Caledonian Trust PLC

(The "Company" or the "Group")

Audited Results for the year ended 30 June 2013

Caledonian Trust PLC, the Edinburgh-based property investment holding and development company, announces its audited results for the year ended 30 June 2013.

Chairman's Statement

Introduction

The Group made a pre-tax loss of £62,000 in the year to 30 June 2013, a large reduction from the £1,424,000 loss last year. The loss per share was 0.52p and the NAV per share was 145.8p compared with 11.98p and 145.6p respectively last year.

Income from rent and service charges was £334,000 compared with £371,000 last year. Rental income was reduced due to the sale of certain investment properties last year. There were no further sales of investment properties this year. Other operating income was £120,000 compared with £85,000 last year. Administrative expenses were £726,000 compared with £821,000 last year. Net interest payable was £97,000, a decrease of £65,000, due to lower debt.

Review of Activities

The Group is changing mode. While the Group continues to invest in enhancing the value of its properties by working towards or gaining valuable planning consents and by expanding or improving existing consents, equal emphasis is now being given to development, including development to secure existing planning consents, and to the provision of infrastructure for and the marketing of development plots.

We started realising our investment portfolio in 2005, two years before the investment property peak in 2007, completing the sales of all the remaining large investments without development potential when specific opportunities arose or the property "matured". We are retaining two small, high-yielding retail investments.

St Margaret's House, London Road, a 92,000ft² 1970s multi-storey office building on the A1 about one mile east of the Parliament and Princes Street, is our largest individual property. Since November 2010 it has been let at a very modest rent to a charity, The Edinburgh Palette, who have reconfigured and sub-let all the space to over 250 "artists" and "artisans" and "galleries". Tenant turnover is minimal and there is a lengthy "waiting list". 120 of the 168 parking spaces are let to our neighbours, the Registers of Scotland, on a short-term lease. Thus we hold the building at no cost and are gaining small annual rent increases while we await redevelopment opportunities.

In July 2007 our architects produced Draft Development Proposals and then, at the City of Edinburgh Council's suggestion, a Development Brief for the triangle covering St Margaret's House, the adjacent 120,000ft² Meadowbank House, owned and occupied by the Registers of Scotland, and the various small properties lying between the A1 and "Smokey Brae". After many months of consultation and negotiation it was adopted by the Council in August 2009, as a Master Plan for the whole area. In July 2009 we lodged an application for Planning Consent in Principle for a 231,000ft² mixed-use development of residential and/or student accommodation, an hotel, offices and other commercial space together with parking for 225 cars for which consent was issued in September 2011.

The consented proposal allows for a street frontage to London Road (A1) and direct vehicular access from it and an "at grade" pedestrian plaza which will transform the area where the street frontage has been recently improved by a modern multi-storey glass extension to Meadowbank House which replaces the previous drawbridge walkway and links Meadowbank House directly to the street, providing it with a positive "edge". Amongst other possible uses, the 231,000ft^2 consent would be eminently suitable for any centralisation of Government offices or for the expected needs of Government following further "devolution" or possible independence, or for a very large-scale relocation of "back offices" from London.

We are considering a wide range of development options for the site. If the existing building were retained, at least initially, a series of smaller developments, each of 40,000ft^2 to 60,000ft^2, could be built as pods. Similarly a draft proposal for an hotel occupying the higher westerly "tower" with views to the Castle, Arthur's Seat, the City and the Forth estuary has been considered. A part of the site has also been assessed for social housing to be occupied at the "higher market rent level" – about 80% of open-market rents – with a long-term option to sell off individual flats at open market prices. Provision of student housing has also been considered but as the supply will increase soon, due to current and proposed developments, that market appears less attractive at present.

We continue to receive unsolicited approaches for St Margaret's, most recently for the development of a very large, residential investment of the type becoming increasingly popular in the South East. More mainstream approaches have been for an hotel development or for private residential development, mostly for first-time flats. St Margaret's value is very sensitive to changes in house prices to which it is exceptionally highly geared.

Each marginal increase in residential value in real terms *ceteris paribus*, increases the combined residual value and development profit, markedly: a 10% increase increases it by over £4.0m. An increase in house prices of at least this order in the next five years is highly probable, as discussed below. This ugly duckling will indeed metamorphose into a lovely swan.

In 2007 we delayed the development of our three sites in or near Edinburgh because of worsening economic conditions. Last year I said: "there is a tangible risk of a further fall in house prices. In these circumstances a large development of a block of flats or a number of houses requiring heavy infrastructure investment would result in an illiquid investment with very limited or nil profit margin: accordingly, we continue to delay any major investment but to start, or prepare to start, on small, low-investment, low-infrastructure projects" and so it has proved. The residential market is reviewed below under "Property Prospects", but the performance of the local market can be fairly described as neutral over the year but improving now, possibly rapidly. For the City of Edinburgh the Registers of Scotland report a fall of 2.5% compared with September 2012, but a rise of 4.6% in the quarter to September 2013.

In the autumn of 2012 we started the extensive alterations to three listed Georgian stone-built cottages at Brunstane Home Farm together with the infrastructure necessary for the next stages of the development. In addition to the cottages we own a large listed steading and some two acres of land. The property is in east Edinburgh and is in the Green Belt, but just off the A1 and lies immediately adjacent to Brunstane railway station with services to Edinburgh (7 minutes) and north over the Forth Bridge to Fife. The route south is currently being constructed and the Borders Railway to Tweedbank is due to open in 2015. The refurbishment was lengthy but required little investment and the first of the two-bedroom 800ft^2 two-storey cottages sold recently for nearly £250,000. The other two cottages are now being marketed. In June 2013 we obtained vacant possession of a further similar cottage for which the services and infrastructure are in place and the common repairs already completed under the refurbishment programme and this further cottage is now being similarly refurbished for sale in the spring.

We hold a consent obtained in October 2012 to convert the listed stone-faced Georgian steading, to reconstruct a cottage attached to it and to form ten houses of various sizes over 14,648ft^2 altogether. These houses have recently been extensively redesigned, principally to provide contemporary-style large dining/living spaces, more en-suite bathrooms and better fenestration, together with lower construction costs! East of the main steading lies a detached stone building with consent for conversion and extension to a detached farmhouse extending to 3,226ft². This house sits on open ground with views north to the Forth estuary and south to the Pentland Hills.

Work has started recently on the next phase of five houses, the "Horse Mill", which comprises the five stone-arched cart sheds, a single-storey cottage, the main barn and an hexagonal Horse Mill, a notable feature. A further five houses are proposed in the balance of the farmyard and the "Stackyard". The farmhouse sits in a private garden beyond these houses. Next to the farmhouse we hold a further two-acre site, currently in the Green Belt, but, anomalously, lying between the farmhouse and a large area of ground recently abstracted from the Green Belt for housing.

Last year we implemented a consent for eight detached houses in Wallyford, Musselburgh, at a site which is within 400m of the East Coast mainline station and near the A1/A720 City Bypass junctions. It is contiguous with a larger recently-completed development of 250 houses by two national house builders and Taylor Wimpey are building over 400 houses nearby, but on the other side of the mainline railway, which are selling rapidly at prices that have recently risen to above £200/ft². The market for smaller houses there has improved relative to larger houses, therefore we have obtained consent to replace the two largest detached houses with a terrace of four, providing ten houses with a larger saleable area of 12,496ft². The environment at Wallyford, formerly a mining village, but well located on the fertile East Lothian coastal strip, continues to improve as a result of recent and current developments. Provided the recent improvement in the market is maintained we will restart the development in the spring by building on the existing foundations to provide a furnished showhouse.

