

THE FABRIC OF SCOTLAND

How a dynamic approach to
developing Scotland's infrastructure
can unleash economic growth

reform
scotland

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The Fabric of Scotland

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Five questions about infrastructure

1. What has happened to infrastructure investment in recent decades?
2. What have we learnt about successful and unsuccessful management of infrastructure projects?
3. What is and should be the fiscal framework for infrastructure projects in Scotland and the UK?
4. How should infrastructure projects be financed?
5. What should be the governance structure of hybrid institutions?

What is infrastructure?

Capital investment which is either

- a. plant and buildings used in the provision of tax financed services, eg schools, hospitals, prisons
- b. essential and widely used services funded through regulated access charges, eg transport and utility networks

What has happened to infrastructure investment in recent decades?

Gross UK public investment peaked at almost 10% of GDP in the period 1965 – 1975

This figure fell to 1.7% in 2000 and has since recovered to around 2.5%

Adding back investment which would have been public investment in 1970 would add c.2% to the current overall figure.

Infrastructure investment as share of GDP since 1970

- large decline
social housing, roads, gas/electricity,
education
- some decline
health
- stability
communications, water
- large increase
rail

Housing completions, 1968 – 2006 (thousand)

	Private	Local authority	Registered social landlord	Total
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UK

1968	226	184	15	425
2006	185	0.3	26	212

Scotland

1968	8.7	26.8	6.5	42.0
2006/7	20.0	-	3.2	23.2

Problems of managing infrastructure project

Strategic misrepresentation

Conflict among contractors and project managers

Too many cooks

Misrepresentation of progress and lack of transparency

Great leaps forward.

Strategic misrepresentation

Gross misstatement of costs and benefits by project sponsors

Tradition of successive overruns

'The hook' – very large increases in budget once project has acquired momentum.

Transparency – or not

Openness aggravates 'too many cooks' problem

Lack of openness encourages misrepresentation of project progress.

The great leap forward

The attempt to compensate for past failures through a more ambitious forward programme

Attractive to politicians with more rhetorical than managerial experience.

Success factors for projects

Engineering based project management at arm's length from both political sponsors and contractors

Repetitive projects of similar character.

The fiscal framework – UK position

- Fiscal rules
- the golden rule (current expenditure)
 - the sustainable investment rule (borrowing limit)

Familiar targets

Shift from pure cash accounting to attempt to shoehorn public spending into private accounting categories

Key question - to what extent do current expenditure commitments imply higher levels of taxation in future?

The fiscal framework – the Scottish position

Scotland Act prohibition: Scottish ministers may not borrow

Relationship with UK Treasury:

- Barnett formula governs current expenditure
- Otherwise Scottish government treated as English government department in respect of capital allocation, capital charges and VAT.

How should infrastructure projects be financed?

Popularity of PFI/PPP resulted from the coincident interests of the project finance industry in finding new markets and governments in pursuing off balance sheet financing.

But while project finance originated in the private sector's search for new financing mechanisms, the public sector's real need (though not necessarily its perceived need) was and is for more effective project management skills.

PFI/PPP has developed skills in structuring complex financial transactions and in contract specification, in the public sector and associated consulting industry but has done little to reinforce, and may in fact have diminished, public sector skills in project management.

How should infrastructure projects be financed? basic economic principles

Fundamental confusion between sources of capital and methods of provision. 'Private financing' does not make new sources of capital available but interposes layers of intermediation. Such intermediation imposes costs but may have compensating advantages if intermediaries achieve more effective project management.

The current cost of long term government borrowing in real terms is probably at levels lower than ever previously experienced in modern economic history.

Low government borrowing costs reflect real government advantages in credit quality and liquidity but can be used to disguise transfers of risk to taxpayers. The rate at which government can borrow for infrastructure projects is a function of governments overall credit status, not project quality.

Scottish Futures Trust

Objectives:

- to promote infrastructure investment
- a body with a public interest objective
- to facilitate financing arrangements (especially so long as Westminster relationship is in flux)
- developing expertise in capital project management and facilities management outsourcing.

Scottish Futures Trust

Activities:

- SPV in PFI type arrangements
- owner and lessor of assets to public bodies
- repurchase equity of existing PFIs
- lender (if PWLB no longer available)

Hybrids

Hybrid institutions are organisations which deliver services, and hence have a requirement for business management skills, but whose purposes reflect broad public interest concerns, and their revenues are not normally earned in competitive markets.

Examples of hybrids

Network Rail (Railtrack)
TFL (London Underground)
Electricity/gas networks
BBC

Post Office/Royal Mail
Public schools
PFI SPVs
Channel 4
Housing associations
BAA

Universities
Foundation hospitals
Museums and galleries
Contracted out public
service providers
(eg waste disposal)
City academies
NATS
Roscos
Water supply companies
Care homes
Sports clubs/associations

Defining hybrids

What is the governance structure? (who appoints management and to whom does it report?)

What is the financial structure? (in particular, how is equity provided, whether implicitly or explicitly?)

What, if any, external regulation (i.e. accountability other than through governance structure) exists?

Some provisional proposals

1. Raise overall infrastructure investment.
2. Raise plain vanilla long term indexed finance as soon as possible.
3. Gain greater power over capital budgets.
4. Plan infrastructure spending in aggregate.
5. Develop project management expertise.
6. Develop independent monitoring of fiscal stance.
7. Enhance project assessment and value for money auditing.
8. Raise equity for future development through refinancing of existing public and private sector assets.

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