a public authority on its day-to-day operations. This type of expenditure does not normally lead to the creation of an asset (see capital expenditure above).
RHSC	Royal Hospital for Sick Children – the predecessor to the Royal Hospital for Children and Young Persons
SFPA	Standard Form Project Agreement – see paragraph 3.6.1
SFT	Scottish Futures Trust – see paragraph 3.3.3.
SGHSCD	Scottish Government Health and Social Care Directorate
SPV	Special Purpose Vehicle. The project company set up specifically for the purpose of carrying out a project under the NPD model (and most other privately financed contract models). Sometimes referred to as the “Project Company” or “Project Co”.

1. Introduction

1.1 Purpose Of This Paper

1.1.1 This Provisional Position Paper has been produced to assist the Chair in addressing the terms of reference of the Scottish Hospitals Inquiry, specifically term of reference 2:

> **"**To examine the arrangements for [the]…contractual structure adopted for the financing and construction of the buildings, to determine whether any aspect of these arrangements has contributed to such issues and defects [as are subject to the Inquiry's investigations]."

1.1.2 For the purposes of this paper, the "issues and defects" subject to the Inquiry's investigations are those in relation to the adequacy of the ventilation system at the Royal Hospital for Children and Young People and Department of Clinical Neurosciences (RHCYP/ DCN) in critical care areas that gave rise to the decision on 4 July 2019 that the move of services from the Royal Hospital for Sick Children to RHCYP/ DCN should be halted.

1.1.3 The paper outlines the Inquiry Team's understanding of the contractual structure, the financing model adopted and the structure and the financing arrangements that were put in place in relation to the RHCYP/DCN project. It follows on from a draft that was distributed to core participants with knowledge of the contractual and financial structures in relation to that project. Comments were provided by all, namely IHS Lothian, NHS Lothian, the Scottish Futures Trust and the Scottish Government.

1.1.4 The Inquiry has carefully considered the comments received, together with the supporting material submitted and other material held by it. It has reviewed and revised the draft accordingly to produce this Provisional Position Paper.

1.1.5 As a result, the views expressed in this Paper are firmer than those set out in the draft. It follows that the Chair will be invited by the Inquiry Team to make findings

in fact based on the content of this paper. However, while the views may be firmer, that should not be equated with “final”. The Inquiry’s investigations are not yet concluded and, at the time of publication, there is to be a hearing dealing with matters arising in relation to the Royal Hospital for Children and Young Persons/ Department of Clinical Neurosciences commencing on 26 February 2024. Evidence at that hearing and submissions made following it (as well as any other evidence received) may require the Inquiry to reconsider matters set out in this paper. Nonetheless, in the absence of such evidence or submissions, it is likely that the contents of this paper will be used as a basis for the Inquiry’s report.

1.1.6 It should be noted at the outset that this paper looks at the contractual structure and financing arrangements at a general level, and the comments made herein should be read on that basis. It therefore follows that nothing in this paper supersedes any specific comments made in relation to particular parts of the contractual structure and financing arrangements made by the Inquiry elsewhere.

1.2 Provisional Conclusions

1.2.1 On consideration of the material that it has (including comments received on the original draft), the Inquiry would provisionally conclude that there is no evidence that in and of itself the contractual structure for the financing and construction of the buildings adopted in relation to the RHCYP/ DCN project directly contributed to the issues that arose in relation to RHCYP/ DCN that are the subject of the Inquiry’s investigations. It is important to clarify exactly what is meant by this.

1.2.2 Firstly, the issues that arose in relation to the RHCYP/ DCN project that are of interest to the Inquiry are, in the words of Term of Reference 1, ““issues in relation to adequacy of ventilation…adversely impacting on patient safety and care which arose in the construction and delivery of…RHCYP/DCN”. That should not be taken as reflecting a conclusion that no other issues or defects arose or exist in relation to the RHCYP/ DCN building. The Inquiry has published another provisional position paper dealing with some of the other issues that arose in relation to the building.[3] However, for present purposes the provisional conclusion set out above may

[3] Provisional Position Paper 7 – non-ventilation issues

perhaps be re-phrased as being that “the contractual structure adopted for the financing and construction of the buildings did not contribute to the issues arising in relation to, and any defects in, the ventilation system at RHCYP/ DCN.”

1.2.3 Secondly, this paper, and the provisional conclusion set out above, relates to the generality of the contractual structure. The question for consideration is were the relationships between the various parties, and the arrangement and organization of those relationships, as set out in the contractual documents in some way a contributory factor to the issues and defects that arose in relation to the project. This paper, and the conclusion, relates to the formal legal structure adopted for financing and construction.

1.2.4 Thirdly, there is evidence that the complexities of the contractual and financial structure made finding solutions to issues that arose during the project more challenging. It will be evident from what follows in this paper that NPD is a very complex structure with many organisations having a role and interests that are not always necessarily aligned. In this, the NPD model is not significantly different from the other variants of PFI/PPP (see discussion in Chapter 3). However, the Inquiry has been informed that delivering the rectification works to the ventilation system to enable the hospital to open was more challenging because of the nature of the NPD model.

1.2.5 It therefore follows that this paper, and the conclusion set out above, does not relate to matters such as how those relationships worked in practice; nor does it relate to the interpretation and application of specific provisions of the contract relating to for example the standards that the ventilation system to be installed in the buildings. Similarly, matters such as any claimed incompatibility between the NPD model and technical guidance applicable to healthcare projects are outwith the scope of this paper.

1.2.6 A supporting provisional conclusion is that the contractual and financial structure followed both the applicable guidance and what was, at the time, accepted practice. The basic structure, the allocation of risk within that structure and the financing arrangements as set out in the project agreement and other documentation initially entered for the purposes of the project were in line with what might have

been expected. The risk allocation and financing arrangements were varied during the project, and the changes are noted in sections 8 and 9 of this paper. It should be stressed that this paper deals only with the changes to the financing structure made by the agreements dealt with in those sections, and does not deal with broader questions as to the manner in which the terms of those agreements dealt with the ventilation issues that are the subject of the Inquiry's investigations.[4]

1.2.7 Given these provisional conclusions, the matters covered in this paper are dealt with relatively shortly. While the Inquiry invites corrections or clarifications of the matters set out in this provisional paper generally, a specific issue on which it invites comment is whether there is evidence that would contradict the factual basis set out below or the provisional conclusions set out above. The Inquiry will consider any evidence submitted that purports to displace the provisional conclusions.

1.3 Structure Of This Paper

1.3.1 The next section of this paper sets out the evolution of the arrangements for the financing of the project, from which it will be apparent why this paper focuses on the NPD model of procurement. The paper then sets out the background to, and a description of, the non-profit distributing (NPD) model of financing and procuring public infrastructure before moving on to describe how NHS Lothian sought to implement that model in the specific context of the RHCYP/ DCN project. It looks at the structure of both the project agreement and the various financing agreements that were put in place. The contractual payment mechanism is then examined before, as noted above, dealing with the implications of later agreements on the matters dealt with in the paper.

1.4 Capital Expenditure vs Revenue Expenditure

1.4.1 A recurring theme in this paper is the distinction between capital expenditure (capital spending, spending from the capital budget) and revenue expenditure (revenue spending, spending from the revenue budget). This paper is not concerned

[4] On which see Provisional Position Paper 8 - Narrative concerning the Construction Phase of the Royal Hospital for Children and Young People and the Department of Clinical Neuroscience.

with the intricacies of public sector finances as they existed during the project (or today). However, given that the expressions are used frequently in this paper a brief explanation is in order.

1.4.2 Capital expenditure is expenditure from a public authority's own resources that results in the creation or enhancement of an asset. In the public sector this is normally a hospital, a school, a prison or a road for example.

1.4.3 Revenue expenditure is expenditure from the authority's own resources for the purposes of the day-to-day operations of that authority that does not normally result in the creation of an asset. A simple example of revenue expenditure would be the wages and salaries of staff.

1.4.4 At a very high level, during the events narrated in this paper, expenditure by public authorities was categorised as being either "revenue" or "capital". Traditionally, construction of a new hospital would be an item of capital expenditure. However, methods of using private finance to meet the costs of construction (discussed in section 3) enabled the costs of construction to be met from revenue expenditure, essentially by spreading those costs over a period of time during which the company contracted by the authority would operate and maintain the hospital (and be paid for doing so). This enabled classification of the expenditure as revenue payments for a "service" (i.e., the operation and management of a facility made available to the public authority) rather than simply construction. This in turn enabled the Scottish Government to fund additional infrastructure investment. This is because using these contracts means construction costs are not charged up-front against its capital budget or met from capital borrowing.[5]

[5] Audit Scotland, Privately Financed Infrastructure Investment p.13 The accounting treatment of privately financed projects changed in 2014 – see section 3.7

2. Evolution Of Financial Structure Of The RHCYP/ DCN Project

2.1 The evolution of the financial structure for delivery of the Royal Hospital for Children and Young Persons/ Department of Clinical Neurosciences project is, briefly, as follows.

2.2 Agreement by the Scottish Government Capital Investment Group (CIG) for NHS Lothian (NHSL) to proceed to develop an outline business case for the reprovision of the Royal Hospital for Sick Children (RHSC) was given on 21 June 2006. Thereafter, an initial outline business case for a replacement for the Royal Hospital for Sick Children (RHSC) was originally approved by CIG in August 2008, though it subsequently went through various iterations until being finalised on 27 September 2012.

2.3 The reprovision of the RHSC was originally envisaged as being delivered through the Health Facilities Scotland framework as a design and build project.[6] This approach would have meant that the entire cost of the building of the new hospital would have been funded directly by the Scottish Government as an item of capital expenditure.

2.4 An initial proposal for the re-provision of the Department of Clinical Neurosciences (DCN) was approved by the Scottish Government in July 2008. This allowed NHSL to develop an outline business case and options appraisal for the redesign and re-provision of DCN in Edinburgh. That initial outline business case was approved by NHS Lothian (NHSL) in December 2009, but did not proceed to Scottish Government for approval because of issues relating to the availability of capital for the purpose of funding that project. The preferred option set out in that initial outline business case was a joint RHSC and DCN build at Little France.[7] The

[6] OBC paragraph 1.4.
[7] OBC paragraph 1.3.

rationale for a joint build was "the opportunity to deliver economies of scale in clinical departments with high-tech and high-cost equipment such as radiology and operating theatres. While patient pathways do not cross in these areas, staff pathways are made more efficient by co-location of the RHSC, CAMHS and DCN components."[8]

2.5 The Scottish Government Draft Budget for 2011 – 12, published in November 2010, announced that both projects would be delivered using the Non-Profit Distributing (NPD) revenue funded model.[9] This decision was taken against a background of lack of availability of capital funding to meet the cost of this project (and others).[10] This represented a fundamental change to the procurement method for the project[11] that gave rise to some concerns on the part of NHSL[12]

2.6 Those concerns notwithstanding, in March 2011 NHSL submitted a Business Case Update to supplement the outline business case in respect of RHSC and the DCN Initial Agreement to the Scottish Government, setting out the options for delivering both re-provision projects on the Little France site using an NPD procurement route. This update identified a joint build of RHSC and DCN as the preferred option for the project. The Scottish Government gave approval to develop an OBC for this project in July 2011.[13]

2.7 The Outline Business Case for the preferred option using the NPD route was approved by NHS Lothian Board on 25 January 2012 for submission to the Scottish Government. NHSL received confirmation from the Scottish Government of the

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[8] OBC paragraph 1.17; on the rationale generally see paragraphs 1.13 – 1.17.
[9] Scottish Government, *Scotland's Spending Plans and Draft Budget 2011-12* Chapter 8 Health and Wellbeing, What the Budget Does section: "We will also ensure the delivery of a range of other health projects, including the Royal Sick Children's Hospital and Department of Clinical Neurosciences in Edinburgh through the NPD approach outlined in chapter 3.": The project is also mentioned in the "New investment financed through the Non-Profit Distributing model" table in Chapter 3.
[10] See *Scotland's Spending Plans and Draft Budget 2011-12* Chapter 3. See also Written statement of Susan Goldsmith paragraph 10.
[11] OBC paragraph 1.5
[12] Written statement of Susan Goldsmith at paragraph 11; Transcript – Susan Goldsmith – 17.05.2022 at column 26 onwards.
[13] OBC Paragraph 1.6.

approval of the OBC on 18 September 2012. The Outline and Full Business Cases are discussed further at sections 4 and 5 below.

2.8 From that point, the project proceeded as an NPD project. Accordingly, the contractual and financial structures adopted for the financing and construction of the RHCYP/ DCN project is determined by that model. The next section of this paper provides a general description of the non-profit distributing (NPD) model of financing and procuring public infrastructure generally, before turning to how NHSL sought to apply the principles of the NPD model in its outline and full business cases for the project and the ultimate contractual and financial structure adopted.

3. The Non-Profit Distributing Model Of Financing Infrastructure

3.1 Paying for Infrastructure

3.1.1 In general, governments can fund public infrastructure projects from its own money (usually referred to as using the capital budget), borrowing, or using private finance. It was considered at the time that the last named was the best option.

3.1.2 The Scottish Government had no power to borrow for the purposes of capital expenditure until 12 December 2014.[14] Accordingly, that route was not open at the time.

3.1.3 The Scottish Government capital budget was under considerable pressure. Scotland's Spending Plans and Draft Budget 2011 – 12 stated:

> "Under the current funding arrangements for Scotland, the pace at which the Scottish Government can implement its infrastructure plans largely depends on the allocation of capital budgets from HM Treasury at each Spending Review. …As a result of the decisions taken by the UK Government in the 2010 Spending Review, the capital budgets available to the Scottish Government will fall by 36 per cent in real terms by 2014-15 compared to the current financial year (2010-11). …This scale of reduction…will inevitably slow the pace of implementation of the Government's infrastructure programme."[15]

[14] The date on which section 32 of the Scotland Act 2012, allowing borrowing by the Scottish Ministers subject to HM Treasury's controls and limits. See also Audit Scotland, Privately Financed Infrastructure Investment at p. 8.

[15] Scotland's Spending Plans and Draft Budget 2011-12 (webarchive.org.uk), Chapter 3, The Outlook for Capitals Budgets section. For (critical) commentary on budgetary drivers behind the use of private finance see, for example, Hellowell and Pollock, Non-Profit Distribution: The Scottish Approach to Private Finance in Public Services, Social Policy and Society Volume 8 Issue 3 (2009) p.406 - 408

3.1.4 The document went on to note that "funding infrastructure investment through public capital ensures the lowest cost of finance for a typical project".[16]

3.1.5 Thus, in the absence of borrowing powers of its own, the Scottish Government therefore proposed to turn to private finance to provide the funds required to construct the RHCYP/ DCN. At the risk of oversimplification, at the time, if resort was not had to private finance, the project would not have taken place as planned.

3.2 Private Finance Initiative (PFI)

3.2.1 Use of private finance in infrastructure projects in Scotland was not new. While the private sector has long been involved in capital projects as a contractor, its greater involvement in providing both finance and capital works and service provision was formalised by the introduction by the UK Government in 1992, of a scheme known as the 'Private Finance Initiative" (PFI). The first PFI project in Scotland was the construction of the Skye Bridge which was completed in 1995.[17] In 1997 the Labour government introduced the term 'Public Private Partnership' (PPP), which tended to be used interchangeably with 'PFI'.[18] In practice, PPP is often used as an umbrella term describing many different models, of which PFI is just one, and all privately financed projects share a number of features.[19] These are discussed further in section 3.4. However, for the present it should be noted that all PPP projects essentially require investment by lenders to fund the construction of an asset (in this case, a hospital) which is then operated and maintained for the benefit of the relevant public authority (NHSL), all by a project company. This arrangement lasts for a set period (in this case 25 years) during which the public authority pays for the use of the building usually in the form of a monthly "service payment", effectively

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[16] Scotland's Spending Plans and Draft Budget 2011-12 (webarchive.org.uk), Chapter 3, Using Every Policy Lever To Expand The Capital Programme section
[17] Audit Scotland, Privately Financed Infrastructure Investment at p. 8,.43.
[18] Scottish Parliament Finance Committee, The Scottish Parliament - Finance Committee Report, para 26.
[19] Audit Scotland, Privately Financed Infrastructure Investment pp. 9 – 10. This paper does not deal with all variants of privately financed public sector projects. For example, the Hub model, which tends to be used for smaller infrastructure projects, is one that is not relevant to the current discussion.

repaying the capital costs over that period. Thus, the costs to the public authority are revenue costs, not capital costs as noted at paragraph 1.4.4.

