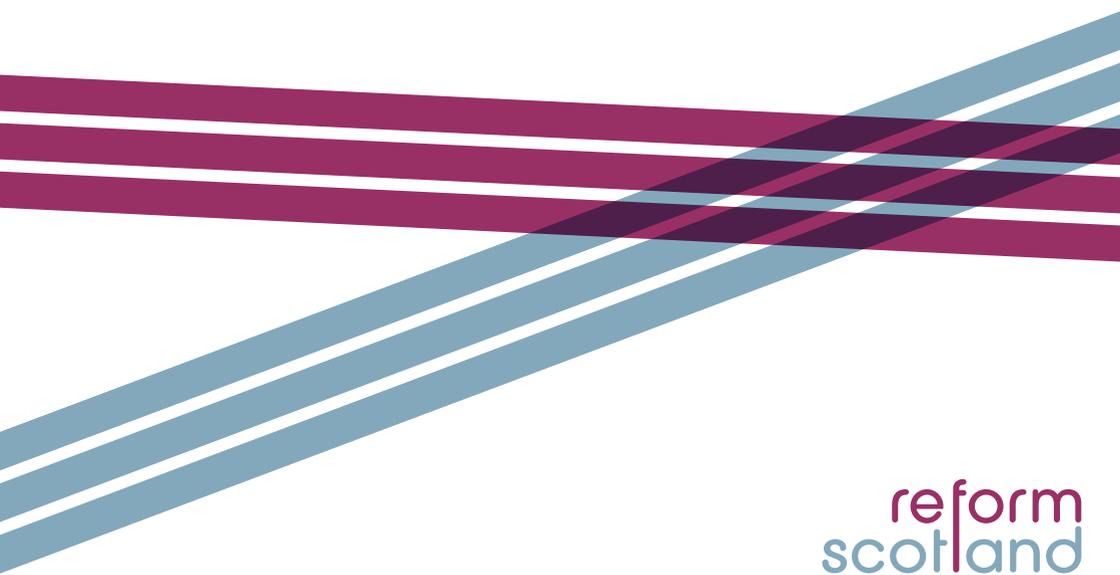


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About Reform Scotland

Reform Scotland is an independent, non-party think tank that aims to set out a better way to deliver increased economic prosperity and more effective public services based on the traditional Scottish principles of limited government, diversity and personal responsibility.

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Executive summary

Objective

This aim of this report is to examine how we might manage and finance future key public infrastructure projects such as schools, hospitals and transport links. Public sector infrastructure and building maintenance is constantly required to provide investment for the long term. It is of vast importance to our society and should be financed efficiently and managed effectively.

The proposed transport improvements¹ set out in Reform Scotland's most recent report 'Power to Connect' are good examples of infrastructure spending which represent a genuine investment in the future prosperity of Scotland. The funding for such improvements will require substantial additional investment. Public funding will be limited in the years ahead, so we need to examine all the options to ensure that the vision of world class infrastructure in Scotland can be turned into reality.

To this end, this study examines the recent methods of funding capital investment projects, in particular use of the partnership between public and private sectors in the PFI/PPP system and the newly created Scottish Futures Trust. It then looks at some of the ways such projects have been funded and managed in other countries. Based on this analysis, Reform Scotland makes recommendations as to how we should proceed in Scotland.

Findings

- According to Professor John Kay, visiting professor of economics at the London School of Economics and a Fellow of St John's College, Oxford University, there has been a large decline in public investment in infrastructure in recent decades. In the UK as a whole, this peaked at around 10 per cent of GDP in the period 1965-75 having risen steadily since the Second World War. It then fell to a low of 1.7 per cent in 2000 and is now about 2.5 per cent of GDP. Some of this decline (around 2 per cent) can be attributed to the effects of privatisation; however this still

¹ Central Hub, improved trunk network and a high speed rail network

represents a steep decline and is in marked contrast to other European countries which have spent more on infrastructure over recent years. As we pointed out in our report *Powers for Growth*, there is a clear correlation between capital expenditure on fixed capital infrastructure and economic growth. (Professor John Kay, Reform Scotland Autumn Lecture, 22nd September 2008)

- The PFI/PPP system was introduced to the UK in 1992 to harness private sector innovation and bargaining skills in public sector projects. It was later also used to remove debt from the public sector balance sheet. The PFI/PPP system has delivered around 500 projects in the UK, some of which might otherwise not have happened or would have been subject to delays. Further, it has a good record of delivering projects on time and on budget compared to public sector procurement as evidenced by the National Audit Office Report in 2001 which found that 80 per cent of PFI projects were completed to time and cost compared to 20 per cent through straight public sector procurement. In addition, it has been recognised that PFI/PPP drives greater innovation and purchase bargaining in projects. However, the way that PFI/PPP has worked in practice has highlighted a number of problems.
- In particular, the long-term costs of PFI/PPP are often higher than straight public sector procurement because the debt used to fund the projects is at commercial business interest rates rather than government rates. Nonetheless, in many cases, particularly in relation to politically sensitive or essential projects, the majority of the risk to the debt provider is not transferred and the risk remains with the public sector which is left to pick up the pieces if there is a default on the contract as happened in high profile examples such as the collapse of Metronet. However, the risk to the equity provider can lead to real losses for the private sector in examples such as East Lothian schools and Aberdeen schools.
- Another problem is that the projects are procured through a bidding consortium which has a main contract covering design, finance, building, maintenance and facilities management and can have a contract period that lasts up to 35 years. This produces very complex and inflexible contracts which take a long time to negotiate. In addition, the public sector cannot select the best elements from each consortium bid but must take the whole package. Furthermore, the funder in this process is part of the consortium

and, therefore, does not have an incentive to negotiate the best economic deal from other consortium members for the benefit of the public.

- The evidence from other countries is that there are innovative funding mechanisms such as Tax Increment Financing and tolls which can be used to fund infrastructure improvements.

