<u>Some Aspects of Scottish Futures Trust and Hub Activities</u>

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Executive Summary

This report is concerned with various aspects of the operation of the Scottish Futures Trust (SFT) particularly concentrating on the operation of the hub system. (Under the hub system was set up by SFT, Scotland is divided into five hubco areas. Each hubco is a partnership between the public and private sectors to deliver new community facilities.)

Section 1 covers the conduct of the study. A major complication has been lack of information. Activities like the operation of the SFT's hub system are regarded, by the hubcos, by the SFT, and by the Scottish Government, as being outwith the scope of Freedom of Information (FOI). As we point out, this stance is actually inconsistent with the spirit of the Territory Partnership Agreements (TPA) under which the hubs were set up.

Section 2 gives background on the purpose and functions of the SFT, which was set up in 2008 to improve the efficiency and effectiveness of infrastructure investment in Scotland. The primary focus of SFT activity has been to develop new methods of delivering and funding infrastructure projects by a variety of different forms of Public Private partnership, so that the resulting capital expenditure is "off the books" of the Scottish Government. This section describes the operation of each of the five main SFT initiatives. Another topic which is covered is the implications of the introduction of the new ESA10 accounting arrangements in 2014, which necessitated significant changes to SFT working.

Section 3 considers various aspects of the operation of the hub system, concentrating on non-financial aspects. The section starts with a case study of the operation of an individual hub. This is followed by a description of the private sector partners, and Tier 1 contractors, in all five hubs. There is a preponderance of large companies headquartered outside Scotland, which raises issues such as:
a) what does this strategy imply for the long run structure of the construction industry in Scotland? Does the advantage which Tier 1 status will inevitably confer on this group of firms mean that they will come to dominate the large scale construction sector in Scotland: and will it effectively prevent other firms, particularly SMEs, from growing?
b) Does the fact that this group of firms is so heavily dominated by firms which are not headquartered in Scotland mean that Scotland will lose out on certain high quality types of employment – e.g., headquarter jobs, research, etc.?
c) Given that the Tier 1 contractors are in the powerful position of managing the lists of Tier 3 contractors, are there adequate safeguards in place to ensure that the Tier 1 contractors do not abuse this power?

The section then continues by looking at available evidence on hub support for the critically important SME sector. In fact, although support for SMEs is a hub key performance indicator, the hubs provide very limited information on this aspect, and are not prepared to back this up with more detail. The section also considers whether the hub structure provides a good environment for encouraging organic growth in the economy: and looks at the implications of the hollowing out of expertise in the public sector.

Section 4 looks at financial issues relating to the hub programme. There are issues both with the supply of senior debt and of subordinate debt.

On senior debt, SFT runs a framework competition each year to appoint a designated lender for the projects falling under each of the five hub areas. SFT has maintained a policy of confidentiality on the resulting senior debt interest rate. The paper assesses the available evidence on the senior debt interest rate, and questions whether the confidentiality is justified.

On subordinate debt, the interest rates on the potentially profitable sub debt lending to hub projects were set, once and for all, when the hubs were originally established. The paper questions the wisdom of this approach, particularly given circumstantial evidence that suggest that hub sub debt rates are high. The paper also examines the question of the 40% of hub sub debt which is held by public sector bodies, or bodies linked to the public sector. A number of dangers are identified associated with this practice, which potentially opens up perverse incentives for the bodies involved.

Section 5 looks at a number of issues associated with other aspects of SFT activities. In particular, it is argued that inadequate controls are in place to ensure that the long term impact of SFT activities on the Scottish Government's DEL is sustainable. It is questioned whether central government is giving adequate scrutiny to SFT activities. And the point is made that the way the SFT is operating is now so far from the original intentions that a critical rethink is required.

Section 6 looks at value for money, distinguishing two possible interpretations. One is a narrow interpretation concentrating largely on cost: and secondly, a wider interpretation, looking more broadly at economic and social benefits as well. Given the lack of auditable information, it is very difficult to tell whether SFT is delivering optimal value for money in either the narrow or broad sense: but there are worrying indications that it is not.

Section 7 gives conclusions and recommendations. The recommendations group under a number of headings as follows:

Openness.

a) The SFT should review their stated position on FOI and the hubs, to bring it into line with the spirit of the TPA: namely, that aspects of hubco activity should in effect be subject to FOI.

b) The SFT should remind hubcos of their obligations in this respect under the terms of the TPAs.

c) The Scottish Government and the SFT should take active steps to monitor that there have been changes in hubco behaviour on openness.

d) Similarly, SFT should review all of their other initiatives to ensure they are achieving maximum openness.

Indicators.

a) All of the key indicators used in relation to the hub programme should be reviewed and extended.
b) In line with the new spirit of openness, the resulting detail should be publicly available as standard.
c) The information available on hub activities should be aligned with, and at least as detailed as, the information available in other sources.
Strategic Scrutiny.
a) The Scottish Government should re-examine its own position relative to the SFT, and should make sure that it has, in-house, adequate resources with a clear remit for auditing/scrutinising SFT activities.
b) The Scottish Government should carry out, or commission, a review of whether the SFT is fulfilling the Scottish Government's strategic objectives – and also of whether there might be unanticipated downsides emerging.
Detailed Scrutiny.
a) The TPAs under which the hubcos were established contain detailed provisions which were meant to ensure that the programme was operating fairly and efficiently. SFT should ensure that such procedures are being operated as intended – and should publish information demonstrating this.
b) The role of the relevant Parliamentary Committees in scrutinising SFT and its associated bodies should be strengthened. The accord agreed in 2013 between the Public Audit and Post-legislative Scrutiny Committee, Audit Scotland and the Scottish Government should be broadened.
Sustainability.
a) The Scottish Government should review, and extend, its modelling for assessing the risks for the Scottish DEL associated with SFT activities: and, in doing so, it should take account of new risk factors, like, for example, the operation of the post-referendum fiscal settlement.
b) Given the critically important role of local government finances, and the difficulty central government has in making long term forecasts in this area, the Scottish Government should consider funding an appropriate body, (not central government itself), to take on the role of providing longer term variant projections of local government fiscal prospects: and of aggregating individual authorities' separate projections into a national version.
Financial Issues.
a) There should be a review of various aspects of the framework competition which is currently operated for the provision of senior debt lending to hub projects. In particular, the SFT, and the Information Commissioner, should re-consider whether it is in the public interest to maintain the present secrecy about the resulting interest rate. In any event, the SFT should present clearer information justifying the claimed savings from the framework competition approach.
b) If the option of accessing European Investment Bank funding remains open, (depending on Brexit developments), the SFT should consider whether the approach of bundling hub funding requirements could be extended to enable access to EIB funding.
c) SFT should review hub sub debt interest rates in the light of the latest evidence: and, if they are indeed unduly high, should consider what remedial steps might be taken.
d) Given that one factor bearing upon potentially high sub debt interest rates is the need to secure adequate cover ratios for the senior debt holders, SFT should consider innovative approaches to achieving adequate cover – e.g., by the use of escrow accounts.

e) The Scottish Government should review the policy of the public sector, or bodies allied to it, investing in the subordinate debt of hub projects, in view of the potential dangers identified in this report.

f) If the policy of public sector investment in hub sub debt is maintained, then there should be greater openness, particularly about any secondary market sales of such debt.

g) There is an urgent need to produce Whole of Government Accounts for Scotland, to give a fuller picture of the liabilities of the public sector, including those relating to SFT procurement initiatives.

Section 1: The Conduct of this Study, and the Structure of the Report.

The Scottish Futures Trust, (SFT), was set up in 2008 to facilitate investment in public infrastructure. In practice, one of its main functions has been to develop ways of providing infrastructure investment so that the costs fall on revenue budgets, rather than on the Scottish Government's capital budget.

This report is concerned with various aspects of the operation of the SFT, particularly concentrating on the operation of the hub system. There are two reasons why this is a partial, rather than exhaustive, assessment of SFT activities. The first is the relatively limited amount of resources devoted to this study. But this constraint on resources interacts with another, more significant, factor – namely, the difficulty of obtaining information on various aspects of SFT activities. This is illustrated in the three examples below:

1. When we approached hubcos for access to information under the provisions of Freedom of Information, (FOI), we were told that hubcos are private companies, which are not subject to FOI. We were also told this in writing by a senior official in the Scottish government, and in discussion by a senior SFT official.

Perhaps tellingly, two hubcos used almost identical forms of words in explaining why they were not covered by FOI. This perhaps suggests that there is a degree of co-ordination here on how (not) to respond to FOI requests: but we have no firm information on this. What is significant, however, is that this view, expressed by both SFT and hubcos themselves, is at variance with the spirit of the Territory Partnership Agreements, (TPA), under which the hubcos are established.

Annex 1 sets out the section on Freedom of Information from a typical TPA: (in this case, the TPA for the North hub.) The intention of this provision in the TPA seems clear. Clause 30.2 of the TPA, and the succeeding clauses, imply that hubcos should refer appropriate information requests to the public sector participant, (e.g., the partner local authority), and then co-operate with the participant in answering the request. This interpretation was confirmed by a Scottish Government official, when we asked for clarification on this part of the TPA, who stated that "I understand the intention is to ensure maximum transparency – and to be helpful to the person seeking information – rather than simply having the hubco refuse to respond to the request."

It is the case that it would not be appropriate for a hubco to handle all the requests that it might receive in this way. As private companies, hubcos are indeed not legally subject to FOI: and there will therefore be aspects of their internal operations which will be legitimately beyond the scope of public enquiry. However, many aspects of hub activity are of legitimate public concern because they relate to how public money is spent. Suppose, for example, that a public sector participant is channelling public money through a hub scheme, and that, as part of the claimed benefit of the approach, there is a key performance indicator like the percentage of subcontracts which will be awarded to small to medium enterprises. Then it is a matter of public interest to know exactly how that performance indicator is defined, and whether any quoted figures are supported by adequate ancillary detail. So requests to a hubco for this type of information should clearly fall within the scope of the Clause 30.2 treatment – rather than being met with a blanket refusal that the hubs are not subject to FOoI. And yet, (as will be seen in Section 3), it was exactly such requests from us that were met by blanket refusals.

It is thus clear that the spirit of the arrangements set out in Section 30 of the TPA is not being observed. This is an issue which needs to be addressed. Indeed, we were given a broad hint that the Scottish Government might welcome public or parliamentary pressure to open this issue up. To quote from the official who answered our enquiry about the operation of the TPA: "… you might wish to raise this issue more formally – either by contacting one of your MSPs or by writing to the relevant Minister…. This will not change anything overnight – but does put the issue 'on radars' " . In a sense this is welcome: but begs the question of exactly what kind of relationship the Scottish Government has to the SFT, that external pressure may be needed to ensure that the arrangements for accessing information on hub activities work as originally intended.

2. The second example is that SFT have taken the view that the terms under which senior debt finance is provided to hub projects should remain confidential for a significant period.

3. And yet another example is that detailed supporting information is not available to back up a number of headline claims made by SFT about their performance.