3.2.2 In Scotland's Spending Plans and Draft Budget 2011 – 12, it was noted that around £5.5 billion of capital investment had been delivered in Scotland through PFI, particularly in the education and health sectors.[20]

3.3 Introduction of Non-Profit Distribution (NPD) and the Scottish Futures Trust

3.3.1 The PFI model was subject to several criticisms, including the cost of financing, the scale of repayments and the potential for excessive profits to the private sector.[21] Partly in response to these criticisms,[22] the NPD (initially known as NPDO for Non-Profit Distributing Organisation) model was developed. This is a form of PPP first developed by Argyll and Bute Council as an alternative to the traditional PFI model. Argyll and Bute Council developed the model when they were appraising options to deal with the backlog in maintenance of the Council's school estate. The model was adopted by the Labour Government, and the first NPD project was signed in 2005.[23] NPD was further developed as the preferred revenue-financed procurement model by the Scottish National Party (SNP) after it was elected to the Scottish Government in 2007. By 2008, NPD was the "default assumption for privately financed projects",[24] and the November 2010 announcement stated that the Scottish Government "has made it clear that it supports the Non-Profit Distributing (NPD) model to deliver revenue financed investment.".[25]

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[20] Scotland's Spending Plans and Draft Budget 2011-12 (webarchive.org.uk) Chapter 3, Revenue financed investment section. Cf Audit Scotland, Privately Financed Infrastructure Investment p.16 which refers to £5.6 billion.
[21] See Audit Scotland, Privately Financed Infrastructure Investment p.21; Scotland's Spending Plans and Draft Budget 2011-12 (webarchive.org.uk) Chapter 3, Revenue financed investment section.
[22] Argyll and Bute Council, "Submission" - Finance Committee Inquiry into methods of funding capital investment projects.
[23] Audit Scotland, Privately Financed Infrastructure Investment, pp. 7-8.
[24] A position supported by only a minority of the Scottish Parliament's Finance Committee in its 8th Report, 2008 - The Scottish Parliament - Finance Committee Report footnotes 1 and 2. The assumption that NPD should be used was reiterated in the Value for Money Assessment Guidance: Capital Programmes and Projects October 2011: value-for-money-guidance-final-version-october-2011 (scottishfuturestrust.org.uk)
[25] Scotland's Spending Plans and Draft Budget 2011-12 (webarchive.org.uk) Chapter 3, Revenue financed investment section.

3.3.2 The development of the NPD model was closely linked to the establishment and work of the Scottish Futures Trust (SFT). The SFT played a key role in developing contracts and documentation, advising on, providing assurance for and generally facilitating use of the NPD model.[26]

3.3.3 The SFT was established in 2008 as a private limited company wholly owned by Scottish Ministers.[27] It is also a non-departmental 'arm's length' public body. The relationship between the Scottish Government and the SFT was formally defined within a Management Statement and Financial Memorandum which was signed in 2009.[28] The Memorandum does not describe the SFT's role with regard to development of the NPD model specifically, rather it states that one of the SFT's objectives is to "innovate and bring fresh approaches and models for infrastructure investment".[29] It also states that a guiding principle of the SFT should be "Government policy and priorities for infrastructure investment and related topics",[30] which included the use of the NPD model as a revenue-finance option. The only explicit reference to NPD in the SFT's constitution documents is in its Memorandum of Association which states: "The Company's objects are to encourage, facilitate, plan, fund, procure and deliver assets, infrastructure and other projects initiated or pursued wholly or partly by or for the benefit of governmental bodies, local authorities, other bodies wholly or partly funded through public funds, and *non-profit distributing bodies*, in Scotland".[31]

3.3.4 According to Audit Scotland, the SFT "acts as a centre of expertise on infrastructure investment, for example advising the Scottish Government on likely levels of market interest when the pipeline of infrastructure investment is being developed. The SFT's responsibilities, with respect to NPD and hubs include: developing overall programme approaches for effective delivery, including a set of standard contractual documents; advising on and organising the funding and

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[26] Audit Scotland, Privately Financed Infrastructure Investment p.12
[27] Ibid
[28] In the 2022/23 financial year, the statement and memorandum was effectively replaced with a new framework agreement.
[29] MSFM paragraph 2.2.1(iii)
[30] MSFM paragraph 2.3.1(ii)
[31] SFT's Memorandum of Association paragraph 3..

financing of projects; advising on project delivery; providing project validation through scrutiny and diligence checks; and encouraging collaborative working."[32]

3.3.5 SFT's role in relation to this project is explored further in Provisional Position Paper 9 - The Governance Structure within the project to construct the Royal Hospital for Children and Young People and Department of Clinical Neurosciences, Edinburgh.

3.4 Characteristics of NPD

3.4.1 NPD shares some of the same characteristics of conventional PFI. Under both models, a special purpose vehicle (SPV) is established to design, construct and operate an asset, the SPV being typically composed of equity investors, which may include financial investors, construction contractors and others.[33] Projects are mostly financed by private debt.[34] The following diagram from Audit Scotland provides a comparison between the PFI and NPD models:

[32] Audit Scotland, Privately Financed Infrastructure Investment, p.12.
[33] Though in the case of the RHCYP/DCN project, this did not apply – see discussion of IHSL corporate structure in section 6.4
[34] Indeed, Hellowell and Pollock describe NPD as a "close relative of PFI": Hellowell and Pollock, Non-Profit Distribution: The Scottish Approach to Private Finance in Public Services, Social Policy and Society Volume 8 Issue 3 (2009) p.406

The NPD model compared with the PFI model

There are greater attempts to fix private sector returns at the start of NPD contracts than under PFI.

Features of the contracts	PFI	NPD
The SPV is set up to build, manage and maintain the assets over the lifetime of the contract	The private sector formed the SPV. Members held dividend-bearing shares in the company, meaning they could receive additional income when the company was profitable, or a surplus was being held. The private sector exercised total control of the SPV with no public sector involvement.	The SPV shares are non-dividend bearing. This means the private sector cannot generate additional profits by issuing dividends and is investing only what it lends. The public sector is represented on the SPV board by a Public Interest Director (PID), who has voting rights. The PID also holds veto rights over certain board decisions.
Surpluses generated by the SPV	Surpluses generated could be paid out as dividends to the SPV shareholders.	Surpluses are unlikely to be distributed until near the end of the contract and are not to be paid out until a range of project costs are met. Any surpluses at the end of the contract go to the public sector or a designated charity. This means that direct private sector returns are agreed when the contract is signed.
Repayment of loans	A source of private sector returns, alongside dividend payments. The majority was issued as fixed rate senior debt.	The main source of private sector returns, the majority of which is issued as fixed rate senior debt.
Private sector profits	Varied depending on the ability of the SPV to generate surpluses and pay out dividends.	Capped and agreed at the outset of the project when the debt is issued.
Refinancing gains	Refinancing decisions were taken by the project company.	The PID has effective control over refinancing decisions and any gains would be shared by shareholders, including the public sector.
Common features that contribute to effective contracts	Risk allocation: transferring appropriate risk to the private contractor. Whole-life costing: ensuring contracts and payments take into account the capital cost, as well as operational, maintenance, repair, upgrade and disposal costs. Performance-based payments: ensuring that the public sector receives specified services.	

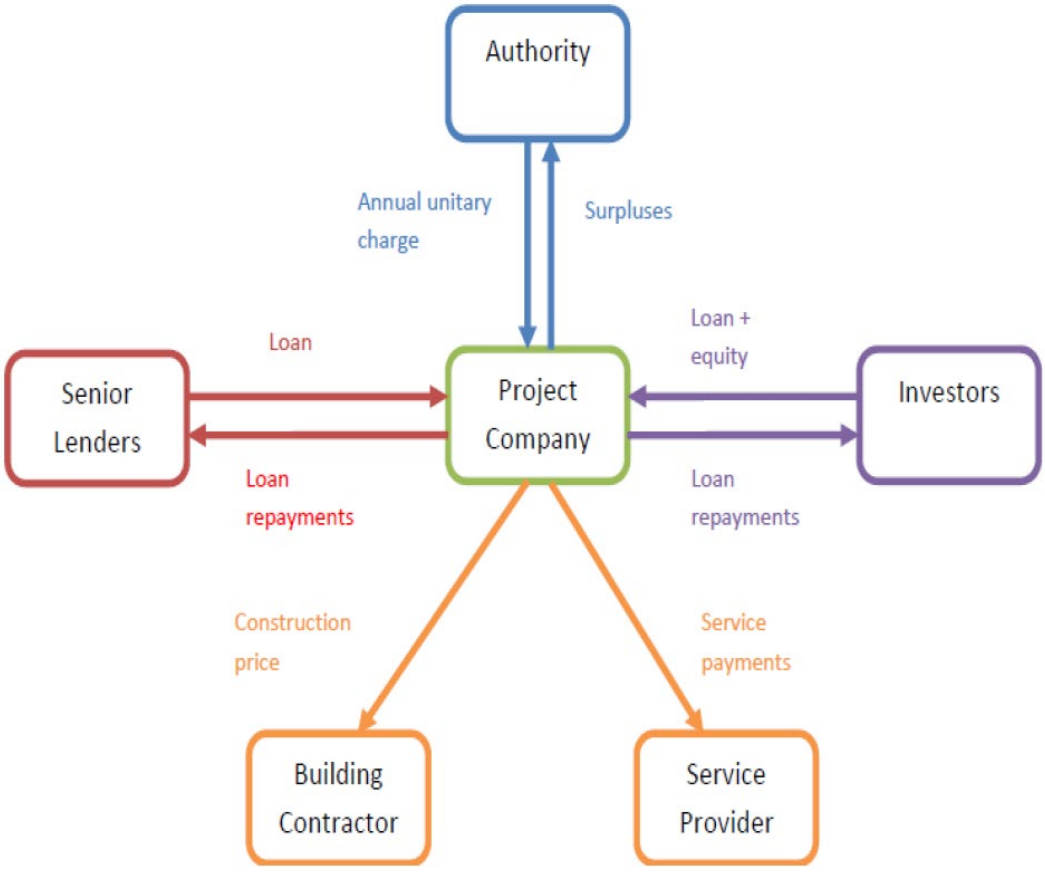
Source: Audit Scotland analysis of the Scottish Futures Trust's NPD guidance documentation

Source: Audit Scotland "Privately financed infrastructure investment: the non-profit distributing (NPD) and Hub models", 2020. Note that the reference to the PID having effective control over refinancing decisions was superseded by changes to the Standard Form Project Agreement which changes were adopted in this project.

3.4.2 As can be seen from the above, the key difference between the NPD model and the PFI model is that in the former, private sector profits are capped and agreed at the outset of the project. The early NPDO project under Argyll and Bute Council involved diverting all surpluses generated during the concession period to a charity

devoted to educational aims,[35] but the involvement of charities was excluded in later iterations of the NPD model. In addition, in the NPD model, the SPV has a public interest director with voting rights and, in early NPD projects, effective veto on some actions of the company.[36]

3.4.3 The structure of a typical NPD project is like that used in other PPP projects, with the public sector authority entering into a contract with the SPV/Project Company. The Project Company secures loans from investors and lenders and enters into contracts with the building contractor and service provider. The basic structure can be illustrated as follows:



Source: Scottish Futures Trust, "NPD Model Explanatory Note" 2015

[35] Argyll and Bute Council, "Submission" - Finance Committee Inquiry into methods of funding capital investment projects.

[36] The veto rights were removed as a result of changes to the rules under which public – private partnership projects had to be accounted for, referred to at paragraph 3.7.1 below. The public interest director in the RHCYP/ DCN project did not have veto rights on the actions of IHSL.

3.5 The Project Company and public sector representation

3.5.1 According to the SFT's explanatory note on NPD: "Whilst there has been no specific corporate structure requirement, all NPD projects to date have adopted a structure where the Project Company is a special purpose company limited by (non-dividend bearing) shares. The shares are held by the private sector investors except for one "golden share" held by the Authority, which increases transparency and accountability and underpins the NPD principle of enhanced stakeholder involvement."[37]

3.5.2 The note goes on to explain that the Project Company should always be managed by the parties whose lending is at risk. This will be the junior lenders (whose management rights are subject to senior lenders step-in rights). The relationship between a senior lender and a junior lender is that senior lenders will generally have one or more forms of security over the project and/ or the Project Company and its assets and be paid back first, before any other creditors are paid. Thus, they take on less risk with their investment than a junior lender does.

3.5.3 However, as noted above one of the characteristics of an NPD Project is greater involvement of the public sector, through holding a 'golden share' and through representation on the Board by a Public Interest Director who is in practice nominated by the SFT.[38] The principal roles of the Public Interest Director are:

a. Monitoring the Project Company's compliance with the core NPD principles and good governance practices
b. Bringing an independent and broad view to the Project Company's board
c. Bringing the Project Company board's attention to opportunities for refinancing

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[37] Scottish Futures Trust, NPD Model Explanatory Note, paragraph 2.2 (p.6)
[38] They were also in practice an SFT staff member: see section 2 of the SFT Board Minutes for March 2013. However, SFT now recruits persons specifically to serve as PIDs. The last round of such recruitment in 2021 included the possibility of appointment to the RHCYP/ DCN project company: publicinterestdirectoropportunitiesinscottishinfrastructurecompanies.pdf (scottishfuturestrust.org.uk). The results of that recruitment exercise can be found here.

d. Bringing the Project Company board's attention to opportunities for realising cost efficiencies and other improvements in the Project Company's performance.[39]

3.5.4 The public authority that entered into the contract with the Project Company is also entitled to appoint an "Observer" to attend and participate (but not vote) at the Project Company's board meetings. According to the SFT explanatory note, "the Observer role has been a feature of traditional PFI/PPP projects in Scotland to date and has been retained in the NPD model."[40]

3.5.5 The SFT model Articles of Association for a Project Company lay out the rights and responsibilities of shareholders, directors and the observer, how they are appointed and dismissed and remuneration for directors, amongst other things.[41]

3.6 The NPD Contract and documentation

3.6.1 There is only one type of contract for an NPD project, and that is the Standard NPD Model Form, which follows HMT's Standardisation of PFI Contracts Version 4 Guidance[42] and its adaptations.[43] The Standard Form Project Agreement ("SFPA") is mandatory for procuring authorities, and is intended to simplify documents and minimize transaction costs for contractors, investors and funders as well as procuring authorities.[44]

3.6.2 The SFPA's basic approach is that:

a. The private sector will provide the authority with serviced accommodation.

b. Payment will only commence once the accommodation is complete and ready for use.