The third of our delayed sites near Edinburgh is in Belford Road, Edinburgh, a quiet cul-de-sac less than 500m from Charlotte Square and the west end of Princes Street, where we have a long-standing office consent for 22,500ft² and fourteen cars where, by commencing construction, the consent has been taken up. We also hold a planning consent for a residential development of twenty flats, over 21,000 ft² plus car parking for twenty cars which we expect to take up shortly.

The present residential design is far from maximising the development value of the site, as it requires extensive excavation of the bedrock and consequent support for the neighbouring structures. The marginal cost of such work increases much more rapidly than the marginal revenue and once the easily excavated areas are extended into the bedrock, the increased marginal costs quickly outweigh the marginal revenues. Moreover, the present design cannot accommodate a variation of the floorplate to reduce excavation without a substantial reduction in marginal revenue with little reduction in cost. Fortunately we think that it should be possible to redesign and to re-engineer the scheme eliminating the areas where the cost of provision of space exceeds this value and simplifying construction, and, possibly adding small areas of high value at a low marginal cost.

The Company has three large development sites in the Edinburgh and Glasgow catchment areas. Two of these sites are at Cockburnspath, Scottish Borders, on the A1 just east of Dunbar and on the East Lothian Border, where we have implemented the planning consent on both the 45 house plot northerly site and on the 28 house plot southerly site. Prices of detached houses in East Lothian rose by 8.8% in the quarter to September 2013, a sharp rise within an annual fall of 3.4%.

The third large development site is seven miles from central Glasgow at Gartshore, Kirkintilloch, on the Union Canal, and comprises the nucleus of the large estate owned until recently by the Whitelaw family. It includes 120 acres of farmland, 80 acres of policies and tree-lined parks, a designed landscape, with a magnificent Georgian *pigeonnier*, an ornate 15,000ft² Victorian stable block, cottages and other buildings and a huge walled garden. Gartshore is near Glasgow, two miles from the M73/M80 junction, seven miles from the M8 (via the M73) and three miles from two Glasgow/Edinburgh mainline stations and from Greenfaulds, a Glasgow commuter station. Gartshore's central location, its historic setting and its inherent amenity identify it as a natural site for development. To make the best use of these attributes proposals have been prepared for a village of a few hundred mixed cottages and houses together with local amenities, all within the existing landscaped setting. Such a development would complement our current proposals of a high-quality landscaped business park, including an hotel and a destination leisure centre. Discussions with and representations to East Dunbartonshire Council on the Local Plan currently being prepared on appropriate uses continue and we are seeking Council support for a joint promotion of the site.

The company owns fourteen separate rural development opportunities, nine in Perthshire, three in Fife and two in Argyll and Bute, all set in areas of high amenity. Such small developments are outwith major housing allocations and local authorities tend not to give them high priority. Being located in attractive areas, they are subject to objection to which members, now elected by proportional representation are increasingly sensitive, as council seats are less secure. Thus, gaining planning consent for such developments has become increasingly more difficult, requiring in some cases the scale of development to be restricted. Fortunately, the more supply is reduced, the more valuable the consent becomes. Notwithstanding these difficulties, we continue to promote sites successfully through the planning process and to gain new or improved consents.

In Perthshire, at Tomperran, a 30 acre smallholding in Comrie on the River Earn, we hold a consent for twelve detached houses over 19,206ft². Approximately two acres of Tomperran, adjacent to the settlement currently zoned for industrial use, has been promoted for a housing allocation, and, as the recent Local Plan has deleted the industrial zoning, and, as it is within the settlement boundary, we expect to gain consent for housing. Such a consent will allow an improved layout for the existing consent with a spine road serving high-quality detached houses. A further larger area was promoted for housing but the Local Plan allocated an infill area elsewhere. However, when the consent recently obtained is developed, the prospects for this larger area will be greatly enhanced.

At Chance Inn we hold a consent for ten houses over 21,836ft² in the farm steading and an improved consent was granted in October 2012 to increase the size of the consented detached houses adjacent to the nearby modern farmhouse from 3,366ft² to 4,118ft². In July 2010 approval was gained to convert the integral garage of the farmhouse into a semi-self-contained "guest suite" and to upgrade the house, including adding an en-suite bathroom. The upgraded house has been sold and the sale completed in November. The house plots will be formally marketed in the spring once improved infrastructure has been installed.

Nearby at Carnbo the recently-published Local Plan retained the paddock of the former Carnbo farmhouse in the village settlement. In consequence we gained consent on 30 June 2013 for a development of four houses over 7,900ft². Our first planning application for this site was registered by the planning authority on 26 June 2008, more than five years ago!

At Strathtay we gained consents in 2011 for two large detached houses totalling over 6,040ft² and for a mansion house, two ancillary dwellings and a service block in a secluded garden and paddock near the River Tay. We have delayed formal marketing of the sites due to poor market conditions. The Local Plan contains proposals which may permit some beneficial adjustments to the layouts.

At Myreside Farm, in the Carse of Gowrie between Perth and Dundee, we have made two unsuccessful applications. Using further guidance from the planning department we submitted new proposals for one new "farmhouse" and four houses on the site of the existing buildings over 8531ft² which has just been approved. Our first application on this site was made in 2007.

In Fife we have attractive rural sites near St Andrews. At Larennie, adjacent to the Michelin-starred Peat Inn, five miles from St Andrews, a consent was gained in April 2011 to renovate and extend an existing stone-built cottage, to convert stone buildings to four houses and to build four new houses over 19,325ft² for the nine dwellings. Due to poor market conditions development has been delayed but may start in the summer. At Frithfield, six miles from St Andrews, a site with stunning views south to the Forth estuary, we have plans for twelve houses over 20,326ft² and are progressively surmounting the technical requirements of a successful application.

Our largest rural development site is at Ardpatrick, a peninsula of great natural beauty on West Loch Tarbert, but within two hours' drive from Glasgow and the Central Belt. At Ardpatrick the prospects for residential property are extremely good but their realisation requires very considerable further inputs of money, time and skill. Restoration is the key to the reinstatement of the full attraction of Ardpatrick which continues to be masked by previous spectacular neglect. Fortunately the high quality of much of both the original Georgian and later Victorian construction and design remains intact or recoverable permitting restoration and repair wherever practicable. Progress has been appreciably slowed by essential repairs to Ardpatrick's buildings, farm sheds and landscape after two exceptional storms on 3 January 2012 and 24 March 2013 causing over £150,000 of mostly insured damage. On 3 January 2012 over thirty trees were blown over causing extensive damage. Prudence and insurance requirements will entail the felling of others to reduce risk.

The development framework at Ardpatrick was changed by the 2009 North Kintyre Landscape Capacity Study. Earlier a consent was gained at South Lodge to double the size of the dwelling and to add a large garage and following restoration it is now being marketed and, provided markets improve, I expect it to be sold in summer 2014. Before 2009 we also gained consent to change the use of "Keepers", a bothy situated among the Achadh-Chaorann group of cottages, and to extend the building to form a three-bedroom house conditional on providing a new access and drive. Consent has recently been granted for an enhanced design and this property is also being marketed with a sale expected next year.

There are a number of practicable development opportunities within the areas designated in the Landscape Capacity Study. In 2011 we secured consent for a 1,670ft² house and double garage on the Shore Road, south west of South Lodge, and consent for two one-and-a-half storey houses of 2,200ft² each at the north end of the estate on the B8024 Kilberry Road. Nearby on the UC33 Ardpatrick Road we have outline consent for a detached house in a woodland setting and are applying for a further two houses on the east side of the road bordering the Cuildrynoch Burn.

Unfortunately other potential new sites and many of the conversion sites are commercially difficult to realise. Current market conditions continue to be unhelpful but major continuing constraints are the high cost of conversion and the overall cost of upgrading the inadequate infrastructure, partially due to the required enhancement of the public and infrastructural services.

