FINANCE COMMITTEE

Tuesday 9 September 2008

Session 3

£5.00

Produced and published in Scotland on behalf of the Scottish Parliamentary Corporate Body by RR Donnelley.

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FINANCE COMMITTEE
19th Meeting 2008, Session 3

CONVENER

*Andrew Welsh (Angus) (SNP)

DEPUTY CONVENER

*Elaine Murray (Dumfries) (Lab)

COMMITTEE MEMBERS

*Derek Brownlee (South of Scotland) (Con)
*Joe FitzPatrick (Dundee West) (SNP)
*James Kelly (Glasgow Rutherglen) (Lab)
*Tom McCabe (Hamilton South) (Lab)
*Alex Neil (Central Scotland) (SNP)
*Jeremy Purvis (Tweeddale, Ettrick and Lauderdale) (LD)

COMMITTEE SUBSTITUTES

Roseanna Cunningham (Perth) (SNP)
Murdo Fraser (Mid Scotland and Fife) (Con)
Liam McArthur (Orkney) (LD)
Peter Peacock (Highlands and Islands) (Lab)

*attended

THE FOLLOWING GAVE EVIDENCE:

Paul Brewer (PricewaterhouseCoopers)
Lynn Brown (Glasgow City Council)
Andrew Gordon (Canmore Partnership Ltd)
Donald McGougan (City of Edinburgh Council)
Dougald Middleton (Ernst and Young)
Nigel Middleton (Barclays Private Equity)
Angela Scott (Chartered Institute of Public Finance and Accountancy)
Dave Watson (Unison)
Michael Watson (McGrigors LLP)

CLERK TO THE COMMITTEE

Susan Duffy

SENIOR ASSISTANT CLERK

Mark Brough

ASSISTANT CLERK

Allan Campbell

LOCATION

Committee Room 4

Scottish Parliament

Finance Committee

Tuesday 9 September 2008

[THE CONVENER *opened the meeting at 13:59*]

Interests

The Convener (Andrew Welsh): Good afternoon and welcome to the Finance Committee's 19th meeting in 2008 in the third session of the Scottish Parliament. I ask all members, witnesses and members of the public to ensure that all pagers and mobile phones are switched off.

As members will be aware, the recent reshuffling of the Liberal Democrat parliamentary portfolios has meant that Liam McArthur has moved to the Rural Affairs and Environment Committee. I thank him for his thoughtful and measured contributions to our committee. We wish him well in his new role.

Liam McArthur's replacement is Jeremy Purvis, whom I welcome back to the committee—he was a previously a member of the Finance Committee in session 2. I am required to ask him whether he has any relevant interests to declare.

Jeremy Purvis (Tweeddale, Ettrick and Lauderdale) (LD): I have no relevant interests to declare.

Decisions on Taking Business in Private

14:00

The Convener: Item 2 is to decide whether item 4, which is consideration of the way forward for our review of the budget process, should be taken in private. Are members agreed that we take that matter in private?

Members *indicated agreement*.

The Convener: I also propose that issues arising from evidence received on our inquiry into capital investments and any draft reports on that inquiry be taken in private at future meetings. Is that agreed?

Members *indicated agreement*.

Methods of Funding Capital Investment Projects Inquiry

14:01

The Convener: Item 3 is further evidence for our inquiry into the methods of funding capital investment projects. The committee agreed that, as the strategic business case for the Scottish futures trust was published after we had taken the majority of our oral evidence, we would invite a selection of previous witnesses to discuss the Scottish futures trust.

I welcome our witnesses: Paul Brewer from PricewaterhouseCoopers; Lynn Brown from Glasgow City Council; Andrew Gordon from Canmore Partnership Ltd; Donald McGougan from City of Edinburgh Council; Dougald Middleton from Ernst and Young; Nigel Middleton from Barclays Private Equity; Angela Scott from the Chartered Institute of Public Finance and Accountancy; Dave Watson from Unison Scotland; and Michael Watson from McGrigors LLP. As in two cases two witnesses share the same surname, I will try to mention people's first names to help those who are recording the proceedings. We are joined at the table by our advisers, Nathan Goode and Marianne Burgoyne, from Grant Thornton.

In today's evidence, which will be taken in round-table format, the committee wants to focus on three key components of the Scottish futures trust: first, the model of finance; secondly, the SFT's role as a provider of central expertise; and, thirdly, the co-ordination of projects to achieve efficiencies in risk, finance and delivery arrangements. We wrote to all our previous witnesses and those who are with us today asking them to comment on those issues. I propose to divide the evidence-taking session into three separate sections to deal with those issues. We aim to spend about 30 to 40 minutes on each.

Let me lay out the ground rules before we commence. Our aim is to have a discussion rather than a formal question-and-answer session. All members and witnesses are free to ask questions of one another, to ask questions of the whole meeting or to make general contributions rather than ask questions. However, all contributions should be made one at a time through the chair. Therefore, when members and witnesses wish to speak, they should either indicate that to me or catch the eye of the clerks, who will let me know. The discussion will be most useful if everyone gets plenty of opportunities to take part, so I encourage everyone to do so but to keep their contributions short.

The first part of the discussion will focus on the model of finance. The SFT's stated aim is to improve value for money, with the non-profit-distributing model at its core. We have already taken extensive evidence on the NPD model, so we want to look at other issues, such as local authority bond financing and the scope to provide the lowest cost of finance.

I will start with a question. One aim of the SFT business case is to generate savings in financing of capital investment, but there are as yet no details on exactly how funds will be raised. What do the witnesses think of the SFT model and what must it do to achieve savings in financing capital investment in a co-ordinated way?

Paul Brewer (PricewaterhouseCoopers): I guess I am the only person around the table who was a member of the delivery team that produced the document "Taking Forward the Scottish Futures Trust", so I can give an overview. The original consultation paper on the Scottish futures trust was produced in an environment in which the idea was contemplated of Scotland being able to raise its bond finance directly under the auspices of the Scottish Government. That option is not constitutionally available at the moment, so it was off the table as an objective by the time we commenced work on the strategic business case for the Scottish futures trust.

