

## Mutual Investment Model - State of Roads in Wales

18 June 2018

### Introduction

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1. We provide this brief paper in anticipation of giving evidence to The National Assembly for Wales' Economy, Infrastructure and Skills Committee on 21 June 2018 in relation to road financing and, in particular, the use of the Welsh Mutual Investment Model ('MIM').

### Our approach

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2. We see the MIM proposal as the only viable tool to provide significant finance to fund the ambitious Wales Infrastructure Investment Plan (which reached its 6-year mid-point in 2018). In doing so, the process must be collaborative and have regard to the lessons learnt from PPP/PFI projects. Our observations in this document are targeted towards the way this may be achieved, and are split into three areas:
  - 1) best practice,
  - 2) risks and opportunities, and
  - 3) highway scheme suitability.

#### 1) Best practice

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*“Best practice in relation to procurement, contracting, and delivery of major highways schemes and how far these are applied in Wales.”*

3. Given our involvement in significant infrastructure projects (such as the M4 Relief Road, Hinkley Point C and the Cardiff Metro), several very clear best practice themes arise, namely:
  - 3.1 **Funding** – Identifying at an early stage an appropriate source of funding to ensure that appropriate funding requirements are incorporated into the procurement process.
  - 3.2 **Procurement** – procurement must be carried out in a way that demonstrates transparency, fairness, integrity, competition, and accountability. Planning and choice of procurement route is crucial at this stage. Competitive dialogue (where candidates are invited to take part in a dialogue process, during which the nature of the project may be discussed and possible solutions may be developed) has a proven track record for delivering high value public sector infrastructure projects.
  - 3.3 **Clearly defining the project and specification** – there should a clear scope based on up to date market price information. Market research is important, but must be approached in a way that allows the prospective contractors to price the project clearly.



- 3.4 **Early Contractor Involvement** – yields benefits in relation to cost estimation, risk management, ease of construction, and post constructive maintenance.
- 3.5 **Well-being of Future Generations (Wales) Act 2015** – Uniquely Welsh, this is a statutory obligation that all public sector projects must improve our social, cultural, environmental, and economic well-being. Its principles are at the centre of delivering sustainable projects by focusing on the long term. This should include using innovative technology, such as Building Information Modelling (BIM).
- 3.6 **Collaborate to deliver** – there needs to be a framework to provide quick decisions on key issues and effective mechanisms to communicate with stakeholders, manage risks, and resolve conflict. Controlling risks is central to this – with the party best placed to handle the risk being tasked to do so.
- 3.7 **Pooling resources** – there have been several projects throughout Wales that have used a collaborative approach. Local Authorities have worked together with suppliers, to produce efficiency savings in costs and share work practices. In turn, this increases the value of prospective contracts, making them more attractive to the market.

## 2) Risks and Opportunities

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### *“The risks and opportunities involved in funding highway projects using the Welsh Government’s MIM”*

4. A successful ‘MIM-able’ project relies on producing a public asset with certainty of cost for the procuring authority, and a guaranteed low-risk return on investment for funding parties. Given the value, construction process, maintenance of the asset, and the general interface between the parties, there are a number of inherent risks to maintaining this balance. However, these risks are not unsurmountable, and solutions and opportunities are available:

	Risk	Opportunities / Solutions
4.1	<b>Capital Investment</b> - Highway projects require significant upfront capital investment.	MIM allows for major projects to go ahead with capital funds from a funder, with the authority paying an annual sum out of income, taking the project “off-balance sheet”.
4.2	<b>‘On-balance sheet’</b> - For example, the Non-profit Distributing Model proposed in Scotland has been designated as on-balance sheet.	The use of pre-approved standard documents (as exist for the purposes of MIM) removes this risk (subject to comments at 4.6 below on the use of standard documents).
4.3	<b>Value of Project</b> - In order for a project to be attractive to funders (given the relative low return on investment), the overall value should be in excess of £300 million capital spend.	There are two opportunities here: 1) Identify a pipeline of high value projects to be made MIM ‘ready’ 2) Pool projects between local authorities that relate to the same asset e.g. a road that

		traverses several local authorities could be procured as one project by a consortium of local authorities. Alternatively, a number of similar projects could be pooled to provide a higher overall capital project value.
4.4	<b>Cost overrun</b> - As with all major construction projects, getting the specification right is critical. Precise budgeting and estimates are required for MIM to work. This ensures that the annual payments made by the authority under the MIM model cover the overall costs of the project.	The value of Highways and Motorways works are traditionally difficult to estimate (for example, consider the M4 Relief Road). By focusing on detailed specification, it provides certainty of anticipated costs. The solution here is that the Authority will require initial capital expenditure to achieve a detailed specification for the project.
4.5	<b>Supply chain stability</b> - As we have seen with the collapse of Carillion, the construction industry supply chain is very unstable. Many contractors and sub-contractors go bust. Given that MIM projects are procured over a long term (25 years plus) having to re-procure a Main Contractor and sub-contractor will affect cost-certainty.	Given that MIM projects have a long-term lifecycle (including a maintenance element) this provides the supply chain with certainty of work that each stake holder can plan its business around. Furthermore, MIM does not aim to achieve lowest price from the supply chain. The aim is to secure contractors that provide best value (which will include high quality outputs and 'something for something benefits, such as community benefits or using local suppliers / contractors. If the main contractor does fold, the rigid structure and specification should be attractive for a replacement contractor to step-in. The use of local contractors in the supply chain will also help ensure that the main contractor does not stick with its usual supply chain – which could become stretched if the main contractor is involved in a number of projects.
4.6	<b>Use of standard form contracts</b> - Using a standardised document can be a double-edged sword. It may reduce the risk of changes to the contract making the project on-balance sheet. However, using generic non-project specific clauses will encourage the Contractor to price for what is in effect an unnecessary risk.	The construction industry is familiar with the use of standard documents that are subject to a set of project specific amendments. Therefore, using the competitive dialogue process should allow the parties to refine the contracts between them to fit the specific requirements of the project. The "off-balance" sheet elements, as described above, should be identified as non-negotiable to safeguard the operation of MIM.
4.7	<b>Interface issues</b> - Given the long relationship that the Welsh Government will have with the contractor, interface issues between the parties are likely to arise.	This is a risk that exists irrespective of the nature of the project. Projects that demonstrate collaborative working tend to reduce this risk best. Within the construction industry, the use of collaborative contracts, such as the NEC form of contract, has prompted collaborative behaviours. However, this does require all parties to 'buy-in' to the benefits of collaboration.