Economic Prospects

"The future has changed" … a phrase allegedly used by Willie Whitelaw, Baroness Thatcher's deputy, illogically but incisively describes the prospects for the UK economy. More prosaically, the Bank says : "The economy is growing robustly as lifting uncertainty and thawing credit conditions start to unlock pent-up demand". The earliest comparison of forecasts for the UK economy for 2013 published by HM Treasury in February 2012 was for growth of 1.8% in 2013, but this fell steadily throughout 2012 to 1.1% in December 2012 and to 0.9% in February 2013. The FT summary of 94 economists in January 2013 reported: "Nearly half the respondents to the FT annual survey of economists do not think a sustained economic recovery will take hold this year …" These forecasts followed a fall of 0.3% in GNP in Q4 2012 and poor growth or even a return to recession was widely predicted for Q1 2013. Contrary to such expectations, the economy grew by 0.3% in Q1 and this improved performance was extended in Q2 when the economy grew by a further 0.7%, achieving in six months the growth until then expected for the full year, and moving, as the Chancellor of the Exchequer says, " from rescue to recovery".

The cause of the unexpected upturn was considered by most economists to be that "confidence had improved among households and companies", an explanation that begs the question why such an improvement had taken place. The "rebalancing" of the economy, the Government's preferred strategy towards higher exports and investments, has played no part in the improvement; as business investment dropped 2.7% over the period and the current account deficit is virtually unchanged. The NEISR argues that "Plan'A" has been modified, reducing the contractionary effects of fiscal tightening, but measurements of this variable are subject to arbitrary assessment of the economic cycle. In 2012 exceptional contraction took place in construction and in oil output and a restoration/rebound to a normal but still depressed level would add to output. A more likely cause of growth is the economic boost following a rise in the demand for houses caused partially by an increase in perceived job security and by the Government's Funding for Lending scheme. Increased demand has increased/raised prices in England apart from the South West and especially in London and the South East. Increasing house prices reinforces demand for them but also increases demand generally due to the accompanying "wealth" effect. The besieged economy was relieved by an expeditionary force it did not detect.

That this relieving force was strongly reinforced is demonstrated by the further high 0.8% economic growth in Q3. As in Q2, no "rebalancing" of the economy took place – indeed business investment dropped by 2.7% and was 8.5% less than a year earlier, although infrastructure and house building boosted overall investment by 0.8%. Unfortunately the Government's desired business investment is a "will-o'-the-wisp". Not only is it subject to greater revision than most official figures, but it also changes anomalously, or so it appears retrospectively, as demonstrated in the 2000s. The new millennium years until, say 2008, the year the US administration so foolishly allowed Lehman to fail, might normally be expected to be boom business investment times, but, curiously, proved not to be so. Investment rose a meagre 1.4% in 2000, but fell, by 8% in total, over the next four years before bursting upwards in 2005 by 14.9% before again falling by 14.4% in 2006. Timing is everything: in 2007, just before the recession, investment rose again by 13.7% and even rose by 4% in 2008.

Business investment may be a lag indicator of changes in economic growth rather than a lead indicator as considered by Government.

All sections of the economy, Industry, Agriculture, Construction and Services grew in Q3, but construction at an annual rate of 10.6% and private services, representing nearly three quarters of economic output, by 3.6% constituted the majority of that growth. The recovery in the economy is evidenced by many and varied indicators, such as rising housing transactions, higher spending on durable and semi-durable goods and PMI indicators in retail and most other sectors and in particular rising house prices. Past episodes of house price rises have been associated with increases in household consumption, but it would be improper to posit that such indicators were causative rather than indicative as these outcomes may represent responses to a common underlying cause.

The cause of the recovery has a poignant but simple elegance, namely the removal of one of the main conditions prolonging the depression. For several years the economy has been subject to a contractionary fiscal policy (the Government's "Plan A"), fortunately one less rigorously applied recently, while an unprecedented massive expansionary monetary policy was implemented including four and a half years of 0.5% Bank rate, £375bn of quantitative easing, a huge flood of liquidity and the provision of subsidised credit *via* the Funding for Lending scheme. Paul Taylor, the Bank's outgoing deputy governor, describes it – with apologies to the "Plan B" Keynesian school of economists – (favouring an expansion of demand via fiscal relaxation) as the Bank's "Keynesian" monetary stimulus. In consequence credit conditions, at least for householders, have at long last improved very significantly. The B of E's quoted rates on household borrowing show that over the last twelve months unsecured rates fell by one third to 6%, five-year fixed rate mortgages by 1 percentage point to 3.75% and two-year fixed-rate mortgages by 1.5 percentage points to 2.25%. The Bank's Credit Condition Survey reports that over this period falls in "unsecured loan rates have been accompanied by improvements in credit availability and a rise in demand (giving) a strong pickup in unsecured credit, including car finance, over the past year … and the availability of secured credit also increased with significant increases in the demand for lending for house purchasing and re-mortgaging." The increase in mortgages in Q3 compared with 2012 has been significant, as re-mortgaging has increased by 25% to 35,000 per month, mortgage approvals by 25.5% and non-mortgage transactions have doubled.

The effects of cheaper and more available credit on the housing market are widespread and complex. House building starts are up 25% increasing investment in new housing which normally accounts for about 1.5% of GNP. A further 1% of GNP is represented by services associated with house purchases such as fees, commission, marketing and stamp duty. Increased house transactions also increase consumption of durable goods – the "Bank staff estimate that they are two to three times more likely to purchase white goods when they move home"! (A homely touch in a "dryish" Report – a Canadian influence perchance!)

Cheaper credit also benefits re-mortgagers and those coming off older fixed-rate schemes. For a typical loan of just over £100,000 a 1% drop in the mortgage rate increases the average disposable income of, say, £20,000 by an appreciable 5%. Those re-mortgaging will also benefit as older, pricier contracts are replaced. Other "older" mortgages are also being paid off and, if all mortgages were on a 20 year or 25 year repayment basis, then 5% or 4% would be paid off each year. Interestingly, while new mortgages have increased by 25% over the last few months, total mortgage debt outstanding has hardly changed, implying that large numbers of householders have been relieved of mortgage credit charges. Additionally, and separately from the cash boost from being free of credit charges, such householders no longer have to make principal repayments.

Increased and cheaper credit has increased the demand for houses, increasing prices. In the past rising house prices have tended to be correlated with increases in consumption. As shown above increases in house purchases do influence consumption but both increased house demand and household consumption have primary common causes, particularly credit conditions and, to an undeterminable extent, income expectations, including job security, and sentiment. House price rises increase the value of house collateral providing additional loan capacity and reduce the risk of such loans to banks' balance sheets, allowing an expansion in lending. Such expansion could be significant as mortgage debt comprises three quarter of the stock of UK sterling loans to the non-financial private sector.