The financing efficiency agenda has a number of ingredients, which are outlined in the business case document. One is the possibility of local authorities using bond finance to help fund their infrastructure projects. There are a number of models in which different organisations aggregate their finance requirements when the finance is being used for similar purposes. They can potentially get better value, but they can also get efficiency, risk disciplines and other advantages from using external finance.

Aside from the local authority bond issues, there is also the concept of aggregating the finance requirements of a number of non-local authority projects. That provides the potential to gain efficiency by financing the projects not on a one-by-one basis but by considering an aggregated line of finance. That is being considered in the higher education sector in Scotland. There is also a range of measures that involve refining existing models to make them work a little more efficiently.

However, consideration of how one implements the model must be done in the context of a financing market that is in chaos just now. The planning must be done by looking ahead at what might emerge from the current market because the market for external financing projects is rather more limited now than it was a year ago.

Elaine Murray (Dumfries) (Lab): Mr Brewer may be able to help on a point of information. In some of the evidence that we have had, doubt has been expressed about whether local authorities would be able to work collectively—on a joint and several basis—under the Local Government (Scotland) Act 1975. What is your view on that? Does legislation exist that would enable local authorities to work collectively like that, or would additional legislation be required?

Paul Brewer: That would be considered at the implementation stage. The remit of the strategic business case was to ascertain whether there is potential benefit. In an option such as that, certain issues will require to be addressed in order to make it work. We considered the broad principles.

Angela Scott (Chartered Institute of Public Finance and Accountancy): For clarity I should add that under the existing legislation two or more local authorities can combine their power to borrow, but there is currently a limit on the amount of borrowing. There are also issues around the security of that borrowing and the calls on the rates and moneys of the local authorities. However, our reading of the legislation is that there is the power for two or more local authorities to combine and exercise the power to borrow.

Dave Watson (Unison): Our difficulty with the strategic business case is, frankly, that it is difficult to see what model of finance is being proposed. The original idea of the SFT was a reasonable one about aggregating conventional finance. However, that seems to have been kicked into the long grass by the second quango of the two that are proposed in the SBC. The problem is that the whole document is based on the concept of additionality. Frankly, that is a myth. Private finance is not a free lunch; it is essentially bought at a premium.

There is no problem with bonds, which have been used by local authorities for years. They are a conventional form of finance, the use of which we support. It is unclear to me from the SBC what the benefits are of aggregating that finance. I certainly see merit in joint financing proposals. For example, a local authority and a health board might combine to build a facility, with the local authority using its prudential borrowing powers or its bond-issuing powers to finance the scheme. However, aggregation creates the risk of bundling. The private sector likes projects to be bundled together because that is a more profitable way for it to work, but bundling skews the public sector's priorities—the public sector ends up dancing to the tune of private sector finance.

Andrew Gordon (Canmore Partnership Ltd): I know that we are meant to be talking about alternatives to conventional private finance initiative methods, but it is noteworthy that when the paper on the Scottish futures trust was published, it was taken as a given that PFI was more expensive than the not-for-profit model. That has never been proved and every time it is challenged an empty answer is given.

Donald McGougan (City of Edinburgh Council): As markets stand at the moment, local authorities can access capital finance from the Public Works Loan Board, which is normally cheaper and involves less administration than bond finance. That is not to say that the situation might not change in the future—access to PWLB finance could be restricted. The fact that access to such finance is not affected by the size of an authority's funding requirement means that aggregation would bring no benefit. The use of bond finance would bring no benefit for local authorities, either.

Paul Brewer: I have two brief points. First, the remit was to consider efficient infrastructure investment. The cost of finance is a component of that, but it often interacts with other elements, such as management of risk. When decisions are made about how to progress infrastructure development, it is important to examine the whole picture rather than single components.

I agree with Donald McGougan that it is not likely that a source could be found that was more available to local authorities, and which would provide finance at a lower cost, than the PWLB, but bond finance models such as those that have been adopted by other public authorities such as Transport for London not only provide finance at a similar cost but bring the disciplines that come with external finance, which in general have been beneficial to achieving successful project outcomes. Such models do not necessarily offer a lower cost of finance, but their overall financing structure provides better value.

Dougald Middleton (Ernst and Young): As regards the business case, I was concerned that the analysis of the cost of capital and the cost of delivering PFI—whether traditional or non-profit distributing—was limited, in that it was aimed at the low-hanging fruit at the level of individual projects. Much of the political rhetoric around PFI, NPD and SFT has been built on that platform, but the analysis that sits behind it is debatable, at best, and some of the calculations are plainly wrong.

The SFT presented a challenge and an opportunity—it could have been an organisation that was independent of Government and which created a new flow of capital into projects to meet some of Scotland's big infrastructure challenges at a time when, as Paul Brewer said, the capital markets are in turmoil. There are a number of models around the world that are quite refreshing in that regard, such as Infrastructure Australia. The Australian Government has gone about things in a different and very straightforward way, so the first thing is that we could have been more radical around the SFT brief on financing.

14:15

The second thing is that there is a danger that a bunch of unintended consequences might come out of this. The procurement benefits that PFI and NPD have brought, through the involvement of the private sector, are in danger of being thrown out with the bath water. If SFT has an investment role, it is important for it to recognise that it should be about working with the private sector, not working or financing instead of the private sector.

For example—[*Interruption.*] Perhaps TFL's most effective interventions in capital procurement are where it uses its funding powers alongside the private sector, ensuring that it gets the benefits of the private sector's analysis of construction contracts and procurement efficiency while optimising the cost of capital in the project vehicles. There is a degree of sophistication in how the public and private sectors can work together, which I think was missing from the SBC—[*Interruption.*]

The Convener: I am sorry. I ask whoever has their mobile phone on to switch it off, please.

Do you want to continue?

Dougald Middleton: No, that is me finished.

The Convener: You mentioned Australia. Do you have any other examples?

Dougald Middleton: The Russians and Norwegians are doing it. Lots of countries that are running budget surpluses at the moment are considering setting up independent-of-Government conduits to direct their investment in infrastructure. There are examples of countries all around the globe where that is happening, but I know the Australian example quite well.

The Convener: Perhaps you could write to us about the others. That would be very helpful.

Dougald Middleton: Yes.

