Centre for Public Policy for Regions

CPPR Briefing Note:

The Scottish Government’s capital funding options, new borrowing capacity & their relation to the ‘fiscal rule’

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Introduction

The 2013 UK Spending Review of June 2013 has increased the influence of private finance on the Scottish Budget, via a loan support mechanism[1], as a means of funding capital projects. This further extends the different funding sources of that are now available for the Scottish Government to deliver Scotland's infrastructure needs.

Alongside this, the Scotland Act (2012) is set to introduce a new annual borrowing limit, commencing in 2015-16.

Understanding just how each of these funding sources is used, and what the short to long term implications are for the Scottish Budget, is becoming increasingly important.

This briefing aims to:

a) Outline the different sources of capital funding that are now available;

b) Observe how the relative importance of each source of funding is changing over time; and

c) Put this into context in relation to (i) the Scottish Government's Budget and (ii) its own fiscal rule, whereby (re)payments associated with non-grant capital funding do not exceed 5% of the Scottish Government's discretionary budget (ie, Total DEL spending).

Types of capital funding

A recent Audit Scotland Report[2] states that the Scottish Government's budget is "*increasingly using borrowing and public private partnerships to fund capital projects"* and it (the Scottish Government) *"….will need to demonstrate that its investment plans are affordable, prudent and sustainable, and to ensure that any future borrowing is reported transparently*."

The fact that there are now a growing number of ways the Scottish Government can fund its capital programme heightens the need for greater clarity over how these, individually and collectively, work. There are currently 5 principle options (see Box 1 for details).

Traditional Capital DEL grants (where capital projects are fully funded by the public sector) are the simplest and most longstanding of routes to delivering capital investment. However, to accelerate the development of Scotland's physical infrastructure, this grant support has been increasingly augmented over time by the use of Resource DEL supported arrangements[3], eg, PFI, PPP, NPD and RAB.

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[1]Capital DEL Loan Support is what HM Treasury calls "Financial Transactions" in its 2013 Budget documents.
[2] See Audit Scotland, 2013, "Developing financial reporting in Scotland" http://www.audit-scotland.gov.uk/docs/central/2013/nr_130704_financial_reporting.pdf
[3] In general terms such arrangements involve the initial capital spend on a project coming from non-government sources, and so not being a drain on the capital budget, but the annual repayment and maintenance costs being paid for from the resource (i.e., day-to-day spend) budget, over a time period of up to 20 years.

Box 1: Key features of Scottish Government's funding options for capital projects

Funding type	**How it works**	**Impact on future Scottish Budget**	**Included in Fiscal Rule calculation?**
Capital DEL - Grants	Up-front grants fund the full capital cost of a project (eg, Southern General hospital)	One-off payment so no future call on Scottish budget(i).	NO
Capital DEL - Loan Support(ii)	Scottish Government loan funding combines with 3rd party finance to fund capital cost of projects (eg, the UK Government has used this to supplement its funding support to social housing).	No resource DEL budget implications, but future Barnett related capital DEL allocations are likely to be top-sliced by HMT as the repayment mechanism.	NO
PFI, PPP & NPD	Private finance funds construction which is then repaid via regular NPD, PPP & PFI(iii) payments over a number of years (eg, hospitals, schools, HUB projects)	Resource DEL budget is used to pay the on-going PFI, PPP, NPD obligations resulting from repayment of the build cost and maintenance costs	YES
RAB	Network Rail funds construction cost of Scotland's rail infrastructure developments.	Resource DEL budget is used to pay the Network Rail's RAB charges(iv).	YES
SG Borrowing	Borrowing (from National Loan Fund) will be used to fund the capital cost of projects.	Resource DEL budget is used to repay interest and loans.	YES?

Notes:

(i) Whilst DEL grant support makes no direct call on the Scottish Government's future DEL Resource budget, any new infrastructure secured via this route will need to be maintained. Without "ring-fencing" future DEL resource to fund on-going maintenance risks the long-term viability of newly developed infrastructure.

(ii) Capital DEL Loan Support is what HM Treasury calls "Financial Transactions" in its 2013 Budget documents. It is a loan as opposed to a grant which means it will need to be repaid at some agreed period in the future.

(iii) NPD are non-profit distributing model revenue payments; PPP are public private partnership revenue payments; and, PFI are Private Finance Initiative revenue payments.