The Government has sought to expand the economy following the 2008 recession by the most stimulative monetary policy in UK history, while simultaneously implementing a very restrictive fiscal policy. Both these policies effect relatively small changes only on the large economy they seek to influence – the economy behaves like a very large tanker and takes a long time to respond, especially into a strong fiscal head wind! Given these constraints the Bank's monetary policy has not been determinative, only contributory. The main reason for
the limited and delayed response to the expansionary monetary policy is illustrated in the following exchange between Sir Mervyn King and Martin Wolf reported in the FT on 1 June 2013:-

"Martin Wolf: Okay, let's leave aside the fiscal policy issues. Is QE, the form you've adopted it, more or less as you'd have hoped?
Sir Mervyn King: Yes, I've always myself seen this as a way of increasing the broader money supply. And the thing that's so extraordinary is that, for the last few years, the banking system, which is normally responsible for creating 95 per cent of it.
MW: Has been contracting it.
MK: Has been contracting it. So our bit of it, and this is why I say that it's creation of money, which is so important, is basically carried out by private sector institutions, which are not coordinated with each other. And since we only supply about five per cent of it, the percentage increase in our bit has to be massive in order to offset the contraction of the rest.
MW: And it hasn't been enough
MK: Well, the broader point is that monetary policy can and should be expansionary, but there is a limit to how effective monetary policy can be, whether you call it "pushing on a string", whether you call it a limit to how far people are willing to sacrifice future spending in order to boost current spending. But there just have to be limits on it.
MW: When was funding for lending introduced? About a year ago?
MK: It was announced in June last year.
MW: Yes, almost exactly a year ago. Some people think that we should have done more, quote unquote, credit easing, not just straight purchasing of government bonds but direct lending either by the Bank of England or via some other mechanism of this type much sooner. Would that have made much difference?
MK: It's hard to know
MW: Too slow?
MK: No, right from the beginning I said that if other assets should be purchased, and I took no view as to whether they should or should not, then the government should decide on which assets are purchased, and we would finance it. I think that's the right division of labour between central bank and the finance ministry. If you're going to buy real assets out there in the economy, then that is putting taxpayers' money at risk, and every time I've ever suggested putting taxpayers' money at risk, government sent parliamentarians

and the treasury committee who've been absolutely adamant that this is a decision for the Chancellor and not the Bank of England."

Martin Wolf and Sir Mervyn King agreed that the Banking system, responsible for increasing the broader money supply, normally 95% of it, has been contracting it, a contraction that has fallen exclusively on firms, as lending to households has increased although only by only 2% pa to 5% pa since 2009. In contrast, as the Economist puts it, British firms "show signs of credit starvation". Real business lending is now 33% below the 2008 peak having fallen every year since then by 2% to 4% pa, and interest rates, gross of various fees, are high.

In Q2 2013 net lending to SMEs continued to fall by £0.6bn or £3.7bn for the year. The fall occurred in spite of the FLS which incentivises banks to lend to business, but has had only £17.6bn drawn so far out of a total "pot" of £69.8bn. The FT quotes bankers saying "business lending stuff is structural, in the sense that you're still looking at balance sheet adjustment by the banks" and several large banks are trying to reduce their "non-core" loan portfolios. In effect, as the FT reports: "They (banks) are being pressed by the Bank of England to strengthen their capital positions". The explicit overall monetary policy defies coherent explanation as its broader aspects are notably inconsistent, if not mutually exclusive. One policy is to maintain credit flows to the economy but another policy requires the banks to lower their loan to equity ratios, or, given the difficulty in increasing equity, effectively means lower the loans or reduce credit flows to the economy! In an attempt to resolve this inconsistency special measures, including FLS and QE have been introduced, although QE may also serve another strategic purpose.

Consumer credit for housing has expanded recently, largely due to successful government initiatives, but evidence of the benefit of QE is less tangible. QE was introduced in the UK in January 2009, at the same time as the US introduced a similar policy, policies previously unused in the West, although Japan introduced this technique in the 1990s. QE increases credit, reduces credit costs and stimulates demand, a strategy similar to reducing Base Rate and has been introduced when Base Rate as a policy tool has already been exhausted, normally considered to be when Base Rate is just positive. However, its effectiveness for these specified purposes is unclear, although the B of E report that the £200bn of QE purchases in 2009 "helped" to increase UK output by 1.5% to 2.0% and that it had been "economically significant".

However, QE had other effects and, as a (small) number of conspiracy theorists contend, purposes resulting from its "mechanics". QE does not "print money" insofar as the Bank does not finance the Government deficit directly by buying its bonds from the Government incidentally disallowed under the Maastricht Treaty. In QE the Bank buys back from the private sector – primarily insurance companies, pension funds and, particularly, the High Street banks. Whether by design – the conspiracy theory - or good fortune, QE has been very helpful to the banks. Bond prices have risen and profits and capital ratios have improved. The cash from bond sales is deposited at the central bank improving the banks' capital ratios without issuing expensive new equity, possibly obtainable only from the Government and delevering the banks' balance sheets. Thus QE effects "backdoor bank recapitalisation" as described by a contributor to the FT. QE may have assisted the economy directly, both by promoting the expansion of credit, its averred purpose, and indirectly by mitigating against a deeper credit-led depression.

Fortunately, at last the depression is lifting, as 0.8% growth in Q3 GDP has been confirmed, giving 1.91% for the first three quarters of 2013, or 2.5% annualised, nearly as high as the growth rate obtaining shortly before the 2008 recession and constituting, in the words of the Bank, a "sustained recovery" which it expects to continue in Q4 with a further 0.9% rise in GNP.

This "sustained recovery" should be viewed with relief, relief that a patient suffering from a long depressive illness has regained, or appears to have regained, normality. What is not clear from his symptoms is why the apparent recovery took so long, what damage may have been incurred and what is the probability of its recurrence. The economy is now growing at a "normal" pace, but it has not recovered its pre-recession peak attained in January 2008. At the end of November the NIESR estimated that, while the current level of GNP is 5.6% above the trough of the 2008-9 recession, it is still 2.3% below the January 2008 peak. Recovery to the pre-recession level is not forecast until 2015. The depression has already lasted 70 months and by November 2014 it will have lasted nearly seven years; three years longer than the Great Depression of 1930-34. Of the six depressions since 1900, four lasted about four years and the very shallow 1990-1993 depression only two-and-a-half years, marking the current depression as exceptionally long. The deepest "recent" recession followed WW1 when a fall of nearly 10% occurred.

The length of this depression has resulted in an exceptionally large "opportunity" cost to the whole economy. Prior to the depression, in the period 1980 to 2007 the UK economy expanded by about 3% pa compound and had this trend continued real GDP would now be 19% greater. The continuing depression may have wrought enormous disguised damage to the economy. Fortunately, an expected manifestation of a depression, very high unemployment, has been absent, as unemployment of about 7.5% is about half the level expected if the growth in productivity had been maintained at the level obtaining before the depression. Unemployment has remained so unusually low because productivity has fallen back to 2005 levels, labour has been hoarded or gone part-time and a great deal is probably disguised by early retirement, aversion to registration as unemployed and "self-employment". That the "misery" has been widely spread and that extremes of social hardship and of political unrest have been obviated, while welcome, does not diminish the loss, but only spreads it out. The Q2 output loss, compared with 2008, was 3.2% resulted in real earnings falling 9% to 2004 levels and in real wages in 2013 being £1,500 lower than in 2010. The slow UK growth in GDP since the 2008 recession contrasts with faster growth in the US where the economy recovered to the pre-recession level in 2010 and has expanded since by a further 6.0%.

The relative poor performance of the UK economy has many causes. The US authorities acted more quickly, more widely and more rigorously than the UK's. At the beginning of the downturn the Bank was still concerned about "moral hazard," akin to pondering whether arson was involved rather than putting out the fire, and, just as growth started to collapse in late 2007, raised the Base Rate to 5.75%, not bringing it down decisively until late autumn 2008 by which time GNP had already shrunk 2.7%. However, a mitigating factor for the UK is its much closer ties to the troubled Eurozone. Additionally, UK fiscal and monetary policies had inherent contradictions. Tightening fiscal policy for budgetary purposes inevitably reduced demand in the economy. An expansionary monetary policy, used to provide cheaper and more available credit and so promote demand, has proved ineffective in stimulating demand sufficiently in spite of the Base Rate being at its lowest rate in the Bank's history since March 2009 and a vast supply of money being provided via QE. However, the Bank's influence on the overall availability of credit is constrained, as the vast majority of credit creation is controlled by the commercial banks who had a primary interest, largely to meet regulators' requirements, to reduce lending, as has been coherently documented in Sir Andrew Large's report on RBS. Moreover, the Bank's QE programme provided only a very partial solution to this problem as it was targeted at Bonds only and, unlike the US Federal Bank, did not include a range of commercial securities. Successive exhortations and Bank schemes, such as Merlin and FLS, were all enthusiastically embraced, but never seemed to deliver on their promises, possibly because, as the conspiracy theorists would say, there was never any intention to do so, or at least not until later …… when the other "problems" (with some commercial banks) were fixed.