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[39] Scottish Futures Trust, NPD Model Explanatory Note, paragraph 3.1 (p.9)
[40] Ibid paragraph 3.1 (p.9).
[41] Scottish Futures Trust, "Mandatory NPD Articles of Association Consolidated ESA10 amendments to standard form NPD articles of association 13 February 2015". The model articles of association were originally published in 2011, and updated in June 2012 prior to the version referred to..
[42] Scottish Futures Trust, NPD Model Explanatory Note paragraph 2.6 (p.7).
[43] Scottish Futures Trust, Standard Project Agreements (hub DBFM & NPD Model) Users Guide (Version 2 – June 2012), p.1
[44] Scottish Futures Trust, Standard Project Agreements (hub DBFM & NPD Model) Users Guide (Version 2 – June 2012), p.2

c. The Authority will pay for available facilities and deductions will be made from the annual service payment if the facilities are not available or the services are otherwise not provided in accordance with the Authority's requirements.[45]

3.6.3 However, the SFT notes that each Project Agreement needs to be tailored to the specific project by the procuring Authority.[46] The SFPA needs to be carefully assessed and reviewed in the light of any further project and sector specific guidance and advice received. It should also "be used in conjunction with any further guidance issued/adopted by the Scottish Government and/or the SFT from time to time."[47]

3.6.4 Any changes to the SFPA made in the context of a specific project need to be approved by SFT. Changes to the Project Agreement are called derogations and the derogations process is as follows: "An Authority must give SFT one month's notice of when it intends to submit a request for derogations… SFT will endeavour to respond to a request for derogations within 2 weeks. In requesting derogations, the Authority must provide its amended version of the relevant standard Project Agreement (including the Schedule Parts) and provide explanations for the proposed amendments in footnotes within its amended document. SFT will then do a comparison of the document submitted against its master version of the relevant standard Project Agreement."[48]

3.6.5 The standard form NPD Project Agreement (which includes the standard Service Level Specifications, NPD articles of association and the User's Guide) was published in 2011 and amended in 2012, 2014 and 2015. Use of the second (2012)

[45] Ibid, p. 1.
[46] Furthermore, the SFPA was not considered to be entirely appropriate for 'acute healthcare projects' which are required to operate on a 24/7 basis. In these cases, "it may be appropriate to revert to some of the measures in the Scottish Standard Health PPP Contract (in particular the measurement of service performance by sessions rather than days and the commissioning arrangements around handover of the new facilities), and in this regard NHS bodies must liaise, and agree an approach with, SFT." Ibid p.9
[47] Ibid, p.5.
[48] Ibid, p.5.

version was mandatory for projects still in the procurement phase before the close of competitive dialogue (and is the relevant version for the RHCYP/ DCN project).[49]

3.7 End of NPD and introduction of the Mutual Investment Model (MIM)

3.7.1 While not relevant to the RHCYP/ DCN project, to complete the general story of the NPD model, it is worth noting that from September 2014 onward, the rules under which public – private partnership projects had to be accounted for changed. This led to reconsideration of the NPD model and its use for public sector infrastructure projects.[50] In short, the changes meant that the full capital costs of the project had to be accounted for in a public authority's capital budget rather than the revenue budget, having a significant impact on the public authority's finances. As a result of this change the Scottish Government stopped using the NPD model, with the final NPD contract signed in 2017.[51]

3.7.2 The Mutual Investment Model (MIM) replaces the NPD model. It is described as "the current model for private finance projects" in Scotland[52] and has been subject to an options appraisal by SFT.[53]

3.7.3 While the NPD model as used in the RHCYP/ DCN project is therefore unlikely to be used in the future, it should be borne in mind that most variations of public-private partnerships have, as has already been noted, similarities as well as differences. The MIM model was developed by the Welsh Government and introduced in 2017. It is a PPP model that has strong similarities to NPD as is clear from the Users Guide for the standard form project agreement:

> "The key principles embodied in the MIM Standard Form Project Agreements will be familiar to those who operate in the UK 'PPP' market. The MIM Standard Form Project Agreements are based on various UK precedent and standard project agreements, updated in order to accommodate the specific

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[49] Ibid, p.5
[50] For background, see Audit Scotland, ESA 10: Classification of Privately Funded Capital Projects Briefing Paper
[51] Audit Scotland, Privately Financed Infrastructure Investment, p.8.
[52] Scottish Government, Infrastructure Investment Plan 2021-22 to 2025-26 Progress Report 2022 to 2023.
[53] Scottish Futures Trust, An Options Appraisal To Examine Profit Sharing Finance Schemes…(2019)

needs of the Welsh Government's infrastructure programme and Welsh Government policy."[54]

The Guide goes on to explain that (unlike NPD) there are no controls or vetoes on the operations of the Project Company on the part of the public authority, nor is there sharing of rewards or profits with the procuring authority. But the underlying contractual and financial structure of the Welsh model remains similar to that which now stretches back to the early days of PFI, and the option favoured by SFT reflects the Welsh model.[55]

[54] Welsh Government's Mutual Investment Model (MIM) Standard Form Project Agreements User Guide p. 2.
[55] Scottish Futures Trust, An Options Appraisal To Examine Profit Sharing Finance Schemes…(2019) p.5

4. The Outline Business Case

4.1 Introduction

4.1.1 The Outline and Full Business Cases relating to the project set out how NHSL intended to implement the NPD model in relation to the RHCYP/ DCN project. For present purposes, there are three key matters dealt with in the business cases that are key components of the NPD model that fall to be summarised:

a. The funding arrangements and allocation of costs relating to the project;

b. The payment mechanism; and

c. The allocation of risk.

4.1.2 The focus is on the matters just referred to, and what follows is not, therefore, a summary of the entire business cases.

4.2 Capital and Revenue Costs For The Project

4.2.1 As noted above,[56] the Outline Business Case (OBC) for the revised project using the NPD route was approved by NHS Lothian Board on 25 January 2012 for submission to the Scottish Government. NHSL received confirmation from the Scottish Government of the approval of the OBC on 18 September 2012. The OBC outlines the proposals for meeting the capital and revenue costs of the project. The new building was to be revenue funded as a result of using the Scottish Government's Non-Profit Distributing (NPD) Model for the project discussed in section 3. Accordingly, no capital funding from NHSL would be required for the actual construction of the building.[57] The capital costs were quantified at £154.9m, to be funded by the NPD partner. The payments by the Board to the NPD partner over the

[56] At paragraph 2.6.
[57] OBC paragraph 1.41.

lifetime of the project would be revenue costs, funded jointly by the Scottish Government, NHS Lothian and other NHS Partner Boards.[58]

4.2.2 In terms of the revenue funding, there would be 100% SGHSCD revenue funding support for the construction, private sector development costs, financing interest and fees and SPV running costs (construction and operational) costs over the life of the facility.[59] It was noted[60] that the SGHSCD funding for construction, development costs, SPV running costs and lifecycle were subject to a capped budget, based on the OBC analysis. If these costs increased over the capped level, those additional costs would fall to be met from NHS Lothian's budget.

4.2.3 Capital funding would be required for some components of the project that fell outwith the NPD model and that would require SGHSCD project specific capital funding.[61] The total capital costs of these components was quantified at £72.1m.[62] This gave a total capital value of the project of £227 million.

4.3 Financial Models

4.3.1 To support the OBC, and its preferred option of locating RHSC, CAMHS and DCN in a single build at Little France, two financial models were developed:

a. A Shadow Bid Model was prepared by Ernst & Young LLP. This model provides an estimate of the likely unitary charge which will be payable to the private sector partner to design, build, finance and maintain the facilities.

b. An Affordability Model was prepared internally, with oversight by Ernst & Young, to forecast the wider financial implications of the project to NHSL and its partners to assess and confirm overall affordability.[63]

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[58] OBC paragraph 1.42.
[59] OBC paragraph 2.100 and Figure 11.
[60] OBC paragraphs 1.46 and 2.100. See also paragraph 5.13 and Figure 27, which provides a calculation of the revenue support that could be expected from the Scottish Government.
[61] OBC paragraph 1.43. Fuller descriptions of the various elements can be found at paragraph 5.16.
[62] OBC paragraph 1.44
[63] OBC paragraph 5.2.

4.3.2 These models, together with the assumptions used and the method of calculation, are explained in section 5 of the OBC. The likely annual unitary charge calculated by the Shadow Bid Model has a range of £14.832m in the year ended 31 March 2017, peaking at £26.560m in the year ended 31 March 2041.[64] The amount of SGHSCD revenue support for the unitary charge payments, and the NHSL funded element, is also set out.[65]

4.3.3 In the "Affordability Statement", NHSL confirmed that "the financial consequences will ultimately be managed as part of their financial and capital plan process; with support from the Scottish Government, NHS Boards and charity partners. This will be fully explored as part of the Full Business Case stage."[66]

4.4 Payment Mechanism

4.4.1 The OBC described the charging mechanisms that were proposed to govern the payments made by NHSL to the SPV.

4.4.2 The payment mechanism adopted in the contract is described in detail in section 6 but largely follows what was proposed in the OBC. The OBC proposed a payment mechanism having the following key features:

a. The mechanism calculates the amount per month that will be paid to the operator, based on the annual unitary charge, indexed as agreed in the contract, converted to a monthly sum from which various deductions may be made if applicable.

b. Deductions are made where the operator fails to perform services as specified in the contract documents, these being a fixed amount per failure based on the severity of the failure.

c. Deductions are made where an area of the facility is deemed to be unavailable, or unsuitable for use in terms of, for example, temperature, safety, lighting. The size of the deduction is dependent on the importance

[64] OBC paragraph 5.9 and Figure 26.
[65] OBC paragraph 5.13 and Figure 27.
[66] OBC paragraph 5.63.

placed on the area in question, with the facility being divided up into areas each of which is given its own weighting.

d. The whole facility can be made unavailable if a certain proportion of areas are unavailable. If the NHS continues to use an area that is deemed unavailable, there is a lower level of deduction.

e. The operator is given a period of time to rectify the problem before a deduction is made.

f. Deductions ramp up if there is a repeated occurrence.

g. Insurance premiums, energy, rates and water charges are treated as pass-through costs (i.e. costs that are simply passed on by IHSL to NHSL).[67]

4.4.3 The OBC noted that the NPD mechanism as described in the previous paragraph differed from payment mechanisms in use within the NHS in one key respect. The NPD standard form project agreement assumed that the facilities will not be required to be available 24/7 and operates deductions on the basis of whole days rather than several sessions within a day. This was unlikely to be workable in an operational hospital that is in use constantly and so the NPD standard would need to be revised in this respect.[68]

4.4.4 The OBC also noted that the SFT standard form of NPD contract and the payment mechanism within it are consistent with the project assets being statistically classified as non-government in the National Accounts as defined in the European System of Integrated Economic Accounts (ESA95). This classification was a

[67] This summary is taken from OBC paragraph 4.16.
[68] OBC Paragraph 4.17; see also *Scottish Futures Trust, Standard Project Agreements (hub DBFM & NPD Model User's Guide version 2 June 2012* at p. 9: ", because the Standard Project Agreements have been developed in anticipation of a pipeline of mostly non-acute healthcare projects, modifications have been made to bring the general approach somewhat into line with arrangements previously used for local authority accommodation (particularly schools) projects. Where the facilities deliver acute healthcare and require to operate on a 24/7 basis, it may be appropriate to revert to some of the measures in the Scottish Standard Health PPP Contract (in particular the measurement of service performance by sessions rather than days and the commissioning arrangements around handover of the new facilities), and in this regard NHS bodies must liaise, and agree an approach with, SFT." See paragraph 7.6.5 on sessions in the specific context of the PA in this project.

requirement for revenue support funding from Scottish Government under the NPD programme.[69]

4.5 Risk

4.5.1 The discussion of the financial model contains a number of statements about apportionment of risk that are worth quoting in full:

> "5.53 Based on the proposed NPD contractual arrangements the operator and not NHS Lothian will be exposed to construction risk. Specifically, NHS Lothian will not be obliged to pay for the assets unless they are delivered in working order and in accordance with the agreed specifications. A requirement for the NHS Lothian to pay without taking into account the effective state of the assets that are delivered would be evidence that the NHS bears the majority of the construction risk and is acting as de facto the owner of the assets. This would also be true were NHS Lothian required to make payments to cover additional costs, whatever their justification. In order for NHS Lothian to be regarded as not having the construction risk the important point is that the NHS should not be obliged to pay for any event resulting in a default in the management of the construction phase by the operator, which is case based on the proposed NPD standard contract. On this basis it would appear that the NPD operator and not NHS Lothian would bear the construction risk in respect of the assets built under the project.
>
> *Availability risk*
>
> 5.54 The NHS is assumed not to bear such risk if it is entitled to significantly reduce its periodic payments if certain performance criteria are not met. Under these conditions, the NHS payments must depend upon the effective degree of availability ensured by the operator during any given period. The application of penalties where the operator is defaulting on its service obligations must be automatic and must also have a significant effect on the operator's revenue.

[69] Paragraph 4.18. ESA 95 was superseded by ESA2010 which in turn led to NPD no longer being used as explained in section 3.7 above.

The proposed payment mechanism arrangements would suggest that this risk rests with the operator.

Demand Risk

5.55 The NHS is assumed to bear this risk where it is obliged to ensure a given level of payment to the operator independently of the effective level of demand. The proposed payment structure suggests that the payments due from the NHS to the operator are, subject to availability of the assets, due regardless of the level of underlying demand for the assets. On this basis demand risk will clearly rest with the NHS."

5. The Full Business Case

5.1 Introduction

5.1.1 The Full Business Case for the Re-provision of the RHSC and DCN at Little France (FBC)[70] was approved by the Scottish Government on 10 February 2015, and an addendum to it noted by SG on 28 April 2015. The addendum updates the FBC, particularly in relation to the final financing and capital costs.

5.1.2 The FBC re-affirmed the OBC's conclusion that "a non-profit distributing (NPD) project which brought together children's and neurosciences services in one facility was the most economically advantageous outcome."[71]

5.2 Changes In Capital Costs Since OBC

5.2.1 The total projected capital costs at OBC state were assessed at £230 million, with the NPD element assessed at £154.9 million. The final tender by the preferred bidder set the capital cost of the new build works at £146.7 million.[72] The FBC notes that "The reduction in the capital value of the NPD new build works…was achieved through the competitive dialogue and tendering process with three bidders."

5.2.2 The £146.7 million figure was subject to additional costs in relation to design development which, at FBC stage, was ongoing. So, although the final figure could not be quantified, "the project management is minimising any financial impact and there is no expectation that the final position will deviate significantly from the tender price."[73]

[70] The Full Business Case can be found in Bundle 3 – Governance Volume 3 for the Hearing Commencing 9 May 2022 starting at page 729 of that Bundle.
[71] FBC paragraph 1.2.2.
[72] FBC paragraph 3.2
[73] FBC paragraph 5.1.2

5.2.3 But by the time the Addendum to the FBC was submitted, the NPD capital costs had risen to £150.014 million. The Addendum noted that "Design development and inflation are the key drivers of the £3.3 million increase…".[74]

5.2.4 Some of the projected capital costs for non-NPD elements of the project had increased since OBC. The specialist adviser fees (mainly technical, legal and financial to support the NPD contract) were estimated at £4.5 million at OBC stage but had risen to £4.8 million. This "…reflects the complexities of the interface of this project with the existing PFI contract…[but] many of the deliverables produced by the advisory team have been used for the benefit of the wider NPD programme."[75]

5.2.5 In addition, by FBC stage capital costs had been added in relation to offsite flood prevention (£4.298 million) and a petrol station site (£0.55 million).[76] The non-NPD capital costs at FBC stage were assessed at £80.083 million.[77] It was assumed for the purposes of the FBC that all non-NPD capital costs associated with the project would be funded by an SGHSCD project specific funding allocation.[78]

5.2.6 The net result of all of the capital cost variations, NPD and non-NPD, was marginal as regards the overall capital cost of the project: the estimate at OBC stage was £226.971 million; at FBC this became £226.771 million.[79] However, the Addendum notes that this figure increased to £230.097 million, as a direct result of the increases in the NPD capital costs noted at paragraph 5.2.3 above.

5.2.7 The conclusion of the consideration of capital and revenue implications of the project was that NHSL confirmed the affordability of the project in terms identical to those set out in the OBC.[80] The Addendum confirmed that "All costs of the project are still within the affordability limits set out in the FBC."[81]

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[74] Addendum paragraph 5.1.2. £2.1 million of the increase was attributed to design development, £1.05 million to inflation.
[75] FBC paragraph 3.3
[76] FBC paragraph 5.1.1 and Figure 7 following.
[77] FBC paragraph 5.1.3 and Figure 8 following.
[78] FBC paragraph 5.2.6
[79] FBC paragraph 5.1.1 and Figure 7 following.
[80] Paragraph 2.3.6 above; paragraph 5.7 FBC.
[81] Addendum paragraph 5.5.1

5.3 Annual Service Payment

5.3.1 The Addendum notes that the projected annual service payment over the 25 year period of the project agreement was estimated at £432 million, a reduction of £75 million compared with the estimate in the FBC.[82] This reduction was mostly accounted for by a reduction in the costs of the repayment of capital and associated financing costs, reflecting the financing rates set by the funders at financial close.

5.3.2 The benefit of this reduction principally accrued to the Scottish Government. The reduction in annual service payment would lead to a reduction in the need for revenue support from SGHSCD.