(iv) RAB charges are revenue payments to reimburse Network Rail for the use of its Regulatory Asset Base to fund capital investment in Scotland's real infrastructure. These are set by the Office of Rail Regulator (ORR) through its period review process.

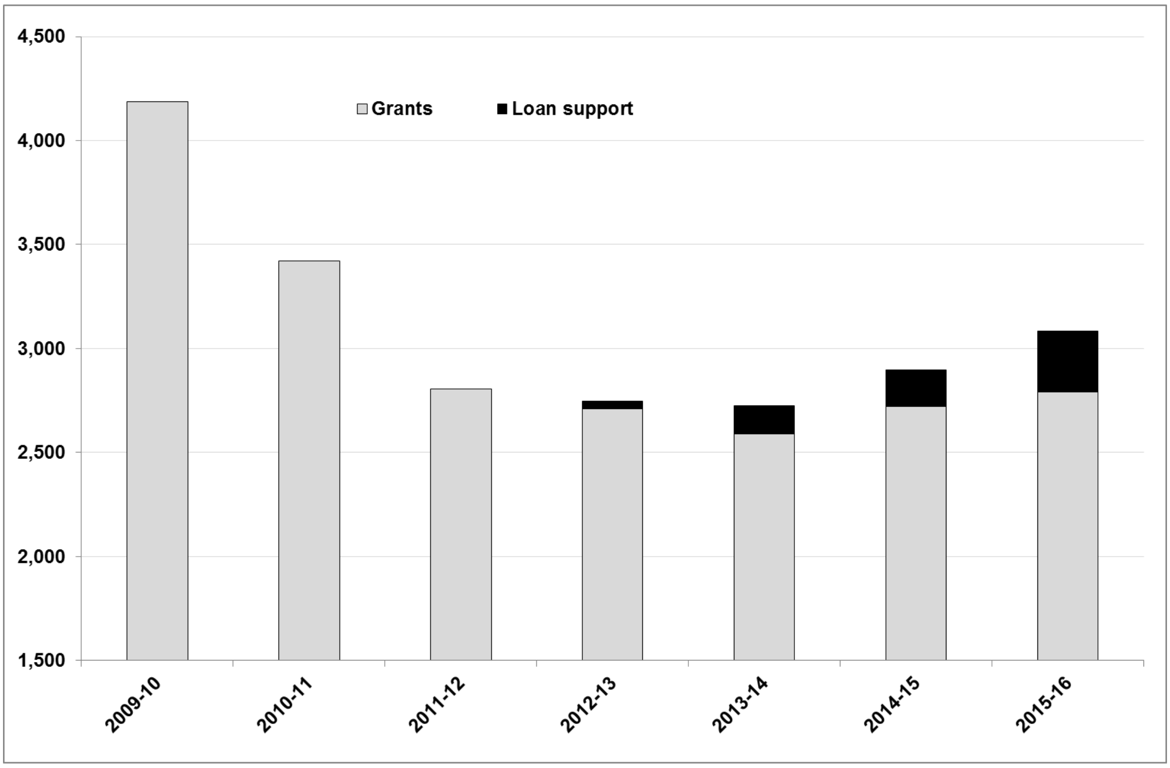
<u>Capital DEL grants and loan support</u>

Capital DEL grants continue to remain well below the 2009-10 peak of £4.2 billion (real terms) and are set to stabilise at around £2.5 billion (real terms) annually between 2013-14 (ie, this financial year) and 2015-16 (see Figure 1).

In 2011-12, such grants amounted to 100% of total capital DEL. By 2012-13 this had fallen only marginally, to 99% but, by 2015-16, these grants are expected to fall to under 90%, with the balance being provided by loan support.

This change raises two important issues.

Figure 1: Capital DEL: Grants and Loan Support, £ million (2012-13 prices)



Source: Scottish Government

First, since loan support needs third-party funding (or an associated future revenue stream to guarantee repayment) alongside this Scottish Government's support, will this alter the Scottish Government's infrastructure priorities? So long as loan support funding remains a small proportion of total capital DEL any such impact should be minimal, as the Scottish Government should be able to juggle its funding priorities. However, if such loan funding grows then whether a project can attract 3rd party funding will be of increasing importance and any such capital projects, which may be more attractive to the private sector, will have a greater chance of being selected.