It is interesting to contrast this lack of openness on SFT activities with general views expressed by, e.g., the First Minister, and by Audit Scotland: namely:-
"I believe that transparency is not an optional add-on but an integral part of policy making." Nicola Sturgeon, Scottish Parliament, November 2012
"Maintaining transparency is a key objective of good governance." Audit Scotland, June 2011

Overall, lack of information has greatly complicated the present study, meaning that we have had to infer, from the limited information publicly available, how various aspects of the SFT are actually operating. The fact that we have been able to infer a great deal from the limited information available potentially renders the study more, rather than less, valuable. But it also explains why we have covered a relatively limited scope.

The structure of the report is as follows:-
Section 2 gives background on the reasons the SFT was established, and on SFT structure and operations.
Section 3 considers various aspects of the operation of the hub system, concentrating on non-financial aspects.
Section 4 looks at various issues surrounding the financing of hub projects.
Section 5 looks at a number of issues concerning other aspects of SFT activities.
Section 6 considers available evidence on whether SFT activities represent value for money.
Section 7 draws overall conclusions, and makes recommendations.
There is a glossary at the end of the report.

Section 2: SFT Background.

This section mainly sets out background on the purpose and structure of the SFT: but at the end there is a subsection on the implications of the introduction of the ESA10 accounting rules.

SFT: Purpose.
The SFT was set up in 2008 by the new SNP led Government, in order, (as Saunders [1] put it), “to deliver SNP’s electoral promise to match Labour’s previous infrastructure investment.” The principal aim of the SFT, as set out in its Management Statement and Financial Memorandum, is
“To improve the efficiency and effectiveness of infrastructure investment in Scotland by working collaboratively with public bodies and commercial enterprises, leading to better value for money and providing the opportunity to maximise investment in the fabric of Scotland and hence contribute to the Scottish Government’s single overarching purpose to increase sustainable economic growth.” (SFT Annual Report and Group Financial Statements for year ending 31 March 2016.)

In actual fact, probably the primary focus of SFT activity has been to develop new methods of delivering and funding projects, by a variety of different forms of Public Private Partnership, so that the resulting capital expenditure will be “off the books” as far as the accounts of the Scottish Government are concerned. Such expenditure would therefore not count against the Scottish Government’s limited capital budget or borrowing powers – but will be funded out of future revenue budgets.

SFT: Structure.
The SFT is a company, which is wholly owned by Scottish Ministers. As such, under the terms of the Companies Act 2006, Scottish Ministers are considered to be a shadow director of the company: that is, SFT’s directors would be expected to act under the direction of Scottish Ministers. Given this, it would be expected that SFT should fall firmly within the overarching aims and priorities of the Scottish Government’s economic strategy: it is worth remembering that the Scottish Government defines its own aims as follows: “…investment, innovation, inclusive growth and internationalisation. We will design our contract and procurement process to contribute to these priorities as far as is practical, in a way that achieves value for money and makes contracts accessible to businesses (especially SMEs), the third sector and supported businesses.” [2] These Scottish Government aims will be relevant when we come to consider various aspects of SFT performance later on.

In 2016/17, the operating budget of the SFT was £10.4 million, £9.2 million of which represented grants from the Scottish Government: (SFT Business Plan). SFT employs over 70 staff, and about 80% of SFT income is spent on salaries and associated costs.

Note, however, that these figures for operating budget and staff cover the direct operating activities of SFT – and bear little relation to the large amount of investment which is

1 E. L. Saunders: “Hub South-East Scotland, Austerity and Public Procurement”: M Sc Dissertation, Edinburgh University School of Geo-Sciences, August 2015.
2 http://www.gov.scot/Publications/2016/12/1660/5

channelled through the various initiatives overseen by SFT, (like the Non Profit Distributing programme, or the hub system.) These initiatives are described in more detail below.

The SFT organises its activities into what it describes as work areas, of which there are six. These are:-
SFT Invest: covering the NPD initiative, and economic investment initiatives like Tax Incremental Funding and the Growth Accelerator.
SFT Place: asset management and management of operational PPP contracts.
SFT Green: initiatives on low carbon, energy efficiency, and district heating.
SFT Connect: development of digital technologies, and public wireless programme.
SFT Home: National Housing Trust, and its Council Variant.
SFT Build: the hub programme, Scotland's Schools for the Future, and review of construction procurement.
(SFT Business Plan 2015/16)

Specific SFT Initiatives.
As already noted, SFT has a major impact through the amount of funding which is raised from market sources, and channelled into infrastructure investment through a variety of PPP initiatives. Overall, the SFT has stated that the total impact of such activities will amount to about £6 billion of infrastructure investment. The major specific initiatives are as follows.

<u>The NPD Programme.</u>
The Non Profit Distributing, (NPD), programme was set up by the SNP Government after it came to power in 2007, as its replacement for conventional PFI. The idea was to cap what were widely seen as the excess profits which could be earned by the equity investors in traditional PFI schemes, by removing all but a token element of equity finance. Any profits generated by an NPD scheme, instead of being taken as dividends by equity investors, would be shared as benefits to the community, as contributions to a nominated public service charity.

A few NPD schemes were implemented before the creation of the SFT in 2008. On the inception of the SFT, the SFT took over responsibility for the scheme, and developed it considerably – so that a major infrastructure scheme like the £469 million Aberdeen Western Peripheral Route scheme was developed as an NPD. Overall, more than £3.5 billion of infrastructure investment has been delivered through NPDs or is in the NPD pipeline.

As under PFI, each NPD scheme is undertaken by a special purpose vehicle, (SPV), set up for that scheme. The SPV is a consortium of private companies, which is responsible for building and maintaining the relevant asset, and for raising finance from the capital markets by way of senior debt, and less secured subordinate debt. The loan charges on that debt, and the long term operating costs of the NPD project, are paid for by unitary charge payments made to the SPV by the client public authority.

Under the relevant accounting rules in operation when NPD was developed, (European System of Accounts 1995, known as ESA95), NPD schemes were successfully classed as being "off the books" as far as the public sector was concerned. However, as discussed later in this section, this changed with the introduction of the ESA2010 accounting rules, with adverse consequences for the Scottish Government's borrowing limit.

The Hub Initiative.

Like PFI, NPD is best suited to large individual projects: but it is not well suited, (because of the large fixed costs involved), to smaller projects. To overcome this difficulty, the public sector developed the idea of bundling smaller infrastructure developments together. This led to the Local Improvement Finance Trust, (LIFT), approach in England: and the rather similar hub programme in Scotland.

The 'hub' programme was developed by the Scottish Futures Trust (SFT) on behalf of the Scottish Government, and the SFT leads the programme. The purpose was to improve the planning, procurement and delivery of infrastructure in support of community services. Essentially, the hub initiative involves a range of public sector organisations in the hub territory working in partnership with each other and a private sector delivery partner in a joint venture delivery company called 'hubco'.

Since the hub structure was set up around 2010, it has been responsible for over £2 billion of investment, either undertaken or in the pipeline.

The hub programme is structured as follows. Scotland was divided into five hub areas. In each area, following a competitive tender process, a Public Private Partnership (PPP), the hubco, was established, representing a partnership between public sector participants, (local authorities, health boards, fire and police authorities, etc): the SFT: and a private sector partner. The private sector partner will typically be a consortium of private sector companies, covering expertise in construction, facilities management, and finance.

Each hubco is constituted under a contract called a Territory Partnership Agreement, which has a 20 year life, with a possible 5 year extension. For the first 10 years of the contract, some of the public sector participants will be offering the hubco the exclusive first opportunity to put forward proposals to build any infrastructure which may be required.

Each hubco established a chain of suppliers. This falls into three tiers. Tier 1 typically consists of main building contractors, and facility management providers. Tier 2 consists of firms specialising in design and consultancy: and Tier 3 consists of potential sub-contractors and suppliers, very often being SMEs. The Tier 1 and Tier 2 contractor networks are managed by the hubco itself. However, the Tier 3 supply chain is managed by the Tier 1 contractors.

Hub projects fall into two main types. Small projects, called design and build, (DB), projects are paid directly by capital grants or contributions from the public sector, and are accounted for as public sector capital expenditure. Larger projects, involving Design, Build, Finance and Maintain elements, (DBFM), are revenue funded, and do not count as public sector capital expenditure

When a specific project is identified, (e.g., the need for a new school), the hubco, working in association with Tier 1 contractors, will develop a costed proposal for the project. This has to be within the initial cost envelope indicated by the public sector client: and also has to demonstrate value for money against a benchmark costing.

If the public sector client accepts the hubco proposal on a DBFM project, then a special purpose vehicle is set up to undertake the project. Prior to 2014, the SPV was a subsidiary of the hubco, (and was denoted a subhubco). After 2014, and the changes required because of the introduction of ESA10, the hub SPVs have to be standalone companies: the shareholders are the SFT itself, (10%); the public sector client, (10%); a newly instituted charitable foundation, the Hub Charitable Foundation, (20%): and the private sector development partner in the hubco, (60%). (More detail on the ESA10 changes, and the establishment of the HCF, is given later in this section.)

As in a PFI project, the SPV for a hub project raises the finance for the project from the market, with the resulting loan charges being paid out of the unitary charges which the SPV will receive from the public sector client during the operational life of the project. The amount of pure equity finance put in by the equity holders is typically small. The main sources of finance are senior debt, (i.e., bank loans), accounting for 90% of the finance required: and subordinate debt, accounting for 10%.

Each year, SFT runs a framework competition for the right to provide senior debt for DBFM projects in each hub area. That is, for each hubco, the successful bank is given the exclusive right to provide senior debt for the DBFM projects reaching financial close in that hubco area in that year, at the interest rate determined in the framework competition. The implications of this arrangement are discussed in more detail in section 4.

As regards subordinate debt, (the main risk capital for the project), the interest rate which sub debt lenders will receive is established as part of the tender process when the hubco was originally set up. That is, the interest rate at which participants will lend to each project has been determined, once and for all, at the start of the hubco's life. Again, the implications of this approach are discussed in section 4.

Tax Incremental Funding.

Tax Incremental Funding, (TIF), was originally developed in the USA as a means of delivering area regeneration and economic growth. In Scotland it is being piloted as part of the SFT's Invest workstream. The idea is that suitable public sector investment in infrastructure might encourage area regeneration: and that this in turn would trigger growth in Non Domestic Rate (NDR) income which would not otherwise have happened: the local authority would then use this increase in tax income to pay the financing costs of the initial public sector investment. In effect, TIF involves borrowing against the future growth in NDR income which will be stimulated by the original investment. There are currently four pilot schemes in Scotland, which will involve £175 million of public sector investment, which in turn is expected to generate a further £900 million of private investment.

Growth Accelerator.