Michael Watson (McGrigors LLP): I want to expand slightly on a point that Dougald Middleton and Paul Brewer touched on. A lot of the proposals around SFT have focused on local authority bonds and other forms of finance. All the focus has been towards the lowest cost of finance that is available. However, if one targets the lowest cost, there will be less risk transfer from the public to the private sector. So, if a local authority issues a bond collectively with other authorities or independently, it will have the ultimate obligation to repay that bond. Under public-private partnership or PFI, that risk is transferred to the private sector.

Any of those modes of finance will involve less risk transfer. That may be appropriate for some projects, but for more established projects it could be argued that we should stick with a greater risk transfer and transfer the risk of raising finance to the private sector.

Paul Brewer: Local authority bonds are one of the more tangible and obvious findings. However, the things that Dougald Middleton has talked about—investing alongside the private sector and finding the right balance to harness private sector skills along with an effective capital structure; looking at the overall cost of infrastructure delivery rather than the cost of finance—are very much within the scope of the findings. In particular, the concept of working with the private sector to get the most effective overall solution is one that the SFT finance and investment conduit role would be directed towards. Those options are very much part of the findings of the document, but they have perhaps not attracted as much attention as local authority bonds.

Nigel Middleton (Barclays Private Equity): It is worth extending the international examples that Dougald Middleton mentioned against the broad base of the discussion that we are having. We are trying to get the lowest cost of capital while getting the best out of the combination so that that is wholly integral with getting the lowest cost of the overall procurement at its heart. The point has been made on several occasions that aiming to consider the lowest cost of each element does not necessarily equate to securing the lowest cost of the whole.

I return to the specifics. The key is to find the optimum level of transfer of risk such that we create incentives for the private sector to bring its skills to bear and take appropriate risk, without being dogmatic about risk transfer and without transferring risks that cannot be managed or appraised or that are fundamentally uneconomic to a private-sector counterparty.

We have heard of a few examples that combine those elements. One such example is provided by the financing of PPP projects in France, where a substantial amount of the debt capital is provided by the private sector but is underwritten by the Government under what is called a cession Dailly, which reduces the cost to marginally above a bank funding rate. The concept can be extended to other sources of finance that are public-sector backed in effect, but it is important in that model that sufficient return is exposed to the private sector in particular areas to create the incentives to deliver, while keeping overall costs to a minimum.

Joe FitzPatrick (Dundee West) (SNP): This is probably a question for Paul Brewer. Would it be constitutionally legal for the Scottish Government to underwrite debt as happens in France?

Paul Brewer: I think that the powers to do that would sit with the Treasury or would be vested in the Scottish Government by the Treasury, but the power to underpin—by which I mean the power to guarantee repayment of a proportion of project debt—currently exists. We have pursued that line of inquiry because we think that the approach could be effective and could help to generate value for money, provided that the risks that go with the guarantee are carefully scrutinised and managed.

I will put it in simple terms. If one considers from a lender's perspective what will happen if a project goes very badly wrong, it is unlikely that the lender will lose all their money, but they will lose a proportion of their money. Therefore, if the Government underwrites that proportion and guarantees its repayment, the risk is relatively small. In principle, the concept is available.

Angela Scott: I want to make two points. First, when Government does something that distorts competition, we are potentially in breach of state aid rules, so there are questions about legality. Secondly, guarantees are not a free commodity. If we give a guarantee, it means that Government will underwrite and there is a potential liability. As a result of the accounting framework, guarantees must now be recognised on the balance sheet, so we have to acknowledge the prospect that we might have to pay out the money if the risk has been underwritten. A guarantee can be given, but it must be accounted for.

The Convener: I think that Dougald Middleton wants to pick up on what Mr Brewer said.

Dougald Middleton: Yes—and I also want to pick up on the question that Joe FitzPatrick asked. If we consider some of the London projects we can see how the co-financing model has worked in practice. On the London Underground PPP Metronet Rail contract, the banks were guaranteed to 95 per cent of the principal and they carried out limited monitoring of the contract post-financial close, so in effect the Government was paying a risk premium for a risk transfer to the banks that did not materialise in practice. In the projects in which the approach has worked, guarantees have been to the 50 per cent or 60 per cent level. In such models, enough is at stake that people monitor the contract closely, but the cost of capital is still optimised.

Alex Neil (Central Scotland) (SNP): On Angela Scott's point, if the French Government can finance projects in such a way, I presume that the hurdle about European Union laws on competition can be overcome.

Angela Scott: We have to look into that and be clear about it. Under the 1975 act, the responsibility for making sure that local authorities are legally entitled to do these things rests with the local authority, so lenders can lend any money they like—if we find that we do not have the legal power to do it, the local authority bears the risk, not the lender. In the strategic business case there was a line that said that consultation had been undertaken with the Government's state aid and a view was being sought, as we need that clarity.

Alex Neil: Nigel Middleton described a model and, I think, he quoted the French Government. As the French always stick to the rules, I presume that the European Commission has cleared such financing of projects as being within the state rules, in which case it should not, in theory, be a problem for us.

Angela Scott: I might be being a cautious accountant, but we should confirm that we can definitely do it.

Alex Neil: I should also point out that John Swinney is making a statement tomorrow, so he might address some of those issues then; we do not know.

The Convener: Tomorrow will take care of itself. I am more concerned about getting as much evidence as possible today.

Dave Watson: Alex Neil said that if the French do it, it must be within European law—which is a very optimistic comment.

The point that I want to make goes back to risk transfer. Dougald Middleton made the point about Metronet—we should remember the huge costs and failure of that. We can look closer to home at Scotland's PFI schemes. We have paid roughly £3 billion in risk transfer. As I said in previous evidence, the Co-op could do a cheaper insurance job than the money that we have handed over to the private finance initiative.

I would also be very wary of adopting new financing models. Experience in the early days of new models showed that the taxpayer gets ripped off. Even the strongest advocates of PFI will admit that the early schemes—the Skye bridge, Inverness airport, and many others—were poor value for money.

A new scheme called the hub is being promoted in the strategic business case, which is very similar to the local improvement finance trust initiative in England. Again, your equivalent Westminster committee considered LIFT in some detail and reported that it is very expensive and does not deliver all that was promised. That has been our experience of new schemes, so be very wary about adopting a new idea of that nature.