The second issue this new funding arrangement raises relates to the HM Treasury's proposed repayment mechanism. As Box 1 highlights, while this funding source has no Resource DEL budget implications, the repayment mechanism is likely to involve any such charges being top-sliced by HM Treasury from the Scottish Government's Capital DEL budget. This "top-slicing" of future Capital DEL reduces the Scottish Government's ability to fund its own particular infrastructure priorities.

Capital projects paid for through the Resource DEL Budget

There are three main 'types' of such capital funding sources.

First, there are PFI/PPP payments, which in the main commenced around 1999-2000. Between then and 2013-14, cumulative annual payments for the 90 projects supported have amounted to £8.2 billion (2012-13 prices); the latest annual payment (2012-13) amounted to £937 million.

Second, the Scottish Government introduced the non-profit distributing method (NPD)[4] of payment. There are currently 5 completed schemes being supported via this route with cumulative payments amounting to £184 million (2012-13 prices); the latest annual payment (2012-13) amounted to £52 million.

Third, Scotland develops its rail network infrastructure through the borrowing capacity of Network Rail[5] and this borrowing capacity is based on what Network Rail's regulatory asset base (RAB) can support; the value of this RAB is established by the Rail Regulator (ORR) on a 5-year periodic basis[6]. Currently, the ORR has issued its Draft Determination which offers three possible charging levels that are currently out to consultation (ie, Low, Medium and High). The ORR's final determination will be published in the Autumn.

The Scottish Government reimburses Network Rail via RAB charges, which are also set by ORR. Between 2009-10[7] and 2013-14, total RAB charges have amounted to £1.84 billion (2012-13 prices); the latest annual payment (2012-13) amounted to £313 million.

All these Resource DEL related capital funding sources attract some kind of repayment charges that are subject to variation, depending on the terms of the financial arrangements established at the commencement of each project. For example, RAB charges are set periodically by the ORR for a 5-year period in real terms. The cash payments paid to Network Rail will rise or fall as RPI changes. Given this potential variability, the call on Scotland's future Resource DEL budget remains uncertain.

Total Resource DEL liabilities

Adding together the annual repayments for each of these different capital funding sources highlights their growing impact on the Scottish Resource DEL Budget (see Figure 2).

Scotland's total Resource DEL obligations for 2013-14 will be £1.1 billion in cash terms. Over the next four years, the projection is for an annual obligation of between £1.3 billion and £1.4 billion (cash) depending on the ORR's Final Determination for network rail RAB charges for the period 2014-15 to 2018-19 (which will be finalised later this year).