The credit position represented a less severe iteration of that occurring in the Great Depression when, as long ago as 1931, it was described by D M Frederiksen in the Harvard Business Review:-

> "We see money accumulating at the centers, with difficulty of finding safe investment for it; interest rates dropping down lower than ever before; money available in great plenty for things that are obviously safe, but not available at all for things that are in fact safe, and which under normal conditions would be entirely safe (and there are a great many such), but which are now viewed with suspicion by lenders .".

Quoting this article, Ben Bernanke, the Governor of the Fed said in 1983: "As this quote suggests, the idea that the low yields on Treasury or blue-chip corporation liabilities during this time signalled a general state of "easy money" is mistaken; money was easy for a few safe borrowers, but difficult for everyone else." A sentiment presaged in 1932 by a complainant writing in the American Banker:

> "The chief criticism of our present system appears to be that in good times credit is expanded to great extremes … but, when the pinch of hard times is first being felt, credit is suddenly

> and drastically restricted by the banks … At the present time, loans are only being made when the banks have a very wide margin of security and every effort is being made to collect outstanding loans. All our banks are reaching out in an endeavor to liquefy their assets."

A similar situation has occurred in the UK since the recession. The monetary policy operated by the Bank did not supply sufficient credit to those areas that would have facilitated a revival of normal economic growth. The Government did not force policies either on the commercial banks or on the Bank that would have eased the supply of credit. While the Government exhorted the banks to ease credit conditions, they also required them to accept higher credit ratios and much stricter regulation in areas that precluded the flow of credit to many sectors of the economy, inevitably those who needed it most. It is almost certain that the QE programme had the approval of Government and probable that one of its main but undisclosed objectives was the safeguarding of the banking system, an entirely proper objective. Notably the Government did not use its effective control of the two largest clearing banks to require them to modify policy.

More importantly, it did not use its powers to alter the Bank's mandate to allow the Bank to make other interventions in the money market that would have eased the flow of credit. Unlike the Bank, the Fed in the US has had and continues to have a large programme of purchasing commercial securities, so providing more direct support to the commercial credit market.

The Government reportedly directly opposed such a wider remit for the Bank. Certainly at his meeting with Martin Wolf on 1 June 2013, the Governor said: "No, right from the beginning I said that if other assets should be purchased, and I took no view as to whether they should or should not, then the government should decide on which assets are purchased, and we would finance it. I think that's the right division of labour between central bank and the finance ministry. If you're going to buy real assets out there in the economy, then that is putting taxpayers' money at risk, and every time I've ever suggested putting taxpayers' money at risk, government sent

parliamentarians and the treasury committee who've been absolutely adamant that this is a decision for the Chancellor and not the Bank of England."

The stimulus to the economy from monetary policy was restricted as interest rates had been reduced to the effective minimum, the commercial banks were reducing credit rapidly, QE was partially diverted to support the financial sector and the Government would not support other unconventional types of Bank support. Monetary policy, although suboptimal, did provide considerable support for the economy, but previously insufficient to counteract the effects on the economy of the fiscal contractionary policy, the so-called "Plan A", or its recent much less restrictive guise termed by Martin Wolf "Plan A minus"!. Supporters of "Plan A" hailed the recent economic upturn as its vindication, but others, including Paul Krugman, the Nobel prize-winning economist who predicted the financial crisis, said in a Radio 4 interview, colourfully: "Saying our policies are a success because we've had a little bit of growth but I just think, you know, you have been destroying the economy and now you have sort of let up and" [because] "the economy has partially regained a little bit of the ground you took away from it by the austerity policies and you are calling the policy a success. It's crazy stuff. It's like, if I keep on hitting myself on the head with a baseball bat and then I stop hitting myself on the head with a baseball bat, I start to feel better and I say: See – hitting myself on the head with a baseball bat was a successful policy. So it's nuts – they really have done a lot of damage and thereto there is a lot of reason to believe that, if not just in the short run, they will have damaged the productive capacity of Britain for a long time to come". In essence the recovery is held to be in spite of, not because of fiscal tightening!

Support for such "expansionary austerity" has a distinguished lineage and was vehemently advocated by Andrew Mellon, the US Treasury Secretary at the start of the Great Depression: "Liquidate labour, liquidate stocks, liquidate farmers, liquidate real estate". Mellon continued "It will purge the rottenness out of the system … people will work harder, live a more moral life"! The long-delayed economic recovery after the "New Deal" reversed all such contractionary programmes and, as Keynes said in 1937: "The boom, not the slump, is the right time for austerity at the Treasury". The policy finds its clearest expression in the German economic thinking as exemplified by German Finance Minister Wolfgang Schäuble's synopsis: "Austerity is the only cure for the Eurozone". The contemporary theoretical basis for "expansionary austerity" is associated with the University of Chicago, but has been criticised by Alan Taylor as the sampling system on which it is based bypasses a fundamental statistical principle. Since this statistical technique was first established in early medical science, the debate on "expansionary austerity" is rich in medical metaphors. Martin Wolf observes that: "The idea that treatment is right irrespective of what happens to the patient falls into the realm of witch-doctoring, not science"; Martin Taylor, former head of Barclays, comments that: "Countries are being enrolled, like it or not, in the economic equivalent of clinical trials"; and Paul Krugman colourfully compared it with "economic blood-letting".

The first "proper" statistically-valid medical trial is considered to have been undertaken in 1809 on a battlefield in Portugal by a Scottish surgeon who tested the effectiveness of blood-letting. To do this he divided the population of 366 soldiers, previously allocated for such treatment, into treatment and non-treatment (or control) groups by alternation – one in, one out, one in, etc – ie randomly. The alleged cure of blood-letting was shown to be bogus, or at least for the conditions tested! That blood-letting was the most common medical practice performed by physicians from antiquity until the 19th century is explicable in the context of contemporary technology and knowledge and, more importantly, by the contemporary culture which favoured authority, including revelation, over observation, testing and measuring. What is surprising is, given all the changes that had taken place since the early 19th century, which have enabled the scientific and technological revolutions to take place, that blood-letting persisted into the 20th century and was even recommended by Sir William Osler in the 1923 edition of Principles and Practices of Medicine. Indeed, in the mid-19th century sophistication prevailed and, rather than cutting the patient open with knives, incidently a practice publicised by the red and white stripe of the barber's pole, the red being the blood, the white the tourniquet and the pole the stick squeezed by the patient to dilate his veins, a scarificator, a brass armlet with spring-loaded enclosed blades was used. Alternatively, to avoid spilling blood, leeches, fifty at a time, were used to gorge on the blood!

The implementation of practices shown to be at best ineffective and at worst dangerous is by no means restricted to medicine. Based on appropriate statistical methods Taylor has shown that without the extreme "economic austerity" measures of "Plan A", GDP would now be about 3.0% higher. The recent recovery in the UK economy has taken most forecasters by surprise. In February 2012 the HM Treasury consensus forecast was for 1.8% growth in 2013 but this dropped to 1.0% in January 2013, while the OBR December 2012 forecast was for
1.2%. Clearly 2013 growth will be much higher as in the first three quarters it is already 1.9% and, if the average growth of the last nine months is maintained it will expand by 2.5% for the whole year. Interestingly, as recently as October 2013, none of the 35 forecasters submitting forecasts for HM Treasury forecast growth above 1.5%!