Policy recommendations

Cheaper overall funding: We recommend that on key infrastructure projects the debt element should come from government either at UK, Scottish or local level. This recognises that on key projects risk is not generally transferred to the debt provider and, therefore, projects should take advantage of the lower cost of government borrowing and substantially reduce the cost of funding infrastructure projects. Public sector borrowing could be achieved in a diverse variety of funding options including:

- Straight UK Government borrowing or guarantee.
- Borrowing by the Scottish Government with new borrowing powers as recommended by Reform Scotland in its 'Fiscal Powers' report and by the Calman Commission.
- A Scottish Infrastructure Bank/Pooling arrangement could be formed to borrow on behalf of the Scottish Government and use the existing local borrowing powers in a cooperative borrowing organisation.
- Municipal bonds issued by states, counties, cities or their agencies could finance public sector infrastructure projects such as schools, roads, bridges, utilities, affordable housing, airports, hospitals, and other public facilities and programmes.
- Tax Increment Financing/tolls/road pricing which allow specific taxes, tolls and road pricing in the future to pay for the infrastructure that is created.

Better management: We recommend that management skills to deliver innovation and efficiencies are harnessed through competition between the private, third and public sectors. This can be achieved on each project by allowing a management company to bid to operate and manage the project as well as put up the risk capital, usually 10 per cent of the total capital in PPP

projects, which can provide an incentive for better performance. The return is agreed with the management company and derived from its equity participation in the project. To achieve this, the public sector would agree a formula with the management company so that the management company receives the benefit of cost savings, efficiencies and additional sources of income in each project. As the equity in a deal is usually only 10 per cent of the total capital this does not have a big impact on the overall project, but does provide an incentive for efficiency as well as causing the management company real loss should they fail to deliver.

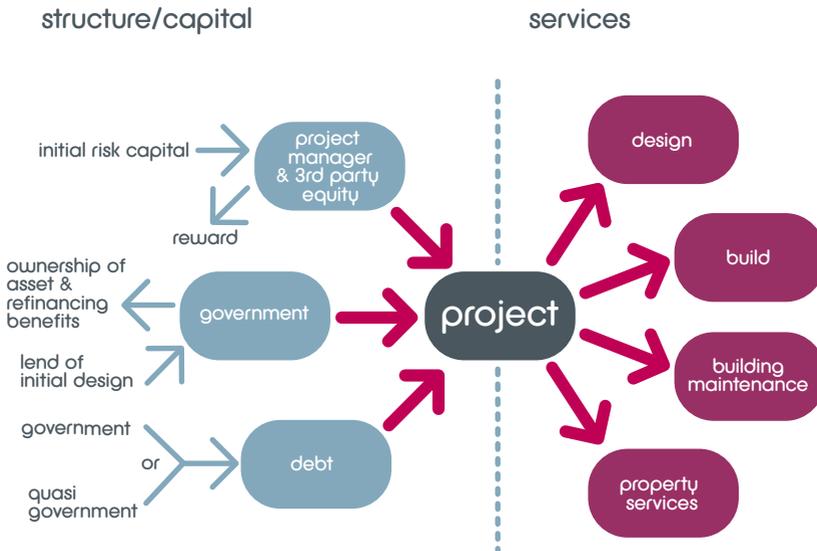
Management companies could be public sector vehicles created by local councils or the Scottish Government, mutuals or from the private sector. These could develop specialisations such as managing hospitals, schools or hub services for local authorities or more general companies that focused on national projects such as high speed trains or bridges. The Scottish Futures Trust could be given the role of deciding which management company is given the tender. This would require those involved to be totally independent of those bidding so that they have no interest in the outcome.

New project vehicle structure: We recommend that a project vehicle is formed between the public sector and management company with the public sector providing the land and outline design. Once the equity return is worked out with the management company, this project vehicle would then invite tenders for each of the other aspects of the project such as full design, construction and facilities management. This would ensure that the best providers were chosen for each part of the job and the management company has an incentive to get the best price from suppliers.

The project vehicle could be structured so that there are two types of share: A shares and B shares. The A shares would receive the benefit of the ownership of the underlying public sector asset and any refinancing benefit. These would be held by the public sector with the objective of recycling the returns into more public sector projects in future. The B shares would be held by the management company and would receive a return for achieving purchasing efficiency, managing the overall project to time and cost and ensuring the operation and maintenance of the building is of the agreed quality throughout the life of the project. When rental payments are received, they would be used to pay down the

government debt and interest and provide a return to the management company. Any sale of land, refinancing of the land and building at the end of the project would be for the benefit of the public sector.

Figure 1: Project vehicle



Scottish Futures Trust: We recommend that the Scottish Futures Trust acts as the catalyst and facilitator delivering project structures that combine the following four elements:

- To have a financing cost at close to government borrowing rates;
- To deliver management efficiency and innovation through competition between the private, public and third sectors;
- To have the flexibility to enable the best bits of a bidding process to be put together to form a project that is right for that location and service; and
- To enable the public sector to retain ownership of strategic assets that are vital to the nation.

Conclusion

The evidence shows that there have been significant problems with the way that PFI/PPP schemes have been managed and financed. A reformed system of partnership between the public and private or third sectors should build on the experience of PFI/PPP as well as learn from its mistakes.

Reform Scotland believes that we need a new and more flexible approach to providing public sector infrastructure in Scotland. This would be based on what we call Scottish Capital Partnerships (SCP) which would provide a more effective and efficient method of financing and managing capital projects.

The recommendations made in this report offer a way of delivering value for money through cheaper funding, better management, a more flexible structure and a clearer role for the Scottish Futures Trust. Lastly, it is vital that whichever methods and vehicles are adopted, we need to move quickly to enable infrastructure projects to proceed so as to ensure that Scotland is investing in its future and that we create the environment for sustainable economic growth.