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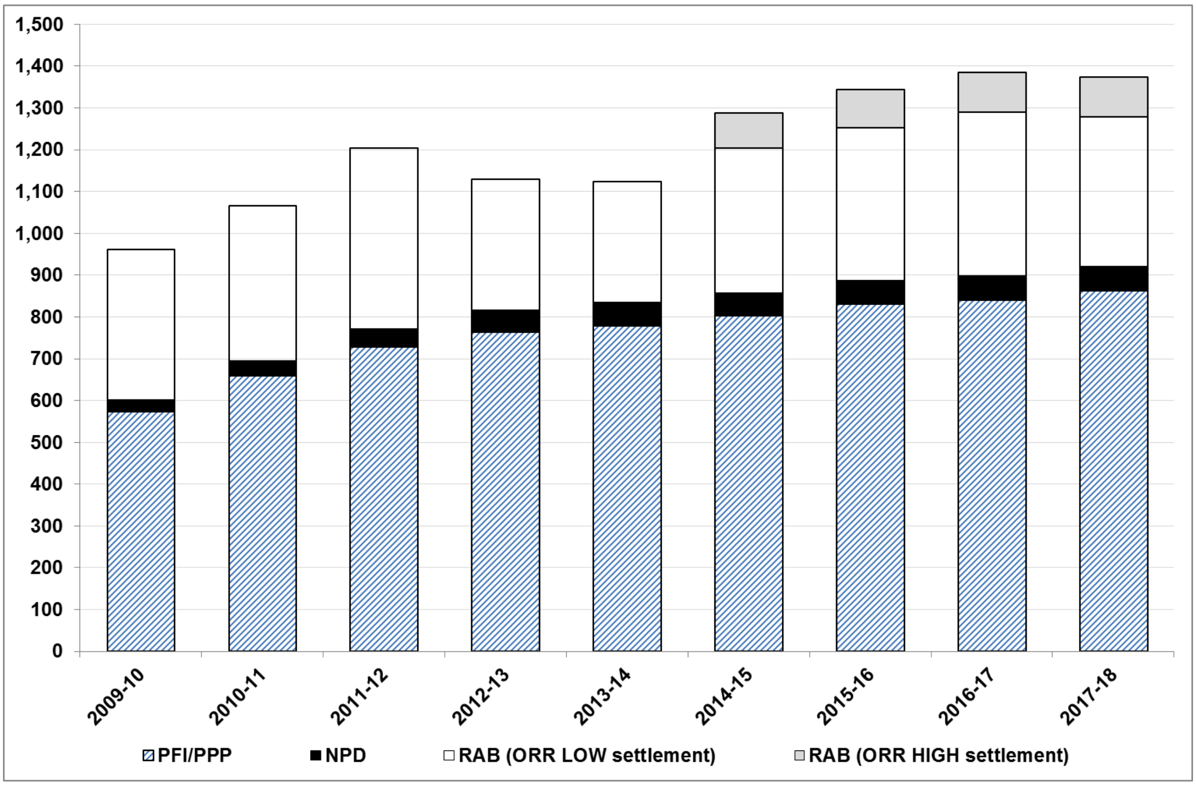
[4] Some care is needed in comparing PFI/PPP and NPD annual payments. The latter are charges that have been established with the benefit of lessons learned on what it took to secure private finance based on pervious PFI and PPP schemes. Consequently, they are likely to have lower financing costs and benefit from better profit and risk sharing arrangements. In addition, all such schemes include charges that are payments for the maintenance and upkeep of the assets, not just financing costs. The extent to which these charges are totally comparable across all schemes is not publicly available.

[5] RAB charges formed part of the Scottish Government's financial obligations following the transfer of rail responsibilities along with associated funding from the Department of Transport.

[6] The ORR has published its Draft Determination on RAB and RAB charges for its 2013 Periodic Review running from 2018-19. Currently, the Scottish RAB charges are a range, relating to possible variations in what efficiency savings ORR expects Network Rail to deliver over the review period.

[7] Data on comparable Scottish RAB charges prior to 2009-10 are not readily available.

Figure 2: Scottish Government PFI, PPP*, NPD & RAB charges funded from Resource DEL £ million (cash)[8]



* Excludes some payments (see Box 2)

Sources: Scottish Government: NPD payments; HM Treasury: PFI & PPP payments; Office of Rail Regulator (ORR): RAB charges which are based on the ORR's Draft Determination LOW and HIGH settlement levels

The Scottish Government's Fiscal Rule and implications for the Scottish Budget

Capital related annual repayments are a large and growing element of the overall Scottish Budget. Mindful of the budget implications (ie, constraining future day-to-day revenue budget opportunities) of using these alternative funding routes for developing infrastructure, the Scottish Government has established its own fiscal rule[9]:

> *The Scottish Government will make decisions on the final balance of funding used over the coming years within a sustainable financial framework. We aim to ensure that we use revenue funded methods at a sustainable level, and do not overly constrain our choices in future years. We will cap our future revenue commitments related to capital investment to a maximum of 5% of our expected future annual DEL budget. These revenue commitments will include existing PFI commitments we have inherited, future debt repayments once we have borrowing powers, and payments made under both the Non-Profit Distributing model and Network Rail's Regulatory Asset Base.*

Although establishing this rule, the Scottish Government has not outlined the basis for why such a level (5%) is the most appropriate capping arrangement. The UK has no equivalent rule, which only adds to the need to explain why it is required and, why it is set at the chosen level.

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[8] RAB charges are set by the ORR in real terms which are then paid in cash terms, escalated by reference to RPI.

[9] This rule is outlined in the Scottish Government's Infrastructure Investment Plan publication (2011).

Neither has the Scottish Government outlined exactly what is included and what is excluded from their definition of future revenue commitments. Box 2 describes the major revenue streams that could also be captured.

Box 2: Payments included and excluded in fiscal rule calculation

The Scottish Government's stated purpose for its fiscal rule is to ensure sustainability of Scotland's public finances. The rationale for what revenue payments supported by the Scottish budget that should be included or excluded from the rule needs further assessment.