While the upturn is a surprise its strength should not be, as crises are normally followed by bouts of rapid catch-up growth – as the FT says: "The UK should be sprinting, not just jogging". Following the 1979 – 1983 recession the economy regained its previous level in Q1 1983 after which it grew rapidly, averaging 4.3% for five years. In the 1990-93 recession the economy gained its pre-recession level in Q1 1993 after which it grew by 3.6% on average for five years. Quarterly annualised growth is now at 3.2% pa which, if continued, would complete a recovery in mid-2014, when, on previous patterns, much higher growth would be expected: "sprinting", as the FT describes it. The recent good growth figures have been reinforced by the rise in the Manufacturers PMI Index to 58.4 in November 2013, the highest since February 2011 while the Index for new orders rose to 64.6 from 61.3, its highest for three years and the employment index rose to 54.5 from 51.9 in October. Current data support the MPC's comment that the UK is in a "sustained recovery".

In this economic cycle the "saviour" of the downturn may be the saboteur of the upturn. A recession of the recent magnitude followed by such a lengthy depression would normally result in 15% or more unemployment levels rather than the current 7.6%. The employment saviour has been lower productivity, which in the private sector has fallen for five consecutive years for the first time since the late 1880s except following the two world wars. In Q2 2013 output per hour and output per worker were almost 5% below their pre-crisis peak and output per worker was 17% below the 1987-2007 trend. Moreover, such deterioration is unusual in other countries in the depression, as output per employee rose by 11% in Spain, 5.6% in the US and by small amounts in Canada, Japan and France although it fell by 0.7% in Germany. If output per employee stays at current levels then, as the economy grows, unemployment will drop quickly and threaten to cause rising inflation so triggering, via the Canadian knockout clause, a rise in interest rates choking off the incipient recovery. The likelihood of such an outcome depends on the causes of the low productivity, as some such causes may automatically be eliminated as output rises.

A supply shock would be the most damaging cause of low productivity. This would have occurred if the long downturn had eliminated key producers, suppliers or manufacturers, important on their own or in a chain, or lost unique specialist skills or techniques which, having been lost, in an upturn created bottlenecks, delays or increased supply costs. The skills, abilities and techniques aggregated in firms are sometimes impossible to re-assemble. Low productivity may be due to substitution of cheaper labour for capital and to labour hoarding. Real weekly earnings have fallen by 10% over the last five years , which lends support to substitution, but labour hoarding - after such a severe recession and long depression – seems unlikely. Shortage of credit may have inhibited both the growth of new high productivity business and to have precluded the normal progressive substitution of capital for labour. There are two other more technical possible causes of low productivity: the composition of overall output may have changed with high productivity output disproportionately reduced; and unrecorded output in intangible assets. These two causes seem of less consequence as the composition may revert with recovery and, although output may be unrecorded, it is still present!

Future economic policy will be dictated by the extent to which the drop in productivity truly represents a supply shrinkage, hence an inflation-producing output constraint, or any combination of the other factors enumerated above. Had growth continued at the pre-2008 rate the productive capacity of the economy would be 18% greater than current output. Thus there should be enormous unused capacity or potential increased capacity into which the economy could grow. However, if the capacity has been destroyed, then the potential level at which it can operate without creating inflation has been reduced. If the current expansion continues against a background of excess capacity then inflationary signs, including a large drop in unemployment, will not require restrictive policies and such an expansion, using up spare capacity without creating inflation, would be a veritable "goldilocks" outcome for the administration. However, on historical precedent it seems more likely that expansion will either disappoint or surge, and, at the present stage in the political calendar, it is not difficult to predict which outcome the administration would favour. Fortunately, the MPC is optimistic saying: "Productivity will pick up as demand recovers, slowing the speed at which unemployment falls"; and "A sustained period of strong growth is likely to be needed before slack is materially eroded".

The MPC's central projection of GDP growth over the next three years is about 2½% - 3%. However, wisely, they say: "The external environment continues to pose the greatest threat to the recovery; in particular, the necessary adjustments to indebtedness and competitiveness within the euro area may yet prove to be a much greater drag on growth" and the Committee's fan charts exclude outturns related to "disorderly Euro-area adjustment". The exclusion of such extreme events both greatly simplifies and narrows the projections, but at the cost of relevance as a very small chance of a disaster is likely to be of greater importance than a large percentage change in the central projection. Many of the contributing causes to the 2008 recession were evaluated at too low a probability, using standard statistical distributions for probabilities that did not actually follow the patterns they were assumed to: the black swans and fat tails as they are colloquially known. Mathematical models follow mathematical rules to represent reality, they are not reality.

The MPC assumes that future oil prices will follow the Brent futures price and fall from $110 to $100 in 2015. The EIU Global Forecasting Service forecasts a fall in Brent prices of about 4.5% by 2017 with similar falls in each of the two following years, but state there is a "moderate probability" that oil prices could be considerably lower. Forecasting oil prices is inherently very uncertain as the price depends on a complex and constantly shifting mix of political, social, technical and economic factors: it has claimed many scalps in the past. In 2012$ the 1860s US "average" crude oil prices were over $100 ($8 then) but fell to $15 to $35 until the 1930s when they rose to between $10 and $20 until, following the Yom Kippur War in 1973, they jumped to about $50 and then rose again following the Iranian revolution in 1979 to over $100 (briefly) – back to the 1860s – before falling generally to some $20 to $30 in the 1990s before reverting to around $100 since 2010. The price variation in the 1990s was particularly marked. Towards the end of 1996 the price of Brent crude was $25 with low stocks and supply and demand evenly balanced, but, as Iraqi exports recommenced and there was a mild Northern Hemisphere winter, the price dropped to $18 in April 1997. In November 1997 OPEC raised production just as the Asian financial crisis broke and the price collapsed to $12. An eminent FT columnist headed his column "Opec's last stand" and the Economist carried an article on the marginal cost of Saudi Oil being under $5 per barrel, indicative of prices should the OPEC oil cartel collapse. These are treacherous waters to chart.

Georgios Paraskevopoulos b. 1919 the son of a Greek goat herder, who died earlier this year matches George Bernard Shaw's definition of the unreasonable man who: "persists in trying to adapt the world to himself: therefore all progress depends on the unreasonable man". Or, according to the energy historian Daniel Yergin, George Mitchell (his adopted name) " …. changed the game in the face of enormous scepticism". The game change took a long time, was nearly abandoned and nearly broke the participants. It changed when his small oil company, whose reserves at Boonesville Bend were largely depleted, started exploration in 1981 on the deep impermeable Barnett, an established gas reserve which had long defied exploration. Mitchell, a veteran pursuer of lost causes, such as Wildcatters Graveyard – which eventually brought in one of America's largest gas fields – sank almost all the company's resources unsuccessfully into this deep hole. Borne out of financial desperation they replaced conventional expensive gels with "soap and water". Eventually these techniques established "hydraulic fracturing" and by 2000 "shale" gas accounted for 2% of US natural gas supplies which by 2012 had risen to 37%. As a result of vastly increased supplies US natural gas prices have tumbled from over $10 per mBtu in 2008 to $3 to $4 in 2012/13. The technique is used in oil extraction as well as gas.

