Financial Scrutiny Unit Briefing

Monitoring long-term investment commitments: the 5% cap

9 October 2013

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“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 [Departmental Expenditure Limit] DEL budget.”

(Scottish Government, 2011)

This briefing looks at the Scottish Government’s commitment in relation to long-term investment commitments, considers how it is defined and reviews the information available to support scrutiny of this commitment.
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EXECUTIVE SUMMARY

Since the introduction of the UK Government’s Private Finance Initiative (PFI) programme in 1992, the public sector has made increasing use of Public Private Partnership (PPP) forms of financing to support capital investment plans. The greater reliance on revenue funding increases the future financing costs that will need to be found from the Scottish Government’s revenue budget. In addition, the new borrowing powers introduced by the Scotland Act 2012 will result in repayment commitments in future years.

In order to provide assurance that these various commitments remain affordable, the Scottish Government has stated that it will ensure that the payments resulting from these commitments will not exceed 5% of its total budget.

The definition of payments included in the 5% cap includes:

- The Scottish Government’s share of payments related to completed PFI projects
- The Scottish Government share of payments related to completed NPD projects
- Debt repayments (both principal and interest) relating to future borrowing under the terms of the Scotland Act 2012
- Regulated asset base (RAB) payments relating to rail network investment

Payments by other bodies, such as local authorities are not included.

The budget definition used as the denominator in the calculation includes:

- capital DEL – although payments are to be from the resource budget alone
- non-cash DEL – which covers depreciation and impairments and does not represent spending power for the Scottish Government
- the local government allocation – although the local government share of payments is excluded from the numerator

In its 2014-15 Draft Budget, the Scottish Government set out for the first time its projections for the future payments implied by the existing PFI projects, planned NPD projects, RAB rail enhancements and future borrowing. These show payments representing 3.5% of total DEL in 2014-15 and peaking at 4.5% of total DEL in 2017-18. The projections were shown in chart format and underlying data have not been provided. This makes it impossible to determine (in monetary terms) how much ‘headroom’ the Scottish Government has within its target (that is, how much more it could spend before breaching the 5% cap).

Future scrutiny of performance in relation to the 5% cap would be assisted by regular publication of figures showing the value of current and projected payments relating specifically to the definition used for the 5% cap.
Since the introduction of the UK Government’s Private Finance Initiative (PFI) programme in 1992, the public sector has made increasing use of Public Private Partnership (PPP) forms of financing to support capital investment plans. Under such projects, the private sector finances the upfront capital costs associated with a project and, on completion, continues to maintain and, in some cases, operate, the asset. Once operational, the public sector makes annual payments (“unitary charges”) to the private sector contractor to cover the capital costs, interest costs and maintenance/service charges. Such payments typically continue for 25-30 years. The payments come out of public sector revenue budgets (as opposed to capital budgets) and this type of financing is therefore often described as ‘revenue funding’.

In Scotland, the Scottish Government has developed a revenue funding model known as the ‘non profit distributing’ (NPD) model. The NPD model is a form of PPP, but places limits on the profits that can be made by private sector partners and requires that any surpluses beyond these agreed limits are returned to the public sector. The Scottish Government has highlighted the use of NPD financing as a means of maintaining capital investment in the face of reductions to the Scottish Government’s traditional capital budget. In addition to NPD financing, the Scottish Government is also making use of ‘regulatory asset base’ (RAB) funding. This is also a form of revenue funding, whereby Network Rail pays for the upfront infrastructure costs by borrowing against its asset base and then repays the loans using payments from the Scottish Government over the lifetime of the asset (usually 30 years).