The Convener: If we are not adopting a new idea, what is your best buy in existing ideas?

Dave Watson: Essentially, our best buy would be to build on the conventional finance model using the prudential borrowing powers that exist for local authorities. Those powers could be used in other ways on joint projects, as I indicated earlier. However, we would also look at methods of extending those prudential borrowing powers using the Public Works Loan Board and, if necessary, bond financing to finance projects. That would mean no private finance and, obviously, that there would be no profit element for those who are promoting that aspect of financing.

Nigel Middleton: I will respond on points that were made about the French model as some concerns were expressed. The French are conscientious about ensuring that the level of risk transfer in their projects is optimised to give them value for money. The accounting, whether it is on or off their Government's balance sheet, comes second. At the moment, the Eurostat environment is generally fairly benign with regard to how Governments account for such projects under European rules. Typically, they can be led by best value for money and optimisation of risk transfer as they see it. Whether that will continue if or when all Europe adopts international financial reporting standards is a different question; that is the risk.

The Convener: Are you talking about large-scale projects, small-scale projects, or the whole range?

Nigel Middleton: The cession Dailly tends to be used for accommodation schemes, and PPPs under French legislation that embrace mid-sized to large accommodation schemes—anything from €75 million to €300 million in capital value.

14:30

Paul Brewer: To put this discussion on the cost of finance in context, I point out that we still have—and always have had—a mixed economy in our approaches to funding infrastructure. By far and away the biggest part of such funding has always come from conventional sources of Government finance. Even at what is—certainly for the time being—the zenith of PFI, conventional finance is the predominant approach. The SFT's role, particularly in its early development, will be to focus on efficient procurement across a whole range of infrastructure procurement. Financing models are an important part of that, but the real effort on that will come from SFT finance and investment, which will be created once the development organisation has been established.

Elaine Murray: On that point about the mixed economy in our models of financing, is there any reason why the conventional PPP model should be excluded when the SFT's NDP model is introduced? Presumably, there is no financial reason why PPP could not be part of the choice that is made available to local authorities and other public sector organisations.

Paul Brewer: Clearly, political decisions have been taken about what the Government's policy should be. As I understand it, PPPs in their PFI form have not been conclusively ruled out, particularly in cases that involve a high degree of risk, but the non-profit-distributing model will be the recommended approach—if not the absolutely mandated approach—for projects that involve an element of private finance. The majority of projects will still have no external private finance. Many projects that use the PPP nomenclature involve collaboration between the public and private sectors but are not fully financed by the private sector.

Dougald Middleton: I will pick up on the points that have been made about the finance and investment element of the SFT proposals. Obviously, we are speaking ahead of tomorrow's announcement, but that role for the SFT was relatively downplayed in the strategic business case and was not given prominence in the commentary that appeared after the document was published.

I think that the finance and investment element is an important potential role for the SFT, but there are two issues with how it might develop. First, if the SFT is set up tomorrow as a relatively low-key development vehicle that it is envisaged will evolve to develop its portfolio of services, the committee should be vigilant. It is very difficult for a company that is essentially owned by Government to evolve into anything, because such a company will not have the required flexibility, and the degree of institutional capture that almost inevitably happens will act as a barrier to that.

Secondly, if the SFT is to be set up as a finance and investment conduit—for which there are strong arguments in terms of value for money and how the organisation works with the private sector—a decision must be taken now that the conduit will be at arm's length from Government. It must be able to take independent investment decisions, albeit that the focus and objectives of the company are to invest in Scottish infrastructure. I cannot see how the SFT could get over the additionality hurdles that Dave Watson rightly highlighted if it is not independent of Government. There will be some quite big challenges for the SFT in its evolutionary phase if it is to achieve its full potential.

Paul Brewer: I think that the report acknowledges that. As has been pointed out, we need to get the right balance. On the one hand, we need buy-in from the public sector, so the initial development organisation will need to be for and of the full range of stakeholders in government infrastructure procurement. Otherwise, people will see the SFT as something that has been imposed on them and it will be unable to deliver its full value. That organisation has to be established and it must then decide how the finance and investment element proceeds. However, once that decision has been made, if the finance and investment element is to work effectively, it must have clear objectives of its own and must be constituted in a way that allows it to focus on those objectives and pursue them without institutional capture and in the most effective way, which is outside the public sector.

Tom McCabe (Hamilton South) (Lab): First, I would like clarification on the SFT's independence from Government. If a large local authority wished to progress a project that it felt was important to its area, but the futures trust decided, making use of its independence, that that was not a model that it could support, are you suggesting that it could veto the project?

Dougald Middleton: No. That scenario is a difficult one to foresee. I cannot see how the SFT, no matter how it is constituted, could have the right to fetter the investment or procurement decisions of a local authority.

You raise an important issue in that the SFT, if it has a financing conduit or an advisory conduit, must not be the only show in town. Local authorities and health boards can make investment decisions off their own bat. It is not the SFT's role to say whether such investments should happen; its role may be to decide whether it participates in an individual investment opportunity. It would be very dangerous if policy, procurement and implementation were to be delegated to a third-party body, as they should sit with elected members.

Tom McCabe: I agree.

Angela Scott: I draw attention to the English model, which is referred to in the strategic business case—Partnerships for Schools. In that model, Partnerships for Schools sits separately from Building Schools for the Future Investments, which is the investment company. Partnerships for Schools does not sit on the investment company and the investment company does not sit on Partnerships for Schools. The decisions on the projects that will go ahead and the selection of the preferred bidders are all made within Partnerships for Schools, which is separate from the investment side. Under the strategic business case for the SFT, the equivalent of Partnerships for Schools has a minority shareholding in the investment company. We should perhaps re-examine that governance issue, because the English model has kept the two companies separate to ensure independence. The strategic business case suggests that the equivalent of the Partnerships for Schools will retain a minority holding in the investment company, so it could bring that influence to bear.

The Convener: Andrew Gordon has been very patient, but it was useful to follow that issue through.

Andrew Gordon: My point is far less interesting. It is a point of clarification.