For example, the list in Box 1 excludes the following:

- Tax Incremental Financing (TIF) funded schemes
- National Housing Trust (NHT) funding
- Local Authority PWLB borrowing liabilities
- Scottish Water's PFI obligations
- Level Playing Field support for PFI / PPP schools
- Others?

Some of these (eg, Scottish Water, TIF and NHT) rely more on user charges, non-domestic rates and rental income to ensure payment, with the Scottish Government's financial support comprising a small proportion of the finance needed. This may justify exclusion from the calculation, but, if longer-term or contingent liabilities supported by the Scottish Government underpin these schemes, there could also be justification for them to be assessed as liabilities in the fiscal rule calculations.

The rationale for excluding Level Playing Field supported school payments is less clear. These are long-term contractualised financial liabilities held by Local Authorities but which rely substantially on payments being made to them from the Scottish Government's future Resource DEL allocations.

Given the potential importance of the fiscal rule on future capital spending, regular updates on the current level of such repayments should be something Parliament seeks to receive. In addition, the Scottish Government should provide an assessment of the size of any headroom for additional future borrowing based on its projections for Total DEL and Resource DEL-related liabilities.

The, most recent review of the budget position with respect to the fiscal rule was given in early 2012, in response to a written PQ (see Table 1).

Table 1: Projected revenue-financed investment charges as % Total DEL

	2012-13	2013-14	2014-15
Revenue-Financed investment Charges as a % of Resource DEL	3.4%	3.5%	3.9%
Revenue-Financed investment Charges as a % of Total DEL	3.1%	3.3%	3.6%

Source: Scottish Government written answer, 2012, (S4W-05030)

The written answer states:

"The charges relate to the Scottish Government share of unitary charges for inherited Private Finance Initiative (PFI) projects, the Regulatory Asset Base (RAB) charges to be paid to Network Rail for rail investments, and the unitary charges for Non-Profit Distributing projects. The projected levels of DEL are those published in the Scottish Spending Review 2011. The total is likely to be an overestimate of the charges related directly to investment, as some of the PFI payments will include costs related to

ongoing maintenance. At present it is not possible to separate the different elements of the unitary charges."

Table 1 suggests there is headroom to extend Resource DEL-related infrastructure spending further. Illustrating the headroom is helpful and these statistics need to be provided to Parliament at least annually; either at Budget time of when the Infrastructure Investment Plan is updated.

An important aspect of this answer relates to the caveat at the end relating to the fact that it is not possible to extract the on-going maintenance elements of the PFI/PPP/NPD payments. Excluding them, it is suggested, creates even greater headroom. However, why should they be excluded? Given infrastructure needs to be maintained to ensure they remain fit for use, should we ignore on-going maintenance costs that are being increased as we add to Scotland's physical infrastructure?

There may also be a need to consider longer-term projections. The share of future spending being tied up in repayments may increase for reasons other than those directly under the control of the Government. For example, where payments are potentially open-ended ie, they rise (or fall) with inflation or interest rates, adverse movements will mean the share of Total DEL changes.

In attempting to update and refine the Table 1 position, a series of issues need to be addressed in respect of what should be included and excluded from the fiscal rule calculation (see Box 3).

As Box 3 suggests it is not at all clear at present what elements of capital-related charges should be included in the definition of the fiscal rule. For this reason CPPR has used three different definitions to illustrate how the inclusion of different elements affects the calculation of the fiscal rule (see Table 2).

It should be noted that even these three variants do not cover in full the breadth of results possible, depending on assumptions are made in relation to the issues highlighted in Box 2 and Box 3.

Box 3: Issues affecting the calculation of the Fiscal Rule

There are some significant unresolved issues that will affect the Fiscal Rule. These relate both to the 'numerator', ie, the total annual PFI/PPP/NPD/RAB payments to be included, and to the 'denominator', ie, the Total Scottish Government Budget to which the 5% rule applies.

For example, greater clarity is needed on whether:

1. The Total DEL Budget should include non-cash items (eg, depreciation) and/or the new loan support amounts
2. Non-financing costs (eg, maintenance) associated with PFI, PPP and NPD payments should be included in Total Charges and if, they are to be included, how this should extend consistently to include the maintenance costs of, for example grant funded infrastructure
3. The loan support payments associated with 'top slicing' should be included in Total Charges give these ultimately need to be repaid
4. Whether charges in relation to Scottish Water PFI's and Local Authority Level Playing Field supported school payments etc (as described in Box 2) should be included in Total Charges
5. Interest and capital repayment charges in relation to the new borrowing powers (see next section for details) are included in Total Charges.

