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Scottish Parliament
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Dear Bruce

Thank you for your letter of 21 December following the Committee's evidence session earlier that day with Barry White and Peter Reekie of the Scottish Futures Trust. In the light of evidence provided by the SFT, the Committee sought further information about impact of ESA 10 on the Scottish Government's capital budget and on our capital borrowing powers. This letter provides the further information sought by the Committee.

The Committee will be aware of the context of the changes to national accounts classifications, driven by Eurostat updating their ESA 10 rules on the classification of revenue-financed infrastructure projects. These rule changes have resulted in several stand-alone NPD projects being classified to the public sector. This in turn requires us under HM Treasury's budgeting rules to use capital departmental expenditure limit (CDEL) budgets to cover the associated capital costs.

There are two points I wish to draw to the Committee's attention here;

- the change in classification and the resulting change in budgeting treatment do not alter the profile of cash expenditure associated with these projects.
- although CDEL is used up during the period of construction and so is no longer available for other projects in the relevant years, the resource DEL (RDEL) budget required to cover the future stream of unitary charge payments – from which capital repayments are made – is reduced by the amount of the capital repayments. Otherwise there would be double counting in budgets, since capital costs are already covered by CDEL during the construction period. This releases additional budget cover over the period of operation of the project to be applied to other uses.

Furthermore, as SFT witnesses said in their evidence to the Committee, any fast-moving rule change by Eurostat has the potential to disrupt developments in the relatively slower-moving world of planning, procuring and delivering infrastructure projects. As the Committee will know, new guidance on classification was issued by Eurostat in August 2014, 18 months after the original invitation to tender for the AWPR contract was published in the OJEU in January 2013, and after the winning bidder was announced on 11 June 2014.

Eurostat made clear that these changes had to be applied from that point onwards. As live procurement of the project was well advanced, it was not practical to re-negotiate commercial terms to satisfy the changed guidance in order to retain a private classification.

Had the Scottish Government made private classification the top priority, it would have been necessary to restart the procurement process. That would have delayed significantly this major capital project, held back economic activity and incurred potentially significant additional costs. The same would have been true of the smaller stand-alone NHS-related NPD projects noted in the Committee's letter. Instead, the Scottish Government's approach was to ensure that classification rule changes had no impact on the cost or timetable of the AWPR and the other relevant NPD projects, so that the associated key economic, connectivity and health outcomes could continue to be delivered as planned.

Of the four projects listed in the Committee's letter as having been formally classified to the public sector by the Office for National Statistics, Balfour Hospital has not in fact yet been so classified. However, we have assumed that it will be and are pursuing a procurement approach that reflects this. The project was at a later stage of development than the other projects when the rule change occurred, and to maximise value for money we have chosen a largely capital funded approach with a limited element of private finance which maintains risk transfer.

Responses to the specific questions raised in your letter are set out below.

- *Given that the £280m in 2015-16 was recorded against the Scotland Act 2012 borrowing limit does this mean that this money cannot be borrowed for other capital projects and does it count towards the cumulative borrowing limit of £3 billion?*

The annual limit on capital borrowing under Scotland Act 2012 powers is 10% of the 'conventional' CDEL total in the year in question, within an aggregate total of £2.2 billion. In 2015-16, the 10% annual limit amounted to £312m. The agreement on capital borrowing provides additional CDEL so that the Scottish Government is able to spend money that it borrows within the Treasury's capital spending control regime. Following the Eurostat rule change, we agreed with HM Treasury that we would use £283 million of the £312 million additional CDEL available to enable us to comply with the budgeting implications of the change. However, because the NPD contracts provide that SG does not start paying for the projects until they are delivered, no actual borrowing was needed. Consequently, we do not expect to pay any interest. The £283 million will count towards the 2012 Act capital borrowing limit of £2.2. billion and will be nominally repaid over the lifetime of the projects.

- *Can you provide a breakdown of the costs for each capital project included in the £280m?*

The breakdown is as follows:

AWPR	£148.4 million
Royal Hospital for Sick Children	£59.5 million
Dumfries and Galloway Royal Infirmary	£53.9 million
Scottish Blood Transfusion Centre	£21.2 million

- *What is the cost of each of the reclassified projects to the DEL Capital Budget for 2016-17?*

The expected budgetary impact of each project in 2016-17 is £398 million as follows:

AWPR	£183 million
Royal Hospital for Sick Children	£75.1 million
Dumfries and Galloway Royal Infirmary	£104.5 million
Scottish Blood Transfusion Centre	£8 million
Balfour Hospital, Orkney	£27 million

- *Will the reclassification have an impact on the Scottish Government's flexibility to use the Scotland Act 2016 borrowing powers in 2016/17, 2017/18 and beyond?*

As explained above, the classification of the projects to the public sector requires us to give up CDEL to reflect capital costs incurred in each year of the projects' construction, even though the Scottish Government is paying nothing for the projects until construction is complete.

Final decisions about capital borrowing in 2016-17 and 2017-18 are likely be taken at the end of each financial year, on the basis that we achieve best value for money by drawing down the full amount of capital grant within the Scottish block before using our borrowing powers. Decisions about use of these powers will be made on the basis of an up to date assessment of programme funding requirements including, but not limited to, the position of the relevant NPD projects. As noted in the Draft Budget 2016-17 and Draft Budget 2017-18, we intend to borrow up to the full amounts available in order to support the overall capital programme.

- *Has this reclassification required the Scottish Government to re-prioritise spending across its budgets, including funding provided to any public bodies, in 2016/17 or 2017/18?*

The timing of the classification decision on the AWPR and its impact on the other four NPD projects meant that the budgetary implications were factored into the budgets for 2016-17 and 2017-18 at the planning stage, so that there was no need to change existing capital budget allocations. Consequently no changes were needed to announced capital programmes. The remaining CDEL required for the NPD projects in 2018-19 will be minimal as construction will be largely complete.

- *Overall, to what extent has the ESA 10 reclassification process reduced the Scottish Government's capital spending, either by imposing a commitment on the DEL Capital budget or by constraining the use of borrowing powers?*

The Eurostat rule change has imposed an opportunity cost on the Scottish Government's CDEL budget in 2016-17 and 2017-18, because (as noted above) budget cover has had to be allocated to the affected projects in order to comply with HM Treasury's expenditure control regime as it applies to projects classified to the public sector. Had the rules not been changed, and the budget cover not therefore been required for these projects, the cover would have been available to support the overall capital programme. However, again as explained above, the amount of the unitary charges that score against future budgets over the lifetime of the NPD contracts will be lower, which we expect to increase budget cover and therefore spending power in these future years.

In addition, the contracts for the construction, operation and maintenance of the transport and health facilities in question continue to ensure the transfer of operational risks to the private sector.

I hope that this is helpful. I should be happy to respond to any further questions from the Committee on these and related issues at the evidence sessions on 11 and 16 January.

Yours

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