Elaine Murray wondered whether PFI/PPP in a more conventional guise might have a role in a mixed economy of funding. By way of clarification, it appears to be the Government's view—whether or not it shouts about it—that it is not a question that will be allowed to be asked, so bidders for the mental health scheme in Tayside could bid any alternative that they wanted as long as it was not PFI/PPP. That seems to show a lack of confidence in the true value for money of what is being offered under NPD. I do not mind losing, but I like to have a chance to put a bid forward.

James Kelly (Glasgow Rutherglen) (Lab): I am interested in the views of the representatives of local authorities on what support they are looking for from a Scottish futures trust, bearing in mind that previous models have provided a significant level of financial support to local authorities in undertaking capital investment work.

Lynn Brown (Glasgow City Council): We used to get about 80 per cent support from the previous Scottish Executive for, for example, PPP projects. When the Scottish futures trust was announced, Glasgow's response was that we were looking for that level of support in cash on the table. I support the views that Donald McGougan expressed earlier and I was interested in Paul Brewer's response, in which he talked about risk transfer. That is covered only vaguely in the document.

From my perspective, bond finance is more expensive than the current options. Raising a bond involves going through robust due diligence involving the banks and legal and finance staff, whereas the prudential borrowing regime gives us a lot of scope to raise the money that we need. From that perspective, we were looking for cash on the table. The report says that £150 million will be saved through better procurement, but that sum is equivalent to the cost of about 15 primary schools. The proposal is not what Scottish local authorities require.

I know that we will move on to discuss procurement. The proposal on procurement, expertise and capacity building is a sound one from which local authorities can benefit, but we are looking for the same level of support that we received previously.

The document is vague and it is written in consultantspeak. We cannot see where it is coming from. However, maybe there will be a further announcement.

Jeremy Purvis: I ask the witnesses for their forbearance as I am a new member of the committee and therefore am new to the inquiry.

I want to ask about a couple of things that arise from Mrs Brown's comments. The first is Government intervention through revenue support grants, unitary grants or however they are termed. As I understand it, such grants exist in almost every form of financing, whether they are given for a PPP scheme for a school in my constituency or for a hospital scheme. However, there is nothing about that in the business case for the SFT. What consideration has been given to that? There is an alternative system of finance, but is there also an alternative form of finance? The Government's infrastructure plan is clear that revenue support grants have been rolled up in the local government settlement. There does not seem to be a source of funding for them.

Lynn Brown: Level playing field support is the term that was used—it was mentioned earlier. It was equivalent to 80 per cent of the capital cost of a project and we got it throughout the life of the contract. It was a fixed amount, so the authority faced greater costs as inflation rose, but that is the support that we received.

Paul Brewer: Level playing field support was established to create some equivalence for privately financed projects where funding could not come as a capital grant but it was required to service on-going costs. That is not explored in the Scottish futures trust document because, regardless of the structure of the Scottish futures trust, there are policy decisions to be made about the appropriate form of financial support for infrastructure projects, be they in local or central Government.

Jeremy Purvis: That is the historical situation with level playing field support, but if I understand the position, that option no longer exists. When a scheme requires support, regardless of whether it is an NPD scheme or another scheme, the local authority will require some form of central intervention. Otherwise, there will be a colossal burden on local authorities to fund projects. I am surprised that that was not included in consideration of the SFT model, which has major implications for the funding of our infrastructure.

Paul Brewer: The overall quantum and form of Scottish Government support for infrastructure projects were not part of the remit. We considered structures that would address effective infrastructure investment. Policy decisions about the funding of that investment were outside the scope of the work.

14:45

Donald McGougan: To underline that point, if the Scottish futures trust talked about efficiency savings on infrastructure investment of 2 to 3 per cent, that would be at the margins as far as addressing the infrastructure backlog across local government and other parts of the public sector is concerned. The big issue is that, over the past period of time, we have been able to make some inroads into that investment backlog because of the 80 per cent support. There will be on-going support through the local government finance mechanism by way of capital grants and the support for local authority borrowing that has now been rolled up in the mainstream grant, but that is only around £25 million per annum for Edinburgh and we have an infrastructure backlog that is many times that amount. The amount that the Government, local authorities and health boards invest in infrastructure compared with their on-going revenue expenditure is a separate political issue.

The Convener: No one else wants to say anything on that, so we will move on to the second issue, which is the proposed role of the SFT as a provider of central expertise in project development. I will start with a general question. A common theme in our inquiry has been a desire to continue to enhance the public sector's skills in contract negotiations and project management, and that is a core theme in the business case for the SFT. What is the best balance between developing skills in each public body and focusing on a central resource? If a central resource is a good idea, how should it relate to existing resources such as the Scottish Government's financial partnerships unit?

Michael Watson: The short answer is that a central resource is needed for a couple of reasons, one of which I gave in my submission. From the perspective of the market for the projects in whatever form they come out, it would be beneficial if projects that different local authorities promoted had a degree of similarity. Therefore, rather than delegate too many skills to individual local authorities, it would be a good thing to have a central resource that is responsible for monitoring projects and delivering homogeneity where variations in different projects arise. That is important because of the scale of the market. Scotland is a relatively small part of a large global infrastructure market to invest in. Therefore, such a central resource is important to encourage the scale of investment that is required.

Secondly, providing central support in negotiations and structuring skills is important. Having a central resource rather than delegating things to individual local authorities would be efficient. I should say that many of the skills are available in the financial partnerships unit at the moment.

The Convener: I think that I saw Lynn Brown keen to get in.

Lynn Brown: I think that you saw me shaking my head.

The difficulty with having everything centrally resourced is that there are then no informed clients among the people who matter and who decide what to do. Democratic organisations in particular need informed clients to be able to advise members on the best option. A mix is needed. It is all about building capacity in the public sector so that we get the best value from the public pound.

Paul Brewer: I agree with what Michael Watson and Lynn Brown have said, which can be reconciled. The concept of SFT development and delivery is not to undertake the procurement function except, potentially, in cases in which projects are particularly large and complex and a set of skills is needed that is not readily available in the public sector. The original concept for development and delivery had two legs. One was the quality assurance leg, which was intended to sharpen up the existing gateway review procedures and to get more consistency and effectiveness in them. The other was to focus on projects and programmes to provide support when large and complex procurement is undertaken, which different bodies in the Scottish public sector need to differing extents. A large and sophisticated council that has a breadth of resources will have less call on outside skills to support it.