The Growth Accelerator (GA) model is another part of the SFT's Invest workstream. It seeks to assess the impact of enabling investment across a wider geographic area than TIF. The model is designed for areas where there is considerable potential for private investment and economic growth, but where there are initial barriers, (like the absence of some suitable public infrastructure), preventing this investment getting underway. Under the GA model, this initial public sector enabling investment is sourced by the local authority. The resulting long term revenue payments which the local authority will have to make will be funded in part from grant payments from the Scottish Government. The idea is that these grant payments will in turn be covered by the increased tax revenues which the Scottish Government will receive from a successful development, (e.g., in the form of income tax and VAT receipts.) Various yardsticks are used to measure the success of the development in generating these extra public sector revenues: and underperformance on these yardsticks might result in reduction of grant payments from the Scottish Government. The first GA project was signed in October 2016 for the development of the St. James Quarter in Edinburgh, where it is hoped that £60 million of public sector investment will unlock around £1 billion of private sector investment.

The National Housing Trust.

The National Housing Trust, (NHT), initiative involves limited liability partnerships, (LLPs), being set up, involving the relevant local authority, the SFT, and a private sector developer. Each LLP is financed by way of a loan from the relevant local authority, accounting for 65% - 70% of the total purchase price of the completed units, with the remaining 30% - 35% being provided by the developer partner in the form of equity and a subordinated loan note.
There is also a local authority variant, which does not involve any private sector borrowing.

The LLP uses its funding to purchase completed housing units from the developer. The units are then let at intermediate rents: the tenants are provided with a Scottish Short Assured Tenancy.

To date, under the main version of the initiative, deals have been secured with 17 developers for the delivery of over 1,600 homes across 10 council areas through this version of the initiative – the Scottish Government estimates this will support around 2,000 jobs in the construction industry and wider economy.

For government accounting purposes, the loan provided by the local authority and sourced from the Public Works Loan Board, would score against the government's National Accounts. The LLP itself would be classified as a private sector body.

Units can be sold by the developer following the fifth anniversary of the unit's initial purchase. The decision to sell is subject to the approval of the LLP's Board of Management which consists of the developer, the local authority and Scottish Futures Trust.
In respect of the NHT Council Variant, any proposed programme of unit sales is developed jointly between the local authority and Scottish Futures Trust.

The Implications of ESA10.

Most of the delivery mechanisms which have been developed by, or brought within the ambit of, the SFT, are designed to allow capital expenditure on public infrastructure to be funded from anticipated future revenue, without counting against the Scottish Government's capital budget. In other words, the projects have to be “off the books” as far as the government is concerned. At the same time, the intention was to avoid the now well documented problems with old style public private partnerships like PFI. For example, the NPD programme was designed so that there would be no equity profits to be taken by the providers of private finance: and so that any eventual surplus in the project would largely be returned to bodies acting with the public sector.

The key principles for determining whether an asset should be on or off the government’s books are laid down in the European System of Accounts, (ESA): and the ultimate decision on any scheme is made by the National Accounts Classification Division of ONS, in consultation, if necessary, with Eurostat. The basic principles in the ESA for determining classification of assets depend on factors like who bears the risks associated with the asset: who profits from any surplus: and who controls the asset. Given this, it was always going to be a difficult balancing act to move away from the old PFI system in a way which retained more benefit for the public sector, without falling foul of the ESA rules.

When programmes like the NPD model, and the hub system, were being set up, the relevant accounting principles were set out in ESA95. And both the NPD and hub schemes were successfully classified as “off the books” under ESA95. However, in 2014, a revised system of accounts, ESA10, came into operation. The way that Eurostat interpreted the new ESA10 requirements meant that schemes had to satisfy tighter criteria on who controlled them, and who benefitted from any surplus, before they could be classified as off the book.

In July 2015, the ONS announced that they were classifying a major new NPD scheme, (the Aberdeen Western Peripheral Route scheme), as being “on the Government’s books.” This view was taken largely because the public sector was held to have too great a degree of control of the Special Purpose Vehicle delivering the scheme: and because the public sector would be the main beneficiary of any surplus generated by the scheme. ONS also indicated that it would be re-considering the classification of other NPD schemes, including the Edinburgh Children’s Hospital, and the Dumfries and Galloway Royal Infirmary.

This decision had major implications, both for the Scottish Government and the SFT. Because of the decision, up to £280 million of expenditure threatened to be an unexpected charge on the Scottish Government’s capital budget in 2015/16. To manage the problem, the Scottish Government’s then Finance Secretary did a deal with the Treasury: this expenditure, rather than being a charge against the Scottish Government’s capital budget, would be recorded against the Scottish Government’s new borrowing powers. (In 2015/16, the Scottish budget included, for the first time, the provision to borrow a significant amount for capital investment - £306 million.)

While this is a neat short term fix for an unexpected problem, it nevertheless has adverse consequences for Scotland’s public finances. Instead of being able to use its new borrowing powers to borrow from the National Loans Fund at an interest rate of around 2%, the Scottish Government is instead using its new powers to enable the “borrowing” element in the private sector financing of the new AWPR to take place – at significantly higher cost.

The ONS decision also had very significant implications for the hub element of SFT activities. It became clear that those hub projects which were to be funded from revenue were also liable to be re-classified by ONS: so SFT had to negotiate with the ONS changes to the structure of hub projects which would prevent this happening. The main changes were that it would no longer be permissible for the public sector participants in hub projects to make direct capital contributions to cover part of the capital cost: (so increasing the amount of financing which would be required from the relatively more expensive private finance sources.) The ownership arrangements for hub special purpose vehicles had to be re-jigged, to make clear that they were private companies. And a new charitable foundation, the Hub Charitable Foundation, (HCF), was set up: this would be independent of government, and would be able to invest in the subordinate debt on hub projects. These changes have important potential implications for the value for money of hub projects, which will be discussed later.

Section 3: Various aspects of the operation of the hub system, concentrating on non-financial aspects.

The previous background section outlined the general principles of how the hub system operates. This section now looks in more detail at factual information on how the hubs actually operate: and then identifies resulting issues. In particular, it examines how the operation of the hubs stands up to the stated strategic objectives of the Scottish Government.

Our starting point is a case study of the structure of one particular hub, namely hub South East.

Case Study of the South East Hub
The public sector participants in Hub South East include the five local authorities within South East Scotland, as well as the NHS, Police, Fire and Ambulance Service: in other words, almost all public infrastructure procurement in the Edinburgh, Lothians, and Borders is covered by Hub South East.

The private sector partner in Hub South East is SPACE, (Scottish Partnership and Community Enterprise).
Space is a trading company, registered in Scotland and created in 2009 by Galliford Try, Fulcrum and Davis Langdon (now AECOM), with the sole purpose of working in partnership with public sector organisations participating in the Hub initiative in Scotland.
Galliford Try is a British construction company headquartered in London. The company has bought over Morrison Construction, originally a Scottish company which had headquarters and decision making taking place in Scotland. Major contracts Galliford Try has won in Scotland include the Queensferry Crossing and the Aberdeen Peripheral Route. The Morrison part of the business gained over £1 billion of public and private sector business in Scotland over the last five years, £833 million of this from construction.
Fulcrum is a New Jersey based management consulting and information and communications technology services company.
AECOM is an American multinational engineering firm that provides design, consulting, construction, and management services.

For the first 10 years of the partnership in the South East Scotland Territory, SPACE has an exclusive right to develop proposals for certain projects. Projects specifically named in the South East Territory Partnering Agreement are:

- All primary/community NHS health facilities with a capital value exceeding £750,000.
- Joint NHS/Authority projects with a capital value exceeding £750,000 involving primary/community health facilities where the NHS is lead procurer.

The Tier 1 contractors were chosen before the signing of the Territory Partnering Agreement in 2010. They are GRAHAM Construction, Morrison Construction (part of Galliford Try which is the only member of the private sector partner of the Hub involved in construction), and BAM Construction. To get on to the Hub South East Scotland’s supply chain, a company has to contact one of the Tier 1 Contractors to register interest. Not one of these three contractors is a Scottish construction company.

In their Territory Annual Report for 2015-2016, Hub South East report involvement in £495 million of projects since 2010: in construction £161 million, in development £215 million and delivered £119 million.

Hub South East Scotland has to meet community benefit targets for local employment, training and educational experience, where these targets show increased opportunities due to the existence of the hub for these and for SME involvement. Performance in this area is measured as a Key Performance Indicator. (Source: Hub South East Scotland Territory Annual Report 2015-2016).
They note "we can evidence that we are delivering real benefits across the South East Territory." Their annual report 2015-16 points to 85% of contracts awarded to SMEs, 83% to Scottish SMEs. However, no information is given on the value of contracts going to SMEs or Scottish SMEs, and the hub has refused to answer the questions on these matters as put to them, other than to produce the following rather uninformative statement, that the 85% "relates to the overall cumulative average derived from figures achieved on completed projects since 2010 which represent the subcontracted work packages awarded to Scottish SMEs as a percentage of the work undertaken on each project."

One thing that this case study demonstrates, therefore, is the lack of openness on the activities of this hub – which contrasts with the principles of openness espoused by the First Minister and Audit Scotland, as noted in section1. And, as we will see, this lack of openness is typical of all the hubs.

Another thing the above case study illustrates is the dominant role played in this particular hub by very large, and in many cases multinational, construction companies which are not headquartered in Scotland. The fact that the private sector partner, (SPACE), is a company registered in Scotland could well give a misleading impression of the involvement of Scottish companies at the key direction and decision taking level in the hub: in fact SPACE, as we have seen, was set up by Galliford Try, Fulcrum, and Davis Langdon, with the sole purpose of participating in the hub initiative.

Private sector partners, and Tier 1 contractors.
Hub South East is, however, not an isolated example: but is typical of all five hubs. We now look at the private sector partners in each of the five hubs, and also at the firms in each of the hubs fulfilling the key Tier 1 contractor roles. First of all, Table A shows the private sector partners.

Table A: the private sector partners in each Hub

Hub	**Private Sector Partner**
East Central	*Amber Blue*: Robertson Capital Projects, Forth Holdings Ltd,

	Amber Infrastructure. (Two of which are headquartered in Scotland.)
North	*Alba Community Partnerships*: Cyril Sweett Investments Ltd, Miller Corporate Holdings. (One based outside Scotland.)
South West	*Alliance Community Partnerships* : John Graham Holdings Ltd, Equitix Holdings Ltd, Kier Project Investments Ltd Galliford Try Investments Ltd (All are headquartered outside Scotland)
West	*WellSprin*g: Apollo Capital Projects Limited, Community Solutions, (which is a trading vehicle for Morgan Sindall Investments Ltd), Morgan Sindall Investments Limited. (All are headquartered outside Scotland.)
South East	*SPACE* : Galliford Try, Fulcrum Davis Langdon (now AECOM) (All are headquartered outside Scotland.)

What is notable is the preponderance of large companies headquartered outside Scotland.

As regards the process of choosing the private partner, a report by Crawford and Lewandowski for the Scottish Government notes that the rights to the private sector share ownership in each of the hubCos were competitively tendered.[3] It was important to examine what was known of the competitive tendered process. The information available from the Scottish Government's Public Contracts department and website showed that West Hub had 3 competing offers, South West had 7, and no information was provided by the Hubs to the Scottish Government Public Contracts Department for North, South East, or East Central.