1. Infrastructure in Scotland

Infrastructure is regarded as an important plank of national economic growth and accordingly the Scottish Government's Economic Strategy recognises the importance of investment in Scotland's economic and social infrastructure. This importance is reflected in the Scottish Budget which has allocations for a capital investment programme of £3.26 billion, £3.58 billion and £3.66 billion in the three years to 2010/2011. In addition, there is spending planned by Local Authorities of £1.2 billion over the same period. Over a 10 year horizon, the infrastructure investment requirement is estimated to be close to £40 billion.²

Infrastructure investment in support of better and modern public services and growth in the Scottish economy is a top priority for the Scottish Government. The 2008 Infrastructure Investment Plan published on 27 March set out the Scottish Government's intentions for enhancing the fabric of Scotland. The Plan supports growth in the economy and modern public services and demonstrates the Scottish Government's commitment to efficient and fair funding across the country's infrastructure. The Plan contains an infrastructure investment programme of some £35 billion over the next 10 years to improve our schools, hospitals, waste disposal and treatment centres and our transport network amongst other things. There is £14 billion of that money being invested in the current Spending Review period (2008/09 - 2010/11). The Plan also presents investment by Local Government for the first time.

1.1 Background to PFI/PPP

A Public Private Partnership (PPP) is an umbrella term for government schemes involving the private sector in public sector projects. The Private Finance Initiative (PFI) is a form of PPP developed by the Government in which the public and private sectors join to design, build or refurbish, finance and operate (DBFO) new or improved facilities and services to the general public. Under the most common form of PFI, a private sector provider will, through a Special Purpose Company (SPC), hold a DBFO contract for facilities such as hospitals, schools, and roads according to specifications provided by public sector departments.

² Scottish Futures Trust. (May 2009) Business Plan 2009/10.
Available at: <http://www.scottishfuturestrust.org.uk/docs/10/SFT%20Business%20Plan%202009-10%20v1.pdf>

Over a typical period of 25-30 years, the private sector provider is paid an agreed monthly (or unitary) fee by the relevant public body (such as a Local Council or a Health Service body) for the use of the asset(s), which at that time is owned by the PFI provider. This and other income enables the repayment of the senior debt over the concession length. (Senior debt is the major source of funding, typically 90 per cent of the required capital, provided by banks or bond finance). Asset ownership usually returns to the public body at the end of the concession. In this manner, improvements to public services can be made without upfront public sector funds; and while under contract, the risks associated with such huge capital commitments are shared between parties, allocated appropriately to those best able to manage each one.

1.2 Private Finance Initiative (PFI)

In the UK, The Private Finance Initiative is the most established and widespread public-private partnership model, with around 500 projects now operational. It is different to other types of PPP as it involves a private sector partner providing an asset, for example a school or leisure centre, and the services associated with that asset; such as building maintenance or cleaning. The model is used for a large number of infrastructure projects and provides strong incentives to deliver on time and on budget, while enabling government to spread the cost of the investment over a 25-30 year period.

One of the key requirements for PFI schemes is that they offer the public sector value for money (VFM). The Government, and indeed the private sector, demand high quality services, delivered on time and to budget. Historically, major investment projects built purely under public finance have failed time and again to keep within the initial schedule and funding constraints. PFI has proven to be substantially more cost-effective and reliable. Some 86 per cent of authorities considered that the value for money of their PFI projects at the time of contract letting was satisfactory or better, 14 per cent said it was marginal and none said it was poor.

Moreover, 81 per cent of public bodies involved in PFI projects believe that they are achieving satisfactory or better value for money from their PFI contracts according to a National Audit Office report.³

PFI concessions are subject to competitive bidding in compliance with EU procurement rules. The private sector consortium chosen as 'preferred bidder' (i.e. to whom the contract is ultimately awarded) has incentives to perform to the highest standards throughout the whole of the concession – not only is its reputation at stake, but revenues are only earned once the asset is operational, and penalties are given for unsatisfactory performance and results by way of deductions to the governmental monthly fee. Contracts are carefully drawn up to ensure any failings of sub-contractors also carry heavy penalties. Performance is monitored closely at all stages, allowing problems to be rectified before they escalate. The largest users of the Private Finance Initiative have been the Department for Transport which accounts for about 20 per cent of all Private Finance Initiative projects by capital value and the Department of Health which has signed about 120 separate Private Finance Initiative contracts (HM Treasury, 2002-3).

1.3 Advantages and disadvantages

In total around 500 PFI/PPP projects have been completed in the UK. According to Mark Hellowell from the Centre of International Public Health Policy, as of October 2007, the total capital value of PPP/PFI contracts across the UK was £56.9 billion. Of this, £5.2 billion was spent in Scotland (Equivalent to £1,028 per head)⁴. This compares with total UK Government expenditure of £520 billion each year.

Each project is assessed for affordability (i.e. we may all want brand new surfaces on our roads but can we afford to pay for them whatever the method). Each proposal, whether by public sector procurement or by PPP, is then assessed for whether it provides the best value for money. However, there are three big disadvantages with PFI/PPP:

- 3 National Audit Office (2001-2b), *Managing the relationship to secure a successful partnership in PFI deals*, Report of Controller and Auditor General, HC 375, Session 2001-2, London: Stationery Office.
- 4 Scottish Parliament. (2008) *Inquiry into Methods of Funding Capital Investment Projects: 8th Report (Session 3)*. Edinburgh: Scottish Parliament Finance Committee. <http://www.scottish.parliament.uk/s3/committees/finance/inquiries/capInvest/report.pdf>

1. The first is the cost of debt funding. The Government saw an opportunity to get PFI/PPP off balance sheet and use bank debt. This was particularly interesting to the UK Government as one of the Golden Rules of Gordon Brown when he was Chancellor of the Exchequer was not to let total Government Debt exceed 40 per cent of GDP; however the recent banking crisis and economic recession has changed all of this. As 90 per cent of the capital used to fund PFI/PPP projects is debt and the cost of funds is at least 20 per cent more for a bank than it is for the Government, private funding raises costs exponentially over the 30 year life of the projects.
2. The next is refinancing gains and the end value of the project. In early deals, if the debt was refinanced at a lower cost then the benefit went to the private sector and, in many instances, gave rise to large gains. In addition, the property value was largely written off over the life of the project so at the end of the project the private sector received another large gain, due to the building still being owned by the private consortium. Both these aspects of PFI/PPP were corrected in latter deals so the benefits go to the public sector. However, the perception that the private sector gets huge benefits from these projects still remains even though it is not the case anymore.