There will be different solutions for different authorities, but certain issues will overarch, such as ensuring that projects are marshalled in a way that gets the best out of the supply side, which cannot be achieved from a single point on the map of procuring authorities in Scotland. Somebody who has an overview is needed to deal with that issue and with some of the more complex financing issues and the relationship with the financial markets in particular. I expect existing skills in the financial partnerships unit to be the kind of skills that SFT development and delivery will continue.

Donald McGougan: The concept is interesting and valuable if we are talking about upskilling, the sharing of expertise or helping with training, for example. I believe that the SFT is now talking to the Convention of Scottish Local Authorities about how that might work in practice. That is a very useful way forward because we need to get the balance right between the client, the specification and what is being enhanced at the centre.

The other issue that I am not sure about is how the SFT is designed to operate alongside Scotland Excel or even the Scottish procurement directorate. Both those organisations are designed to improve procurement in the public sector in Scotland. Indeed, construction is one of the category B projects in which Scotland Excel was supposed to be developing expertise. At the very least, Scotland Excel and the SFT would need to agree how such work would be developed nationally.

The Convener: Am I right in thinking that a clear delineation of roles, responsibilities and powers has been called for?

Donald McGougan: That is optimistic.

The Convener: We can keep hoping.

Dave Watson: It is clear that nobody has any objection to the idea of sharing expertise. As has been said, a range of different teams work in the field at the moment. There can always be better co-ordination, but one of the strengths of the public service model is that we can do that sort of thing.

Why do we need another quango to do such work? There are two bodies within SFT; one is the financing arm and the other seems to be simply a co-ordinating quango. If we take the support staff out of the model, we see that it will have five staff earning more than the chief executive of Glasgow City Council—about £180,000 a year. That sounds like an excellent scheme to me, as a trade union negotiator, if only we could carry it more widely across the public sector. Frankly, how that sort of fabulous salary can be justified is beyond me.

We are concerned that when bodies such as the SFT are set up, they inevitably start to create an ideology and a role for themselves. Our concern about the SBC is that the SFT's role will be to promote the privatisation of Scotland's public services and that it will call for the sort of subsidy that was given to PFI by what was laughingly called level playing field support. At least the English give it its correct title of PFI credits. I think that you will find that the body will then want that Government support to subsidise its proposals.

Andrew Gordon: We support a development and delivery arm of SFT that is fully public sector. Not enough people in Scotland realise that the financial partnerships unit, in our and most bidders' view, does a better job in Scotland than its counterpart does in England. Paradoxically, we have more centralised co-ordination of procurement in PPP and PFI in Scotland, but it is more light touch. I hope that if the development and delivery vehicle is established, it will build on the model of the financial partnerships unit as a guide and co-ordinator rather than a policeman. We see much more of the policeman down south—and sometimes not a very good policeman—with less of a role for clients, elected local bodies and trusts. As a bidder, I find it frustrating not to be able to talk to the people to whom we will provide a service.

Dougald Middleton: I have two points. First, I agree with the point that Andrew Gordon has just made. The SFT's role must be clearly defined. The financial partnerships unit has a dual remit. In part, its role is to promote efficiency and best practice but, at the end of the day, there is a yes/no button in Victoria Quay—the unit can sanction ways forward on individual projects. It is a credit to the unit that it has managed that balancing act pretty well, but there is an inherent conflict of interest in that situation. That would apply particularly to an organisation that was more at arm's length to the Government than the FPU is and more akin to Partnerships UK. It would be a dangerous precedent to give the new body that sanction over projects.

Secondly, the point that Lynn Brown touched on about capacity building is important. At official level, we tend to deal typically with one-time purchasers in local authorities and health boards, so they have relatively little experience of projects. It would be well worth including in the SFT's remit a role in building capacity and a common understanding of the key issues among officials and members.

Elaine Murray: From the comments that have been made, I wonder whether we need a separate SFT. A lot of reference has been made to the skills in the financial partnerships unit and to building on its work. It seems a little odd that a Government that prides itself on getting rid of quangos and which has taken bodies such as Communities Scotland back into the Executive should now be turning an Executive unit into a quango. Could the same effect not be achieved by extending the financial partnerships unit's role?

Paul Brewer: One purpose of the proposed governance structure is to have a body that is accountable to all the stakeholders in capital investment in Scotland. That picks up on Dave Watson's point, too. At present, the financial partnerships unit sits within the Scottish Government and provides a service to a range of procuring authorities. Where it is providing finance, it is empowered to make the yes/no decision. The concept for SFT as a delivery vehicle is that it will report to an infrastructure board for Scotland, so it will not be a quango that goes off and develops its own remit. As I said, the SFT must be for and of the community of bodies that undertake capital investment. That should make its accountabilities rather clearer than the current situation of the FPU sitting within the Scottish Government.

Nigel Middleton: As a private sector investor in and sponsor of many infrastructure projects, we would certainly welcome an improvement in expertise and capacity. I do not think that that is in question—the comments are really about how that should be achieved. Barclays has been investing in PPPs in England and throughout Europe for about 15 years. In England, where we started investing, similar comments probably emerged about 15 years ago. Good projects were being delivered, but questions were asked about what was being done on capability in the public sector. To a degree, everyone agreed that it was a good idea to centralise expertise and build capacity. However, 15 years on, has there been significant or continuing improvement in the way in which the public sector handles development and procurement? Across the board, the answer is no. The situation is patchy. Some bodies are very good and, at a personal endeavour level, phenomenal.

The issue is not just building capacity and harnessing developed expertise but refreshing that expertise, particularly in dynamic areas such as finance, in which the markets change daily and what is good value can change daily. It is also about retaining that expertise and capability to add value to the public sector. Those issues do not seem to have been cracked in England. There must be a powerful focus on them in Scotland.

15:00

Dougald Middleton: I have a short and direct question for Paul Brewer. Will the SFT have a yes/no button in the same way that the FPU has?

Paul Brewer: The first thing that the SFT will be empowered to do is to undertake gateway reviews. In terms of line of command, gateway reviews do not have an absolute yes/no button, but projects will be accountable for the consequences if they do not act on the findings of reviews. If funding streams with an approval attached to them flow through the SFT, I think that their position will be the same as with the FPU at present.