Table B shows the Tier 1 contractors in each hub.

Table B: the Tier 1 Contractors in Each Hub

Hub	**Tier 1 Contractors**
East Central	Bam Construction, Marshall Construction, Kier Construction, Ogilvie Construction, Forth Electrical Services*,

3 http://www.gov.scot/Publications/2013/10/2688/16

	Robertson Facilities Management*. (Two of the largest of the construction companies are headquartered outside Scotland.)
North	Ogilvie Construction Limited Balfour Beatty plc Morrison Construction (part of Galliford Try) Kier Construction Robertson Construction (Three of the largest of the construction companies are headquartered outside Scotland.)
South West	Kier Construction*, Morrison Construction*, part of Galliford Try Graham Construction* Ashleigh. Morgan Sindall, (subsequently drafted in). (All headquartered outside Scotland.)
West	Two companies completely dominate construction: Morgan Sindall* and Bam, neither of which are Scottish businesses. Note, however, that this hub does not appear to have formally appointed tier 1 contractors.
South East	Graham Construction, Morrison Construction*, part of Galliford Try BAM Construction. (All headquartered outside Scotland.)

(The asterisks denote companies which are also private sector partners in the same hub, or are in the same group as a private sector partner.)

Again, the preponderance of large companies largely headquartered outside Scotland is very noticeable. It is also noteworthy how several large companies have tier 1 roles for more than one hub: specifically, BAM for 3 hubs: Morrison Construction, (a subsidiary of Galliford Try), for 3 hubs: Keir Construction for 3 hubs: Ogilvie Construction for 2: and Morgan Sindall for 2. It is also noticeable that several of the tier 1 contractors are also private sector partners in the same hub, or are in the same company group as a private sector partner.

Remembering that the hubcos have been set up on 20 to 25 year contracts, concentrating the Tier 1 function on such a small group of firms raises a number of issues.
a) what does this strategy imply for the long run structure of the construction industry in Scotland? Does the advantage which Tier 1 status will inevitably confer on this group of firms mean that they will inevitably come to dominate the large scale construction sector in Scotland: and will it effectively prevent other firms, particularly SMEs, from growing?
b) Does the fact that this group of firms is so heavily dominated by firms which are not headquartered in Scotland mean that Scotland will lose out on certain high quality types of employment – e.g., headquarter jobs, research, etc.?
c) Given that the Tier 1 contractors are in the powerful position of managing the lists of Tier 3 contractors, are there adequate safeguards in place to ensure that the Tier 1 contractors do not abuse this power?

Support for SMEs.
Next, we look at the operation of the subcontracting chain, and its critically important role in providing opportunities for the SME sector in Scotland. The importance of the SME sector in developing the economy is now well recognised, both internationally, and within Scotland.

The EU has emphasised the importance of SMEs in EU economies and has introduced a number of Directives and initiatives to encourage EU governments in their public procurement to make it easier for SMEs to participate fully in public procurement projects. The Scottish Government has continued and developed programmes previously introduced by earlier administrations to assist Small and Medium sized Enterprises. One of its main methods of so doing is through Scottish Enterprise which provides a range of assistance to SMES including grants to help SMEs develop new products and services, and programmes providing help with research, innovation, and training.

Given the importance of Public Procurement to the Scottish economy, it is therefore essential that in bringing forward new initiatives to give "value for money", as is expressed by the Scottish Futures Trust, that SMEs based in Scotland are given the opportunity (a) to develop themselves, (b) to play as large a part is possible in any public procurement programme: and (c) that any new initiative introduced is properly integrated with existing initiatives.

One of the key performance indicators for all of the hubs is the percentage of contracts awarded to SMEs. The relevant information as reported by the hubs is given in the following table:-

Hub	**SME Involvement**
East Central	49% of contracts awarded to SMEs
North	68% of construction work to SMEs
South West	54% of work contracts awarded to SMEs
West	66% of contracts awarded to SMEs
South East	85% of contracts awarded to SMEs: 83% to Scottish SMES[4]

This data, published by the individual Hubs in their Annual Performance Reports for 2015/16, would indeed suggest that SMEs are benefitting from Hub existence in the public procurement supply chain. However, it is not clear from the published information exactly how each of the hubs was defining and calculating the measure it was using. Accordingly, we asked all of the hubs for more detail on what was meant by the percentage of contracts awarded.

Three hubs responded, noting that they were not covered by Freedom of Information and did not have the resources to answer. Two did not reply. Perhaps tellingly, two hubcos answered FOI requests with almost identical words. That covering South East Scotland replied to a request for information as follows: "*Unfortunately, as a small business we are unable to allocate the necessary resources that would be required to process such a request for*

4 hubsoutheastscotland.co.uk/assets/t/e/territory-strategy-plan_4-june_final.pdf

information. Hub South East Scotland is a private limited company and as such, we are not subject to the Freedom of Information (Scotland) Act 2002.”.

That covering West Scotland replied *“Thank you for your enquiry which has been passed from Steven Whitton to hub West Scotland. Please note that as hub West Scotland is a private limited company we are not subject to the Freedom of Information (Scotland) Act 2002. Unfortunately as a small business we are unable to allocate resource to processing such requests for information. We regret that we are unable to be more helpful and I hope you understand the reasons for this.”*

A third hub, South West stated that they considered our request for information *“will put an untimely strain on the company resources whilst they are committed elsewhere.”* They regretted they were unable to be more helpful.

As regards published information fleshing out the KPIs on SMEs, we noted above in the case study that hub South East did not publish meaningful supplementary information: the same is true for the other hubs.

The hubs, therefore, provide a very limited indicator of their support to SMEs, and are not prepared to back this up with more detail.

We also examined whether the Scottish Government database on public procurement contained any relevant information on hub operations. The Scottish Procurement division of the Scottish Government was asked what information they had on Hub performance and on use of the Scottish Government’s Public Contracts Division for advertising contracts. Their FoI response was that: “HubCos are neither required nor expected to advertise their contracts on PCS, because they are not public bodies to which the public procurement regulations apply, but institutionalised private-public partnerships awarded after European-wide competition.”

It is instructive to compare this lack of detail for hub projects with the greater detail available for some other projects in a source like the “*Infrastructure Investment Plan 2015 - Major Capital Projects Progress Update”* (March 2017), produced by the Financial Strategy Division of the Scottish Government. This source gives information on what is termed “contribution to economic development”. For example, for a non-hub project, the Scottish National Blood Transfusion Service National Centre, it is noted that, although the project is still under construction, it has already awarded 17 contracts with a value of £18.9 million to Scottish based SMEs. By contrast, none of the hub projects listed in this data source had any information on the number or value of contracts awarded to Scottish SMEs. (We are grateful to the Financial Strategy Division of the Scottish Government for producing outturn and background information for us from this source.)

It is worth noting that an important initiative like Scotland’s Schools for the Future, (where individual projects are likely to be delivered by the hubs), offers the following among the economic benefits which the programme will deliver:-

- Subcontract work delivered to local SMEs within 50 miles.
- Subcontract work delivered to local SMEs within Council boundary.
- Subcontract work delivered to National SMEs within Scotland.

- New jobs created to local SMEs; within Council boundary.
- Where relevant, the hub procurement process will ensure that local; resources are used wherever possible.

Offering this range of benefits implies that an appropriate monitoring system must be put in place to ensure that they are delivered. And if this is done for one section of hub activity, (relating to Scotland's Schools for the Future projects), surely this can, and should, be extended to all hub projects.

The fact that the hubcos offer such a limited information on their support to SMEs appears difficult to justify, and appears inconsistent with the Scottish Government's stated commitment to openness.

Does the hub structure provide a good environment for encouraging organic growth in the economy?
The type of work available to SMEs, which is largely as subcontractors within the hub process, is unlikely to be suitable for encouraging innovation and growth. In particular, when SMEs are contracted to work for other private sector firms, they may be reluctant to discuss possible innovations with potential commercial rivals. An environment where the SME was having direct links with an informed public sector client might be more conducive to SME innovation.

The Tier 1 contractors, who are in many ways now the key repositories of much expertise, are mainly large firms headquartered outside Scotland. Without in any sense denigrating the contribution to the Scottish economy made by such firms, it is not obvious that increasing reliance on such firms is in the best interest of the long run growth of the Scottish economy. For example, if such a firm were to develop a healthy export market for a product spun out of SFT activity, it is not clear that this would in any way benefit the Scottish economy – either in terms of an increase in high quality headquarters or design jobs in Scotland, or in terms of repatriation of profits to Scotland.

For reasons like this, it appears likely that the hub structure may actually, in certain important respects, restrict the growth capacity of the Scottish economy.

There is also a geographical issue. Rural areas, sparsely populated areas, and ones which have suffered long term industrial decline are likely to be particularly vulnerable to the structure imposed by SFT for public procurement. The North Territory hub Programme Board, for example, noted that "For the first 10 years of any partnership with hubco, hubco will have an exclusive right to develop proposals for (and, subject to meeting certain criteria, deliver through its supply chain) certain projects." In other words, once a public sector body such as the local authority or hospital board has signed up to being a member of the hub then they almost certainly have to use the hubco for their planned developments. This will obviously have a considerable effect on small and medium sized enterprises in less well populated areas in Scotland. If the SME is not accepted as a contractor in Hub business then it is going to lose out in a substantial chunk of local business.
Hub North appears to have attempted to address this issue and has written as follows: "the Tier 2 supply chain is actively engaged in the delivery of new projects with each work

package being subject to competitive open-book tendering. Furthermore, materials, resource and labour will not be sourced from outside the Territory unless considered beneficial, better value for money or subject to procurement regulations."
However, the KPI information they provide gives no further information on how they are addressing or monitoring the issue.[5]

Hollowing out expertise in the public sector – and possibly also in the hubcos.
The hubcos offer what is in effect a complete "one stop shop" for the public sector, providing expertise in the design, tendering, and construction of infrastructure. The development of the hub system will therefore have resulted in a reduction in the amount of in-house expertise in these aspects within the public sector itself. This is potentially problematic. For one thing, it is likely to adversely affect the public sector's ability to undertake informed scrutiny of the service they receive from the hubs: in addition, it will limit the public sector's ability to potentially access other procurement routes.

There are some indications, however, that this hollowing out process extends to the hubcos themselves. The hubcos are small organisations, (a point made by several of them in arguing why they would not respond to FOI requests.) As noted by Saunders[6], there is a suspicion that the actual source of expertise now rests firmly with the private sector partners, and Tier 1 contractors. Saunders gave the following quotation from a project manager in one council's procurement team:-
"For a long time, we thought it was a bit of the tail wagging the dog with the Tier1 contractor […]. Actually it's […] Morrison's or Graham's [Tier 1 contractors] that are dictating most of the things, they just go to HubCo, and then HubCo passes it to us."