The National Audit Office conducted a survey of a number of PFI contractors and the public sector bodies that had contracted them (NAO, 2001-2b). It showed that in some projects there is disagreement over whether risks have been allocated to the party best able to manage them. Only two thirds of contractors shared the public sector bodies' view that risks had been allocated appropriately. Seventy-nine per cent of authorities thought the risk allocation was totally satisfactory, but only 53 per cent of contractors had this view. Contractors recognised that risk allocation was an important area where there were often problems. All the contractors who were dissatisfied with the risk allocation thought that risks had been inappropriately transferred to them rather than inappropriately retained by authorities.

The unitary charge is agreed in advance and is usually paid annually to the private consortium for undertaking the relevant services e.g. a health board will pay for the building of a hospital. This amount can be reviewed so that it is possible for either party to recoup money due to a change of circumstances. The main criticism is that there is evidence that the unitary charge is, in

reality, uniformly indexed to inflation rather than being dependent on actual cost increases and decreases. Therefore, the high profits that private companies have made from PFI are not a result of greater efficiencies or better performance.

The early payment of senior debt means that the Net Present Value (NPV) of the equity increases even though there is a decrease in the Internal Rate of Return (IRR). This means that the private consortium can use the IRR model as a presentational tool in order to persuade the public sector that profits will not be 'excessive'. When, in actual fact, by paying off debt quickly, rather than over the whole period of the project as one may assume to be the case, the private consortium can make much greater profits than it originally presented in its plans.

3. Lastly, the process in concluding the deals was long and was tortuous. The problem here is twofold, first the insistence that a whole consortium (debt provider, equity provider, builder, designer, facilities manager etc) has to bid together rather than picking the constituent parts, and secondly the equity providers were on the opposite side of the table from the public sector when it came to negotiating the construction and service contracts.

1.4 Scottish Futures Trust

On 10 September 2008, the Cabinet Secretary for Finance and Sustainable Growth, John Swinney, announced in the Scottish Parliament the establishment of the Scottish Futures Trust (SFT). The SFT has inherited a number of functions from units within the Scottish Government and in particular some of those from the disbanded Financial Partnerships Unit (FPU). However, the internal policy and strategy work of the FPU in support of Scottish Ministers has been retained and will now be provided by the newly created Infrastructure Investment Unit (IIU). The IIU is part of the Expenditure Policy Division within the Finance Directorate.

The IIU works closely across the full range of portfolio divisions and other public bodies in providing advice and information to Ministers on public sector infrastructure investment as well as providing support to the Scottish Government's Infrastructure Investment Group. The IIU also has sponsorship responsibilities in relation to the SFT. The main role of the SFT is to act as a

catalyst for additional and more efficient infrastructure investment, and to supplement private partnerships, local government projects and other forms of investment delivery.

The Scottish Futures Trust is addressing in excess of £2.7 billion worth of infrastructure projects in or nearing procurement. This includes validation work in cooperation with Transport Scotland on the Forth Replacement Crossing and Borders Railway. Active support is being given to four schools projects, totalling some £270 million, and to a project providing £90 million of investment into new mental health facilities. Work is also at an advanced stage on two major initiatives: The first community facilities Hub Partnership pathfinder project is on track to commence procurement in 2009, and the development of a collaborative schools procurement pilot has already started. Taken together these two new initiatives would provide substantial investment in schools, doctors' surgeries and other community facilities in the next three years.

On 28 September 2009, the Scottish Government announced the first 14 secondary schools to benefit from a £1.25 billion school building programme, Building Better Schools: Investing in Our Future. The Scottish Futures Trust (SFT) is said to have a central role in managing the new school building programme, working alongside local authorities. The SFT will develop, recommend and implement approaches that it is claimed will secure a better schools programme across Scotland and provide better value for money than could be achieved through each local authority working separately.⁵

⁵ Scottish Government. "Building better schools." 1. Web. 28 September 2009. <http://www.scotland.gov.uk/News/Releases/2009/09/28103853>

2. Case studies of PPP in other countries

The UK is far more advanced in its PFI/PPP projects than other countries, but over the past couple of decades, other countries such as Ireland, France, Spain, the Netherlands and New Zealand have followed suit. The following are examples of how PPP can work in other countries.

2.1 Ireland

Co-operation between the public and private sectors in Ireland to deliver services or to build infrastructure is not new. Hospitals and schools which have been built by the religious orders in the past are examples of the public sector working together with the private, or in this case voluntary, sector to provide infrastructure. Public Private Partnership (PPP) arrangements provide a structured and more co-ordinated approach to extending the areas of co-operation between the public and private sectors.

In 1998, PPP Units were set up in the Departments of Finance, Environment and Local Government, Education and Science and Public Enterprise (now Transport). On 1 November 2001, the then Minister for Finance, Charlie McCreevy TD, launched the Framework for PPP in Ireland.

In 2003, the National Development Finance Agency (NDFA) was established under the National Development Finance Agency Act 2002. The role of the NDFA is to advise State authorities on the optimum means of financing public investment projects in order to achieve value for money and to advise on all aspects of financing, refinancing and insurance of public investment projects. The NDFA may also fund projects itself or form companies for the purposes of financing projects, although to date it has not used these options. In July 2005, the Government established a Centre of Expertise for PPP procurement in the NDFA.