5.4 Financing of NPD Capital Costs

5.4.1 The Addendum narrates a post-preferred bidder stage funding competition to determine the final funding package for the project that was completed on 13 October 2014. The result of this competition was that M&G were appointed as the preferred funder alongside the European Investment Bank each of whom provided approximately 50% of the senior debt requirement. The senior debt constitutes 92% of the total funding requirement. [83]

5.4.2 The senior debt was sub-divided into two tranches, as required by M&G so that they could draw their debt contribution from different sources within their fund structure. EIB matched this structure. Accordingly, senior debt was sub-divided into senior debt (comprising 80% of the overall funding) and senior subordinated debt (12% of the overall requirement).[84]

5.4.3 The 8% balance of the funding requirement was risk bearing junior debt provided by Macquarrie, IHS Lothian's sole investor.[85]

5.4.4 Each of the tranches of debt carried differential interest rates, determined at financial close, with the rates payable to M&G being set by reference to Government

[82] FBC paragraph 5.2.1.
[83] FBC paragraphs 4.2.2 and 4.2.3.
[84] FBC paragraph 4.2.3.
[85] FBC paragraph 4.2.3

gilt rates on the day of close and the EIB portion by reference to the prevailing rates in the interest swap market.[86] The rates set "are significantly lower than the assumptions provided at the time of the final tender, since which time the debt market has become considerably more liquid and competitive."[87]

5.5 Risks and Risk Allocation

5.5.1 The FBC sets out in a table[88] the ownership of known key risks of the project, which is reproduced here in full:

	Risk Description	Allocation		
		NHS Lothian	Project Co	Shared
1.	Design risk		√	
2.	Construction and development risk		√	
3.	Transitional and implementation risk		√	
4.	Availability and performance risk		√	
5.	Operating risk			√
6.	Variability of revenue risks		√	
7.	Termination risks			√
8.	Technology and obsolescence risks		√	
9.	Residual value risks		√	
10.	Financing risks		√	
11.	Legislative risks			√
12.	Sustainability risks			√

Figure 4: Allocation of key risks in the NPD contract

5.5.2 The general principle was to ensure that responsibility for risks should rest "with the party best able to manage them", subject to value for money."[89] A brief explanation of each of the risks referred to in the above table is provided. For the present, it will suffice to note that:

a. The construction and development risk "sits with Project Co, subject to the Project Agreement. For example, a small number of delay and compensation events could entitle Project Co to compensation if the risks materialised…";[90]

[86] FBC paragraph 4.2.4.
[87] FBC paragraph 4.2.5
[88] FBC paragraph 4.1.3
[89] FBC paragraph 4.1.3
[90] FBC paragraph 4.1.3 (2)

b. Financing risks "predominantly sit with Project Co subject to the Project Agreement: however relevant changes in law, compensation events that compensate Project Co and changes under the Project Agreement all may give rise to obligation to NHS Lothian to provide additional funding…".[91]

It is perhaps worth noting that the "subject to the Project Agreement" rider attaches to the allocation of seven of the twelve risks specified in the above table.[92]

5.5.3 In addition to the risks in the table above, the FBC noted political and financial risks arising as a result of the fact that the funding competition for the project, and financial close, were programmed either side of the Scottish independence referendum.[93] In particular, a risk was identified that the cost of financing could be higher than anticipated, or contractual protection sought by funders before the outcome of the referendum was known. NHSL, SFT and the preferred bidder had engaged and continued to engage with funders during the funding competition, and it was noted that private financiers had funded several NPD transactions in Scotland in the recent past.

5.6 Payment Mechanism

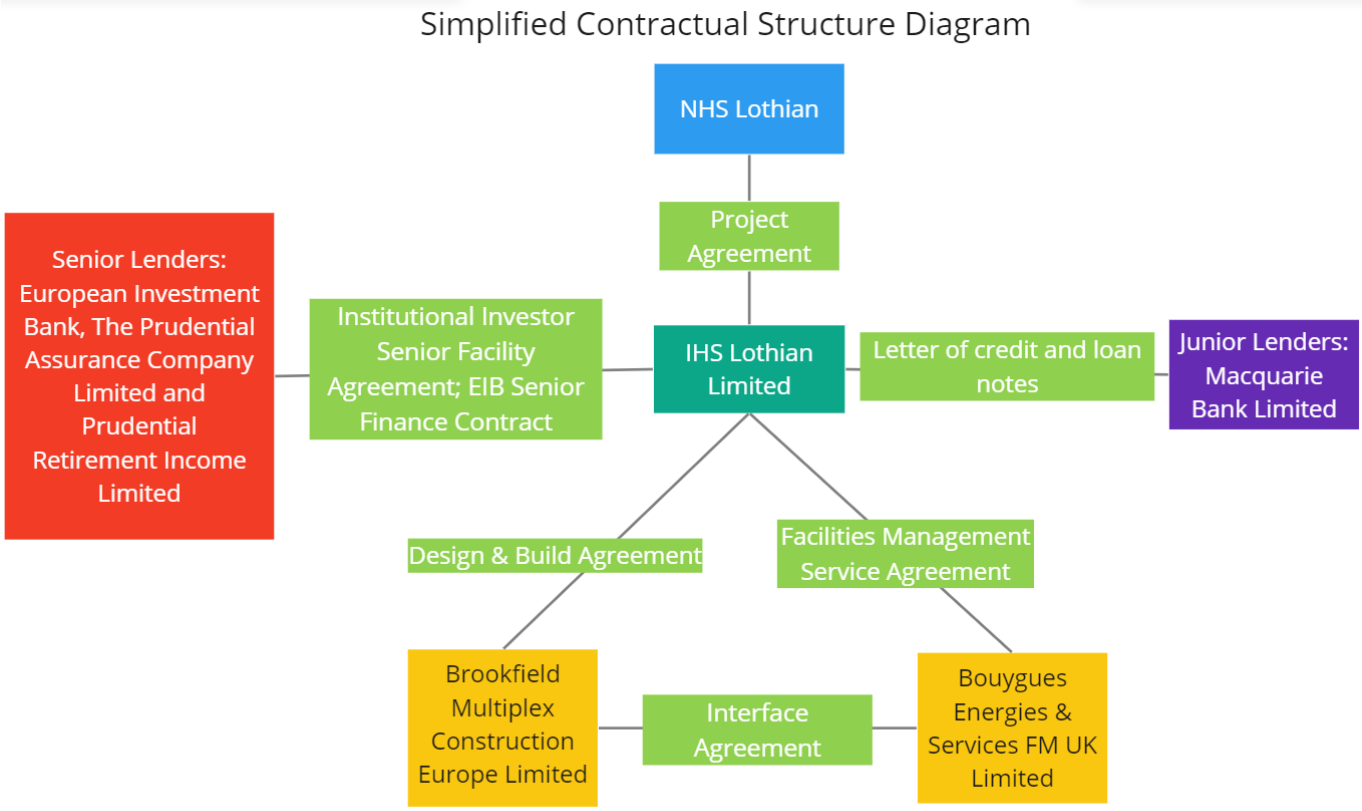
5.6.1 The FBC notes that annual service payments (the "unitary charge") to Project Co "will only commence when the development is made operational and will be managed and regulated by means of the payment mechanism that will protect NHS Lothian (by deductions from payment) if there are failures in availability or performance."[94] The payment mechanism follows "standard form drafting" with deduction from payment for availability and performance failures "such that should the entire facility be unavailable, no payment would be due." However, it was amended to reflect the acute healthcare nature of the accommodation.[95]

[91] FBC paragraph 4.1.3 (10)
[92] The Addendum confirmed that there were no changes to the underlying Project Agreement position and risk allocation reported at FBC remained unchanged (Addendum paragraph 4.1.1)
[93] FBC paragraph 2.11.3
[94] FBC paragraph 4.1.4
[95] See discussion at paragraph 4.4.3.

6. Contractual and Financial Structure

6.1 Introduction

6.1.1 It is possible to adapt and populate the diagram at paragraph 3.4.3 above to illustrate the basic contractual structure adopted in relation to the RHCYP/ DCN project[96] as follows:



[96] This section focuses on the arrangements that were in place at financial close (13 February 2015) or immediately thereafter. While there have been some changes to the companies involved, the structure outlined has remained largely the same.

6.1.2 The names of the actual parties have been used rather than the placeholders in the earlier diagram, and the names of the principal contractual documents governing the relationship between the parties inserted in the green boxes on the linking lines. The basic contractual structure thus reflects the standard NPD approach: Project Company (IHS Lothian Limited) secures loans from investors and lenders (those in the red and purple boxes) and enters contracts with the building contract (Brookfield Multiplex) and service provider (Bouygues).

6.1.3 This is, however, a simplified view of the contract structure. The following section describes the contractual matrix relating to the project in more detail (the contractual matrix relating to the financial structure is dealt with in the section following that). The contractual matrix is complex, and is spread over very many documents, both formal agreements and otherwise. What follows is not an analysis of every one of those documents, but rather an overview to give a flavour of the overall contractual structure. To paraphrase the guidance from the Welsh Government quoted at paragraph 3.7.3, what follows will, for the most part, be familiar to those who operate in the UK 'PPP' market.

6.2 Contractual Structure

6.2.1 The key contractual document from which everything else flows is the Project Agreement ("PA") between NHSL and IHSL signed on 12 and 13 February 2015 (the latter date being the date of "financial close") for the design, build, finance and maintenance of the RHCYP/ DCN adjoining the Royal Infirmary, Edinburgh. This agreement is based on the SFPA, the main divergence being in the payment mechanism to reflect the acute healthcare nature of the accommodation.[97] The PA also incorporated drafting to reflect the interface issues between the project and the Royal Infirmary of Edinburgh ("RIE"). This was because the project was constructed on a car park previously part of the RIE, which was a PFI hospital, and was clearly a project-specific divergence from the standard form. The PA is long and detailed – the version held by the Inquiry runs to 748 pages, excluding various provisions including,

[97] As noted above at paragraph 5.6.1. The payment mechanism is discussed further in section 7

for example, the details of the specification for the construction and the financial model (the latter coming to 351 pages).

6.2.2 As is clear from the diagram above, under the PA lie the design and build contract and the facilities management service agreement. In short, the design and build contract passes on all the obligations under the PA to design and build the new facility from IHSL to the construction contractor, Brookfield Multiplex Construction Europe Limited ("Multiplex") and the facilities management service agreement all the obligations to maintain and operate the new facility after construction from IHSL to Bouygues Energies & Services FM UK Limited (Bouygues). These contracts too are long and detailed – the former is 532 pages long, the latter 520.

6.2.3 In terms of the contractual matrix, it is worth noting that each of these agreements is supported by other documents. Principal among these are the following:

- The parent companies of both Multiplex and Bouygues granted parent company guarantees of the obligations of their respective subsidiary companies.
- Both Multiplex and Bouygues granted collateral warranties in favour of NHSL, allowing NHSL to enforce obligations or claim directly against them in respect of a failure to comply with their respective contracts with IHSL subject to certain conditions, particularly the right of the funders to step in and perform the obligations of IHSL under the PA.
- The construction contract was supported by an on-demand performance bond providing for payment in the event of default by Multiplex, and an adjudication bond, providing for payment if Multiplex failed to comply with any award by an adjudicator under the construction contract. Both had Euler Hermes SA (NV) as guarantor, and both were in favour of IHSL and its assignees.
- Bouygues, IHSL and Multiplex entered into an interface agreement (noted in the diagram above) to detail arrangements between them and to regulate the recovery of any costs, losses or expenses caused to or incurred or injury suffered by Bouygues or Multiplex by reason of any breach of their obligations by the other. It also set out other matters which are ancillary and incidental to

the performance by them of their respective obligations under their respective agreements.

6.2.4 While Bouygues and Multiplex are the principal contractors to IHSL, they engaged several subcontractors, consultants and suppliers. For present purposes it is sufficient to focus on those engaged by Multiplex given the focus of the Inquiry's investigations. The following is a list of the key subcontractors and consultants engaged by Multiplex:

- TUV SUD Limited (trading as Wallace Whittle) – building services engineer;
- HLMAD Limited – lead designer, architect, landscape architect and project BIM manager.
- Robert Bird & Partners Limited – structural engineer
- Acoustic Logic Consultancy (UK) Limited – acoustic consultant.
- Ove Arup & Partners Limited – traffic consultant.
- WSP UK Limited – fire engineer.
- Ironside Farrar Limited – planning consultant.
- Brookfield Multiplex CDM Services Europe Limited – CDM co-ordinator
- Balfour Beatty Ground Engineering Limited – sub-contractor for reinforced concrete piling and contiguous walls
- Schindler Limited – supply and install of passenger and FM lifts.
- Mercury Engineering – mechanical, electrical and public health services.

6.2.5 Each of these were engaged under a separate agreement between them and Multiplex. However, in addition, each granted a separate collateral warranty in favour of IHSL, NHSL and the Security Trustee as representing the senior lenders, essentially undertaking to each of them the obligations undertaken by the company concerned in their contract with Multiplex and so permitting each of IHSL, NHSL and the Security Trustee to take independent action to enforce those obligations in certain circumstances and subject to certain restrictions.

6.3 Financial Structure

6.3.1 The high-level structure of the financing arrangements for the project have already been touched on above.[98] The financing arrangements were consistent with the NPD model in providing for exclusively private capital funding, with no public sector contribution other than in relation to ancillary matters falling outwith the scope of the NPD project.[99] This section briefly outlines the underlying structure of those arrangements.

Senior Debt

6.3.2 Senior debt is generally a loan provided by a financial institution to a project. This debt enjoys priority for repayment and will have first call on a project's cash flows and security arrangements. Senior debt for this project amounted to 79.7% of the total funding.

6.3.3 Senior debt for the project was supplied by (i) European Investment Bank (EIB) (49.6%) and (ii) The Prudential Assurance Company Limited and Prudential Retirement Income Limited (50.4%). This funding was injected directly at the level of Project Company (IHSL). There were a number of key agreements underpinning the arrangements for senior debt including:

- Common Terms Agreement: the agreement that sets out the terms that are common to all levels of debt in a project. In addition to the lenders providing the senior debt, the lenders providing the senior subordinated debt were parties to this agreement (and the next named) as were, two other companies in the IHSL structure (see further below) and other parties involved in the financing arrangements.
- Intercreditor Agreement: the agreement that principally regulates the relationships between the various creditors (i.e., the lenders) in relation to the sums loaned by each.

[98] At section 5.4
[99] These matters are listed in Figure 8 following paragraph 5.1.3 of the FBC.

- Institutional Investor Senior Facility Agreement: the loan agreement between IHSL and the lenders named at (ii) above.
- EIB Senior Finance Contract: the loan agreement between IHSL and the EIB.

Senior Subordinated Debt

6.3.4 Senior subordinated debt sits between senior debt and junior debt. Generally, it is debt that is repaid after the senior debt has been repaid in full, and in many cases will be unsecured. Senior subordinated debt amounted to 11.6% of the total funding for this project.

6.3.5 In this project, the senior subordinated debt was injected at the level of IHS Lothian Investments Limited (see further section 6.4 below). The lenders for this debt were the same as for the senior debt, with EIB providing 49.1% of the senior subordinated debt and the others providing the rest. The key documents in relation to this level of debt as those set out in relation to the senior debt.

Junior Debt

6.3.6 Junior debt is the lowest ranking debt, with the lowest priority for repayment and is unsecured. It is therefore the riskiest form of lending. Junior debt contributed 8% of the total funding for this project.

6.3.7 Under the original terms of the Shareholder Support Agreement,[100] a junior debt loan was to be injected at the planned end of construction (July 2017) by IHS Lothian Corporate Limited (see section 6.4 below). This obligation was supported by a letter of credit provided by Macquarie Bank Limited. The beneficiary of the letter of credit is IHS Lothian Corporate Limited, but by virtue of various loan arrangements in the IHSL corporate structure, the project company is the ultimate beneficiary of this funding. This element of the funding package is contractually and structurally subordinated to the Senior Subordinated Debt and the Senior Debt (and hence described as "junior debt"). The junior debt amounted to approximately 8% of the funding for the project. Key documents that detail the terms of this arrangement include:

- Letter of Credit issued by Macquarie Bank Limited
- Loan Notes issued by companies within the IHSL corporate structure (see section 6.4 below)
- Shareholder Support Agreement

6.3.8 In accordance with the NPD requirements, each of the Senior Debt, the Senior Subordinated Debt and the Junior Debt had fixed interest rates for the lifetime of the repayment period. Those interest rates varied between the various tiers of debt and between different lenders, but by way of illustration ranged from 2.881% at the Senior Debt level to 9.47% at the Junior Debt level.

6.3.9 It can be seen from the above that the financing structure for the project was complex, and this was reflected in the number of lengthy and detailed agreements

[100] Essentially an agreement between the sponsors or shareholders, the project company and the lenders likely to contain a number of commitments that the lenders require of the sponsors/shareholders with respect to the project and the project company including a requirement to provide funding to the project company.

between those involved (those specifically referred to above do not constitute a definitive list of all the agreements in place for this project[101]). This is not unique to the RHCYP/DCN project however – all project finance invariably involved a complex set of contractual relationships. The arrangements in place in this case are like those used in many PPP projects in the United Kingdom. However, the Inquiry has not discovered anything apparent in these agreements and the financial arrangements that they establish that in and of themselves would have given rise to the issues that are the subject of the Inquiry's investigations, directly contributed to them.