If this is indeed the case, then it is a potentially worrying situation. One view of the role of the hubcos is that, while they are not in the public sector, they nevertheless occupy an intermediate – one could say, intermediary – position between the public and private sectors. But if the hubcos themselves contain limited expertise, then their actual effectiveness in this intermediary role may be limited.

5 https://www.hubnorthscotland.co.uk/uploads/files/downloads/hub-2016-report-44pp-artwork.pdf
6 E. L. Saunders: "Hub South-East Scotland, Austerity and Public Procurement": M Sc Dissertation, Edinburgh University School of Geo-Sciences, August 2015.

Section 4: Financial Issues Relating to the Hub Programme.
Hub projects come in two types – those funded from capital, and those funded from revenue. "Capital" projects, typically smaller projects, are funded directly from the Scottish Government's capital budget: so there is no need to access other sources of finance. Projects which are funded from revenue do require external finance. Typically, 90% of this is in the form of senior debt. For those lending to a hub project, senior debt is the least risky of the types of loan. It is the lending that takes priority over all other borrowing debts of the hub project, and as such, has the lowest rate of return. 10% is in the form of subordinate debt, (that is, less secure debt, which attracts a higher rate of interest). There are issues with both forms of debt finance.

Senior Debt Issues.
Each year, SFT runs a framework competition to appoint a designated senior debt lender for projects falling under each of the five hubcos. For example, in the first such competition, Aviva was appointed as senior debt lender for hub North, hub East Central, and hub West territories, and Nord LB for hub South and hub South West. In fact, these two companies appear to be the sole providers of hub senior debt, up to the last published information in November 2016.

The rationale for this approach is that by bundling the requirement for senior debt funding up to hub territory level, it was possible to secure more advantageous senior debt rates. To quote from a written response from SFT, about the 18 projects requiring senior debt finance in the year of the first framework competition:- "*The senior debt requirement across these projects was about £560m – an average per project of about £30m. Individual projects of this size of* [sic] *not of significant interest to many funders, but by aggregating the opportunity to a hub territory level we were able to attract more interest from potential funders and create greater competitive tension. We estimate that by competing the funding opportunity at an aggregate level, we reduced the funder debt margins by at least 25 basis points (0.25%).*"

SFT estimated that the resulting saving was about £20 million per annum. There are, however, some difficulties about assessing this figure.
a) First of all, it appears that the estimated £20 million may be a cash figure, spread over the project lives of all the projects involved in this year's framework competition. It would be normal practice, (e.g., in public sector project appraisal), to express the worth of a cash saving which is spread over many years as a net present value at today's prices. If this had been done in the present case, the claimed £20 million saving might well have a present worth of around £12 million – much less significant than claimed.
b) Second, it is not known what senior debt interest rate was actually agreed during the framework competitions. SFT has consistently argued that, to protect the commercial interest of the lenders, this interest rate should be kept confidential: and this stance was supported by the Scottish Information Commissioner, when a freedom of information request on this matter was taken to appeal [7].
Despite this cloak of confidentiality, some evidence is available on the senior debt interest rates applied to hub projects. For example, the financial projections for one hub project which we have seen indicate an average senior debt interest rate of 4.43%. A paper by East Ayrshire, [8], notes that the interest rate on subordinate debt on that particular project would be 10.5%, and that this would be "approximately 5% higher than the average rate anticipated for senior debt." Calculations based on

7 Scottish Information Commissioner: Decision 042/2017 .
8 East Ayrshire Council: Treasury Management – Amendment to Permitted Investments to Include Subordinated Debt: Report by Finance Director to Cabinet, 18th February 2015.

the published figures for the Woodside and Gorbals Health Centres project [9] suggest a senior debt rate of just under 5%. And a note by Ernst and Young, [10],suggests that the Nord LB senior debt rate for hub projects would be just over 5%. Overall, this evidence suggests that the senior debt rate for hub projects would be around 5%.

It is of interest to compare this estimate with the senior debt rates on a number of PFI projects, before the financial crash. Information we obtained on 6 such schemes indicates a range of senior debt rates from 6.8% to 8.3%. At the same time, LIBOR interest rates were typically over 5%. Since the financial crash interest rates have fallen steeply, (with LIBOR rates below 0.5% for most of the time). Given the fall in interest rates, a senior debt rate of around 5%, (if this is indeed the case), for current hub projects does not appear outstandingly low. It is difficult to see, against this background, how SFT can justify, as being in the public interest, the need to keep senior debt interest rates on hub projects confidential.

We recommend that:-
a) SFT, and the Information Commissioner, should re-examine the case for confidentiality against what would seem to be a clear public interest in disclosure.
b) In any event, the SFT should present much clearer information on the claimed savings from the framework competition approach.

One further aspect of hub senior debt financing which, (were it not for Brexit), should be investigated, is the potential for accessing funding from the European Investment Bank. The EIB provides very cheap project finance: (e.g., one loan by the EIB to a UK water utility was at a real interest rate of 1.2%). However, the EIB is only interested in large projects: it will typically provide no more than 50% of the senior debt for a project, and will generally invest amounts more than £75 million. The typical hub project is therefore much too small to access EIB funding: and no use has been made of the EIB by the hub programme.

Nevertheless, as the SFT's approach to the senior debt framework competition has shown, there are potential advantages from bundling the requirement for hub senior debt. It would be worth considering whether a similar bundling approach might open up the possibility of EIB funding for the hub programme. SFT was asked whether they had considered this possibility, but have so far not responded.

Subordinate debt issues.

As noted in section 2, 60% of subordinate debt is typically put up by the private sector participants in the special purpose vehicle delivering a hub project: and the public sector, or bodies allied to the public sector, have the right to put up 40% of the sub debt. (This 40% is comprised as follows: the public sector participant, 10%; the SFT, 10%; and the Hub Charitable Foundation, 20%).

The interest rate on sub debt is not determined afresh for each hub project: instead, when each of the five hub partnerships, (the hubcos), was established, the interest rate on sub debt for all projects which would come under that hubco was determined as part of the bidding process for the hubco contract. That is, the sub debt rate for every project in each hubco area is determined once and for all, with only minor variations in practice. The sub debt rates for

9 NHS Greater Glasgow and Clyde: Gorbals Health Care Centre and Woodside Health Care Centre: Project Bundling Paper, December 2016.
10 EY: Subordinated Debt in a Revenue Funded Hub Project: this is an annex to a Dumfries and Galloway Policy and Resources Committee paper, "Investment in South West Hubco Project", 17 February 2015.

individual projects are published in the Annual Report produced by Scottish Futures Trust Investments: and, for the five hubcos, have fallen in the following ranges:-

Hub North: 10.2%
Hub South East: 10.5% - 10.87%
Hub South West: 10.5% - 10.85%
Hub West: 9.75%
Hub East Central: 10% - 10.2%.

SFT confirmed, in a written response, that “there is no mechanism within the hub procurement to revise (up or down) the sub debt rates on new hub projects. The successful private sector bidders committed to provide sub debt and equity at a fixed rate of IRR return for all DBFM project delivered by a specific hub company.”

As an indication of the scale of payments implicit in loans undertaken at interest rates like these, the financial projections for one hub scheme to which we have had access imply that, over the 25 year lifetime of the scheme, the total payments of interest, principal, and dividend on subordinate debt would amount to over three times the amount of capital originally raised through sub debt.

The process of effectively fixing sub debt interest rates at the start of the life of each hubco, raises a number of questions: in particular:-
a) from the point of view of obtaining the lowest possible funding cost, is it an efficient process to determine the interest rate on sub debt on the basis of a competition which is at the same time looking at a number of other characteristics, (e.g., building costs and performance), and not just financing cost?
b) Locking in a fixed sub debt rate over the extended period could expose the public sector to the downside risk of paying too much if interest rates subsequently fell.

Given such concerns, is there any evidence that the sub debt interest rates on hub projects have in practice been too high? This is a difficult question to answer directly, because the type of market evidence which would have been available if rates were competitively determined on an ongoing basis is not available. However, there is a significant amount of circumstantial evidence which does suggest that hub sub debt interest rates are indeed unduly high. This comes in the following forms.
1) When the Hub Charitable Foundation (HCF) was being set up, a document produced by SFT [11] noted that one of the sources of finance which would be available to HCF would be “fees received in return from passing on subordinate debt investment opportunities.” What this statement really means is that the market would be willing to pay a fee in order to invest in the subordinate debt of hub projects at current sub debt interest rates – which is equivalent to saying that the current sub debt interest rate is higher than it needs to be in order to attract investors in sub debt.
In fact, we were told by an authoritative source in the course of this investigation that the HCF was indeed able to sell on its right to invest in hub sub debt, and that the fee paid to HCF was such that the new investor would receive an overall return of around 8%, (on their input of sub debt investment plus fee.) Given that, as we understand, this transaction is taking place before the construction phase of the relevant project, most of the project risk will still

11 Scottish Futures Trust: Revised Structure for Design, Build, Finance and Maintain Projects: June 2015.

attach to this investment. The significant difference between the original 10-11% sub debt rate, and the 8% being earned by the secondary investor, is thus very suggestive evidence that the original IRR is a good deal higher than the competitive market rate.
2) A second piece of evidence is the scale of return that might be earned on sale of sub debt holdings in the secondary market. For example, in one case, (a document produced by Aberdeen City Council [12]), in putting the case to the Council for permission to invest in hub sub debt, it was envisaged that a possible sale in the secondary market might yield 2.7 times the capital originally invested. See also Cuthbert [13], where there is modelling which illustrates how multiples of this order of magnitude might well be possible on secondary market sales of sub debt, if the original IRR on sub debt was around 10%. Multiples of this size are not unlike those possible on early PFI projects – where it is now recognised that potential profits were excessive. This is again circumstantial evidence that hub sub debt interest rates may well be unduly high.
3) To understand the third piece of evidence we need first to give a little technical background. In the special purpose vehicle carrying out a hub project, an important indicator which senior debt lenders will consider is known as the cover ratio. The cover ratio is essentially the ratio of interest charges plus debt repayment on senior debt plus subordinate debt, to interest charges and debt repayments on senior debt. Senior debt repayments have precedence over sub debt payments, in the sense that, if the project gets into financial difficulty, payments of sub debt loan charges will be suspended, and the resulting savings will be used to continue payment of senior debt loan charges. A high cover ratio is thus an insurance for senior debt lenders that funds are likely to be available to pay the charges due to them: so senior debt lenders specify, as a condition of their loan, that the projected cover ratio should never fall below a specified level.
The third piece of evidence, still circumstantial, is an argument put forward to us by a senior SFT official, that a relatively high interest rate on hub sub debt was in fact unavoidable, in order to secure the cover ratios which the senior debt lenders would require. The fact that a senior SFT official saw fit to make this argument is itself suggestive that sub debt interest rates may be unduly high. But it is also worth pointing out that, as a justification for high sub debt interest rates, this argument looks particularly weak. From the point of view of a senior debt lender, it would surely be equally satisfactory if the funds needed to secure a particular cover ratio were paid into ring fenced account held by a trusted third party: (such an account is technically known as an escrow account). The funds would then be paid back to the public sector in due course if not required. There does not seem to be any fundamental need to re-imburse sub debt holders with high interest rates just to secure a particular cover ratio.