The greater reliance on revenue funding, combined with existing commitments resulting from PFI projects, increases the future financing costs that will need to be found from the Scottish Government’s revenue budget. In addition, the new borrowing powers introduced by the Scotland Act 2012 will result in repayment commitments in future years. In order to provide assurance that these various commitments remain affordable, the Scottish Government has stated that it will ensure that the payments resulting from these commitments will not exceed 5% of its total budget. This commitment was set out in the 2011 Infrastructure Investment Plan:

“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 [Departmental Expenditure Limit] DEL budget.” (Scottish Government, 2011)

The continued planned expansion of the Scottish Government’s NPD programme, as well as new borrowing powers introduced as part of the Scotland Act 2012, has led to increased focus on the 5% cap and how current and future commitments will impact on its achievability.

CURRENT AND PLANNED COMMITMENTS

In Scotland, a total of 93 projects with a combined capital value of £6.1bn have been completed using some form of revenue financing (Scottish Government, 2013a). This includes hospitals, schools, prisons and waste management plants. Analysis by Audit Scotland shows that such financing methods account for around 10% of the total value of assets in the devolved public sector in Scotland. The health sector has made the most extensive use of revenue financing, with over a fifth of total assets by value financed through such methods. (Audit Scotland, 2013a)
In its 2013 update of the Infrastructure Investment Plan, the Scottish Government set out a project pipeline involving 103 projects each with a capital value of more than £20m. For those projects that had a capital value identified, the estimated capital values total around £6.5bn. Planned investment identified in the project pipeline was split roughly equally between conventional capital funding and revenue funding. This implies that revenue funding will be used to support investment in projects with a total value of at least £3bn within existing capital investment plans (Hudson, 2013).

The 2014-15 Draft Budget provided a more detailed profile of planned NPD investment for the period 2013-14 to 2015-16. This identified plans for a total of £1.9bn NPD investment over this period, spread across transport, education and health projects (Scottish Government, 2013a).
COVERAGE OF THE 5% CAP

When first setting out the intention to limit revenue commitments to 5% of its total budget, the Scottish Government stated that:

“The 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.”
(Scottish Government, 2011)

Until now, there has been no regular reporting on performance against the 5% cap and there has been some confusion over exactly what is included within the 5% cap, and the definition of the baseline Scottish budget figure used as the denominator in the calculation.

Definition of payments (numerator)

In the 2014-15 Draft Budget (Scottish Government, 2013b), the Scottish Government set out some further information on the scope of the 5% cap, stating that it includes:

- The Scottish Government’s share of payments related to completed PFI projects
- The Scottish Government share of payments related to completed NPD projects
- Debt repayments (both principal and interest) relating to future borrowing under the terms of the Scotland Act 2012
- Regulated asset base (RAB) payments relating to rail network investment

An important distinction is that the monitoring of future commitments relates only to the Scottish Government share of payments. In some projects, the Scottish Government is not responsible for the full unitary charges and there will be other public bodies responsible for a share of the payments. For example, in school projects, depending on the contractual arrangements, local authorities are likely to be making a contribution towards the payments. The local authority share of payments would not be included in the 5% cap.

For NPD projects within the health sector, the Scottish Government share of payments represents the majority of the unitary charge. The payments for which the NHS boards are responsible would not be included in the 5% cap, but these would represent only a small share of the total payments. The Scottish Government explains that this is because the NHS boards receive all their funding from the Scottish Government, local authorities have access to additional sources of revenue (such as non-domestic rates) from which to fund their commitments.

Payments in relation to revenue financed projects typically cover both initial construction costs and ongoing maintenance costs. The 5% cap includes both these elements.