The Convener: For the sake of the long-suffering public, can you explain gateway reviews for the record?

Paul Brewer: Certainly. Gateway reviews seek to ensure the quality of capital investment projects across government. The Office of Government Commerce implements them in England right across the board. Adopting the same methodology, the financial partnerships unit conducts gateway reviews on privately financed capital projects in Scotland. That quality control mechanism is applied to different stages of all significant capital projects. The gateway review comes before each significant decision, which means that scrutiny is applied at the right time to ensure that recommendations are taken account of before moving ahead.

The Convener: Thank you. I thank all our witnesses for the absence of acronyms, apart from SFT.

Dougald Middleton: I have a follow-up question on a point of clarification. The most effective yes/no button in the financial partnerships unit just now is the one around PFI credits and revenue support. Will that sit within the SFT or will the Government retain it? It strikes me that it would be difficult to delegate it.

Paul Brewer: As I understand it, the only yes/no button that formally sits in the Government at present is associated with the finance that the Scottish Government historically provides through what is called revenue support grant or level playing field support. That funding stream is not in place for future programmes at the moment, and the yes/no button will attach to them only when they come forward.

Angela Scott: When we gave evidence to the inquiry previously, we said that it is important to develop skills in capital procurement, but that it is also important to develop skills, systems, knowledge and planning way before the decision to procure is made. We are keen to see that area developed.

The Improvement Service undertook a review of asset management planning in local government and the Cabinet Secretary for Finance and Sustainable Growth reviewed asset management across central Government. The conclusion of both reports was that asset management planning and the skills involved were equally patchy and that investment in skills had to take place way before decisions were taken on what would be purchased and the purchasing methodology that would be used—all public sector organisations must undertake certain things before reaching that stage. It is just as important to develop skills in that area as it is to develop capital procurement skills.

Jeremy Purvis: I have a couple of questions on the gateway function. Interestingly, it is not explicit in the Government's literature that the new body will inherit that yes/no function for schemes; it will be able to say only no, because there will be no money for it to say yes. Is that right?

Paul Brewer: The principle behind the gateway function is quality control. The gateway function is not an integral part of the decision-making process on a project. Any large local authority project, whether or not it is privately funded, would be expected to seek a gateway review of its progress as a quality-control check, but the review would not be part of the management decision-making process. The review would make recommendations and the local authority would be held accountable if it failed to take them into account, but there would be no decision-making power through that process. The financial partnerships unit's current decision-making power attaches only to the line of funding, which it can agree to provide or not agree to provide.

Jeremy Purvis: If the gateway process is to be a major function of the SFT, how will that function exist if no funding stream is available for the SFT to carry out the function? Therefore, what functions will the SFT carry out? The central Government centre of procurement expertise, which was established after the 2006 review into effective procurement in Scotland and sits alongside procurement Scotland and Partnerships UK, is quite explicit in stating that its functions include:

> "Conducting and facilitating collaborative procurement activity for the central government sector for Category B commodities".

I understand that to mean infrastructure and investment, so what new things will the SFT do? In the Government's paper, the set-up costs alone for the SFT are nearly £2 million over the next five years, with an overall cost of £17 million. That seems a very good way of ensuring that some people earn a lot more money, but will it add anything new to the advice that is available to local bodies?

The Convener: That was a long question. Does Mr Brewer want to respond?

Paul Brewer: The detail of the governance has yet to be established. Whether the SFT will be so empowered will depend, I guess, on a decision by the infrastructure board. Such a decision would need to be agreed by the Scottish Government and, if appropriate, by local authorities. I expect that, as an established centre of expertise, the SFT's views will be, at the very least, highly influential in the progress of capital projects. However, whether the SFT sits in the line of direct decision making and has a power of veto is a detailed question of governance. I think that the organisation will need to be established, or at least be in the detailed planning stage, before we will get a clear outcome on that issue. For example, if the SFT were to have a decision-making power on the progress of local authority projects, local authorities would be required to cede their management decision-making process to another body. That would be a significant step. Detailed consideration would be required before one went as far as that.

On what the SFT will add, I think that it will bring to the existing capability of the financial partnerships unit a more formalised quality-assurance role. The depth of the financial partnerships unit's role has varied a great deal according to whether projects have involved private finance. Given that the Audit Scotland report on major capital projects found that the issues that the financial partnerships unit addresses in privately financed projects are relevant to all capital projects, the SFT should achieve much more effective coverage of that expertise and provide a much more coherent view that will have an impact on the successful development of infrastructure and capital investment in Scotland as a whole.

The Convener: We have now moved into the third section. The final issue that we want to cover today is the co-ordination of projects to achieve efficiencies in risk, finance and delivery arrangements. As part of that, we will explore the governance and accountability of the Scottish futures trust and how it will interact with the governance arrangements for public bodies on whose behalf it might fund or commission projects. Again, I will ask a question to start us off.

The SFT business case suggests that co-ordinating and managing the way in which projects come to market should create some savings and efficiencies. What approaches do the witnesses think could usefully be developed to co-ordinate projects from different public bodies? What are the potential benefits and disadvantages of trying to co-ordinate projects?

Andrew Gordon: I suspect that we have excessively high expectations of any central body that tries to co-ordinate procurement across all sectors in the short to medium term, simply because the rest of the world does not know what it is doing. At the moment, the financial partnerships unit does about as good a job as could realistically be done. The reality is that the private sector people who are expected to build and service projects do not actually have medium-term programmes to match the public sector as a buyer of their services. We can go out and take all the market soundings that we like, but the truth is that the private sector people whom we are talking to do not really know what they are going to be doing in three years. They have a rough idea, at best.

Paul Brewer: There is the issue of the time that we are in, which, at the macro level, means a relative shortage of debt capital for projects in the United Kingdom. Bigger players are looking ever more globally for their projects, including those who have historically taken quite a strong interest in Scotland. In Scotland, while overall capital investment continues apace, the programmes for which the contracting community was able to organise itself and achieve a high degree of predictability of future work flow are very quiet at the moment. Compared with the situation two years ago, there is rather less in the programme pipeline. So the uncertainties that Andrew Gordon has picked up on have both those aspects to them. The difficulties that the construction sector is facing and the shortage of projects are going to develop over time. The situation is dynamic and the SFT will have to look forward to when the market will be stronger and be ready to deal with that.