Overall, on the question of sub debt interest rates, we would draw the following conclusions:-
a) it is arguably not efficient, from a public sector point of view, to determine sub debt interest rates once and for all, as part of the initial competition for setting up hub territory partnerships. If an opportunity presents itself, then this aspect of the process should be re-considered.
b) There is evidence, circumstantial but strong, that hub sub debt interest rates are higher than would result from a competitive market.

12 Aberdeen City Council: Report to Finance, Policy and Resources Committee on Purchase of Subordinated Debt, 23 April 2015.
13 J. Cuthbert: Potential Dangers of Public Sector Investment in Hub Sub Debt: Common Weal Policy Paper, April 2017.

c) Insofar as one factor bearing upon potentially high sub debt interest rates is the need to secure adequate cover ratios for the senior debt holders, SFT should consider innovative approaches to achieving adequate cover – e.g., by the use of escrow accounts.

Issues surrounding public sector holdings of hub sub debt.
As already noted, up to 40% of the subordinate debt in a hub project can be held by bodies in the public sector, or allied to the public sector. This is, on the face of it, a surprising state of affairs. The loan charges on hub sub debt are funded by the public sector itself, through the stream of unitary charge payments: so public sector investment in hub sub debt effectively amounts to the public sector taking money out of one pocket, and putting it back in another.

SFT have stated that the main reason for public sector bodies to take out subordinated debt would be to improve value for money by having an element of return come back to the public sector rather than accrue to private investors: this would add to the partnering ethos and transparency through co-investment and Board Directorships. This seems a relatively weak rationale: after all, the public sector, as the customer, could hardly have a bigger incentive to seek close partnership working with the hub special purpose vehicle, without the additional incentive of having invested sub debt: and putting in risk capital, in the form of sub debt, is liable to cloud the risk transfer to the private sector which is part of the ultimate rationale for any public private partnership.

In addition, public sector investment in hub sub debt raises further serious issues, which were the subject of the paper by J. Cuthbert referred to above. As has already been noted, one of the possibilities arising from such investment is that the holder might sell their sub debt investment in the secondary market, so realising a capital gain. As explained in detail in the paper, this procedure would be formally equivalent to the public sector body:-
a) making a capital grant to the project equal to their original investment in hub sub debt: and
b) borrowing a capital sum equal to the sale value of the sub debt stake, at a rate of interest equal to that being received by the secondary market investor.

Following the publication of the paper, the SFT clarified their position on their 10% stakes in hub sub debt, stating that they had no intention of selling their stakes in the secondary market. However, it is clear that the public sector participants, (health boards and local authorities), may well consider selling their stakes in due course: witness, for example, the Aberdeen City Council document [14] already referred to. As regards the HCF, it was specifically envisaged in the SFT document [15] that one of the sources of finance for HCF would be secondary market sales of their sub debt holdings: and, as already noted, HCF is currently engaging in the equivalent practice of selling, for a fee, the right to invest in sub debt.

As noted in the Cuthbert paper, the issues raised by such sales include the following:-
a) the capital gain which the public sector will receive on a sub debt sale will be larger, the larger the sub debt interest rate is: this could potentially weaken the public sector's incentive to take action if it became clear that hub sub debt interest rates were in fact too high.

14 Aberdeen City Council: Report to Finance, Policy and Resources Committee on Purchase of Subordinated Debt, 23 April 2015.
15 Scottish Futures Trust: Revised Structure for Design, Build, Finance and Maintain Projects: June 2015.

b) a public sector sub debt sale is equivalent to borrowing at the secondary market interest rate: this could be an expensive source of borrowing relative to, e.g., borrowing from the National Loan Fund.
c) since the "borrowing" arising from a sub debt sale will appear in the public body's accounts as a capital receipt, such borrowing may escape the normal level of prudential scrutiny which public sector bodies should undertake.

Given these potential dangers, it is important that the recommendations made in the Cuthbert paper are implemented: namely:-
1) There should be more openness about the returns being earned on hub sub debt, (and also by way of dividends.) This openness should extend to the projected phasing of the relevant payments, (of interest and principal). This latter aspect is important, because the phasing of returns is critical in determining what capitalised value is likely to be realised in a sale in the secondary market: and hence what scale of windfall profit the original sub debt holders might receive on such a sale.
2) There should be mechanisms for determining whether sub debt interest rates are too high. One piece of evidence, for example, which should be publicised, and assessed, is what scale of fees the HCF is able to command, if it is selling its right to invest in hub sub debt.
3) There should be openness about any sales of hub sub debt undertaken by the public sector, (including by the HCF.) And this openness should extend, not just to the capital value realised on such sales – but also to the implicit internal rate of return involved in the transaction. (The public sector body knows both the stream of payments it is selling, and the price it is receiving: so it can work out the implicit IRR used by the purchaser in valuing the stream of payments.) This information will enable not just the scale of the "concealed" public sector borrowing implicit in sub debt sales to be assessed: but also the critically important aspect of the interest rate the public sector is paying on this borrowing.

Section 5: Wider Issues with the SFT Approach.

While, for reasons which have been explained, much of this paper has concentrated on the hub portion of SFT activities, the general approach adopted with the SFT does raise a number of other issues. But before considering these issues with the SFT itself, it is important to put them in context. Local authorities have found themselves increasingly having to turn to the private sector as a source of finance, in order to maintain and improve their capital stock.

The Scottish Government provides the vast majority of capital grant funding to Councils. However, changes in the treatment of capital spend resulted in the Scottish Government moving capital grant funding of £120 million and £100 million, originally due to councils in 2012/13 and 2013/14, to the following two years. The purpose of so doing was to enable the provision of additional funding to those parts of the public sector in Scotland that have no borrowing powers. According to a report by the Accounts Commission, the Scottish Government "hoped that councils would work with the Scottish Ministers and use their ability to borrow to supplement capital spending and so contribute to local economic recovery.[16]

In this situation, the existence of the Scottish Futures Trust, with its aim of finding alternative and innovative sources of finance for public sector projects was a godsend for local authorities. And not only because SFT were capable of coming up with innovative financial ideas, but it also had the expertise to turn these innovative ideas into models, some of which were variants of models already in practice in other countries. This expertise was already missing in local authorities as budget cuts had had severe effects on professional staff numbers in local authorities.

Sustainability of future income streams.

With some relatively small exceptions, the capital financing required for SFT projects is raised by the private sector from the capital markets – with the loan repayments and interest charges paid, via the unitary charge for the project, from anticipated public sector revenue streams. The principal such revenue stream is the Scottish Government's resource DEL: though also important are the resources which local authorities will raise themselves, (from council tax and non domestic rates (NDR)): and, as described in Section 2, in the special case of Tax Incremental Financing (TIF), the anticipated growth in NDR receipts from the economic stimulus provided by the TIF investment.

SFT financing, in effect, largely boils down to the public sector borrowing against future public sector income streams. It is important, therefore, that appropriate safeguards are in place to ensure that the revenue consequences of commitments currently being entered into do not risk overburdening the future revenue streams.

It is, in fact, difficult to see that the safeguards currently in place are adequate. As regards local authorities' own resources, the major safeguard against local authorities over-committing themselves on conventional procurement, and PPPs, is the obligation on authorities to abide by the Prudential Code on Capital Finance. It is clear, however, (see, e.g.,

16 Major capital investment in councils Follow-up, Accounts Commission, January 2016

the paper [17] on the prudential code), that few local authorities are taking an adequately long time horizon in the financial planning underlying their Prudential Code statements: and even if authorities were trying to look reasonably far ahead, they are not provided with adequate information from central government on the likely behaviour of their major source of funding – the revenue grant from central government. As regards the likely pressure on their own resources, therefore, there is indeed a significant danger that local authorities may over-stretch themselves on the continuing payments arising from SFT projects, particularly given the current uncertain climate for the public finances.

As regards the Scottish Government's DEL, the major safeguard is that the Scottish Government commits itself to a limit of 5% as being the maximum percentage of its DEL which will be committed to direct contributions to fund revenue funded capital projects. There are, however, two major problems with this safeguard. First of all, the new fiscal framework for Scotland's public finances, introduced as part of the implementation of the post-referendum Smith reforms, introduces a new, and major, element of uncertainty about the future size of the Scottish Government's budget. The Holtham indexation arrangements for the Block Grant Abatement mean that the Scottish budget will suffer, if tax receipts in Scotland grow less rapidly than those in the rest of the UK. The potential effects here are large: and the danger of the Scottish budget being penalised in the medium term is also large, given the possibility of adverse shocks for the Scottish economy relative to rUK. There is no evidence that the Scottish Government has taken these dangers adequately into account in any forecasting work it has done on its 5% limit.

Secondly, the Scottish Government is mistaken if it is assuming that the only impact on its DEL from SFT activities will come via the direct commitments it is making to fund SFT projects. If local authorities were to run into trouble on their own resources, then the resulting pressure on council tax would put the Scottish Government into a position where it had to provide more support from the Scottish Government DEL.

For the above reasons, it seems clear that the risks associated with commitments to make future payments on SFT projects are not being adequately managed. The paper on the prudential code referred to above made certain recommendations on how the situation could be improved at the local authority level: but these proposals would also be of more general value. Specifically, it was proposed that an appropriate central body, (but not central government itself), should take on the role of providing longer term variant projections of local government fiscal prospects: and of aggregating individual authorities' separate projections into a national version, to compare with the central body's own variants. And that it should also comment on the consistency, or otherwise, of authorities' demographic assumptions. In addition, the Scottish Government would need to be much more willing to speculate realistically about long term budgetary prospects.

In addition, we recommend that Whole of Government Accounts, (WGA), should be produced for Scotland. Among other things, WGA give an indication of the total liabilities of the public sector, including a measure of the "off balance sheet" debt associated with initiatives like the hub programme. Some of the issues surrounding the production of WGA

17 Cuthbert, J. R.: "The Prudential Code": Jimmy Reid Foundation Policy Paper, December 2016

are discussed in a recent paper.[18] The data for the production of WGA for Scotland is, apparently, available: so there should be no great difficulty in their production.

Dangers of inadequate central government scrutiny of SFT actions.

All five of the innovative financial mechanisms to support the Scottish Government's programme of infrastructure investment are led by SFT. Further, the creation of the SFT has led to a string of other bodies, (e.g., the hubcos), which are not covered by Freedom of Information. This means that effective scrutiny and oversight of SFT is essential if a large and very important area of activity is going to be adequately monitored.

In fact, the establishment of the SFT represents just one example of a trend that has become increasingly apparent in both Scotland and elsewhere: namely, for central government to pass over to NDPBs, and the private sector, responsibility for delivering what used to be central and local government functions.