In each year since 2012-13, the Scottish Government has received ‘financial transaction’ Barnett consequentials resulting from the UK Government’s Help to Buy and Build to Rent equity/loan finance schemes (allocated to the Scottish Government following the 2012 Autumn Statement and the 2013 UK Budget). The Scottish Government has to use these funds to support equity/loan schemes beyond the public sector, but has some discretion in the exact parameters of those schemes and the areas in which they will be offered. The Scottish Government will be required to make repayments to HM Treasury in respect of these financial transactions, although the repayment terms have yet to be determined. These repayments will not be included within the 5% cap.
### Table 1: Coverage of 5% cap

<table>
<thead>
<tr>
<th>Included within 5% cap?</th>
</tr>
</thead>
<tbody>
<tr>
<td>YES</td>
</tr>
<tr>
<td>Scottish Government share of payments – all projects (construction and maintenance)</td>
</tr>
<tr>
<td>NHS board share of payments</td>
</tr>
<tr>
<td>Local authority share of payments</td>
</tr>
<tr>
<td>RAB payments</td>
</tr>
<tr>
<td>Debt repayments (principal and interest)</td>
</tr>
<tr>
<td>Financial transaction repayments</td>
</tr>
</tbody>
</table>

[It should be noted that in the 2014-15 Draft Budget document and in previous years’ Draft Budget documents, the Scottish Government provides a table setting out total PPP payments (see, for example, Scottish Government, 2013b (Annex H)). This figure includes payments due by public bodies, such as local authorities, and so is not the appropriate figure to use in relation to the 5% cap].

### Definition of Scottish budget (denominator)

The Scottish Government has stated that the cap calculation is based on the total departmental expenditure limit (DEL) budget (Scottish Government 2013b, p168). As such, the denominator used in the 5% calculation would include:

- capital DEL (£2.6bn in 2014-15) – although payments are to be from the resource budget alone
- the local government allocation (£7.8bn in 2014-15) – although the local government share of payments is excluded from the numerator
- non-cash DEL (£0.8bn in 2014-15) – which covers depreciation and impairments and does not represent spending power for the Scottish Government

The DEL figure used as the denominator excludes:

- financial transactions (£0.2bn in 2014-15) – which represent a future liability for the Scottish Government and so could, arguably, be included in both the numerator and the denominator
- any amounts carried forward from the previous year’s budget allocation through the budget exchange

### Table 2: DEL definition used in calculation

<table>
<thead>
<tr>
<th>Included within DEL?</th>
</tr>
</thead>
<tbody>
<tr>
<td>YES</td>
</tr>
<tr>
<td>Resource DEL</td>
</tr>
<tr>
<td>Capital DEL</td>
</tr>
<tr>
<td>Non-cash DEL</td>
</tr>
<tr>
<td>Financial transactions</td>
</tr>
<tr>
<td>Local government allocation</td>
</tr>
<tr>
<td>Budget exchange carry forward</td>
</tr>
</tbody>
</table>
The inclusion of items such as capital DEL, non-cash DEL and local government allocations in the denominator means that this figure does not reflect the amount available for future payments. The use of a larger denominator has the effect of making the percentage calculation lower. Resource DEL (excluding local government allocations) would be a more meaningful denominator (although local government allocations will not be determined beyond the current spending review period). The effect of using different denominators is discussed below.

PERFORMANCE AGAINST THE 5% CAP

In its 2014-15 Draft Budget, the Scottish Government set out for the first time its projections for the future payments implied by the existing PFI projects, planned NPD projects, RAB rail enhancements and future borrowing.

Figure 3: Scottish Government investment commitments as % of projected DEL

Source: Scottish Government (2013b)

The graph takes account of both existing and planned commitments. Future plans reflect the NPD pipeline and planned rail (RAB) investment as well as £296m borrowing in 2015-16. The borrowing plans represent the maximum amount available under the terms of the Scotland Act 2012 in 2015-16, but do not include any assumptions about borrowing in years beyond 2015-16. The projections assume a 25 year repayment period and an interest rate of 5%.  

The projections were presented in graph format and the underlying data have not been made available.

The figures for the years 2013-14 to 2015-16 are based on actual DEL figures, as presented in the Draft Budget. However, the figures for the level of Scottish Government investment

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1 The assumed 25 year repayment period is yet to be agreed with HM Treasury and is longer than the 10 year timeframe outlined in the Scotland Act White Paper.
commitments have not been published. There is a table in the Draft Budget which shows payments under PPP contracts (Scottish Government 2013b, Annex H) but this includes payments by other bodies, such as local authorities, and excludes NPD payments (which will have commenced by 2015-16). As such, these figures are not relevant to the 5% cap.