There is now a significant programme of PPP projects underway across a number of sectors. The latest Multi-Annual Capital Envelope for PPPs published with the 2009 Budget provides for €8.64 billion in PPP investment funded by future Exchequer payments. In addition, the target for PPP funded by user charges is €795 million.

There are also a number of PPPs, notably in the water investment area, which will be developed on a Design, Build, and Operate basis with the capital cost being funded by the Exchequer.

As of April 2009, the main areas where PPP procurement has been used include:

- Accommodation projects e.g. schools, National Conference Centre, Cork School of Music, National Maritime College, Criminal Courts Complex etc using Design/Build/Finance/Operate/Maintain (DBFOM).
- Transport e.g. tolled roads, using a concession model (similar to DBFOM but with licence to collect user charges).
- Social Housing and Waste/Wastewater projects in the local government area, where a mix of models is used.

There are currently seventy projects, with an estimated capital value of over €20 million each, which Departments and Agencies are advising at various stages of the PPP procurement process. A total of 13 projects are operational and 19 are in construction. In addition, the Department of Environment, Heritage and Local Government advises that there are over 100 projects with a capital value of less than €20 million each progressing as PPPs in the local government sector.

2.2 France

In France, a substantial amount of the debt capital for PFI/PPP projects is provided by the private sector but this is then underwritten by the government under what is called a Cession Dailly. The adoption of a PPP procurement model, through the Ordinance of 17 June 2004, is fairly recent compared with the well-established model in place in the UK. However, until now the results have been quite satisfactory: the public sector considers PPPs as a real opportunity to purchase and finance public infrastructure. The French PPP deal pipeline tends to prove this: initially 35 projects were identified by ten different ministries as potential PPP projects at the state level. In total, central government sponsored projects will require an initial capital investment of approximately €6-7 billion. This is in addition to the €1.4 billion investment programme launched in 2002 for the renovation and construction of 35 new hospitals and the

€1.3 billion prison programme launched by the Ministry of Justice in 2004 for the construction of 18 prisons in five batches, currently in progress. A good example is the 62-year contract with ALIS in 2001 to design, build, finance and operate a 125km motorway in the Northwest of France (total cost: €900 million) with the motorway opening in October 2005. (OECD 2006)

France has a long history of these types of contracts, such as concessions for public services involving private operators. That suggests that the *contrat de partenariat* (private public partnership contracts) are more evolutionary than revolutionary. The implementation of the Ordinance of 17 June 2004 took place over a relatively short period of time and demonstrates significant political will and commitment to the use of PPPs as an alternative procurement method for public infrastructure in France. The *contrat de partenariat* contributes to the diversification of the scope of the available contracts relating to public infrastructure. The aim is to transfer the project risks (design, construction, maintenance and management) to the private partner through payment mechanisms based on performance.

2.3 Netherlands

The market for privately funded infrastructure is growing in The Netherlands and in recent years PFI/PPP projects in the UK have led Dutch Government bodies to realise the potential benefits of PPP in infrastructure development. Most PPP projects in The Netherlands occur in the areas of transport, housing and urban development. Studies of 51 of the larger PPP projects by Ecorys demonstrated that most of the projects that were taking place then were either infrastructure or are development projects. Until recently, the Dutch Government had no budgetary reason to follow the PPP model. Private-sector money was not specifically required to provide the infrastructure needed for the Dutch economy. However, the government has recently awarded two large PPP contracts: the €1.2 billion design, build, finance and maintenance contract for the HSL-South High Speed Rail link between Amsterdam and the Belgian border and the €480 million design, build, finance and operate contract for the construction and redevelopment of a wastewater treatment facility in the Hague region. Several other project types have been identified, such as school building and hospitals with PFI construction schemes.

2.4 Spain

Spain was not a newcomer to PPP when projects involving cooperation between the public and private sectors began to spread in size and variety at the end of the 1990s. It appeared natural for Spain to explore the PPP option under the Conservative Government that came into office in 1996, whose platform focused on deregulating and privatising the economy. The first PPP projects in Spain in the 1990s were in the transport sector and the focus remains very much on transportation.

In 2005, the regional governments monopolised the PPP market in Spain, and projects were being negotiated and signed in waste management, construction of public buildings and health. In 2006, Spain resembled the main EU countries that employed PPP; and was a leading country in terms of project volume. Under a new Infrastructure Plan from 2005-2020, the Spanish Government plans to obtain from the private sector 40 per cent of a total financing of €241.4 billion until the year 2020 for a new and improved transportation system. This would be equivalent to about 0.5 per cent of Spanish GDP per year until 2020.⁶

2.5 New Zealand

New Zealand followed in the footsteps of the UK and Australia by considering a PPP model for the Waterview Connection in Auckland and signals a shift in policy for developing New Zealand's infrastructure. New Zealand has suffered due to decades of under-investment in infrastructure, and the resulting poor state of aspects of its transport and utilities networks. However, New Zealand's first ever PPP infrastructure fund was launched in July 2009 and the Public Infrastructure Partnership fund (PIP), has NZ\$500 million of debt and equity. It plans to commit to long-term infrastructure such as schools, healthcare facilities and student accommodation. The PIP will also help local and central authorities to identify possible PPP projects. The company expects to start investing in projects within the next year.

6 Allard, Gayle, and Amanda Trabant. (2007) "Public-Private Partnerships in Spain: Lessons and Opportunities." IE Business School Working Paper WP10-07 Web. 2 September 2009. Available at: http://latienda.ie.edu/working_papers_economia/WP07-10.pdf

3. Alternative methods of funding

There are a number of different ways in which the public sector could fund future infrastructure projects including some innovative methods used in other countries.