As part and parcel of this trend, certain expertise which used to reside in the public sector will diminish, as it comes to be exercised in the NDPB/private sectors. To some extent this is inevitable. But it is important that the decline in the public sector's direct, hands on, expertise should be compensated by an increase in another form of expertise – namely, that involved in scrutinising the activities of the NDPB, and of the private sector. If the public sector does not develop this scrutiny role, then there is a real danger that the NDPB may not be held adequately to account in the exercise of its responsibilities.

We are not confident that the Scottish Government has adequately developed its scrutiny role in relation to the SFT. Scottish Government comment on SFT activities takes place largely at the level of uncritical repetition of "good news" headline figures from SFT reports. There is little evidence of the Scottish Government exercising ongoing critical assessment. In particular, the changes implied by ESA10 should have prompted a high level rethink on whether the SFT model was still appropriate: the issue should not just have been dealt with reactively under the existing SFT framework. Further, the way in which SFT operations have become obscured in secrecy is also inconsistent with adequate scrutiny. The lesson does not appear to have been learned that headline figures taken from SFT reports are not adequate for proper scrutiny, unless they are backed up by an auditable trail.

We recommend that the Scottish Government re-examine its own position relative to the SFT: and should make sure that it has, in-house, adequate resources, with a clear remit for auditing/scrutinising SFT activities.

Will the Open Data Policy of the Scottish Government solve the problem of obtaining data on the whole range of SFT activities?

The Scottish Government has recently introduced a new initiative on Open Data. It turns out, however, that this will have no effect on the ability of organisations like the hubs to withhold information necessary for the monitoring and evaluation of Government policy.

18 M. Cuthbert: Public Procurement in Scotland, the Case for Scrutiny, Transparency and Accountability, CommonWeal, May 2017.

In 2014, the Digital Directorate of the Scottish Government wrote "The European Commission identifies open data as an "engine for innovation, growth and transparent governance". A commitment to open data goes beyond the approach of FOI in focusing further on, for example, proactivity and formats that ease re-use". However, in a recent correspondence to ourselves the Directorate wrote "As SFT is included in the list of bodies noted above it will be required to implement an Open Data Publication Plan. However, the 5 hubCos (responsible for each of the 5 hub areas) are not listed and therefore not required to implement the strategy." Presumably the same will be true of other similar organisations within the SFT umbrella. We recommend that the Scottish Government should use the effective control which it has over SFT as a shadow director to ensure that the principles of Open Data extend to all parts of the network.

How far the SFT has moved from the original intentions.
It is an interesting exercise to contrast the present structure and functions of the SFT, with the original intentions when the SNP first started to think about a public service trust to deliver capital investment. What was originally envisaged, in those early discussions, was a body which would be in, or closely allied to the public sector, and which would do two main things:-

- First, it would concentrate public expertise in the design and procurement of public infrastructure, so that individual health boards and local authorities would have expert support, and would not themselves have to duplicate expensive expertise.
- Second, it would tap what was hoped would be a new source of finance, supported by public investment bonds issued to the general public.

In the event, the way the SFT has been set up, and has developed, has resulted in something which is rather the opposite of the original intention. As has been noted, a criticism which has been made of, for example, the hubcos, is that they themselves are so small that expertise actually largely resides with the Tier 1 contractors: so that, rather than an augmentation of public expertise, development of SFT has in important respects resulted in a diminution of public expertise.

Second, rather than opening up new, and cheap, sources of bond finance, the financing sources ultimately being tapped by SFT are senior and subordinate debt finance. Saunders [19], quotes a point made by Pautz and Bailey that the SFT has become "a mere advisor for local government borrowing from already existing and used sources." This criticism is perhaps somewhat harsh, since it neglects the genuinely innovative work undertaken by SFT in developing new infrastructure delivery mechanisms. But nevertheless there is a criticism to be made, that the new delivery mechanisms developed by SFT still largely depend on traditional sources of finance.

To some extent, these changes in direction may have been inevitable – e.g., the ESA10 changes represented a pressure to move back to structures more like traditional PFI. But it is an interesting question: if the development of the SFT had been conducted in an environment of greater openness, and with ongoing constructive scrutiny, would it have ended up where it

19 E. L. Saunders: "Hub South-East Scotland, Austerity and Public Procurement": M Sc Dissertation, Edinburgh University School of Geo-Sciences, August 2015.

is today? In any event, the contrast between what has happened, as against original intentions, is an argument for much greater openness about the policy development process, which we recommend the Scottish Government should take on board.

Section 6: Value for Money.

The concept of value for money, (VFM), is subject to a range of possible definitions and interpretations. At one end is a narrow interpretation, concentrating on minimising cost. But it is also possible to take a much wider interpretation, taking into account not just the cost of procuring a particular asset or resource, but also the impact the procurement process will have on a whole variety of factors, like:-

- local employment opportunities;
- the effect on the skill base of the local workforce;
- the effect on industrial structure;
- the potential to use public procurement to drive innovation, and hence potentially to establish new industries;
- social effects: for example, the impact on social cohesion of new types of facilities enabling joint use.

The potential importance of these wider types of effect is widely recognised. For example, The European Commission considers SMEs and Entrepreneurship as key to ensuring economic growth, innovation, job creation, and social integration in the EU.[20]

It is perfectly permissible, within the terms of the EU Procurement Directive, for the public sector to adopt a wide definition of value for money. Here, for example, is the definition of VFM adopted in Northern Ireland:

"Best value for money is defined as the most advantageous combination of cost, quality and sustainability to meet customer requirements.

In this context

- *cost means consideration of the whole life cost*
- *quality means meeting a specification which is fit for purpose and sufficient to meet the customer's requirements*
- *sustainability means economic, social and environmental benefits, considered in the business case, in support of the Programme for Government"*[21]

The concept of VFM adopted in the SFT hub initiative is a good deal narrower than this. To take an example, the tender evaluation criteria for the market testing element of a typical hub project specifies the following as critical elements in the evaluation process:-

(a) Finance and pricing
(b) Health and Safety
(c) Legal
(d) Human Resources including ability to impact on local employment
(e) Technical
(f) Cultural fit with the requirements of hub and those organisations involved.

(source: hub North Territory Partnership Agreement.)

20 http://ec.europa.eu/eurostat/statistics-explained/
21 https://www.finance-ni.gov.uk/articles/definition-best-value-money

One of the performance indicators for the hub programme as a whole is the extent to which hub contracts at the tier 3 level are awarded to small to medium sized enterprises. So overall, it seems clear that the hub concept of VFM falls somewhere in the middle of the possible range: with a strong emphasis on cost, but taking account of local employment and skills, and of tender opportunities for SMEs. However, so far, there are no detailed statistics available from the hubs either in their Annual Reports or in their KPIs which can be scrutinised in order to determine hub performance.

The question then arises as to whether the programme actually delivers in this concept of VFM. In principle, the hub programme should certainly be delivering on this aspect. First of all, there is a strong emphasis on achieving VFM. To quote from a typical Territory Partnership Agreement, (that for hub North), "*Value for money is the essential test against which any market testing exercise is to be justified.*" Moreover, from the same document, "*It is essential that the evaluation methodology offers a robust, objective, transparent and equitable process against which bid submissions are evaluated and that inherent in the process is a clear and comprehensive audit trail.*"

Unfortunately, in practice, it is not possible for those outside the system to check whether these criteria are being fulfilled. There are statements in SFT reports about cost savings and other performance indicators, (like the percentage of contracts awarded to SMEs): but these headline type statements are not backed up by publicly accessible and auditable information. Requests to hubcos made in the course of this study, e.g., for the basis of statements about contracts awarded to SMEs, were refused, with two reasons given. First, on the grounds that hubcos are not subject to FOI. This happened even though, (as noted in section 1), such refusal is inconsistent with the spirit of the Territory Partnership Agreements. Second, that the Hubs are too small to give the time to producing the information requested.

It also seems clear that some of the headline reporting by SFT is on a non-standard basis. (As already noted in section 4, the claimed saving from the framework agreement for hub senior debt appears to be a cash figure spread over the lives of the projects, which would, in standard presentation, have been expressed as a smaller net present value figure.)

What this indicates is that the reporting of evidence on whether the SFT is actually achieving its concept of value for money is not adequate to enable firm conclusions to be drawn. This is a serious lack, as previous experience with the old PFI programme demonstrates. PFI, likewise, was meant to achieve clear VFM: but it was only when detailed information on the operation of PFI became publicly available, (largely because of the more robust way FOI was operated at that time), that it became clear that PFI was grossly failing, in many cases, to actually deliver good VFM.

There are, in fact, some worrying aspects which indicate that the SFT may not be achieving its full potential on VFM. Section 4 has already discussed indications that the interest rates which have been established for the provision of hub sub debt may be unduly high: and yet there is no mechanism for reviewing this. The implementation of ESA10 has meant that the proportion of funding for hub projects coming via the relatively more expensive private financing route, (as compared with direct capital contributions from the public sector), has increased. And although the framework agreement for hub senior debt funding involves bundling the funding requirement to achieve cheaper senior debt finance, the opportunity which bundling might represent to access EIB funding has apparently not been explored.

In order that there can be confidence that the SFT is actually achieving maximum VFM, it is recommended that:-
a) specific issues like those identified in the preceding paragraph are addressed.
b) the auditing arrangements for VFM which are meant to be in place should be operational, and seen to be operational.
c) SFT should report on achievement of VFM in a standard, and auditable, way.

That leaves the question of how SFT activities are impacting on VFM in the wider sense: that is, as regards the wider effects on the economy, and on social factors. Here, again, the picture is mixed.

On the one hand, it is clear that the SFT has paid quite a lot of attention to attempting to achieve wider social and economic benefits: for example, as noted in section 2, the SFT is pushing forward with a number of initiatives, in areas like low carbon, energy efficiency, district heating, and development of digital technologies

But, on the other hand, there are aspects of SFT structure and practices which may impact adversely on wider VFM. In particular:-
a) As has already been noted, the development of SFT has been accompanied by a hollowing out of procurement expertise in the public sector. This will reduce the public sector's procurement options in the longer term, and its ability to scrutinise proposals being put forward by the private sector – with a potential long term adverse impact on costs.
b) Reduction of expertise in the public sector may also reduce the public sector's ability to drive innovative procurement. This could potentially blunt what has proved, in other countries, to be a key driver of technological change.
c) The type of work available to SMEs, which is largely as sub-contractors within the hub process, might not be suitable for encouraging innovation and growth. In particular, when SMEs are contracted to work for other private sector firms, they may be reluctant to discuss possible innovations with potential commercial rivals. An environment where the SME was having direct links with an informed public sector client might be more conducive to SME innovation.
d) The Tier 1 contractors for the hubs, who are in many ways now the key repositories of much expertise, are mainly large firms headquartered outside Scotland. Without in any sense denigrating the contribution to the Scottish economy made by such firms, it is not obvious that increasing reliance on such firms is in the best interest of the long run growth of the Scottish economy. For example, if such a firm were to develop a healthy export market for a product spun out of SFT activity, it is not clear that this would in any way benefit the Scottish economy – either in terms of an increase in high quality headquarters or design jobs in Scotland, or in terms of repatriation of profits to Scotland.