The projections for future years will depend on:

- Assumptions made about the timing of projects planned or underway (and in particular, the timing of completions, which will determine when payments will commence) – while information on the project pipeline is available, which indicates planned timeframes, this does not provide information about future payments (although details for individual projects will be commercially sensitive until contracts are signed, aggregate figures would be sufficient for this analysis).

- Assumptions made about the size of the Scottish Government DEL – while projections of Scottish Government DEL have been presented in graphical format in the past, there are no published figures which reflect the latest UK Government Spending Round.

Without this information, it is not possible to determine (in monetary terms) how much ‘headroom’ the Scottish Government has within its target (that is, how much more it could spend before breaching the 5% cap). It is only possible to make some approximations based on an interpretation of the graphical data.

- In 2014-15, commitments are set to account for 3.5% of the DEL budget, which would be equivalent to £1,021m on the basis of the HM Treasury DEL set out in the Draft Budget 2014-15 and the definitions set out earlier in this briefing.

- The graph indicates that commitments will peak at just over 4.5% in 2017-18. According to the 2014-15 Draft Budget, the Scottish Government is anticipating a 14% real terms reduction in the Scottish budget between 2010-11 and 2017-18. This would imply a budget of £28,270m in 2017-18, implying payment commitments of £1,270m.

Table 3: Estimated payments and implied ‘headroom’

<table>
<thead>
<tr>
<th>Payments as % of DEL</th>
<th>Source</th>
<th>2014-15</th>
<th>2017-18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scottish DEL, £m</td>
<td>2014-15 Draft Budget / SPICe calculation</td>
<td>29,167</td>
<td>28,270</td>
</tr>
<tr>
<td>Implied payments, £m</td>
<td>SPICe calculation</td>
<td>1,021</td>
<td>1,270</td>
</tr>
<tr>
<td>5% of Scottish DEL, £m</td>
<td>SPICe calculation</td>
<td>1,458</td>
<td>1,410</td>
</tr>
<tr>
<td>Implied ‘headroom’, £m</td>
<td>SPICe calculation</td>
<td>437</td>
<td>140</td>
</tr>
<tr>
<td>Implied headroom as % of payments</td>
<td>SPICe calculation</td>
<td>43%</td>
<td>11%</td>
</tr>
</tbody>
</table>

1 2014-15 figure is DEL budget excluding financial transactions; 2017-18 figure is SPICe calculation based on 2017-18 projection presented in Draft Budget

This analysis suggests that, in 2014-15, the Scottish Government’s payments would have to increase by £437m (43%) above its current estimates before it would breach the 5% cap.

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2 Most recently in March 2012, in ‘Outlook for Scottish Government Expenditure’
In 2017-18, based on the current estimates, the headroom is narrower. The 5% cap would be breached if payments are £140m (11%) higher than currently forecast. Higher than anticipated payments could result from earlier completion of projects, funding of new projects through NPD or from additional borrowing in years beyond 2015-16. The headroom would also be narrower if 2017-18 Scottish DEL is lower than currently anticipated.

As highlighted earlier in this briefing, the choice of denominator has an impact on the cap calculation. The Scottish Government has stated that it intends to use the total Scottish DEL (excluding financial transactions). Table 4 shows the impact of selecting different definitions of DEL as the denominator for the calculation. On the current definition, payments in 2014-15 represent 3.5% of the DEL budget. However, if the definition of DEL is restricted to resource DEL (the budget from which payments will be drawn), the 2014-15 payments represent 4% of the DEL resource budget. If the local government resource allocation is excluded from the denominator, payments represent 5.5% of this DEL budget definition.