6.4 IHSL Corporate Structure

6.4.1 It will be apparent from the explanation above that not all the funding was paid direct to IHSL as the project company but was rather paid to various other companies within the corporate structure of IHSL subject to various agreements between the lenders and the companies within that corporate structure requiring payment onwards ultimately to the project company to enable it to meet the payments required for the project.

6.4.2 The relationship between the various companies in the corporate structure and how they interact with the various financing arrangements can be illustrated in the graphic following on the next page. It should be noted that each company in the corporate structure from IHS Lothian Limited upwards is wholly owned by the company directly above it – so IHS Lothian Limited is wholly owned by IHS Lothian Holdings Limited;[102] IHS Lothian Holdings Limited is wholly owned by IHS Lothian Investments Limited;[103] and so on.

6.4.3 It is not part of the Inquiry's remit to comment on the corporate structure of the IHSL companies in so far as not impacting on the issues that arose at RHCYP/ DCN, and accordingly this material is provided for information only to assist in the understanding of the financial arrangements adopted in relation to the construction of the hospital.

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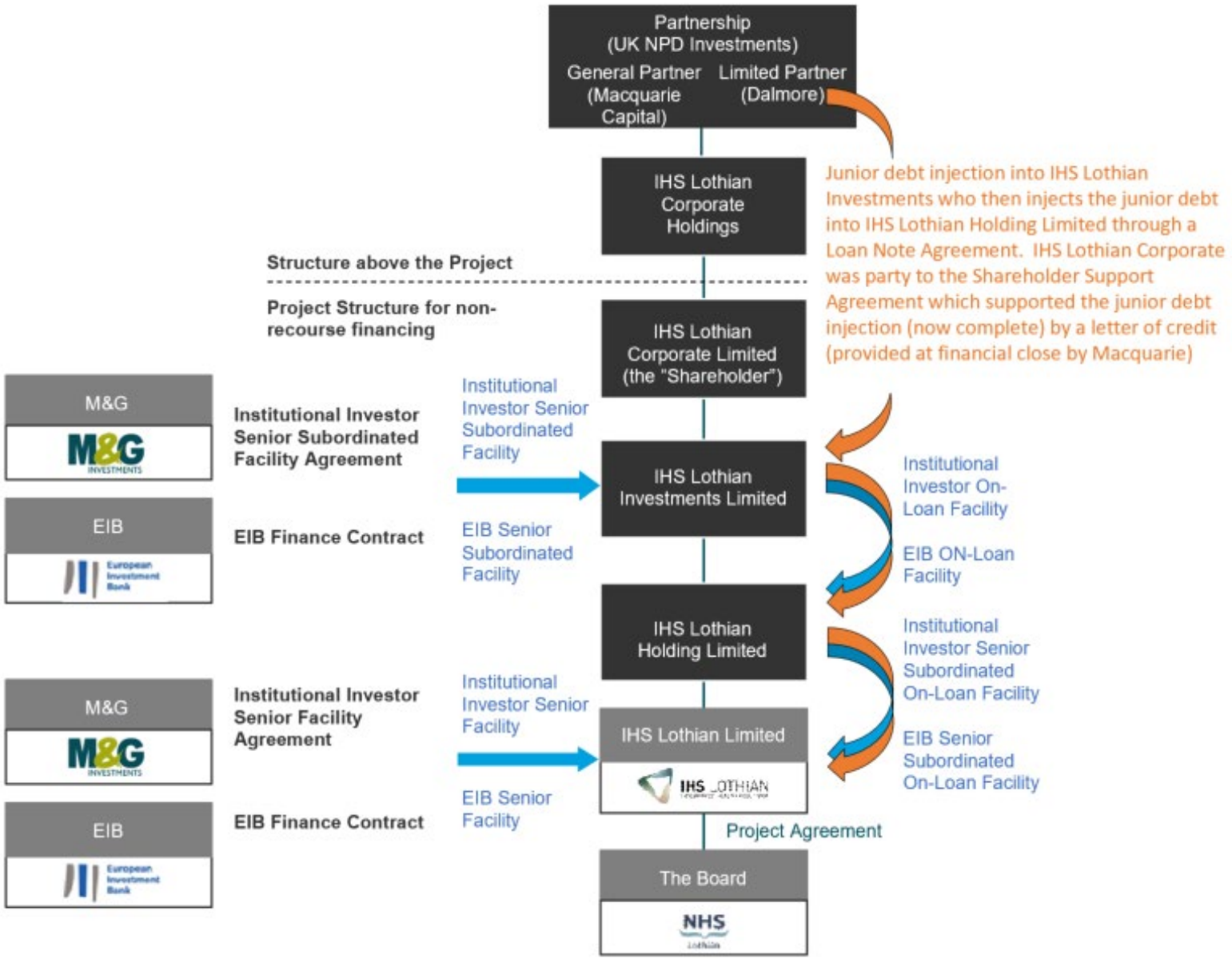
[101] The Inquiry holds at least 22 documents relating to finance arrangements (excluding security documentation), totalling 779 pages.
[102] Incorporation documents of IHSL.
[103] Incorporation documents of IHS Lothian Investments Limited.


Partnership
(UK NPD Investments)
General Partner
(Macquarie Capital)
Limited Partner
(Dalmore)
IHS Lothian Corporate Holdings
Junior debt injection into IHS Lothian Investments who then injects the junior debt into IHS Lothian Holding Limited through a Loan Note Agreement. IHS Lothian Corporate was party to the Shareholder Support Agreement which supported the junior debt injection (now complete) by a letter of credit (provided at financial close by Macquarie)
Structure above the Project
Project Structure for non-recourse financing
IHS Lothian Corporate Limited (the "Shareholder")
M&G
Institutional Investor Senior Subordinated Facility Agreement
Institutional Investor Senior Subordinated Facility
IHS Lothian Investments Limited
Institutional Investor On-Loan Facility
EIB
EIB Finance Contract
EIB Senior Subordinated Facility
EIB ON-Loan Facility
IHS Lothian Holding Limited
Institutional Investor Senior Subordinated On-Loan Facility
M&G
Institutional Investor Senior Facility Agreement
Institutional Investor Senior Facility
IHS Lothian Limited
EIB Senior Subordinated On-Loan Facility
EIB
EIB Finance Contract
EIB Senior Facility
Project Agreement
The Board
NHS

7. The Project Agreement

7.1 Introduction

7.1.1 One of the key characteristics of NPD contracts is the transfer of appropriate risk to the private sector.[104] The approach that NHSL proposed to take was set out in the OBC[105] and the FBC.[106] For the purposes of this paper, it is not necessary to review all the project agreement provisions relating to the allocation of risks as between the parties. However, in terms of understanding the contractual and financial structure of the project it is necessary to review the provisions relating to construction and design risk and availability risk, which in turn requires an understanding of the payment provisions set out in the project agreement.

7.1.2 Neither "design and construction risk" or "availability risk" are fully defined in either the OBC or the FBC. For present purposes, without seeking to give a definitive explanation, it can be taken that:

a. "design and construction risk" is the risk that the project be built on time, on budget and in accordance with the applicable contractual specifications and performance criteria. For example, should the project not be completed on time, then any additional costs arising would be borne by the body bearing that risk;[107] and

b. "availability risk" is the risk that the hospital is not available for use for its designed purpose at any time during the lifetime of the project agreement.

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[104] See diagram in Audit Scotland, Privately Financed Infrastructure Investment reproduced at paragraph 3.4.1 above. Some explanation of some of the aspects of risk transfer is given in Scottish Futures Trust, Standard Project Agreements (hub DBFM & NPD Model) Users Guide (Version 2 – June 2012) pp. 1 – 4.
[105] Section 4.5 above.
[106] Section 5.5 above.
[107] A generalisation, subject to exceptions. As the FBC notes at paragraph 4.1.3 (2), "a small number of delay and compensation events could entitle Project Co to compensation if the events materialised, such as no access to the site and incomplete enabling works which impact upon the site."

7.1.3 The intention was that both risks sat with IHSL. The Inquiry's provisional view is that the provisions of the project agreement achieve this, though that position may be thought to have been varied by agreements entered into after the project agreement was entered into. These agreements are discussed in subsequent chapters.

7.1.4 What follows should not be taken as a complete explanation or summary of the provisions of the PA, but as a summary only of the provisions that are relevant for present purposes. There is not, therefore, detailed analysis of every exception to a general proposition for which reference should be made to the PA itself.[108]

[108] A copy of the PA can be found in Bundle 5 issued by the Inquiry for the Hearing commencing on 25 April 2023.

7.2 Design And Construction Risk

7.2.1 The PA provisions relating to design and construction of the hospital were dealt with in some detail in the Inquiry's Provisional Position Paper 4 – Project Agreement,[109] and therefore this paper does not repeat that analysis.

7.2.2 It is sufficient for present purposes to note that clause 12.1 of the PA requires IHSL to carry out the Works to procure satisfaction of the Board's Construction Requirements, in accordance with Project Co's Proposals and in accordance with the other terms of the PA.

7.2.3 In the terminology adopted at paragraph 7.1.2a. above, the Board's Construction Requirements and Project Co's Proposals were effectively the "the applicable contractual specifications and performance criteria". The Works were defined in the contract as "the design…, construction, testing, commissioning and completion of the [hospital]…in accordance with this Agreement".[110] While responsibility for delivery of the Works lay with IHSL, at the risk of stating the obvious, responsibility for the Board's Construction Requirements lay with NHSL, and the risk of errors, omissions or inaccuracies in those remained with NHSL notwithstanding what follows.

7.2.4 The PA goes to deal with other aspects of design and construction. In terms of clause 14.1, for example, IHSL are obliged to complete the Works by 3 July 2017 (as that date may be varied in accordance with the provisions of the PA). Failure to achieve actual completion within 18 months of that date was an event of default in terms of clause 40.1.2.

7.2.5 In addition, as will become clear from the explanation of the payment mechanism below, IHSL would not receive any payment under the project agreement until the date on which the Certificate of Practical Completion was issued. That Certificate would only be issued when the Independent Tester was satisfied that the works were complete in accordance with the criteria set out in the PA.[111] Accordingly,

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[109] Available in Bundle 11 – Provisional Position Papers at page 317 of that Bundle.
[110] PA Schedule Part 1, p.181
[111] PA clause 34.1 and 17.12 read with appropriate definitions. See paragraph 7.5.2 below.

if the completion of the Works was delayed, IHSL bore the risk that they would not be paid until a later than anticipated date, which may have had implications for them under the financing agreements.

7.2.6 These provisions have the effect set out in the OBC and FBC i.e., that design and construction risk was effectively transferred to IHSL. The relevant contractual provisions are also in line with the SFT model agreement.[112]

7.3 Availability Risk

7.3.1 The rest of this section deals with the question of availability risk. In terms of the PA, availability risk is dealt with primarily through the payment mechanism, more specifically deductions from the monthly service payments made to IHSL due to lack of availability or performance failures. It is therefore necessary to start by looking at the payment mechanism before dealing with the question of deductions from monthly payments. It is necessary to enter two cautions before doing so however. First, to repeat what has been said already, what follows is not a complete guide to the payment mechanism set out in the contract. It is only an overview and omits some provisions that do not impact significantly on the question of calculation of monthly payments and availability risk, but which nonetheless may be important in other respects.

7.3.2 Second, this paper does not deal with any payments due, or related to, the expiry or termination of the PA (including variations of the Monthly Service Payment because of either event) or any other payments that may become due under the PA from one party to another. It deals solely with the Annual/ Monthly Service Payments.

[112] Scottish Futures Trust, Standard Project Agreements (hub DBFM & NPD Model) Users Guide (Version 2 – June 2012). See for example clauses 12 and 40 of that standard form.

7.4 Principal Payment Provisions

7.4.1 The principal provisions in the PA relating to monthly payment are found in clauses 34 – 38 and Part 14 of the Schedule.

7.4.2 The essential payment model is a monthly payment (the "Monthly Service Payment"[113]) calculated and paid in accordance with the provisions of the PA. IHSL is only entitled to payment after the Payment Commencement Date.[114] "The Payment Commencement Date" is defined as "the Actual Completion Date", which is in turn defined as the later of the date stated in the Certificate of Practical Completion issued by the Independent Tester or the Completion Date.[115] The Certificate of Practical Completion was issued by the Independent Tester on 22 February 2019.

7.4.3 The starting point for calculating the monthly payment is an Annual Service Payment, which is discussed in section 7.5. From this, a Monthly Service Payment is calculated (essentially by dividing the Annual Service Payment amount by 12, and thereafter assessing whether any deductions fall to be made). This is discussed in section 7.6. The mechanism for triggering payment of the amount due is discussed in section 7.7.

7.5 Calculation of Annual Service Payments (PA Schedule Part 14)

7.5.1 The Annual Service Payment for any Contract Year[116] is calculated according to a formula specified in the PA.[117] The formula provides for part of the Annual Service payment to be adjusted according to movements in the Retail Prices Index. Indexation is applied to part only of the Annual Service Payment as it is intended to

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[113] Defined in PA Schedule Part 14 p. 349
[114] PA Clause 34.1 p. 70
[115] The Completion Date as stipulated in the PA was 3 July 2017. However, as a result of the occurrence of Delay Events during construction which entitled IHSL to an extension, this became 9 July 2017.
[116] "Contract Year", as defined in the PA, means "(a) for the first Contract Year, the period from the date of this Agreement [13 February 2015] to the subsequent 31 March; and (b) for all subsequent Contract Years, the period of twelve (12) calendar months commencing on each anniversary of 1 April…" - Schedule Part 1 p. 143
[117] PA Schedule Part 14 Section 2 paragraph 2, page 352.

cover only that proportion of the contractor's underlying costs that are not fixed.[118] The formula, and a simplified example of how it works, is given at Appendix 1. The formula adopted in the PA is that recommended in the SFT's model contract.[119]

7.5.2 Note that while actual payment of the Monthly Service Charge does not start until after the Payment Commencement Date as explained at paragraph 7.4.2, indexation of the Annual Service Payment effectively commences from February 2015 (in the words of the PA, the "Base Date"). Put another way, after the Payment Commencement Date, the Annual Service Payment to be paid by NHSL was not the Annual Service Payment calculated as at the date on which the PA was signed. Rather, it was the Annual Service Payment as at that to which indexation had been applied in accordance with the formula set out in Appendix 1.

7.6 Monthly Service Payments (Schedule Part 14)

Monthly Service Payments

7.6.1 The monthly payment (the "Monthly Service Payment") is calculated in accordance with the formula specified in Part 1 of Section 2 of Part 14 of the Schedule to the PA.[120] Put simply, the formula provides that the Monthly Service Payment is 1/12 of the Annual Service Payment, less the sum of Deductions in respect of the performance of the Services during the month falling two months

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[118] See explanation in *Standardisation of PFI Contracts Version 4*, March 2007, section 15.2 (https://webarchive.nationalarchives.gov.uk/20130123191515/http://www.hm-treasury.gov.uk/d/pfi_sopc4pu101_210307.pdf); *Standardisation of PF2 Contracts*, December 2012 section 19.11 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/207383/infrastructure_standardisation_of_contracts_051212.PDF); and Scottish Futures Trust, *Standard Project Agreements (hub DBFM & NPD Model) User's Guide,* Version 2: June 2012 p.42 (https://www.scottishfuturestrust.org.uk/storage/uploads/Standard_Project_Agreements_Users_Guide_(Version_2_-_June_2012).doc)

[119] See SFT, *Standard Form Project Agreement (NPD Model)* Version 2: June 2012 at p.287 (https://www.scottishfuturestrust.org.uk/storage/uploads/Standard_Form_Project_Agreement_(NPD_Model)_(Version_2_-_June_2012).doc)

[120] PA page 352.

previous,[121] then adding any Pass Through Costs due for which supporting uncontested invoices are available.

7.6.2 "Deductions" are discussed in more detail in the following paragraphs. "Pass Through Costs" are costs payable to IHSL specified in Section 6 of Schedule Part 14 to the PA.[122] They fall into three main categories:

a. Utility Charges – charges for electricity, gas, water, sewerage, waste disposal, telephony and similar charges;[123]

b. Rates – local authority rates; and

c. Operational Insurance Premiums: premiums for the insurances that IHSL are obliged to maintain under the PA including property damage insurance, business interruption insurance, and third-party public and products liability insurance.