3.1 UK level borrowing

In Reform Scotland's report '*Fiscal Powers*', we recommended borrowing powers for Holyrood so that the Scottish Government would be in a position to plan revenue and expenditure over a number of years. Scottish Ministers should be given additional borrowing powers to allow for managing cash flow when devolved taxes are used and for borrowing from the National Loans Fund or the Public Works Loans Board to increase capital investment in any one year (subject to an overall limit to such borrowing, similar to the Prudential regime for local authorities). There would be an expectation that the Scottish Government only made spending commitments in line with revenue raised over the economic cycle.

However, as current arrangements do not allow this; we recommend UK level borrowing for projects beneficial to the whole of the UK, such as North-South high speed rail links. Network Rail, which is financed through the UK Government, could be the vehicle to provide such finance.

3.2 Local government borrowing and pooling

Borrowing is the principal means by which local authorities fund infrastructure projects. The Scottish Government helps local governments to do so by a variety of means, which can take the form of funding the cost of servicing the debt or allocating a capital grant which can either be ring-fenced for a specific project or have a general purpose. The shortfall is paid for out of local authority general funds.

All money that is borrowed must be paid into loan funds, which local authorities are required by law to operate. The loan fund then makes advances to service accounts to fund capital spending. All borrowing by local authorities is monitored by the Scottish Government.

Section 35 of the Local Government in Scotland Act (2003) gives local councils the responsibility to determine the maximum amount they can spend on capital expenditure. There is also a requirement for this limit to follow the guidelines set out by the CIPFA Prudential Code which means that local authorities have a responsibility to ensure that capital expenditure is prudential, sustainable and affordable.

Section 38 of the Act allows the Scottish Government to pay the Public Works Loans Commission in order to reduce partially or totally, the debt of a local authority. In order to do so, the Scottish Government must write a report explaining their reasoning and then present this to the Scottish Parliament.⁷

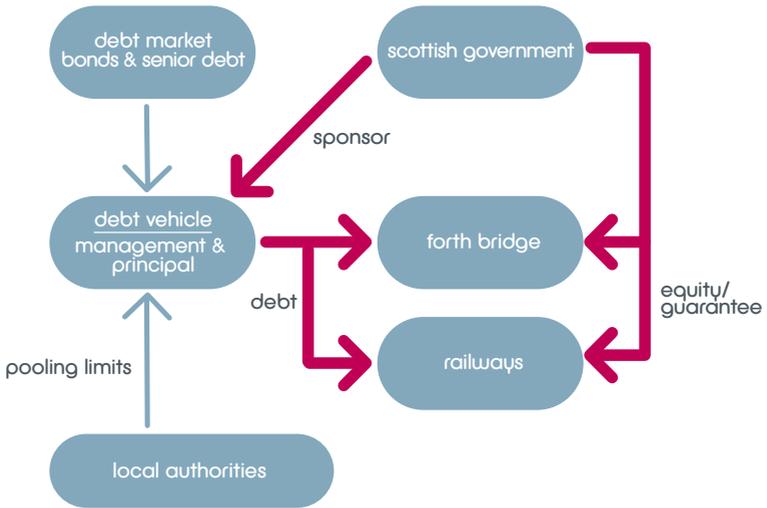
Summary of statistics relating to local government finance

- Borrowing to finance capital expenditure in 2007-08 was £710 million.
- Capital grants from the Scottish Government to finance capital expenditure in 2007-08 were £628 million.
- The value of Local Authority fixed assets at 31 March 2008 was £27.3 billion.
- Total outstanding debt at 31 March 2008 was £9.6 billion.

Under the constitutional arrangement between the Scottish Parliament and Westminster, the Scottish Parliament does not have the power to borrow; therefore, all borrowing for Scottish infrastructure projects is limited to local authorities. As such, a pooling arrangement could be created between local authorities in order to fund large infrastructure projects. This could also be expanded to form an infrastructure bank which could also borrow on behalf of the Scottish Government.

⁷ UK Government. (2003) *“Explanatory Notes to Local Government in Scotland Act 2003.”* Office of Public Sector Information. Crown Copyright. 20 September 2009. Available at: http://www.opsi.gov.uk/legislation/scotland/acts2003/en/aspn_20030001_en_1

Figure 2: Scottish Infrastructure bank/pooling arrangement



3.3 Municipal bonds

Popular in the United States, municipal bonds are bonds issued by states, counties, cities or their agencies to finance public sector infrastructure projects such as schools, roads, bridges, utilities, affordable housing, airports, hospitals, and other public facilities and programmes. Municipal bonds come in many forms, including long-term fixed rate bonds, short-term notes, adjustable-rate securities (such as variable rate demand obligations, auction rate securities, and others), zero-coupon bonds, taxable securities and other types of debt obligations.

Bonds bear interest at either a fixed or variable rate of interest, which can be subject to a cap known as the maximum legal limit. If a bond measure is proposed in a local county election, a Tax Rate Statement may be provided to voters, detailing best estimates of the tax rate required to levy and fund the bond.

The issuer of a municipal bond receives a cash payment at the time of issuance in exchange for a promise to repay the investors who provide the cash payment (the bond holder) over time. Repayment periods can be 20, 30 or 40 years or even longer.

3.4 Tax Increment Financing

Tax Increment Financing (TIF) was invented in America in 1952 and is a way of funding infrastructure development by borrowing against future increases in tax revenue. A local authority creates a district in an area in which it wants to develop roads, factories and schools amongst other things. The property values and tax revenues for this area are then calculated and the local authority seeks a loan on the understanding that all increases in tax revenue that are accrued as a result of the development will be ring-fenced and used to pay back the loan. This is based on the idea that housing construction, for example, will lead to an increase in investment in the area and so increase land values and property tax revenue. TIF is designed to appeal to local authorities as it means that infrastructure improvements can be made in under-developed areas where funding would otherwise be difficult to achieve. Established in California, there are now thousands of TIF schemes across the USA. It is hard to calculate precisely how many TIFs operate there since not every state requires their registration, but the number has expanded exponentially. Illinois, which had one TIF district in 1970, now has over 900.⁸

The recession has meant that many building projects in Scotland have come to a halt as private companies are unable to fund the clear up of brown-field sites. Some believe that Tax Increment Financing will mean that the development of sites such as Ravenscraig and Leith's docks will be able to resume. In the current economic climate local councils face tight budgets and TIF represents a method of allowing infrastructure development to continue.