The inclusion or exclusion of each of these elements will affect the final calculation of the fiscal rule as it currently stands. The Scottish Government has not thus far clearly explained the rationale for what is included and what is excluded and so it is unclear how each of the questions above would be answered. This is highlighted in the Scottish Government's answer to the PQ referred to earlier where the figure given actually includes elements that the government thinks should be omitted.

As a result there is no 'right' way currently defined as to how to calculate the fiscal rule, a situation that should be remedied as soon as possible.

Applying the 5% fiscal rule to a Total DEL Budget of around £30 billion suggests that the cap on such funding routes would be £1.5 billion.

Option A in Table 2 produces a measure of the current known Resource DEL payments that takes commitments to just below the fiscal cap of 5%. On the other hand Option C produces a measure that is lower than that published by the Scottish Government[10].

Table 2 illustrates clearly why greater clarity on the current fiscal rule is now essential, not only to understand whether or not some payments should be included (or excluded), but also to re-evaluate how close we are to reaching the self-imposed cap.

[10] From the information publicly available it is has not been possible to replicate the Scottish Government's figures in Table 1.

Table 2: Resource DEL payments (cash terms, £ billion) and as a % of Total DEL

	2012-13	2013-14	2014-15	2015-16
Total DEL*	**29.0**	**29.1**	**29.3**	**29.6**
ALL payments				
PFI /PPP	1.0	1.0	1.0	1.0
NPD	0.1	0.1	0.1	0.1
RAB charges**	0.3	0.3	0.4	0.4
Total charges	1.3	1.3	1.4	1.5
A - % Total DEL	**4.4%**	**4.4%**	**4.8%**	**4.9%**
EX Scottish Water payments				
PFI /PPP	0.8	0.8	0.8	0.8
NPD	0.1	0.1	0.1	0.1
RAB charges**	0.3	0.3	0.4	0.4
Total charges	1.1	1.1	1.2	1.3
B - % Total DEL	**3.9%**	**3.9%**	**4.2%**	**4.4%**
Ex Scottish Water & Schools payments				
PFI /PPP	0.5	0.5	0.5	0.5
NPD	0.1	0.1	0.1	0.1
RAB charges**	0.3	0.3	0.4	0.4
Total charges	0.8	0.8	0.9	1.0
C - % Total DEL	**2.8%**	**2.8%**	**3.1%**	**3.3%**

Notes:

* Total DEL includes depreciation and capital DEL loan support; the UK Spending Review 2013 only shows Scotland's Budget up to 2015-16.

** RAB charges show above are the ORR's LOW estimates.

Totals may not add up due to roundings

Sources:

(i) Scottish Government: Total DEL to 2015-16 & NPD payments. The DEL figures would be lower if non-cash items of £1 billion and capital DEL loan support repayments were excluded.

(ii) HM Treasury: PFI & PPP payments. These may be lower or higher depending on potential interest rate variations and inflation adjustments to associated service charges.

(iii) Office of Rail Regulator: RAB charges are based on ORR's Low settlement figure contained in its 2013 Draft Determination.

Borrowing powers

From 2015-16, the Scottish Government will be able to borrow up to £2.2 billion (cash terms) to support longer-term capital investment activity[11].

When utilising this loan facility, the UK Government set an initial annual cap of £240 million, or 10% of Scottish Capital DEL. The impact of the 2013 UK Spending Review was for this annual cap to be raised to £296 million; an increase in borrowing capacity of £56 million.

There are important implications arising from the change to this new power.

[11] The economic rationale and precise basis for the £2.2 billion cap has never been made clear by the UK Government, neither has the basis for any, higher, alternative put forward by the Scottish Government.

- The Scottish Government's total borrowing facility remains at £2.2 billion. So, drawing down £296 million each year instead of £240 million means this loan amount will be fully drawn in just under 7.5 years compared to an original period of 9 years+.