7.6.3 These Pass Through Costs must be paid to IHSL in full each month, irrespective of the total amount of Deductions that NHSL are entitled to make.[124]

Deductions From Monthly Service Payments – General

7.6.4 In the preceding paragraphs "Deductions" are deductions "to be made in calculating a Monthly Service Payment, calculated in accordance with Section 3 (Deductions from Monthly Service Payments) of Schedule Part 14 (Payment Mechanism)".[125]

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[121] The reason for Deductions being made two months after the event is explained in *Scottish Futures Trust, Standard Project Agreements (hub DBFM & NPD Model User's Guide version 2 June 2012* at p. 23, commentary on clause 34.2: "The drafting here and in Section 2 of Schedule Part 14 (*Payment Mechanism*) assumes that the Authority will pay for services delivered in the current Contract Month at the end of the current Contract Month. In order to allow sufficient time for reporting and agreeing performance and any resulting Deductions, monitoring and reporting will work two months behind. Thus, payment for month 3 will be invoiced near the beginning of month 3 and paid before the last working day of month 3 and will be based on service performance in month 1. Month 2 will be spent reporting and agreeing that performance. This is considered to be the optimum timing for value for money consistent with the principle that payment should not be made before services have been delivered. An Authority proposing any alternative payment cycle will have to demonstrate to SFT the value for money benefit."

[122] PA Schedule Part 14 Section 1 p.349.

[123] The full list is set out in the definition of "Utility" at PA Schedule Part 12 Section 1, p.4.

[124] PA Schedule Part 14 Section 3 paragraph 1.3.

[125] PA Schedule Part 1 p. 145

7.6.5 There is a cap on the amount of Deductions that the Board may make, the Gross Month Availability Deduction. According to SFT guidance, "The monthly cap on Deductions operates to ensure that, over the course of a year, the total Deductions will be capped at an amount equal to the Annual Service Payment. In any Contract Month[126] that the monthly cap exceeds the Monthly Service Payment, the drafting provides for the excess to be carried forward and set-off against future Monthly Service Payments (rather than being an amount payable by the SPV to the Authority)."[127] The drafting of the PA follows the drafting of the SFT standard contract with the exception that it provides for Deductions in relation to Sessions in the relevant Contract Month,[128] a Session being "a period of 8 hours, beginning at 6 a.m., 2 p.m. and 10 p.m. in each 24 hour period".[129]

Deductions From Monthly Service Payments – Availability and Performance Failures

7.6.6 Section 3 of Schedule Part 14 entitles the Board to make deductions from the Monthly Service Payment in respect of:

a. Availability Failures: that is an incident or state of affairs with reference to a Functional Area[130] that does not comply with the Availability Standards specified in the Service Level Specification[131] which has not been rectified within the permitted time; and

b. Performance Failures: that is an incident or state of affairs that does not comply with the Performance Standards specified in the Service Level Specification that has not been rectified within the permitted time.[132]

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[126] A "Contract Month" is a calendar month with specific provision being made for the first and last such months: PA Schedule Part 1 p. 143

[127] Scottish Futures Trust, *Standard Project Agreements (hub DBFM & NPD Model) User's Guide,* Version 2: June 2012 p. 41 – explanation of definition of "Gross Monthly Availability Deduction".

[128] Rather than "Days" in the SFPA

[129] PA Schedule 14 Part 1 p.350; cf. Scottish Futures Trust, *Standard Form Project Agreement (NPD Model)* Version 2: June 2012, definition of Gross Month Availability Deduction at p.282 and Day at p.281. But see footnote 68 above (page 9).

[130] Listed in PA Schedule Part 14 Appendix 2.

[131] The Service Level Specification is "the requirements of the Board set out in Section 1…of Schedule Part 12…as amended from time to time…": Schedule Part 1 p. 175

[132] Reference should be made to the full definitions of Availability Failure and Performance Failure contained in Schedule Part 14 Section 1, which will require regard also to be had to Schedule Part 1, particularly for the definition of "Functional Area" and "Service Level Specification".

7.6.7 Availability Standards cover accessibility, operational function condition, use condition and safety condition. The definition of those standards is for the most part technical. An example of an Availability Standard relating to Accessibility Condition is as follows:

> "The relevant Functional Area is maintained such that the range of functional requirements for the proper use and enjoyment of a Functional Area for its particular purpose relating to air-flow are the same as specified on the Room Data Sheets for the relevant Functional Area."

7.6.8 The Response Period for a failure to meet that standard is 15 minutes during operational hours (6 a.m.–10 p.m.), 1 hour outwith. The applicable Rectification Period is 1 hour within operational hours and 2 hours outwith.[133] The list of Functional Areas to which the Availability Standards relate is lengthy[134] but covers areas such as medical gas cylinder stores, wheelchair parking bays, ward management offices, ward kitchens, treatment rooms and bedrooms. Each Functional Area is assigned a GSU, or Gross Service Unit.[135] These vary widely, from 0 for several corridors (and others) to 200 for a General X-Ray room (and others). The aggregate of the GSUs for areas affected by Availability Failures per Deduction Period is taken into account in calculating the deduction.[136]

7.6.9 Response Periods and Rectification Periods run concurrently. The Response Period is the period within which IHSL must respond to the event in question and if relevant remove any immediate risk of injury or incident that might impinge on the heath and safety of users of the hospital either temporarily or permanently.[137] The Rectification Period is the period allowed for the Rectification of the relevant event.[138] Rectification is also a defined term and means making good the incident or

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[133] PA Schedule Part 12 Section 1 Chapter 6 AS Ref A06.
[134] Schedule Part 14 Appendix 2 runs to 43 pages.
[135] Schedule Part 14 Appendix 2, table column 7.
[136] A Deduction Period is essentially the number of Sessions from (and including) the Session in which the Performance Failure occurs until the Logged Rectification Time, unless there is no Rectification Period for a Performance Failure, in which case the Deduction Period is 1: Schedule Part 14 Section 1 p.347
[137] PA Schedule Part 12 Section 1 Chapter 1, p.3
[138] The details for computation of the period are set out in the definition of "Rectification Period", Schedule Part 14 Section 1 p.349.

state of affairs, restoring all functional capability and compliances with the Availability Standards and the Performance Standards.[139]

7.6.10 Performance Standards cover a wide range of IHSL's activities, including management and strategy, integration with board policies and operation, quality, environment, health and safety, access and works management, recruitment, supply chain management, helpdesk, efficient operation, monitoring and records, programmed maintenance and so on.[140] Generally, Performance Standards have a specified "Remedy" and a "Remedial Period" within which the Remedy must be implemented. For example, Performance Standard FM64 provides:

> "Project Co shall clean all internal and external panes of glazed areas of the building envelope on a quarterly basis, dates to be agreed with the Board".

The Remedy for failure to comply is to complete the outstanding Programmed Maintenance for the relevant month, and the Remedial Period is 3 business days.

7.6.11 Performance Standards are assigned a Performance Category of "Minor", "Medium" or "Major".[141] This is of relevance to the calculation of deduction for a failure to meet a performance standard - £30 per Deduction Period for failure to meet a standard the Performance Category of which is Minor, £75 per Deduction Period for Performance Category of Medium and £200 for a Performance Category of Major.[142]

Calculation of Deductions

7.6.12 The method by which the precise amount of deductions that may be made in respect of Availability and Performance Failures is set out in detail in Section 3 of Part 14 of the Schedule to the PA. There is a different formula for Performance

[139] PA Schedule Part 14 Section 1 p.349.
[140] The full list is in PA Schedule Part 12 Section 1 paragraph 5.
[141] PA Schedule Part 12 Section 1 paragraph 5, second column of table.
[142] PA Schedule Part 14 Section 3 paragraph 2.1. All figures are index-linked and so adjusted in accordance with RPI.

Failures[143] and Availability Failures,[144] although the basic approach is the same to both: the amount calculated in accordance with the provisions of Schedule Part 14 (and other relevant provisions) that is relevant to the failure is multiplied by the number of Deduction Periods for which the failure lasted. In the case of Availability Failures only, the amount that falls to be deducted is the higher of the amount calculated according to the formula the effect of which has just been explained or the Minimum Availability Deduction multiplied by the number of Deduction Periods.[145]

7.6.13 No deduction may be made for a Contract Month for any failure to meet Performance Standards designated as “Minor” in the PA if there are less than five such failures in that month. Where two or more Performance Failures occur in a Functional Area in a single Session, only the Performance Failure that results in the highest deduction applies.[146] There can be a deemed Performance Failure in certain circumstances where IHSL fail to monitor or accurately report an incident or state of affairs that does not comply with the Performance or Availability Standards.[147]

7.6.14 The PA contains provisions relating to an increase or decrease in the amount of Deductions in certain circumstances. For example, where the relevant Functional Area that is subject to an Availability Failure is actually used notwithstanding the Availability Failure, the deduction for that failure is reduced by 50%.[148] There are increases in the GSU’s applicable to an Availabilty Failure affecting a patient bed lift if more than one patient bed lift is affected during the same Session.[149] There are also provisions for repeated Availability and Performance Failures over a rolling period of 3 Contract Months that increase the applicable deduction by a factor of 1.5. These provisions apply in the case three or more Performance or Availability Failures in respect of the same Performance/ Availability Standard and some upper limits on particular kinds of failures.[150]

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[143] See Schedule Part 14 Section 3 paragraph 2
[144] See Schedule Part 14 Section 3 paragraph 4
[145] Minimum Availability Deduction is defined (by a formula) at Schedule Part 14 Section 1 p. 348
[146] Schedule Part 14 Section 3 paragraph 2, paragraph 2.3
[147] Schedule Part 14 Section 3 Chapter 3. See also Chapter 6 which creates another deemed Performance Failure.
[148] Schedule Part 14 Section 3 Chapter 4 paragraph 4.2
[149] Schedule Part 14 Section 3 Chapter 4 paragraphs 4.3 and 4.4
[150] Schedule Part 14 Section 3 Chapter 5

7.6.15 Similarly, the PA contains provisions dealing with circumstances where a Performance Failure and an Availability Failure overlap. Where the circumstances of a Performance Failure affecting a particular Functional Area also give rise to an Availability Failure in that Functional Area, in general only the deduction for an Availability Failure applies.

7.7 Monthly Payment Mechanism (Clause 34)

7.7.1 The payment mechanism is triggered by the submission of an invoice by IHSL to the Board on or before the first day of each Contract Month (a "Monthly Invoice") aggregating the following sums:

a. the Monthly Service Payment for that Contract Month, calculated in accordance with Section 2 (*Calculation of Service Payments*) of Schedule Part 14 (*Payment Mechanism*) (discussed at section 7.6 below);

b. adjustments to reflect previous over-payments and/or under-payments;

c. any other amounts due by one party to the other (and where owed by Project Co applied as a negative figure); and

d. any VAT payable in respect of the above amounts.

7.7.2 The invoice is to be accompanied by supporting information that clearly sets out the derivation and calculation of the amounts specified in the monthly invoice.[151] In addition, no later than the tenth day of each Contract Month, IHSL must give to the Board a Monthly Service Report[152] in respect of the preceding Contract Month which sets out:

a. details of each and the aggregate amount of all Deductions[153] incurred in relation to Performance Failures;

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[151] *Ibid*.
[152] Defined PA Schedule 1 Part 1 p. 159 as "a monthly report to be prepared by Project Co and provided to the Board in accordance with the relevant provisions in Section 1 (Service Level Specification) of Schedule Part 12 (Service Requirements);
[153] Defined PA Schedule 1 Part 1 p. 145 as "a deduction to be made in calculating a Monthly Service Payment, calculated in accordance with Section 3 (Deductions from Monthly Service Payments) of Schedule Part 14.(Payment Mechanism);

b. details of each and the aggregate amount of all Deductions incurred in relation to Availability Failures;

c. other information detailed in Schedule Part 12 (Service Requirements).

7.7.3 The parties are to endeavour to agree the contents of a Monthly Service Report within ten Business Days[154] of its submission, failing which either party may refer the matter to the Dispute Resolution Procedure. The PA contains provisions relating to disputed amounts and interest on late payments.[155]

7.8 Payment of Surpluses and Compliance with NPD Requirements (PA Clause 36)

7.8.1 Subject to anything in its Articles of Association, IHSL must pay the Surplus available on the date falling five business days after 31 March and 30 September in each year following the Commencement Date[156] to the Board, or to such other party as the Board may direct, (as a rebate of the Monthly Service Payments for the Contract Year most recently ended prior to the relevant Surplus Date) within 30 days of the date in question.[157]

7.8.2 The "Surplus" is defined in the PA as the amount (if any) standing to the credit of the Surplus Account. The "Surplus Account" has the meaning given in the Common Terms Agreement (effectively a nominated bank account held at Sumitomo Mitsui Banking Corporation Europe Limited, the bank that held all the project accounts as at financial close). In practical terms, the "Surplus" is the amount left after payment of the following (in the order in which payment should be made):

a. Any sums due and payable in relation to Project Expenditure;[158]

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[154] Defined PA Schedule Part 1 p. 140 as being any day other than Saturday, Sunday or a bank holiday in Edinburgh.
[155] PA Clause 34.2 – 34.5
[156] Each of these being a "Surplus Payment Date" – see definition of that term at p. 178 PA
[157] PA Clause 36.1. Note that the Commencement Date here is the Commencement Date of the PA i.e., "the last day of execution of [the PA]" or 13 February 2015.
[158] Defined in Clause 1 of the Intercreditor Agreement.

b. Any sums required to be transferred in accordance with, or due to be paid under, any of the financing agreements; and

c. Any amounts required to maintain a cash buffer of £100,000 (Index linked.[159]

At the risk of oversimplification, the Surplus is therefore the amount left over from the payments received by IHSL after its operating costs and financing costs have been met.

7.8.3 IHSL are also obliged to comply with the NPD Requirements at all times throughout the Project Term.[160] For this purpose, the NPD Requirements are:

a. not to make a distribution of profit or surplus, or any transfer of assets to one or more shareholders whether by means of any payment or transfer of assets, directly or indirectly, in cash or in any kind, whether by way of dividend, bonus or release of obligation or in any other way otherwise than in certain specified circumstances; and

b. to comply with Clause 4.4 of the PA (Changes to Funding Agreements and Refinancing), which sets out that IHSL could not (without the prior consent of NHSL make changes to the conditions pertaining to the Surplus Account or Surplus Payments.

7.8.4 Specific provision is made in relation to breach of the obligations relating to payment of surpluses and compliance with NPD requirements. If IHSL breach these obligations, then NHSL may terminate the PA at any time within 18 months of becoming aware of any such breach. NHSL is required to inform IHSL of any such breach as soon as reasonably practical after becoming aware of it.[161] Termination is effected by the giving of notice of termination by NHSL to IHSL, and the PA terminates 30 business days after receipt of the notice unless IHSL demonstrates to the satisfaction of NHSL that the breach was caused by an administrative error and it is rectified within 10 business days of receipt of the notice (in which case the notice

[159] For the complete list, see Articles of Association of IHS Lothian Limited, article 3.1.
[160] PA Clause 36.2.
[161] PA Clause 45.1.

is deemed not to have been served).[162] On termination, NHSL becomes obliged to pay compensation to IHSL calculated in accordance with the PA.[163]

7.9 Records and Open Book Accounting (Clause 38)

7.9.1 This clause provides that the provisions of Schedule Part 19 of the PA apply to the keeping of records and the making of reports. That Part requires IHSL to retain and maintain records falling into 24 categories in chronological order and in a form that is capable of audit.[164] IHSL are required to make the records available to NHSL on reasonable notice where NHSL has reasonable cause for requiring such records.

7.9.2 Where practical, original records are to be maintained in hard copy form. Financial and other records[165] are to be retained for a period of at least six years in sufficient detail and in a form that enables IHSL to comply with its obligations relating to information and audit access.[166]

7.9.3 IHSL are also required to provide to NHSL:

a. a copy of its unaudited interim accounts at the end of, and for each six month period of, each financial year of IHSL;

b. a copy of Project Co's audited accounts, prepared in accordance with the Companies Act 1985 and generally accepted accounting principles and bases in Scotland;[167]

c. on 31 March, 30 June, 30 September and 31 December each year a document listing all information provided by it to the Senior Funders during the preceding three month period and, at the request of the NHSL, any

[162] PA Clause 45.2
[163] PA Clause 46.5. The bulk of any such compensation payment would find its way to the lenders by virtue of the various agreements relating to the financing of the project.
[164] PA Schedule Part 19 Section 1 paragraph 1. The categories of records are listed in Section 2 of that Part.
[165] Except for records relating to Project Operations, including the design, construction, development, enhancement and maintenance of the facilities), which are to be retained for the duration of the PA: PA Schedule Part 19 Section 1 paragraph 3.
[166] PA Schedule Part 19 Section 1 paragraph 4.
[167] PA Schedule Part 19 Section 1 paragraph 7.

information provided by it to the Senior Funders and any other information relating to the Project that NHSL may reasonably require.[168]

7.9.4 These provisions should be read along with Clause 63 PA (Information and Audit Access). Amongst other things, this clause provides that for the purpose of:

a. the examination and certification of NHSL's accounts; or

b. any examination pursuant to section 23 of the Public Finance and Accountability (Scotland) Act 2000 of the economy, efficiency and effectiveness with which NHSL has used its resources,

the Auditor General for Scotland may examine such documents as he may reasonably require which are owned, held or otherwise within the control of IHSL (and IHSL must procure that any person acting on its behalf who has such documents and/or other information shall also provide access). The Auditor General for Scotland may further require IHSL to produce such oral or written explanations as he considers necessary.[169]

[168] PA Schedule 19 Part 1 Paragraph 8
[169] PA Clause 63.2

8. First Supplemental Agreement

8.1 Introduction and Background

8.1.1 NHSL and IHSL entered into a settlement agreement and supplemental agreement relating to the Project on 22 February 2019 (SA1).