Another advantage of the United States TIF system is the availability of tax relief. In TIF, private investors have a tax-exempt bond that generates tax-free returns.⁹ The same incentives could apply for Scotland in terms of a specific exemption for all interest arising from the bonds as a specific tax relief for those investing in TIF bonds which would make TIF an even more attractive proposition.

One of the reasons that Tax Increment Financing appeals to local authorities is that the land remains under public ownership. Since 1976, California law has dictated that at least 20 per cent of tax increment income must be spent

⁸ British Property Federation. (November 2008). Tax Increment Financing: A new tool for funding regeneration in the UK? Available at: http://www.corecities.com/dev07/Publications/BPF_TIFS_Paper_Final_A4%5B1%5D.pdf

⁹ Ibid.

on housing for low and medium income households. For instance, in 2004/5 regeneration agencies channelled \$1.2 billion into building affordable housing. In Portland, Oregon, the requirement is 30 per cent for all households that earn 80 per cent or less of the Median Family Income. These Tax Increment Set Aside (TISA) Funds are set aside until used to build housing. In some cases affordable housing takes longer to materialise than in others. One potential problem is that in more affluent areas, such as the California Bay Area, the house prices are already so high that households with incomes of up to \$70,000 can be included in this affordable housing requirement. Under California Law, if an agency does not spend the required amount within seven years the funds will be transferred to affordable housing organisations under the so-called 'use it or lose it' clause. Municipal Councils do not have an obligation to service the debt from any other services but only from the tax increment. This means, for example, that social services will not have to be cut in order to service the debt taken on as a result of TIF. Also, TIF debt is generally not viewed as part of a municipality's debt.

Critics have claimed that a system aimed at increasing funding to economically depressed areas has in some cases instead been used in prime-market areas. For example, Newcastle City Council wants to use Tax Increment Financing to build a centre for university science research. Some could argue that there were other areas of the city that had a greater need for development.

Another contentious issue is the way in which funds go to local authorities. In New York, the municipal council is given the tax revenue from property up to the level which was calculated in the last year prior to the Tax Increment Financing. Once the municipal council has received this money the rest is used to service the debt of the TIF. Some may argue that schools in TIF districts, for instance, should benefit from the rising tax revenue rather than receiving a flat sum from the year before TIF began. Critics suggest that this, along with inflation, serves to unfairly hurt the finances of municipal government. However, it can also be said that after the TIF expires, the municipality will collect higher taxes from the increased value in property and in the cases where the area was previously economically depressed, also from higher income taxes.

Tax Increment Financing relies on strong economic conditions and is based on borrowing against assumed future economic growth. TIFs are more successful when the economy is growing and development can be attracted more readily.

Although the economy is currently in recession, now is the perfect time to put enabling legislation in place so that local authorities could be in a position to use TIF for infrastructure projects when the economy begins to improve.

3.5 Tolls/road pricing

Oresund Bridge-Denmark/Sweden

In our previous report, *Power to Connect*, we cited the Oresund Bridge as an excellent example of how to increase economic activity through improved transport links. In 1991, the Danish and Swedish governments signed an agreement to establish a fixed link across the Oresund. The agreement was ratified by the two countries' parliaments in August of the same year. Oresundslonsortiet, a joint venture, between A/S Oresund and Sevenk-Danska Broforbindelsen SVEDAB AB, constructed the permanent link between Sweden and Denmark.

In 2000, Denmark and Sweden opened the Oresund Bridge to rail and motor traffic. The Oresund Bridge is a 10 mile bridge that connects the Oresund region of Denmark with the Skane region in Sweden. It provides the most direct connection between Copenhagen and Malmo, Sweden's third largest city, replacing an hour long ferry ride with a 10 minute drive between the two regions. The bridge services high speed trains as well as cars. Trains leave frequently from Copenhagen and Malmo and are specially designed to shorten the journey time with fast acceleration, high top speeds and wide doors. The Oresund Bridge has effectively connected the two regions into a single, multinational conurbation of 3.5 million people. It now represents the largest, most densely populated area in Scandinavia, larger even than Oslo, Stockholm or Helsinki. The project cost more than DKK12 billion.

The Oresund Bridge is owned and operated by the Oresundsbro Konsortiet, which in turn is jointly owned by A/S Oresund and Svensk-danska Broforbindelsen (SVEDAB) AB.

The latter is owned by the Swedish government through the Vagverket (the Swedish National Road Administration) and the Banverket (the National Rail Administration) while A/S Oresund is owned by the Sund and Baelt Holding A/S, which is owned by the Danish government (The Danish Ministry of Transport.)

Oresundsbro Konsortiet's main objective is to run and operate the Oresund Bridge and pay off the loans for the financing of the link. Oresundsbro Konsortiet is managed by an independent Board of Directors and a Management Board. The Board of Directors comprises eight members, four of whom are appointed by A/S Oresund and SVEDAB respectively. The chairmanship alternates biannually between Denmark and Sweden so that when the Chairman is Danish, the Deputy Chairman is a Swede and vice-versa. The company's CEO is responsible for day-to-day operations.

Oresundsbro is financed through loans and bonds issued in the domestic as well as the international capital markets. The loans will be repaid through income from the Fixed Link, where users will pay a toll for crossing the bridge. The financing is jointly and severally guaranteed by the Kingdom of Denmark and the Kingdom of Sweden, giving very high credit rating on the project.