Fracking is effecting a quantum change in the oil and gas industry. Russia has the largest identified "technically recoverable" reserve of 75bn barrels followed by the US at 58bn, China at 32bn and Argentina and Libya at 26bn each. Even larger reserves await "being proved". In the US one of the oldest and most prolific oil basins is the Permian field in West Texas – J R Ewing country! - which has produced over 21bn barrels of oil since it was first drilled in 1921. It had been declining rapidly since 1973 and when, a few years ago, output and prices slumped further a popular local car bumper sticker read: "Please God, give us another oil boom, we promise not to piss it away this time". Fracking has provided the necessary *deus ex machina,* with Texas's overall production doubling and US onshore oil production rising 50% over the last five years. The Permian field, previously nearing exhaustion after producing 29bn barrels, is now estimated to hold a further 50bn barrels of recoverable oil. The significance of such a reserve is that the Permian field's 50bn barrels represent about twelve years' output by Saudi Arabia or Russia, the world's two largest oil producers: that's a lot for even the Texans to "piss it away this time", but there is a lot more elsewhere, with two even larger shale oil fields: Eagle Field in South Texas and Bakken and Three Forks in North Dakota where each "horizontal well" produces 2.5 to 3.0 times as much as in the Permian, up to 350,000 barrels, costing currently in Bakken $8.6m to drill or $25 per barrel. Due to continuing improvements in drilling technology and economies of scale, costs are expected to continue to decline at rates separately estimated at 2½% and 9% per annum for the next few years.

The hydraulic fracturing technique, originally developed by Mitchell to exploit shale gas reserves in Texas, is revolutionising the oil industry in the US and spreading across the world. The BP review, "Energy in 2012", says: "The most noticeable phenomenon remains the American shale revolution. In 2012 the US recorded the largest oil and natural gas increase in the world and saw the largest gain in oil production in history". The US is already producing more crude than it is importing, whereas in 2002 it was importing 50% more than it was producing. Total oil production is forecast to increase by 6% to 7% this year and for the next few years and thus is expected to become the world's largest oil producer, surpassing Russia and Saudi Arabia. As US consumption has been falling and is now 10% below the 2005 level, world oil trade patterns will change significantly. The increase of supply, largely in the "sweeter" light shale oils (more like Brent than West Texas Intermediate WTI) of higher quality, has coincided with infrastructural improvements in the US, bringing lower cost supplies via improved pipelines and rail links to the Gulf and to the East Coast where it replaces the imported crude supplying Gulf, East Coast and Canadian refining hubs. These refined products, together with other feedstocks, now more cheaply produced, are increasingly being imported into the UK, and, for example, will form the basis for the production changes at Grangemouth.

The oil market is surreal, like "Alice through the Looking Glass". In a competitive market the lowest cost producers would maximise output and higher cost suppliers enter the market as and when the price was commercially attractive. Thus the highest cost producers are the marginal suppliers. In the oil market the mirror image applies as by contractual agreement or convention the lowest cost producers, the OPEC cartel, are the marginal suppliers, led currently by Saudi Arabia whose 2012 output was 11,530 b/d or 13.3% of world production. Interestingly Saudi is reported to have said that it no longer intends to increase its oil capacity beyond its current level of 12,500 b/d before 2040 because of the growth of supplies elsewhere. The increasing supply from fracking coupled with other higher cost sources such as oil sands and artic oil and the increasing competition from gas, where supply is likely to benefit even more from fracking, seem likely to outweigh the continuing but differing supply interruptions as exemplified by the "Arab Spring". Prices will fall from the present $100, but on present technology a limit of $60 to $80 seems likely as that is currently the cost below which most oil from most unconventional sources, including fracking, becomes uneconomic.

The increase in supply from "fracked" shale gas will have far-reaching effects on the gas markets and, by substitution, on the oil and the other primary energy markets. Gas, like oil, is a major energy source, providing 23.9% of the world's primary energy consumption, increasing by 2.2% in 2012, slightly below the historical average growth of 2.7%, while oil provides 33.1% of the world's primary energy consumption, a proportion that has fallen steadily for thirteen consecutive years. Gas differs from oil in not being easily transportable – flaring off the gas by-products of oil production represents an extreme example of the cost of its transport. In 2012 the average price per million Btus in different locations was: Alberta, Canada $2.27; US Henry Hub $2.76; UK $9.46; German imports $11.03 and Japan LNG cif $16.75. The OECD cif price for oil (equivalent to a million Btus) was $18.82. Gas supplies at the Canadian and American production nodes are clearly worth very much less than those at those points of consumption lacking their own supplies.

The UK could receive an exceptional benefit from fracking to supplement its very successful but declining extractive industries. The UK's oil production is diminishing rapidly and in 2012 was only 967,000 b/d compared with 2,495,000 ten years ago. Moreover, the current reserves represent only nine years' supply at 2012 output – the OPEC average is very nearly 90 years! Finds continue to be made and existing reserves extended and production rates fall, all extending the actual life of UK oil production. Unfortunately, unlike the US, there is apparently no shale oil in the UK, an assertion that many readers may contest, especially those familiar with the vast "shale bings" despoiling the West Lothian landscape, of which three, surprisingly, are "listed". These are monuments to the "oil shale" mining industry pioneered by James "Paraffin" Young in 1847 who prepared lighting, lubricating oil and wax from an oilshale, torbanite, and in 1850 patented "oil cracking", commercialised in 1859 by Robert Bell in Broxburn. Oil shale is not shale containing oil but a rock containing kerogen, an undefined variable mixture of organic chemical compounds.

Existing gas production is diminishing fast and, having fallen 14.1% last year, was only 39.5% of production in 2002, but the quantity of shale gas within the UK is prodigious. A 300 square mile area in the north west of England between Liverpool and Manchester is estimated to hold 172.3 trillion cubic feet and this area represents less than 10% of the UK land area containing gas deposits. Even larger deposits lie offshore. The BGS estimated the Borland Shale (quoted above) of central Britain to contain 1,329 trillion cubic feet and said: "Estimates of the amount of recoverable gas and the gas resources are variable. It's possible that the shale gas resources in the UK are very large. However despite the size of the reserve, the proportion that can be recovered is the critical factor". BGS suggested there are even more substantial shale gas reserves offshore. The technical, economic and environmental problems of extracting the gas are almost wholly unknown, but as

the UK's current consumption is 3 tcf a year of which about 1.5 tcf a year is imported, the resource has quite exceptional potential. The existing UK reserves (8.7 tcf) are equivalent to only six years' current production.

The benefit to the economy of new supplies of shale gas would directly affect primary energy costs, especially electricity generation, and indirectly by competition and substitution of other energy costs. The fiscal benefit would depend on the tax residence of the site and of the operator. However, unlike oil, the vast majority of the shale prospective sites lie in England as do virtually all existing gas wells, possibly a mirror image of the *c* 90:10 split in the oil production. Scotland had oil shale in the 1800s, oil in the 1900s but is unlikely to have shale oil in the 2000s: surely an ironic twist to Scotland's energy prospects.

Fracking takes place about 10,000 feet below ground; Mount Etna rises strikingly about 10,000eet above ground. Etna symbolises deep fracking at the margin between the African and Eurasian Tectonic Plates whose movements give rise to periodic eruptions as the enormous unseen energy in these two colliding plates is dissipated in an orgy of kinetic energy, heat, light and noise. I have climbed to Etna's crater and gazed into the bubbling cauldron, an alternative to Vesuvius' Phlégréen fields' entrance to Hades. The scorching fires and barren wastelands around the crater jar with the luxuriant citrus groves thriving on the deep and extraordinarily fertile lava soils which support prosperous adjoining populations. Apparently assured economic prosperity lies contingent on the continual quiescence of a deep underlying unpredictable force: a powerful allegory for the Eurozone.