8.1.2 Recital B of the Agreement narrates that "The Board and Project Co entered into settlement discussions regarding various matters relating to the Project and the terms of this SA 1 reflect the outcome of those settlement discussions." The original Completion Date specified in PA was 3 July 2017.[170] This date was not achieved, and a subsequently agreed "handover date" of 12 October 2017 was also not achieved. NHSL Board discussed a number of significant issues – high voltage, ventilation and MRI accommodation – at their meeting on 4 October 2017. The Board accepted a recommendation that these issues proceed to dispute resolution process.[171]

8.1.3 At the NHSL Programme Board meeting on 6 November 2017, it was noted that "Construction completion, including all remedial works, is entirely possible by July 2018. Addition of planned 14 week commissioning period would indicate migration dates in October/ November 2018".[172] However, this was an NHSL estimate (based on technical advice), and it was observed that the further the construction progresses, the more complex the remedial works would become. The Programme Board were also informed that there was a "significant amount of paperwork" relating to changes to the Board's Construction Requirements proposed by IHSL still to be progressed. The Board approved progression to dispute resolution process.

8.1.4 Discussions concerning the areas of dispute was ongoing. At the Programme Board's meeting on 27 November 2017, it was noted that IHSL had offered a revised programme with a completion date of 22 May 2018. This was conditional on a

[170] PA Schedule Part 1, p. 142 definition of "Completion Date"
[171] See summary in Programme Board Papers 6/11/17
[172] Programme Board Meeting Note 6 November 2017 p.3

number of things, including a payment by NHSL of £6.8 million. That payment was "unacceptable" to NHSL, and there was "no confidence" in the proposed programme.[173] At its meeting on 19 December 2017, the Programme Board was provided with "a summary of between 50 and 60 areas of potential non-compliance which the Board are awaiting remedies by IHSL. Should these items not be remedied to a satisfactory position they may also require escalation to D[ispute]R[esolution]P[rocess]."[174] NHSL discussed matters with IHSL's lenders on 2 February 2018, stressing that NHSL "has yet to have a facility that is compliant or a credible programme to completion…The Board are yet to recognise any reliability of delivery."[175] It was also noted that the [NHSL] Project team still estimated "July 2018 completion exc remedial work to 4 Bed Room Ventilation and subject to other current potentially significant non compliances not escalating."[176]

8.1.5 On 21 March 2018, NHSL wrote to IHSL regarding the ventilation issue. The letter noted "as has been made clear to you repeatedly the ventilation to multi bed rooms is of critical clinical importance to us. No acceptable solution has been forthcoming from you to date in connection with this issue…. We cannot allow this issue to remain unresolved. The hospital is already over 8 months late. A further delay pending the outcome of the dispute pursuant to the dispute resolution procedures in schedule part 20 of the Project Agreement is unacceptable." The letter enclosed a draft summons that NHSL proposed to lodge in the Court of Session.

8.1.6 Court proceedings were not proceeded with following submission of a commercial proposal by IHSL. A completion date of 31 October 2018 was given, which appeared a "credible programme". The Scottish Government agreed to finance the commercial proposal so that it would not impact directly on NHSL funding. This did not, however, cover the costs of double running (i.e. continuing to run the old hospital while the new one was completed), though as no sums were being paid to IHSL, there was a surplus in the budget that would offset those

[173] Programme Board Meeting Note 27/11/17 p.2
[174] Programme Board Meeting Note 19/12/17 p.3
[175] Programme Board 19 March 2018 Update p.3
[176] Programme Board 19 March 2018 Update p.8

costs.[177] The Scottish Government funding was to be in the form of a capital injection rather than a loan.[178]

8.1.7 Negotiations continued – it was a "fluid situation, with daily conferences and very complex negotiations." It was noted that "IHSL desperately need this to service debts to Funders. 81 technical items. have been reduced to <70, with cable calculations and works outside the boundary having been taken into another process. Drainage and Automatic Fire Detection (Voids) are now the most pressing technical matters. The proposal includes milestone payments to incentivise delivery – NHSL wish to introduce performance/ delivery standards to payments."[179]

8.1.8 The update to the Programme Board for its meeting on 6 February 2019 notes that the settlement agreement was approved by the Finance & Resources Committee on 23 January 2019 and was going to the full NHSL Board on 6 February 2019.[180] It was noted that although the documentation was very advanced, there were some technical and commercial issues remaining and the funder approval process was not completed. The settlement agreement was signed on 22 February 2019.

8.2 SA1 – Summary

8.2.1 The key provisions of SA1 may be summarised as follows:

a. IHSL was obliged to design, construct, test, commission and complete the Works (other than the Post Completion Works[181] and Outstanding Works[182]) and Facilities in accordance with the Project Agreement as

[177] Programme Board Meeting Note 21/5/18 p.2. The funding position is also set out in the Programme Board 21 May 2018 Update at p. 4. Note that in the Update, funding details with Scottish Government identified as a risk, as was the consent of senior funders (p.6)
[178] Programme Board Notes 16 July 2018 p. 2
[179] Programme Board Notes 24 September 2018 p. 1
[180] Programme Board 06 February 2019 Update p. 3
[181] Various drainage works, void detection works and heater battery works all as described in Parts A and B of Part 5 of the Schedule to SA1
[182] Works set out in Part 6 of the Schedule to SA1 that the parties agreed were to be completed after the Actual Completion Date.

amended by the Agreed Resolution[183] so as to satisfy the Completion Criteria as amended by the Agreed Resolution; the Agreed Resolution was to be used by the Independent Tester for the purposes of interpreting the relevant aspects of the Completion Criteria as amended by the Agreed Resolution for those parts of the Works (other than the Outstanding Works and Post Completion Works) detailed in Part 1 of the Schedule to SA1;

b. IHSL was obliged to procure the design, build, test and commissioning of the Post Completion Works including detailed technical specifications and operational procedures by agreed programme dates (and failure to complete them by 26 July 2019 would have given rise to an event of default under the PA);

c. Solutions to other disputed technical issues accepted by NHSL (those referred to at paragraph 8.1.8 above) form part of a schedule to the Settlement Agreement which IHSL were obliged to implement;

d. NHSL required to pay to IHSL £6 million (plus VAT) on signature of SA1 to be used towards IHSL's obligations to the funders;

e. NHSL was to pay a further £5.6 million (plus VAT) to IHSL as follows:

    - Certification by the Independent Tester in relation to completion of the post-completion drainage works – £2 Million;
    - Certification by the Independent Tester in relation to completion of the post-completion void Detection – £2 Million;
    - Certification by Independent Tester in relation to completion of the post-completion heater batteries works – £1.6 Million.

f. NHSL would commence payment of the full Annual Service Payment on the Actual Completion Date (that is the date of actual completion of all

[183] The "Agreed Resolution" is "the technical solution required to resolve the disputes between IHSL and NHSL (other than the Post Completion Disputed Works) and the obligations on each party to meet (or procure the meeting of) that agreed technical solution all as detailed in Part 1 of the Schedule to SA1" – SA1 Clause 1.3. The Post Completion Disputed Works were set out in of Part 5. to the Schedule to SA1

works to be carried out under the PA in relation to the construction of the hospital less the Post Completion Works and Outstanding Works[184]); and

g. IHSL and NHSL both released each other from claims in respect of the original disputes relating to the technical issues (referred to at paragraph c above), the Post-Completion Works and any events known by the parties as at the date of SA1 that would otherwise have qualified for relief under the PA.

8.2.2 What follows is not a full analysis of SA1, but rather focuses on those parts of SA1 that impact upon the payments to be made in respect of the project as previously described.

8.2.3 It should be noted that to finance its obligations under SA1 the ultimate shareholders in IHSL were to invest an additional £5.4 million by way of subordinated debt under the terms of an amended and restated shareholder support agreement between IHSL, IHS Lothian Holdings Limited, IHS Lothian Investments Limited, IHS Lothian Corporate Limited and Prudential Trustee Company Limited.

8.3 Payment of the Settlement Sum (Clause 4)

8.3.1 SA1 makes provision for payment of £11.6 million plus VAT by way of a "Settlement Sum" by NHSL to IHSL in instalments.[185] These payments would be made (with the exception of that at Milestone 4 below) prior to the conclusion of the construction phase and therefore before the services relating to the operation and maintenance of the new hospital had begun.

8.3.2 The amount was payable in instalments as set out in the following table:[186]

Event	Element of Settlement Sum (£)	Invoicing Arrangements	Payment Date

[184] Works listed in Part 6 of the Schedule to SA1.
[185] SA1 clause 4.1
[186] Derived from Part 7 of the Schedule to SA1

Milestone 1 Signature of SA1	£6m (Plus VAT)	IHSL to submit invoice to NHSL on the date of final signature of SA1	NHSL to pay invoice within 5 business days of receipt of a valid VAT invoice
Milestone 2 Completion of the Drainage Works in accordance with the Drainage Completion Criteria (target completion date 24 May 2019)	£2m (Plus VAT)	IHSL to submit an invoice to NHSL when the Independent Tester has certified that Milestone 2 has been achieved	NHSL to pay invoice within 5 business days of receipt of a valid VAT invoice (which valid invoice can only be issued once the Independent Tester has certified that Milestone 2 has been achieved
Milestone 3 Completion of the Void Detection Works in accordance with the Void Detection Completion Criteria (target completion date 13 June 2019)	£2m (Plus VAT)	IHSL to submit an invoice to NHSL when the Independent Tester has certified that Milestone 3 has been achieved	NHSL to pay invoice within 5 business days of receipt of a valid VAT invoice (which valid invoice can only be issued once the Independent Tester has certified that Milestone 3 has been achieved
Milestone 4	£1.6m (Plus VAT)	IHSL to submit an invoice to NHSL	NHSL to pay invoice within 5

Completion of the Heater Battery Works in accordance with the Heater Battery Completion Criteria target completion date 27 May 2019)	when the Independent Tester has certified that Milestone 4 has been achieved	business days of receipt of a valid VAT invoice (which valid invoice can only be issued once the Independent Tester has certified that Milestone 4 has been achieved

8.3.3 These payments were declared to be in consideration of:

a. IHSL carrying out its obligations under clause 3.1.1 (to design, construct, test, commission and complete the works relating to the construction of the hospital (other than the Post Completion Works and Outstanding Works) in accordance with PA as amended by the Agreed Resolution and the other provisions of SA1);

b. The costs of the Agreed Resolution;

c. Associated on-site costs; and

d. Senior debt funding payable by IHSL from the period from 20 April 2018 to 31 October 2018.[187]

8.3.4 Provision is made for payment of interest and other remedies should NHSL fail to pay an instalment of the Settlement Sum by the date shown in the table above (SA1 clauses 4.2 and 4.3). Provision was also made for each party to bear its own

[187] See Grant Thornton, *NHS Lothian Internal Audit Report – Report for the Audit and Risk Committee 31 July 2020 and the NHS Lothian Board 12 August 2020 – Governance and Internal Controls: Royal Hospital for Children and Young People and Department of Clinical Neurosciences, Edinburgh*, at paragraph 270: "At this stage, it is understood [IHSL] were experiencing cash flow difficulties. A risk was identified that the funders of the project could withdraw their funding support. The consequences, for NHS Lothian, would have been significant including a substantial time delay on the project and a risk that new funders may not be identified." A copy of this report can be found in Bundle 3 for the Hearing of the Inquiry commencing 9 May 2022 (Volume 1) starting at page 30 of that Bundle.

costs in relation to the disputed matters that were effectively resolved by SA1 and the negotiation, execution and implementation of SA1 and in relation to various other matters (clauses 4.4 and 4.5).

8.4 Payment of Service Charge Ahead of Completion of Works (Clause 6.12.1)

8.4.1 Clause 6.12.1 provides that "completion of the Post Completion Works and the Outstanding Works shall not be a requirement for the issue of a Certificate of Practical Completion by the Independent Tester pursuant to Clause 17.12 (Completion Certificate) of the Project Agreement or the occurrence of the Actual Completion Date, and the Certificate of Practical Completion shall be issued the dispute between the Parties regarding the Concrete Specification, De-Watering, Geotechnical Reports, Submains Schedule and the Energy Centre Lighting Calcs". (All of the disputes referred to being defined in SA1 – the details are not relevant for present purposes, it being sufficient to note that there were several ongoing disputed matters relating to construction.)

8.4.2 As explained in paragraph 7.4.2 above, the Actual Completion Date is also the Payment Commencement Date, which is the trigger for payment of the Monthly Service Charge to IHSL (and the trigger for IHSL to start providing services under the PA). Accordingly, clause 6.12.1 makes explicit that notwithstanding that the Post Completion Works and the Outstanding Works are not complete, the Certificate of Practical Completion may be issued and payment of the Monthly Service Charge begin. SA1 made no changes to the definition of "Actual Completion Date" and as noted at paragraph 7.4.2. the Certificate was issued on 22 February 2019 – the same date as the date of signature of SA1. Accordingly, liability for the Monthly Service Charge, amounting to £1.35 million per month, started on the date on which SA1 was signed.[188]

8.4.3 As explained at paragraph 7.6.6 and following, the PA makes provision for deductions from the Monthly Service Charge in relation to performance and availability failures. Clause 6.16 goes on to provide that "No Deduction shall

[188] Audit Scotland, *The 2018/19 Audit of NHS Lothian – Delay To The Opening of the Royal Hospital for Children and Young People*, p. 12.

apply…where such Deduction…arises solely as a result of the carrying out of the relevant Post Completion Works or Outstanding Works providing that such relief shall only apply from the Actual Completion Date until the Milestone 2 Target Completion Date[189] (in respect of the Drainage Works) and/ or Milestone 3 Target Completion Date[190] (in respect of the Void Detection Works) and/ or Milestone 4 Target Completion Date[191] (in respect of the Heater Battery Works) and/ or the Outstanding Works Target Completion Date (in respect of the Outstanding Works)". Apart from these limited grounds of relief (that applied for a limited period), the deductions regime discussed above was applicable from the Actual Completion Date.

8.4.4 A number of amendments consequential on SA1 are made to Schedule Part 14 to PA (Payment Mechanism) relating to a number of Service Events.[192]

[189] 24 May 2019
[190] 13 June 2019
[191] 27 May 2019
[192] A "Service Event" is an incident which means that Performance Standards and/ or Availability Standards are not met.