Angela Scott: The governance and accountability arrangements are a weakness in the current strategic business case because there is an absence of detail in them. Lynn Brown and Donald McGougan have the post of section 95 officer, which is one of only two local government positions that are required by statute, and they have a statutory responsibility to safeguard public assets and public money. Local authorities also have a statutory duty, to get best value and value for money. Any proposed arrangements must therefore allow Lynn Brown, Donald McGougan and their respective organisations to meet their statutory responsibilities.

Dave Watson: The business case claims that there will be efficiency savings of approximately £100 million to £150 million, but that must be put in the context of £40 billion of investment over 10 years, so the efficiency savings are very small. Also, I can see no evidence in the document that the aggregation of finance is going to deliver even that modest level of savings. The UK Government set up the Public Works Loan Board many years ago, and one of its functions was to create that aggregation of finance. It is hard to see how we are going to do that in Scotland.

On governance, from Paul Brewer's answer and the document, it appears that it is proposed to create a body and then decide what powers to give it. That is a strange approach, and contrary to the Government's simplification programme, which is supposed to be about reducing the number of quangos in Scotland, and is certainly about clarifying their roles and functions. I would be particularly concerned if there was any suggestion that the SFT would have controlling powers with yes/no buttons or anything like that. Bear it in mind that the Scottish Government has gone for outcome agreements, which we welcome, and direct elections to health boards, so the focus is on decentralising power rather than controlling things from the centre.

When we talk about who is involved, one thing that we know from the strategic business case is that it is intended that there should be, as is stated on page 46, not only private sector expertise but

"sufficient private sector influence over decision making."

That seems to describe a very different body from the sort of democratic, accountable body that we are talking about in other areas.

15:15

Dougald Middleton: On the co-ordination and bundling of finance, there is clearly a minimum size of project against which it is cost effective to raise finance. There may be opportunities for local authorities to bundle projects and bring them to the market jointly. Angela Scott touched on the point that in bundled projects you tend to get into difficult issues about joint and several liability across two or more authorities, which is difficult for finance directors and their members to deal with because of the risks that it brings to the table.

That brings me back to the finance and investment function of the SFT. The benefits of portfolios of investments come from the diversity of the investments rather than from bundling them together and financing them all together off the same set of contracts with the same contractors and the same risk profile. Many of the financial gains in PFI and PPP have come from having similar projects with a diverse range of outcomes. The benefits have come not at the individual project level but at the portfolio level. The SFT should be interested in capturing those benefits, but it should do so in a way that does not squeeze out the likes of Barclays Capital and other equity providers, which have a legitimate role to play in the marketplace.

Paul Brewer: I come back to the point that Dave Watson and a couple of others have made about the governance arrangements being relatively vague and not well worked out at this stage. I make it clear that the role of the body that produced the strategic business case was to set out the way forward and outline the potential governance structure. It would not have been appropriate at that strategic stage to make decisions on governance. It is extremely important that governance is examined more carefully and that stakeholders are involved in the process. There was an element of deliberateness in not going into governance in more depth at that stage.

The words that Dave Watson quoted on the involvement of the private sector relate specifically to SFT finance and investment and to the risk that if one set up an investment body there would not be private sector interest in participating in it. When it comes to private sector participation in an investment body, you clearly want the private sector to have enough influence so that you can understand and be able to respond to the needs of the investors that you seek to involve. That is a statement of principle; it is not attached to any specific structure that has been developed as a result of this business case.

Michael Watson: I will pick up on the point about co-ordination. One of the central tenets of the strategic business case appears to be the desire to co-ordinate the activities of a number of local authorities and other public sector bodies. It occurs to me that, to the extent that the financial partnerships unit has been successful, it has been as a result of its financial influence in relation to level playing field support and its legal influence in the sense that the legal structures that are employed are mandatory. Nothing in the SFT proposal demonstrates that there is either a carrot or a stick that will require local authorities to follow that route. I suspect that the carrot has always been the more successful device. If you are trying to co-ordinate a number of local authorities and bodies and to get them to buy in, it will require more than the SFT being a centre of intelligence: a financial incentive will also be required.

Lynn Brown: I welcome Paul Brewer's comment that governance will be examined in a lot more detail, because it concerns me greatly—governance has been vague throughout the different stages of the establishment of the trust. Two aspects concern me. The first is decision making. Who will make the decision about what gets done and why? There are competing priorities between and within councils as well as between councils and other public sector bodies. The other aspect is accountability. When a project is approved, who will be accountable for its being delivered on budget and on time? The current lack of governance guidance means that the SFT could be accused of having a democratic deficit, because we do not know who will be responsible for deciding what gets done and how.

The Convener: You want clearer lines of accountability and control.

Angela Scott: I want to pick up on Michael Watson's point about the challenge of co-ordination. Scotland Excel is the centre of expertise for local government that was set up in response to the McClelland review a couple of years ago. As I understand it, we are only now at the point where 27 out of 32 local authorities have signed up. There is not yet an obvious carrot to incentivise co-ordination. The challenge for Scotland Excel is to establish where everybody starts from and the time that it will take to get everybody on to a common procurement platform. We cannot underestimate the challenge of co-ordination or the time that it will take to get the benefits from it.

Michael Watson: My point relates to transparency and it is one that I made in a previous submission. On assessing and co-ordinating local authorities' decision-making processes for the funds that they spend, you should not underestimate the time taken to plan projects, as I think Andrew Gordon mentioned earlier, particularly in relation to the whole-life costing of projects, transparency and comparing the benefits of, say, a PPP project, which involves costing at the outset of all the maintenance of the asset over its lifetime, with traditional procurement. I would welcome an explanation and delivery of those benefits through an SFT structure, if that could be promoted.

The Convener: We are coming to the end of this market day; it is wearing late. If there are no final comments, I thank all our witnesses for their contributions to what has been an extremely interesting and important evidence-taking session. I thank you all for sharing with us your experience and expertise, which is greatly appreciated and will be useful and important to the committee when we produce our final report.

15:22

Meeting continued in private until 15:38.

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