Overall, it is clearly very difficult to establish whether the SFT is delivering optimal value for money in either the narrow or broad senses distinguished in this chapter. To a considerable extent, this reflects the way in which the move towards delivering public infrastructure by means of public private partnerships, (of which the various initiatives connected with the SFT are specific examples), has made the whole problem of openness and accountability much more difficult. One step which could potentially be of great assistance, and which we recommend, is that the value auditing role of Audit Scotland be extended to cover private companies, like the hubcos, which are within the SFT's ambit. Such a move would be entirely consistent with the statements made by the First Minister, and the Auditor General, (quoted in Section 1), on the importance of transparency and openness.

Section 7: Conclusions and Recommendations.
We group our conclusions and recommendations under a variety of headings.

Openness.
As noted in section 1 and section 3 of this report, at least one important area of SFT activity, that relating to the operation of the hubs, is regarded as being beyond the scope of Freedom of Information. This severely restricts the availability of information on hub activities, and effectively puts the operation of the hub programme beyond adequate scrutiny. This is in itself an unacceptable state of affairs, which should in any event be rectified. But the situation is made doubly unacceptable because the terms of the original Territory Partnership Agreements under which the hubcos are set up were designed so that aspects of hubco activity would, in effect, be within the operation of FOI.
Accordingly, we recommend: -
a) That the SFT should review their stated position on FOI and the hubs, to bring it into line with the spirit of the TPA.
b) That SFT should remind hubcos of their obligations in this respect under the terms of the TPAs.
c) That the Scottish Government and the SFT should take active steps to monitor that there have been changes in hubco behaviour on openness.
d) And that, similarly, SFT should review all of their other initiatives to ensure they are achieving maximum openness.

Indicators.
As noted in sections 3 and 4, the indicators, including Key Performance Indicators, used in relation to various aspects of hub activity are limited: they are often not backed up by clear definitions: they suffer from the lack of an audit trail which enables the data to be checked: and are sometimes of a non standard form. In particular, it is essential that the information produced by the Hubs is refined to make it meaningful and be more useful in determining how Scottish based SMEs are faring under the Hub initiative. Accordingly, we recommend that:-
a) All of the key indicators used in relation to the hub programme should be reviewed and extended, so that each of the above aspects is covered.
b) that in line with the new spirit of openness, the resulting detail should be publicly available as standard.
c) that the information available on hub activities should be aligned with, and at least as detailed as, the information available in the sources like the Scottish Government's "Major Capital Projects Progress Update".

Strategic Scrutiny.
As noted in section 5, the Scottish Government does not appear to have developed its scrutiny role in relation to the SFT. We recommend:-
a) That the Scottish Government re-examine its own position relative to the SFT, and should make sure that it has, in-house, adequate resources with a clear remit for auditing/scrutinising SFT activities.
b) Now that the SFT has been in operation for approaching 10 years, the Scottish Government should also carry out, or commission, a review of whether the SFT is fulfilling

the Scottish Government's strategic objectives – and also of whether there might be unanticipated downsides emerging. Such a review should cover a number of issues already identified in this report. In particular:-

- what does the operation of the hub initiative imply for the long run structure of the construction industry in Scotland? Does the advantage which Tier 1 status will inevitably confer on a particular group of firms mean that they will inevitably come to dominate the large scale construction sector in Scotland: and will it effectively prevent other firms from growing?
- Does the fact that the group of Tier 1 contractors is so heavily dominated by firms which are not headquartered in Scotland mean that Scotland will lose out on certain high quality types of employment – e.g., headquarter jobs, research, etc.?
- Does the hub structure provide a good environment for encouraging organic growth in the economy, particularly since the hub approach will tend to limit SMEs to a subcontracting role to other private sector firms?
- What are the implications of the hollowing out of expertise from the public sector, and indeed, from the hubcos, which is likely to have accompanied the development of the hub approach.
- Is it of concern that the SFT is now operating in a way which is rather the opposite of the original intentions when the initiative was being planned?
- Is the SFT achieving value for money – particularly in relation to the broader concept of value for money identified in Section 6.

Detailed Scrutiny.

An initiative like the hub programme involves putting a great deal of power, for an extended period, in the hands of the hubco private sector partners, and the Tier 1 contractors. The TPAs under which the hubcos were established contain detailed provisions which were meant to ensure that the programme was operating fairly and efficiently: for example, that activities like management of the supply chain, and market testing, should be conducted in a fair and auditable fashion. SFT should ensure that such procedures are being operated as intended – and should publish information demonstrating this.

There is also a requirement to strengthen the role of the relevant Parliamentary Committees in scrutinising SFT and its associated bodies. We recommend that the accord agreed in 2013 between the Public Audit and Post-legislative Scrutiny Committee, Audit Scotland and the Scottish Government should be broadened such that the following are included:

- The expected economic impact of projects on the local economy, and on the Scottish economy.
- The numbers of jobs expected due to the construction phase of the project by type of job and by some measure of level of job.
- An assessment of the potential for the project to encourage local innovation
- Any potential negative effects (eg. on existing businesses.)

Information should also be made available to the Committees in due course on outcomes on these indicators.

Sustainability.

As noted in section 5, it does not appear that the risks for the Scottish DEL associated with the commitments to make future payments for SFT projects are being adequately managed. We recommend:-
a) that the Scottish Government should review, and extend, its modelling for assessing the risks for the Scottish DEL associated with SFT activities: and that, in doing so, it should take account of new risk factors, like, for example, the operation of the post-referendum fiscal settlement.
b) Given the critically important role of local government finances, and the difficulty central government has in making long term forecasts in this area, the Scottish Government should consider funding an appropriate body, (not central government itself), to take on the role of providing longer term variant projections of local government fiscal prospects: and of aggregating individual authorities' separate projections into a national version.

Financial Issues.
Some of the general recommendations made above, (e.g., on the need for openness), extend also to the financial aspects of the operation of the hub programme. But, in addition:-
a) There should be a review of various aspects of the framework competition which is currently operated for the provision of senior debt lending to hub projects. In particular, the SFT, and the Information Commissioner, should re-consider whether it is in the public interest to maintain the present secrecy about the resulting interest rate. In any event, the SFT should present clearer information justifying the claimed savings from the framework competition approach.
b) If the option of accessing European Investment Bank funding remains open, (depending on Brexit developments), the SFT should consider whether the approach of bundling hub funding requirements could be extended to enable access to EIB funding.
c) SFT should review hub sub debt interest rates in the light of the latest evidence: and, if they are indeed unduly high, should consider what remedial steps might be taken.
d) Given that one factor bearing upon potentially high sub debt interest rates is the need to secure adequate cover ratios for the senior debt holders, SFT should consider innovative approaches to achieving adequate cover – e.g., by the use of escrow accounts.
e) The Scottish Government should review the policy of the public sector, or bodies allied to it, investing in the subordinate debt of hub projects, in view of the potential dangers identified in this report.
f) If the policy of public sector investment in hub sub debt is maintained, then there should be greater openness, particularly about any secondary market sales of such debt.
g) There is an urgent need to produce Whole of Government Accounts for Scotland, to give a fuller picture of the liabilities of the public sector, including those relating to SFT procurement initiatives.

In conclusion, it was Keynes who said
"Experience is accumulating that remoteness between ownership and operation is an evil in the relations among men, likely or certain in the long run to set up strains and enmities which will bring to nought the financial calculation."[22]

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22 John Maynard Keynes, National Self-Sufficiency, 1933.

One of the unlooked for side effects of the SFT initiative has been to introduce several degrees of separation between the public, who are the consumers and ultimate funders of infrastructure investment, and the means of delivering that investment – leading to exactly the kinds of problems foreseen by Keynes. Implementing the recommendations in this report would go some way towards rectifying the situation.

Annex 1: Extract on Freedom of Information from North Territory Partnership Agreement.

"30. FREEDOM OF INFORMATION
30.1 hubco acknowledges that a Participant is subject to the requirements of the FOI(S)A and the Environmental lnformation (Scotland) Regulations and shall assist and cooperate with a Participant (at hubco's expense) to enable the Participant to comply with any lnformation disclosure requirements.
30.2 In the event that an lnformation Request is received by hubco, hubco will transfer the lnformation Request to the Participant as soon as practicable after receipt and in any event within two (2) Business Days of receiving the request.
30.3 In the event that an lnformation Request is received by a Participant in relation to lnformation that hubco is holding on its behalf and which the Participant does not hold itself the Participant shall refer to hubco such lnformation Request as soon as practicable and in any event within five (5) Business Days of receiving such information Request and hubco shall:
30.3.1 provide the Participant with a copy of all lnformation in its possession or power in the form that the Participant requires within five (5) Business Days (or such other period as the Participant may specify) of the Participant requesting that Information; and
30.3.2 provide all necessary assistance as reasonably requested by the Participant to enable the Participant to respond to the Information Request within the time for compliance set out in section 10 of the FOI(S)A or regulation 5 of the Environmental lnformation (Scotland) Regulations."

This wording, from the North TPA, follows the wording laid down for all TPAs in the Standard Form for TPAs produced by SFT, as set out, for example, in the version dated 19/05/2011.

Glossary

AWPR	Aberdeen Western Peripheral Route
DB	Design and Build: small hub projects paid directly by capital grants.
DBFM	Design, Build, Finance and Maintain: revenue funded hub projects
DEL	Department Expenditure Limit
EIB	European Investment Bank
ESA10	European System of Accounts 2010
ESA95	European System of Accounts 1995
FOI	Freedom of Information
GA	Growth Accelerator: see Section 2
HCF	Hub Charitable Foundation: see Section 2
Hub/hubco	A hub company, or hubco, is a partnership between the public and private sectors to deliver new community facilities. Scotland is divided into five hubco areas. The five hubcos are hub South East, hub East Central, hub North, hub West, and hub South West. See Section 2
IRR	Internal Rate of Return
KPI	Key Performance Indicator to be met by Hubs
LIBOR	London Interbank Offered Rate: a key benchmark interest rate.
LIFT	Local Improvement Finance Trust: see Section 2
LLP	Limited Liability Partnership
NDR	Non Domestic Rates
NHT	National Housing Trust: see Section 2
NPD	Non Profit Distributing: see Section 2
ONS	Office of National Statistics
PFI	Private Finance Initiative
PPP	Public Private Partnership
SFT	Scottish Futures Trust
SMEs	Small and Medium Sized Enterprises
SPV	Special Purpose Vehicle: company set up to undertake a PPP.
Tier 1 contractors	Main Building Contractors and facility management providers of Hubs
Tier 2 contractors	firms specialising in design and consultancy in Hub projects
Tier 3 contractors	potential sub contractors for Hub contracts, managed by Tier 1 contractors
TIF	Tax Incremental Funding: see Section 2
TPA	Territory Partnership Agreement, under which hubcos are established: see Section 2
WGA	Whole of Government Accounts