A similar principle would apply if a system of road pricing was adopted in the future. It would be possible to borrow against the future revenue from road pricing as it is against future revenue from tolls.

4. Policy recommendations

Cheaper overall funding: We recommend that on key infrastructure projects the debt element should come from government either at UK, Scottish or local level. This recognises that on key projects risk is not generally transferred to the debt provider and, therefore, projects should take advantage of the lower cost of government borrowing and substantially reduce the cost of funding infrastructure projects. Public sector borrowing could be achieved in a diverse variety of funding options including:

- Straight UK Government borrowing or guarantee.
- Borrowing by the Scottish Government with new borrowing powers as recommended by Reform Scotland in its 'Fiscal Powers' report and by the Calman Commission.
- A Scottish Infrastructure Bank/Pooling arrangement could be formed to borrow on behalf of the Scottish Government and use the existing local borrowing powers in a cooperative borrowing organisation.
- Municipal bonds issued by states, counties, cities or their agencies could finance public sector infrastructure projects such as schools, roads, bridges, utilities, affordable housing, airports, hospitals, and other public facilities and programmes.
- Tax Increment Financing/tolls/road pricing which allow specific taxes, tolls and road pricing in the future to pay for the infrastructure that is created.

Better management: We recommend that management skills to deliver innovation and efficiencies are harnessed through competition between the private, third and public sectors. This can be achieved on each project by allowing a management company to bid to operate and manage the project as well as put up the risk capital, usually 10 per cent of the total capital in PPP projects, which can provide an incentive for better performance. The return is agreed with the management company and derived from its equity participation in the project. To achieve this, the public sector would agree a formula with the management company so that the management company receives the benefit of cost savings, efficiencies and additional sources of income in each project. As the equity in a deal is usually only 10 per cent of the total capital this

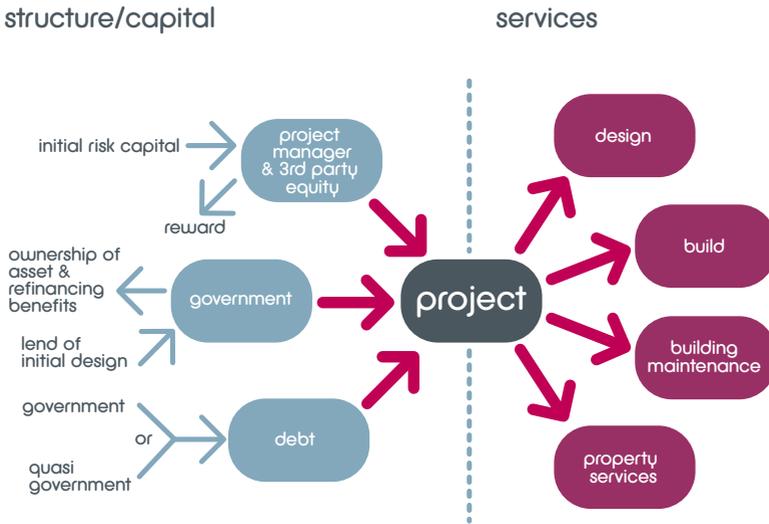
does not have a big impact on the overall project, but does provide an incentive for efficiency as well as causing the management company real loss should they fail to deliver.

Management companies could be public sector vehicles created by local councils or the Scottish Government, mutuals or from the private sector. These could develop specialisations such as managing hospitals, schools or hub services for local authorities or more general companies that focused on national projects such as high speed trains or bridges. The Scottish Futures Trust could be given the role of deciding which management company is given the tender. This would require those involved to be totally independent of those bidding so that they have no interest in the outcome.

New project vehicle structure: We recommend that a project vehicle is formed between the public sector and management company with the public sector providing the land and outline design. Once the equity return is worked out with the management company, this project vehicle would then invite tenders for each of the other aspects of the project such as full design, construction and facilities management. This would ensure that the best providers were chosen for each part of the job and the management company has an incentive to get the best price from suppliers.

The project vehicle could be structured so that there are two types of share: A shares and B shares. The A shares would receive the benefit of the ownership of the underlying public sector asset and any refinancing benefit. These would be held by the public sector with the objective of recycling the returns into more public sector projects in future. The B shares would be held by the management company and would receive a return for achieving purchasing efficiency, managing the overall project to time and cost and ensuring the operation and maintenance of the building is of the agreed quality throughout the life of the project. When rental payments are received, they would be used to pay down the government debt and interest and provide a return to the management company. Any sale of land, refinancing of the land and building at the end of the project would be for the benefit of the public sector.

Figure 1: Project Vehicle



Scottish Futures Trust: We recommend that the Scottish Futures Trust acts as the catalyst and facilitator delivering project structures that combine the following four elements:

- To have a financing cost at close to government borrowing rates;
- To deliver management efficiency and innovation through competition between the private, public and third sectors;
- To have the flexibility to enable the best bits of a bidding process to be put together to form a project that is right for that location and service; and
- To enable the public sector to retain ownership of strategic assets that are vital to the nation.

Conclusion

The evidence shows that there have been significant problems with the way that PFI/PPP schemes have been managed and financed. A reformed system of partnership between the public and private or third sectors should build on the experience of PFI/PPP as well as learn from its mistakes.

Reform Scotland believes that we need a new and more flexible approach to providing public sector infrastructure in Scotland. This would be based on what we call Scottish Capital Partnerships (SCP) which would provide a more effective and efficient method of financing and managing capital projects.

The recommendations made in this report offer a way of delivering value for money through cheaper funding, better management, a more flexible structure and a clearer role for the Scottish Futures Trust. Lastly, it is vital that whichever methods and vehicles are adopted, we need to move quickly to enable infrastructure projects to proceed so as to ensure that Scotland is investing in its future and that we create the environment for sustainable economic growth.

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