Scottish Futures Trust
Evidence for National Assembly for Wales – Finance Committee
Inquiry into the Welsh Government's capital funding sources

Scottish Futures Trust has been invited to give evidence to the Committee and this paper is intended to assist members in advance of oral evidence from Peter Reekie, SFT's Chief Executive on 1 May 2019.

1. Background to SFT

Scottish Futures Trust is an infrastructure agency established by Scottish Government in 2008. Its overall aim is:

> "to improve the efficiency and effectiveness of infrastructure investment and use in Scotland by working collaboratively with public bodies and industry, leading to better value for money and providing the opportunity to maximise the investment in the fabric of Scotland and hence contribute to the Scottish Government's overarching purpose to increase inclusive economic growth"

In order to deliver the aim, SFT works between policy and delivery across all sectors, geographies and stages of infrastructure life-cycle, collaborating with Scotland's public and private sectors to:

PLAN asset investment and management effectively across sectors and places – **doing the right thing**

INNOVATE in approaches to funding, financing and delivery – **maximising the things we can do**

DELIVER projects and programmes to drive life-cycle value and vibrant construction and related industries – **doing things well**

MANAGE existing assets, estates and contracts productively – **making the most of the things we have**

SFT is publishing its 2019-24 Corporate Plan and 2019-20 Business Plan over the coming days. Members will be able to access these on our website: www.scottishfuturestrust.org.uk.
SFT has grown over 10 years to a team of 70, drawn from across the public and private sectors, characterised by:

Infrastructure expertise: The team retains technical skills and understanding of infrastructure systems and economics, social infrastructure design, costing and briefing/development, housing and commercial property development, asset and facilities management, digital and low carbon infrastructure, space planning, programme and change management.

Commercial / financial acumen: The team includes many senior individuals with 10-20+ years each of experience in infrastructure related debt and equity financing, financial advice and structuring across the public and private sectors, commercial deal structuring and legal documentation, transaction management, investment decision making and governance, corporate governance, commercial contract understanding and management and approaches to dispute resolution

2. Relevant Work Areas

SFT has investigated and implemented public and privately financed approaches to investment in public infrastructure across Scotland including:

- A programme of 10 major infrastructure projects with a value of approximately £1.5bn delivered using the “Non-Profit Distributing” (NPD) model of privately financed investment and spanning the roads, hospital and colleges sectors;
- The hub programme of institutional public private partnerships for community infrastructure developments which comprises 5 hub companies across Scotland developing and delivering schools, health centres, council and blue light facilities and other community infrastructure under both capital funded and profit-sharing private financed arrangements. The hub programme has delivered approximately £1.6bn of assets with a further £600m in construction, including 41 Design, Build, Finance and Maintain (DBFM) privately financed projects.
- Tax Incremental Financing (TIF) and Growth Accelerator (GA) projects which use local authority borrowing powers to raise finance to invest in public infrastructure which enables private economic development, with the finance being repaid either through an increment in tax-take retained by the Authority (TIF), or Scottish Government revenue funding for the outcomes delivered by the overall investment.
- National Housing Trust affordable homes, of which over 2,000 are now occupied across Scotland, and which have been delivered through limited liability partnerships (LLPs) established between SFT, Local Authorities and (under one variant of the approach) private developers.

3. Comments on Inquiry Considerations

SFT is careful to differentiate between the funding and financing of infrastructure and it may be helpful for the Committee to understand our use of language in this regard:

Any asset ultimately has to be paid for (or **funded**) either as it is built or as it is used. Funding for infrastructure assets come either from public sector budgets, or from “customers” in the form of user / occupier / developer charges.

If the asset is paid for as it is used, a form of **finance** (which comes with an expectation of repayment) can be raised to build the asset[1]. Financing can be either public sector borrowing or private debt / equity.

[1] An exception is an asset financed using corporate or national debt where the debt stock is increased in perpetuity to pay for the asset. As this form of borrowing is not available to Scottish Government we do not consider it across our work

In respect of the forms of funding and financing mentioned in the terms of reference for the Inquiry:

Conventional Funding – capital budgets is a form of funding infrastructure assets as they are built using public budgets.
Conventional Funding – financial transactions is a form of financing which must ultimately be repaid to HM Treasury. Members will know that FTs must be lent outside the public sector boundary and utilised by a privately classified entity for a purpose which has an associated funding stream (for example rental income) which can eventually repay the finance.
Government Loans & Bonds – are again forms of financing which either increase the Government's debt stock in perpetuity (if regulations allow) or must be repaid using funding from future capital / revenue budgets or customer charge.
Capital Receipts create an additional source of funding over and above budget allocations.
Borrowing Powers of Bodies – In Scotland, Local Authorities have separate borrowing powers from Scottish Government which are used by them as a source of financing for assets, ultimately funded by their own future budgets or customer charges.
Mutual Investment Model – is an arrangement to use private finance to pay for the creation of an asset which must be classified to the private sector, and where the public sector funds the asset as it is used through revenue budgets over a 25-30 year period.