### 3) Highway Scheme Suitability

*“The factors which might make particular highway schemes suitable to be financed through MIM.”*

5. Once a project has been identified as ‘MIM-able’, the next step is to get the project ‘MIM-ready’. In our view, the criteria of these two tests are as follows:

5.1 ‘MIM-able’ is a project that produces a public asset which has certainty of cost for the procuring authority and a guaranteed low-risk return on investment for funding parties. Given the value of highway schemes, this element of the test is unlikely to be an issue. It is evidenced by the fact that sections 5 and 6 of the A465 has already been identified as ‘MIM-able’, with A55/A494 corridor improvement, A55 upgrade, 3rd Menai Crossing, and the M4 corridor around Newport looking like a potential pipeline.

5.2 ‘MIM-ready’ – once a project has been identified as MIM-able, it will need to be assessed against the following considerations:

- Stakeholder support
- Project De- Risking
- Collaboration
- ‘Something for Something’
- Contractual Structure
- Procurement.

5.3 The table below identifies how the considerations above fit with highway schemes.

	MIM Criteria	Highways Suitability
5.3.1	<b>Stakeholder support</b> - Given that MIM projects will extend beyond the electoral cycle, the project will require multi-political party support and be in the public interest generally.	If the proposed project is in the public interest, it will, more than likely, receive multi-political party support. Highway schemes tend to divide public and political opinion, so this is key element for highways. By way of example, from the outset, the dualling of the A465 has had multi-party support from within Welsh Government, and is backed by the local authorities and local communities. As such, it has been included in the three initial MIM projects.
5.3.2	<b>Project De-Risking</b> - Road projects are typically complex with site issues, land considerations, CPOs, and Statutory Undertakers. MIM works best with certainty of project cost and programme. So, an element of de-risking is required to make road projects MIM suitable.	In relation to highway schemes, this will involve making capital expenditure at the front end of the project – to explore planning and feasibility issues.

5.3.3	<p><b>Collaboration</b> – Identifying the potential project delivery partners from the outset and working with these parties collaboratively is essential to the success of a MIM project.</p>	<p>In relation to funding a highway scheme, this will require identifying funder requirements (which will include the level of due diligence to be undertaken). Involving potential funders from the outset will allow them to input into the requirements. This could also result in a competition between the funders at the time funding is required, and may drive a better deal.</p> <p>In relation to delivering the project, the construction sector uses early contractor involvement to drive efficiencies. Again, this allows for a potential contractor to input into the specification for the works, and to better understand the risks it is being asked to control during the project.</p>
5.3.4	<p><b>'Something for Something'</b> - The MIM model is not necessarily in search of the lowest price but rather best value. Consideration should be given to the ancillary benefits available. For example, those driven by virtue of the Well-being of Future Generations (Wales) Act 2015.</p>	<p>Highways projects are very well suited for this type of investment, especially given that the work itself intended to improve community well-being (providing safer and quicker access), and the works themselves require a large work force. In relation to the A465, the focus will be on:</p> <ul style="list-style-type: none"> <li>• £300 million spend with Welsh companies (70% of the total spend)</li> <li>• Creating 140 apprentice roles</li> <li>• Community benefits.</li> </ul>
5.3.5	<p><b>Contractual Structure</b> - A MIM project has a defined contractual structure which places the 'Project Co' at its centre. The project itself will be procured by the 'Project Co', using a main contractor who can in-turn sub-contract the services, as appropriate. A MIM project must fit into this structure.</p>	<p>Given that the contractual structure below the 'Project Co' is a recognised construction industry structure for delivering works, this makes highway projects suitable for MIM.</p>
5.3.6	<p><b>Procurement</b> - The MIM model requires the main contractor to be procured on the basis of clear specification and requirements. With the above in place, the next step is to proceed to procurement. The proposed competitive dialogue process should assist clarify specification and further mitigate the remaining elements of cost uncertainty.</p>	<p>Infrastructure projects are commonly procured via the competitive dialogue route (e.g. the recent procurement of the Cardiff Metro). This method translates into highway projects as it continues the de-risking process described above.</p>

## Conclusion

6. The challenge / opportunity will be to advance the project pipeline. This will make sure that several projects that are suitable for delivery via MIM are available for potential investors to consider.