Table 4: The effect of using different DEL denominators, 2014-15

<table>
<thead>
<tr>
<th>Denominator</th>
<th>£m</th>
<th>Payments as % of DEL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implied payments</td>
<td>1,021</td>
<td></td>
</tr>
<tr>
<td>Scottish DEL (excluding financial transactions)</td>
<td>29,167</td>
<td>3.5%</td>
</tr>
<tr>
<td>Fiscal resource DEL</td>
<td>25,692</td>
<td>4.0%</td>
</tr>
<tr>
<td>Fiscal resource DEL excluding local government resource allocation</td>
<td>18,622</td>
<td>5.5%</td>
</tr>
</tbody>
</table>

**TRANSPARENCY AND REPORTING**

The Centre for Public Policy for Regions (CPPR) has suggested that greater clarity is required on the rationale for the cap and the level chosen:

“…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.” (CPPR, 2013)

The lack of clarity around the definition of the 5% cap and the need for better reporting of performance against the cap has also been highlighted on a number of occasions, including by those who welcome the general principle of a cap.

In evidence to the Scottish Parliament’s Public Audit Committee, the Auditor General commented that:

“The Government’s action in setting a cap for the amount of future revenue funding that it wants to commit to the revenue consequences of capital projects is a very good move. It helps transparency and it helps to ensure that decision making is sustainable….The next step, though is that the Government should consider how it reports commitments against that cap to the Parliament to ensure that that is transparent. There are some definitions to be clarified regarding what is included in the cap and the way in which reporting will happen. That is very much the next step in what is already a positive direction of travel by the Government in this area.” (Scottish Parliament Public Audit Committee, 2013a)

And in the same session, Audit Scotland commented that:
“…we have suggested that there be very clear reporting about exactly what the cap covers and how it is being measured to ensure that, particularly in relation to local government projects, we are clear about what is being financed by local government, what is being financed by the Scottish Government and therefore what the cap relates to.” (Scottish Parliament Public Audit Committee, 2013a)

Audit Scotland also made recommendations on future reporting of commitments relating to revenue-financed investment. Their suggested template is included at Annex 1. (Scottish Parliament Public Audit Committee, 2013b)

The CPPR has also recommended regular and detailed reporting in relation to the 5% cap (the ‘fiscal rule’):

“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.”

In its June 2013 report on Scotland’s Key Transport Infrastructure Projects, Audit Scotland recommended that the Scottish Government report regularly on estimated long-term revenue commitments (noting that release of information for individual projects prior to signing of contracts would not be appropriate due to commercial sensitivities). (Audit Scotland, 2013b)

In its written response, the Scottish Government said:

“We are reflecting on how best to respond to the recommendation on long-term revenue commitments and expect the Cabinet Secretary for Finance, Employment and Sustainable Growth will look to address this point when he sets out his future spending plans to the Scottish Parliament in September. As Audit Scotland has recognised, it would not be appropriate to disclose estimates for individual projects, as these are commercially sensitive.” (Scottish Parliament Public Audit Committee, 2013c)

When asked by the Public Audit Committee how it planned to report against the cap, the Scottish Government commented that:

“The cabinet secretary will set that out in his budget document; it will be set out in next week’s budget and I expect that to be the pattern from then on”. (Scottish Parliament Public Audit Committee, 2013a)

As these comments pre-dated the publication of the projections presented in the 2014-15 Draft Budget, the inference would be that the Scottish Government’s plan is to report annually on performance against the cap in the format presented in the budget document. This has some limitations, as highlighted earlier in this report, in terms of the absence of monetary values attached to the projections. Future scrutiny would be assisted by regular publication of figures showing the value of current and projected payments relating specifically to the definition used for the 5% cap.
SOURCES


CPPR (2013), The Scottish Government’s capital funding options, new borrowing capacity & their relation to the 'fiscal rule'. Available at: http://www.gla.ac.uk/media/media_288946_en.pdf [Accessed 03.10.13]


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