4. Scotland's Public Private Partnership Models

SFT manages Scottish Government's programme of privately financed infrastructure investment funded from revenue budgets as assets are used. Since 2011, this programme has been delivered through the NPD and hub DBFM arrangements.

The programme was launched in the 2011/12 Scottish Government Budget[2]. The context of the decision to deliver a progamme of privately financed infrastructure was set out in Chapter 3 of the budget document:

> "Capital investment is vital to strengthening recovery and supporting sustainable economic growth. It sits at the heart of our economic strategy. The Scottish Government views the severe cuts in capital spending imposed by the UK Government as deeply damaging. We will do all we can to mitigate their effects."

The rationale for using privately financed investment was also set out in the budget document:

> "As a result of our concern about the effect of the rapid and deep reductions in capital spending flowing from decisions in the UK Spending Review and the implications that these will have for the pace of implementation of the capital programme and the strength of the Scottish economy, the Scottish Government will explore all possible means to support higher levels of infrastructure investment than would be possible through the capital budget alone. This effort will be particularly important to support recovery and sustainable economic growth, as capital budgets will fall sharply in 2011-12 and are likely to remain low for several years.

[2] https://www.webarchive.org.uk/wayback/archive/20170107125418/http://www.gov.scot/Publications/2010/11/17091127/23

"In general, funding infrastructure investment through public capital ensures the lowest cost of finance for a typical project. Under the current public finance framework, the Scottish Government does not have the flexibility to borrow to fund additional capital expenditure. However, there is an overwhelming economic and financial case for providing this flexibility to borrow as soon as possible.

"In the absence of borrowing powers, there are a number of levers which can be used to help to expand Scotland's public infrastructure programme. While ensuring these levers are used sustainably and responsibly, the Scottish Government – working closely with the Scottish Futures Trust and local authorities – will work to maximise their positive impact. Therefore, in addition to its planned capital investments in 2011-12 and future years, the Scottish Government will:

- take forward a new, affordable pipeline of revenue financed investment worth up to £2.5 billion, to be delivered through the Non-Profit Distributing (NPD) model; and
- make full use of innovative measures such as Tax Incremental Financing, the National Housing Trust and investment through the JESSICA Fund."

The value for money sought from the NPD programme is the additionality of capacity to invest in infrastructure over and above traditional capital budgets which it brings, and the widely recognised value to the economy of that investment.   It was recognised that the cost of finance would be higher than public borrowing and that maximising value for money, and ensuring affordability across the programme was critical.

4.1 Value for Money

SFT has sought to maximise value for money across the investment programme by:

- adopting profit capping (NPD)[3] and profit sharing (hub DBFM) approaches to capture investment up-side for the public sector and improve on the value offered by older PFI contracts
- having an expert central team managing standard contract documents to ensure commercial consistency and reduce market bidding costs
- reducing the scope of contracted services to exclude catering cleaning etc. (soft facilities management)
- selecting projects and programmes of investment to be taken forward with characteristics suited to private finance arrangements
- managing a programme of "key stage review" assurance across all projects to share good practices across procuring authorities and ensure the correct steps have been completed before projects proceed
- for smaller projects, using a programme approach (hub) to bring consistency, reduce transaction costs and develop longer term partnering arrangements between the public and private sectors
- Maximise community benefits of SME engagement and training delivered across projects and programmes
- Bring a public sector mindset to the delivery of projects through placement of a Public Interest Director on the board of each delivery company.

[3] Found by the ONS and Eurostat in 2015 to be classified to the public sector under ESA10 guidance and therefore no longer pursued as the key characteristic of delivering additional investment is no longer achieved

4.2 Affordability

From the outset the programme has delivered within an affordability limit. This year, the budget includes capping the revenue funding for infrastructure investment at 5% of Scottish Government's Resource budget (excluding social security). This figure includes annual revenue budget impact of Scottish Government capital borrowing, , historic PFI project unitary charge payments and the Scottish Government's share of payments made under NPD and hub DBFM projects. These payments are expected to peak for contracted and committed payments at 3.2% in 2020-21 and 2021-22

4.3 Monitoring

The Scottish Government and SFT maintain a high level of transparency over revenue funded investment projects and have been commended by the international Infrastructure Transparency Initiative for the data points published in respect of major investment projects[4]. Important aspects of transparency, which SFT continuously seeks to build upon, include:

- Six Monthly Capital Investment Project Reporting to the Parliamentary Audit and Post Legislative Scrutiny Committee[5];
- Publication of annual unitary charge information[6]
- Publication of 5% affordability cap monitoring in budget documentation[7]
- Publication of NPD and hub DBFM contracts and Financial Models [8]
- Publication of hub project pipeline information[9]
- Publication of hub programme community benefits delivery monitoring[9]

5. Future Investment

In the 2018-19 Programme for Government[10], a new National Infrastructure Mission was established to support inclusive economic growth through an increase in infrastructure investment by £1.5bn, or approximately 1% of 2017 GDP, per annum by 2025-26. The Office for the Chief Economic Advisor has published evidence linking infrastructure investment to economic growth[11].

This ambitious mission to deliver additionality of investment cannot be delivered using the currently projected levels of Scottish Government capital budgets and borrowing powers.

Scottish Government Borrowing Powers are limited both annually and in aggregate in the Fiscal Framework[12]. In its 2014 evidence to the Smith Commission on Proposals for Further Devolution to Scotland, SFT argued that Scotland should have the powers to be able to determine the right level of

[4] http://infrastructuretransparency.org/news/cost-research-finds-major-learning-opportunity-for-scotland-and-cost-members/

[5]https://www.parliament.scot/S5_Public_Audit/General%20Documents/Major_Capital_Projects_Progress_Report_-_September_2018.pdf

[6] https://www.gov.scot/publications/pipeline-npdhub-projects-unitary-payment-charges/

[7] https://www.gov.scot/publications/scottish-budget-2019-20/ (Page 45)

[8] https://contracts.scottishfuturestrust.org.uk/category/hub

[9] https://www.scottishfuturestrust.org.uk/page/hub

[10] https://www.gov.scot/programme-for-government/

[11] https://www.gov.scot/publications/exploring-economic-rationale-infrastructure-investment/pages/1/

[12] https://www.gov.scot/publications/fiscal-framework-factsheet/pages/borrowing-powers/

infrastructure investment to affordably meet its economic and social objectives, and how this investment is both funded and financed. SFT's evidence pointed out that Scotland has unlimited powers to take on future repayment obligations through PPP-type arrangements and that "It appears inconsistent that borrowing powers, which could provide both flexibility and a lower cost of finance for investment, should have a cash value borrowing limit imposed as a reserved matter[13]". SFT suggested that the annual and total limit on Scottish Ministers borrowing powers be removed. This proposal was not adopted in the revised Fiscal Framework and Scottish Ministers Borrowing Powers remain capped.

In the light of this ambitious National Infrastructure Mission, and constrained borrowing powers, it is likely that additional forms of financing will be required to deliver the Mission. Public Financing, for example Local Authority borrowing powers, which are independent of the limited powers of Scottish Ministers, are likely to be better value than private financing approaches. Wherever possible, these will be considered under approaches such as SFT's Growth Accelerator[14]. It is however possible that forms of private financing will be required in order to deliver the Mission. Following the reclassification by ONS and Eurostat of NPD projects to the public sector this approach is no longer able to deliver additionality of investment under a privately financed PPP approach and will not be used any further. SFT is currently examining profit sharing finance schemes, such as the Welsh Mutual Investment Model, to help secure both the investment needed and best value for the taxpayer.

In this investigation, we have had substantial engagement with the local, UK and European construction markets which have faced substantial challenges in recent years, exemplified by the demise of Carillion in early 2018. It is essential that our future approaches to project selection, development of project pipelines, funding and financing structures and procurement methodologies allow us to deliver high-quality assets which meet Scotland's economic and social needs **from** the construction industry, and provide opportunities **for** the indigenous construction industry, which represents around 6% of Scotland's economy to invest in productivity, fair work and wider social and environmental benefits.

6. Conclusion

We hope this evidence is useful to the Committee in its inquiry into the Welsh Government's capital funding sources. It focusses on SFT's experience of privately financed approaches to investment in public infrastructure as we though this may be of the most use. SFT has experience of innovation in financing and delivering affordable housing, and in enabling private development through our Tax Incremental Financing and Growth Accelerator approaches. Peter Reekie will be pleased to expand on the evidence in this paper, or provide information on other areas of our work if that would be helpful in oral evidence.

Scottish Futures Trust
April 2019

[13] https://www.scottishfuturestrust.org.uk/storage/uploads/Smith_Commission_SFT_31_October.pdf
[14] https://www.scottishfuturestrust.org.uk/page/growth-accelerator