- The £296 million annual cap is based on the rule that it should be no more than 10% of Capital DEL in any one year. In 2015-16, Capital DEL is set to be £2,964 million, thus the cap of £296 million. However, as we see from Figure 2, Scotland's Capital DEL now comprises traditional grant support plus the loan support arrangement. Assuming any annual cap on the Scottish Government's borrowings is aimed at ensuring the Scottish Budget is not overly burdened with debt repayments, a cap that is based on a total capital DEL that itself includes loans could over-estimate what is affordable.

- Drawing on the new borrowing arrangement will have an impact on future Resource DEL payments and so could influence the 'fiscal rule' calculations shown above. If borrowing costs from the NLF remain at their current low rates, this may help moderate any such impact. However, there is no certainty about what the extra cost will be and any initial borrowing will ultimately also need to be repaid. Both these elements will reduce the amount of Resource DEL available in future years for spending on day-to-day services.

Table 3 illustrates the budget capacity currently available that could be used to pay these associated borrowing costs, as well as any other new revenue payments, assuming the retention of a 5% cap.

Table 3: "Free" Resource DEL available to support new borrowing,[12] £billion (cash)

	2012-13	2013-14	2014-15	2015-16
All Resource DEL payments included	0.2	0.2	0.0	0.0
Exclude Scottish Water payments	0.3	0.3	0.2	0.2
Exclude Scottish Water & Schools payments	0.6	0.6	0.5	0.5

Note: Figures in Table 3 differ to those implied in Table 2 due to roundings.

Source: CPPR calculations

Table 3 shows that the headroom to utilise new borrowing powers may be substantial or it may be non-existent. This highlights why much more discussion and understanding of this fiscal cap assessment is needed prior to the full utilisation of the new borrowing powers.

Infrastructure implications

The ability of the Scottish Government to implement its infrastructure strategy will be increasingly influenced by the type of funding support it has available or it can leverage in from the third parties (eg, the private sector, local authorities or via taxes and user charges) .

The increasingly scarce "grant" Capital DEL support will need to be allocated to those infrastructure projects that cannot easily be funded by 3rd parties or private debt; either because the cost of securing debt is too expensive or because lenders are unwilling to lend to such schemes.

[12] This spending capacity may also be used to fund additions to the PPP and NPD projects list.

The pipeline of projects in the Scottish Government's Infrastructure Investment Plan[13] (IIP) was updated in January 2013; currently there are over 100 such projects or programmes[14]. Some of these are already funded or are underway but a number rely on future Capital DEL grants and NPD solutions. The extent to which suitable funding will be available in the timescale assumed merits further assessment.

The growing complexity over funding options open to the Scottish Government in this area suggests that there is a greater need for transparency on how funding will be being allocated efficiently and effectively across those projects and if this growing complexity changes relative priorities.

Summary and Conclusions

Although traditional capital grant funding has significantly fallen in value since its 2009-10 peak, there are a growing number of complementary solutions that will help deliver some of Scotland's infrastructure needs. How well these funding sources are being managed is not clear at present, given traditional information sources have not caught up with this change in funding arrangements.

One key piece of information we now need is how well the Scottish Government is staying within its own fiscal rule. Indeed, this Budget round is an opportune time for the Committees and Parliament to debate the nature of any such rule or rules given this increasingly complex financial background.

Overall, should Scotland's infrastructure needs keep growing, the budgetary implications of what each incremental investment means, not only in terms of its impact on Capital DEL but also in relation to future Resource DEL budget pressures (via repayments), illustrates the need for more openness on how and when the Scottish Government's investment plans will be funded and just how much borrowing Scotland's budget can support.

With 2015-16 offering the opportunity to utilise new borrowing powers for capital investment purposes, Scotland's increasing reliance on borrowing to fulfil its infrastructure programme will grow. Far greater clarity on how much debt can be supported from a constrained DEL total is now needed, not least because adding to borrowing reduces what can be made available for other day-to-day revenue budget lines

If the Scottish Government's fiscal rule is to provide confidence in its budget stewardship, then it is essential it provides greater information on how the rule works, not only now but also under these intended new fiscal arrangements.

Finally, this increase in funding options means there is a growing need for more sophisticated assessment of which infrastructure projects are best suited to which of the various funding routes available.

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[13] See Scottish Government, Infrastructure Investment Plan, 2011; Infrastructure Investment Plan 2011 – Updated Project Pipeline, 2013.
[14] No rail schemes are included in this list as they are being separately developed through Network Rail's RAB arrangement.