9. Second Supplemental Agreement

9.1 Introduction and Background

9.1.1 NHSL and IHSL entered into a second supplemental agreement relating to the Project on 5 August 2020 (SA2). This agreement came about because of ongoing issues in relation to the ventilation system at the new hospital. Problems with the system had been identified in a series of reports in June and July 2019 from the Institute of Occupational Medicine (IOM) that were commissioned by NHSL. On 1 July 2019, IOM reported that the ventilation system could not deliver 10 air changes per hour in critical care areas. The Cabinet Secretary for Health and Sport made the decision to halt the move to the new site on 4 July 2019.[193]

9.1.2 On 5 December 2019, NHSL issued High Value Change Notice No. 107 "Paediatric Critical Care and Haematology/ Oncology Ventilation" (HCV 107).[194] This notice required IHSL to design, manufacture, supply, construct, test, commission and complete, and thereafter maintain, repair, renew and replace:

a. a ventilation system or systems which will deliver 10 air changes/hour at +10pa as per SHTM 03-01 to listed single bedrooms and multi-bedrooms in Paediatric Critical Care;

b. a ventilation system or systems for a positive pressure ventilated lobby PPVL Single Bedroom Isolation Suite with a lobby air supply terminal with a HEPA filter, as per SHTM 03-01, SHPN 04-01, Supplement 1: Isolation Facilities in Acute Settings (Version 1.0 September 2008) Table 1, to five listed isolation rooms in Paediatric Critical Care;

c. a ventilation system or systems which will deliver 10 air changes/hour at +10pa as per SHTM 03-01, Appendix 1, Table A1 and fit HEPA filters (H12

[193] See summary in Audit Scotland, *The 2018/19 Audit of NHS Lothian – Delay To The Opening of the Royal Hospital for Children and Young People*, pp. 12 - 13

[194] A High Value Change is a change to the contract specification requested by the Board that is likely to cost more than £500,000 or to require an adjustment to the Annual Service Payment of more than 2%. See definition in PA Schedule Part 16 Section 1 Definitions at p.387. The procedure relating to High Value Changes proposed by the Board is set out in Section 4 of that Part of the Schedule (at p. 404)

grade) to the air inlets to fourteen single and multi- bedrooms in haematology and oncology; and

d. a ventilation system or systems for a positive pressure ventilated lobby PPVL Single Bedroom Isolation Suite with a lobby air supply terminal with a HEPA filter, as per SHTM 03-01, SHPN 04-01, Supplement 1: Isolation Facilities in Acute Settings (Version 1.0 September 2008) Table 1 to five isolation rooms in haematology and oncology.

9.1.3 The proposed change had a target capital cost of £4.6m.

9.1.4 SA2 was primarily directed at an agreed solution to the issues with the ventilation system. Recital B to SA2 provides that "The Board wishes to amend the ventilation system within the Facilities from 4 air changes to 10 air changes per hour with an associated change to the pressure regime…". Consequential changes were made to the financial relations between the parties applicable under PA, and these matters are discussed below. What follows is not a full analysis of SA2, but rather focuses on those parts of SA2 that impact (or potentially impact) upon the financial relationships between the parties. They are taken in the order in which they appear in SA2.

9.2 Key Definitions

9.2.1 As indicated above, SA2's principal purpose is to make provisions for the Ventilation Works to be carried out under the Ventilation Works Contract by the Ventilation Works Contractor starting on the Ventilation Works Commencement Date and to be completed by the Ventilation Works Target Completion Date. Each of these capitalised terms is defined in the contract as follows:

> "Ventilation Works" means the ventilation works described in and as instructed under HCV 107 more fully described in the Ventilation Works Contract.
>
> "Ventilation Works Commencement Date" means 22 June 2020.

"Ventilation Works Contract" means the contract between IHSL and Imtech Engineering Services Central Limited in the form set out in SA2.

"Ventilation Works Contractor" means Imtech Engineering Services Central Limited (hereinafter "Imtech"); and

"Ventilation Works Target Completion Date" means 25 January 2021.

9.3 Compensation Events (Clause 6.5.2)

9.3.1 If Imtech is entitled to a claim for a compensation event[195], IHSL are entitled to equivalent relief and compensation under SA2. Following notification by the project manager of any change to the prices, completion dates and/ or key dates to NHSL, NHSL shall reimburse IHSL for any costs claimed by the Ventilation Works Contractor and/or grant to IHSL an equivalent extension of time. IHSL are not, however, entitled to reimbursement of any costs where its negligence, error or default gave rise to the compensation event in question.

9.4 Delay Damages (Clause 6.5.5)

9.4.1 Where Imtech is liable to pay delay damages[196] to IHSL under the Ventilation Works Contract, IHSL is required to use reasonable endeavours to enforce its rights and to pay to NHSL the amount of delay damages which IHSL deducts from, recovers or is paid by Imtech within 14 days of deduction, recovery or receipt.

9.5 Limits On IHSL's Liability in Respect of the Ventilation Works (Clause 6.8)

[195] Compensation Events are, broadly speaking, events occurring during the execution of the works that are not the fault of the contractor and change the cost of the work, or the time needed to complete it. As a result, the prices, key dates or the completion date may be reassessed, and the contractor may be entitled to more time or money

[196] Delay damages are payable under NEC Engineering and Construction Contract (part of the contractual arrangements under which Imtech were appointed) as an option (X7) which means that if the contractor (Imtech) does not achieve the completion date then delay damages are payable to the client (IHSL). The option was selected in this case, and the amount of delay damages was set at £5000 per week, or pro rata for any part of a week.

9.5.1 Clause 6.8.1 of SA2 limits IHSL's aggregate liability to NHSL in respect of the Ventilation Works, until the date occurring 12 years after the Ventilation Works Completion Date, to the amounts which can be recovered by IHSL from Imtech, the project manager of the Ventilation Works Contract, the supervisor of the Ventilation Works Contract and any other consultants or sub-contractors appointed in relation to the carrying out of the Ventilation Works, together with any amount recovered by IHSL under the insurances to be maintained in accordance with SA2.[197]

9.5.2 Further, clause 6.8.2 provides "For the avoidance of doubt" that IHSL shall be under no greater liability, until the date occurring after the expiry of 12 years after the Ventilation Works Completion Date, than Imtech owes to IHSL under the Ventilation Works Contract, and the project manager and supervisor owe to IHSL under their respective appointments. Any equivalent rights of defence, exclusions or limitations on the liability of Imtech, the project manager and supervisor contained in the Ventilation Works Contract or their respective appointments apply to SA2.

9.5.3 It should be noted that Imtech, the project manager and the supervisor were all to grant collateral warranties in favour of NHSL in the form specified in Part 5 of the Schedule to SA2 in terms of which all gave undertakings in respect of the work that they would be carrying out directly in favour of (and therefore enforceable by) NHSL.

9.6 Waiver Letter (Clause 6.12.4)

9.6.1 NHSL had sent a letter to IHSL on 12 December 2019 the terms of which were confirmed under SA2, which confirmed that in terms of that letter, NHSL:

a. Waived £280,000 (exclusive of VAT) of Deductions[198] that were accrued in accordance with PA up to and including 30 September 2019. The parties agreed that there will be no further adjustments in calculating the Deductions for the period up to and including 30 September 2019;

[197] See in particular SA2 clause 6.9
[198] On Deductions, see paragraph 7.6.6 above

b. Required to pay IHSL the sum of £120,000 (exclusive of VAT) within 10 business days of the date of execution of SA2. No explanation is given in SA2 as to what this payment is for; and

c. Waived all accrued rights under various parts of clause 40 PA (events of default that may ultimately lead to termination of PA), although this was without prejudice to any future rights available to NHSL under clause 40.

9.7 Revised Annual Payment (Clause 6.12.5)

9.7.1 Clause 6.12.5 provides that the parties "acknowledge and agree" that a revised Annual Service Payment will not be calculated until the date on which the Financial Model[199] is next re-run at a time to be agreed between the parties. When re-run, the Financial Model would be re-run based on an increase to the Annual Service Payment (at then - current 2020 prices) of £84,789.75 (exclusive of VAT) (the "Price Adjustment"). This was to cover the additional maintenance costs and providing the additional services associated with the works undertaken under SA2.

9.7.2 In relation to any period between the Ventilation Works Completion Date and the next re-run of the Financial Model, the parties acknowledge that an amount equal to 1/12th of the Price Adjustment shall be added each month to the Monthly Service Payment.[200]

9.8 Payment for the Ventilation Works (Clause 7 and Schedule Part 8)

[199] The Financial Model is defined in the PA as "the computer spreadsheet model for the Project incorporating statements of [IHSL]'s cashflows including all expenditure, revenues, financing and taxation of the Project Operations together with the profit and loss accounts and balance sheets for [IHSL] throughout the Project Term accompanied by details of all assumptions, calculations and methodology used in their compilation and any other documentation necessary or desirable to operate the model, as amended from time to time in accordance with the terms of Clause 37 (Financial Model), a copy of which is attached to this Agreement on disk as Attachment 1;" – PA Schedule Part 1 p.150

[200] General provisions as to changes to the Financial Model are set out in Section 6 of Part 16 of the Schedule to PA. These provisions apply in the case of a "Relevant Event". A High Value Change such as that set out in HVC 107 would have been a relevant event triggering these provisions, leading to a change in the Annual Service Payment (Paragraph 13 of Section 4 of Part 16 of the Schedule to PA).

9.8.1 Clause 7 provides that "In consideration of [IHSL] procuring the design, construction, testing, commissioning, maintenance, repair, renewal and replacement of the Ventilation Works", NHSL shall pay IHSL in accordance with Schedule Part 8. It is expressly provided that Clause 34 of and Schedule Part 14 to the PA[201] do not apply in respect of the Ventilation Works. This mirrored what occurred under the PA during the construction phase when no deductions were levied against IHSL as no payment were being made by NHSL to IHSL during that phase. The obligation to pay under clause 7 includes any other entitlement of IHSL to payment under SA2, including any compensation payments.[202]

9.8.2 Schedule Part 8 essentially provides for a "pass through" model of payment. In short, Imtech, the project manager and the supervisor submit applications for payment to IHSL. IHSL in turn pass the applications and supporting documentation to NHSL. NHSL are then obliged to pay to IHSL "the amounts which [IHSL] is obliged to pay as properly assessed…in terms of the Ventilation Works Contract, the Project Manager Appointment and the Supervisor's Appointment respectively". The pass-through nature of the payment mechanism is made clear in paragraph 9 which provides: "Subject to receiving payments from [NHSL] in accordance with the process described in the Schedule Part 8, [IHSL] shall comply with its obligations to pay [Imtech]…the Project Manager and the Supervisor".

9.8.3 Provision is made for further information regarding the payment requests to be obtained, NHSL to make comments or representations in relation to the information received, deadlines for payment and other steps in the process, payment of interest in relation to late payments and for repayment to NHSL by IHSL where amounts assessed under the Ventilation Works Contract, or the appointments of the project manager or supervisor are later assessed downwards.

9.8.4 Payment of the costs of the Ventilation Works by NHSL does not reflect a radical departure from the principles of the PA. As explained at paragraph 9.1.2, the Ventilation Works had initially been instructed by NHSL by virtue of a change notice under the PA pursuant to Part 16 of the Schedule to the PA. The PA provided for

[201] See section 7.6 above
[202] Paragraph 9.3.1 above

payments being made by NHSL for changes to the contractual specification required by NHSL pursuant to this Part of the Schedule. This is in line with both the SFT Standard Form Project Agreement and general practice in PFI/PPP projects that the procuring authority pays capital sums for changes which it instructs to the original scope of works. So the agreement to pay the costs of the Ventilation Works is not necessarily a departure from the approach that one would expect under the NPD model.

9.9 Indemnity (Clause 7A and Schedule Part 3)

9.9.1 Clause 7A provides for an indemnity by the Board in favour of IHSL in accordance with Schedule Part 3.

9.9.2 Schedule Part 3 provides for a comprehensive indemnity by NHSL in favour of IHSL against all Direct Losses[203] sustained by IHSL as a result of, or in relation to:

a. any unplanned interruption to the utilities infrastructure and/or the carrying out of the other works by IHSL or the requirement for unplanned installation of any apparatus to provide connectivity to any utilities supply networks, as a result of the Ventilations Works or a Ventilation Works Defect.[204]

b. any claim in respect of or arising out of or in connection with the Ventilation Works which is not a Ventilation Works Contractor Excluded Liability[205] and which is not otherwise recoverable;

c. a Ventilation Works Contractor Excluded Liability

[203] "Direct Losses" are, subject to certain exclusions, "all damage, losses, liabilities, claims, actions, costs, expenses (including the cost of legal or professional services, legal costs being on an agent/client, client paying basis) proceedings, demands and charges whether arising under statute, contract or at common law" but excluding indirect losses – PA Schedule Part 1 at p. 146. "Indirect Losses" are defined in clause 54.1 PA

[204] A Ventilation Works Defect is "any Defect as defined in clause 11.2(6) of the Ventilation Works Contract".

[205] Defined as "any entitlement that [IHSL] would have had to make any claim or recover any Direct Losses under the Ventilation Works Contract were it not for the existence of a cap or exclusion or limitation of liability including a maximum aggregate cap on liability"

d. the occurrence of certain insolvency events in relation to the Ventilation Works Contractor;[206] and

e. a Ventilation Works Interface Claim –a claim by IHSL against Multiplex, Bouyges or Imtech arising out of the situation where the works or services to be provided under PA has been altered or impacted by the Ventilation Works.[207]

9.9.3 The indemnity is for the period from the Ventilation Works Commencement Date until the Ventilation Works Indemnity Expiry Date (five years after the Ventilation Works Completion Date).[208]

9.9.4 There are a number of limitations and conditions put on the indemnity. The following are particularly relevant in the present context:

a. The indemnity shall put IHSL is no better and no worse position than it would have been had the circumstances giving rise to the claim under the indemnity not occurred.[209]

b. IHSL are under a general duty to pursue contractual and insurance claims that may reduce any amounts to be paid under the indemnity promptly.[210]

c. Where IHSL subsequently recovers an amount from the Ventilation Works Contractor, Bouyges or insurances an amount that is directly referable to a claim under the indemnity, IHSL are obliged to repay to the Board the lesser of (i) the sum recovered (less the reasonable costs of recovery) or (ii) the amount paid under the indemnity.[211]

9.9.5 The indemnity provisions also provide that with effect from the Ventilation Works Commencement Date, NHSL shall not make any Deduction, or serve a notice in respect of a Service Event,[212] as a result of and to the extent caused by or materially contributed to by various matters related to the Ventilation Works. The

[206] See definition of Ventilation Works Contractor Insolvency, clause 1.2 SA2
[207] Full definition of Ventilation Works Interface Claim at Section A SA2 Schedule Part 3
[208] SA2 Schedule Part 3 Part A paragraph 1.
[209] SA2 Schedule Part 3 Part A paragraph 1.2.2
[210] SA2 Schedule Part 3 Part A paragraphs 1.2.3 and 1.2.4
[211] SA2 Schedule Part 3 Part A paragraph 4
[212] On Deductions and Service Events generally, see paragraph 7.6.6 and following above.

restriction on making Deductions is limited to events occurring prior to the date falling five years after the Ventilation Works Completion Date.[213]

[213] All the above in SA2 Part 3 Part A paragraph 5.

Appendix 1 – Example of Indexation of Annual Service Payment

1. The formula for indexation of the Annual Service Payment referred to at paragraph 7.6.1 above is:

$$ASP_n = ASP_o \times (1 - IF) + [(ASP_o \times IF)x[1 + \frac{(RPI_n - RPI_o)}{RPI_o}]$$

Where

ASP_n is the Annual Service Payment for the relevant Contract Year;[214]

ASP_o is the Annual Service Payment at the Base Date – for the purposes of this simplified example assumed to be £100;

IF (or Indexation Factor) is 26%;

RPI_n is the value of the Retail Prices Index published or determined with respect to the month of February which most recently precedes the relevant Contract Year; and

RPI_o is the value of the Retail Prices Index published or determined with respect to the Base Date (i.e., for February 2015 – 256.7)

2. For the purposes of RPI_n, the relevant RPI figures in each February are:

February 2015 - 256.7

[214] "Contract Year", as defined in the PA, means "(a) for the first Contract Year, the period from the date of this Agreement [13 February 2015] to the subsequent 31 March; and (b) for all subsequent Contract Years, the period of twelve (12) calendar months commencing on each anniversary of 1 April, provided that the final Contract Year shall be such period as commences on 1 April and ends on and includes the date of expiry or earlier termination of this Agreement (as the case may be)" - Schedule Part 1 p. 143

February 2016 - 260

February 2017 - 268.4

February 2018 - 281.5

3. Inserting these figures into the formula, one gets the following results for Contract Years 2 (2015 – 2016) to 5 (2018 – 19):

$ASP_2 = 100 \times (1 - 0.26) + [(100\ x\ 26\%)$ x $[1 + \frac{(256.7-256.7)}{256.7}]$ = 74 + [26 x [1+0]] = £100.

$ASP_3 = 100 \times (1 - 0.26) + [(100\ x\ 26\%)$ x $[1 + \frac{(260-256.7)}{256.7}]$ = 74 + [26 x [1+0.0128]] = £100.33.

$ASP_4 = 100 \times (1 - 0.26) + [(100\ x\ 26\%)$ x $[1 + \frac{(268.4-256.7)}{256.7}]$ = 74 + [26 x [1+0.0456]] = £101.18.

$ASP_5 = 100 \times (1 - 0.26) + [(100\ x\ 26\%)$ x $[1 + \frac{(281.5-256.7)}{256.7}]$ = 74 + [26 x [1+0.0966]] = £102.51.