Fracture of the Eurozone or even any pre-seismic shocks presaging such an eruption would cause inestimable economic damage. Wisely the Bank of England "conditions" its reports to exclude outturns related to the "disorderly euro-area adjustment". It observes that in the absence of such an extreme outcome, "some countries continue to face considerable challenges" resulting in sluggish growth. Economic analysis cannot reveal the Eurozone's future as the outcome will be primarily determined by political considerations: the Euro, while dressed in fine economic costume to make it acceptable, was always inherently ideological. At present it lurches from expedient to expedient, always at risk of being overtaken by world market conditions or by an individual member's decisions or circumstances, rather than embracing one of four broad economic solutions, elegantly outlined by the Governor and reported by the FT on 1 June 2013, as follows:- "One is to continue with mass unemployment in the south in order to depress wages and prices until they've become competitive again. The task facing those countries is bigger than the task we faced in the 1920s when we look back on the Gold Standard ….. and … the attempt to go back to the Gold Standard on the pre-war parities was [not] a terribly sensible approach. The second is to say, well, we have to get rid of this imbalance in competitiveness, so we need inflation in Germany. A, you've got to generate the inflation and, B, keep it going for long enough. And then stop it quickly, without causing costs there. That seems unattractive. It seems difficult economically and unattractive politically, certainly for the Germans. The third is to give up on this question of restoring competitiveness quickly and just accept that there is an indefinite transfer union. That requires two things. One is for people in the North to give money to people in the South, and people in the South to accept that in return for this they'll have to accept the conditions imposed on them, which will limit the size of the transfer. That's the third one. There doesn't seem any support for that anywhere, even though there's an element of that going on, clearly. And the fourth one is to change the composition of the membership" and he added: "Now, I don't know what the right answer is, and it will depend on their political objectives, but economics tells you that you have to have one, or some combination of these".

The Euro crisis would be cured by any of the Governor's four solutions but politics presently preclude such an outcome. His fourth possibility, an "exit", could arise almost by default if, for instance, there was an extreme and sustained political move by a debtor country against the creditors' conditions. Alternatively, although world credit conditions are extraordinarily lax, especially in the US and Japan, the US will shortly return to a neutral position, world interest rates will rise and capital will be repatriated, conditions which might re-open the financial wounds in the Eurozone debtor countries. Happily, precedent indicates that in this crisis, as before, the Eurozone should "muddle through" – an adjustment here, a policy change there! The instigators of the Euro thought monetary union might lead to much greater coherence and, if it does, it will be through taking risks on the whole enterprise of European integration that they would never have even contemplated.

The intertwining motives of the current politically-inspired European integration are often considered to originate in the rejection of the militant nationalism which led to the two World Wars. A deeper cultural connection is exemplified by "Europa – the dream of centuries" a concept originating in Greek mythology.

Europa, after which the continent is named, was the beautiful daughter of the King of Tyre, plucked from the sea- shore by a white bull, a manifestation of Zeus by whose son she founded a dynasty.

The perennial dream of Europa underlies many European cultures, but the existence and diversity of those very cultures pre-empt the dream's materialisation. Cultural differences were less embedded in society two thousand years ago when half the world's population had come under the control of just two similarly-sized empires at
opposite ends of Eurasia: the Roman Empire and the Han Chinese empire. Both empires were run by God-like emperors controlling 1,500 to 2,000 administrative districts and hundreds of thousands of soldiers and both administrative systems experienced but controlled the allocation of economic surplus between the central government and local elites and warlords and both resisted successfully the pressures from secondary competitive states building outside their hegemony. Both states ruled the world: *orbis terrarium* and *tianxia*. The collapse of the Roman Empire in Western Europe was mirrored by a similar failure of the north in China. In China a restoration of the Empire took place gradually, but in the West the decline of empire and central government proved more far-reaching and the emergence of successive local empires pre-empted Roman re-unification, notably following Justinian's successive failures. The Eastern Roman state was undermined by the Persians, Avars and Arabs, the latter originally extremely successfully, but whose regional diversity and religious schisms pre-empted the restoration of a central empire. In the West the failure of Charlemagne's imperial revival led to fragmentation into separate monarchies, lordships, local strongmen, city states and clerical principalities. These resolved only in the late 17th, 18th and 19th centuries into the modern nation states with different religious schisms, maritime empires and intellectual and philosophical cultures and an history of self-aggrandisement and mercantile and military competition. In China imperial re-unification restored the bureaucratic state that continued without interruption into a Chinese empire under Chinese or even foreign leadership until 1911 and, effectively, until now. The dream of Europa, an empire fractured and not rebuilt, stands in harsh contrast to the reinvention of China, currently extending a worldwide economic empire.

The realisation of Europe's political ambition will be hindered by its economic constraints, as the unresolved economic consequences of the Euro experiment will impair the economy which is forecast to contract this year and grow only very slowly for the next three years. In the same periods the non-OECD countries are expected to expand by about 5.5%pa with China and India growing even more quickly. In a world of increasingly more powerful countries the political advantages of European political integration may seem increasingly less worth the economic cost, especially as almost all the economic benefits of a "union" are available without the political cost. However, given the deep political imperatives, the most likely outcome is that the Eurozone will "muddle through" with low economic growth; and stable high world growth will maintain such a union, but any major external shock presents a real threat of destabilisation. The dream of Europa faces to a dawn of reality.

The dusk in Europa presages two separate dreams: the Eurozone of unity; Scotland of separation. The current polls indicate that the result of the vote on 18 September 2014 will be a large majority for unity, but, if a week is a long time in politics, nine months is more than enough for the gestation of a new country. Anecdotal evidence indicates that the Yes vote campaign is much more fervent and organised than the No, that the PR presence of the principals is much greater and much more intense and with the advantages of Office and patronage and that the date of 2014 coincides with the Homecoming, the Commonwealth Games, the Ryder Cup, the anniversary of Bannockburn in 1314, the completion of various trophy infrastructural works and much other well-orchestrated and very effective razzmatazz. As Mao Tse-tung said of the effect of the French revolution: "It's too early to tell" so it is now of the separation vote on 18 September 2014.

The effect on the economy is even more difficult to foretell with any meaningful accuracy. Most of the key issues – national debt, pensions, the monetary system, the central bank, the EU membership–are only determinable post-referendum.

However, whatever the outcome several general principles hold. The effects on Scotland *per capita* will be much greater than in the rest of the UK (UKr). In trade, for instance, as the gain is shared amongst so few people in Scotland the effects are greater per person than in UKr. Similarly, Scotland's membership of the EU or the Eurozone or NATO matter much more to individuals in Scotland than to those in the rest of the UK: for Scotland it is a higher risk strategy than the *status quo*. As UK growth has traditionally been greater than Scotland's and, as there is no obvious reason why this should change, Scotland would be disadvantaged by separation. Assertions are made that "freedom" would liberate suppressed innovation and entrepreneurship and that strategic intervention by central government would enhance growth, but, unfortunately, there is no tangible evidence for such assertions. Scotland may be distant from the most rapidly growing part of the UK, London and the South East, but separation, if any, would create a bigger disadvantage. Scotland already has a full range of support for "innovation" and as Scotland has produced a disproportionate share of UK innovation over the centuries, it seems unlikely that dismemberment of the UK would dramatically improve it. The involvement of central government in industrial policy, innovation, infant industries and capital investment is almost always disastrous. Scottish administrations have given us the Parliament building, the Queensferry Crossing, the Commonwealth Games, the Homecoming and the Borders Railway to name a few. Past governments have given us Upper Clyde Ship Builders, Bathgate Leyland, Ravenscraig, Scottish Enterprise and innumerable quangos. While benefits accrue from most of such investment the overall rate of return is negative. Scottish or UK Government's industrial policy failures are not isolated: in the US the celebrated economist Milton Friedman said: "If you put the Federal Government in charge of the Sahara Desert, in five years there would be a shortage of sand". True, I think, if taken with a pinch of … umm "sand"! No case can be made, or indeed has been made, for a flowering of enterprise after separation or of a relative stultifying strangulation of enterprise in Scotland resulting from its UK adherence.

Separate Scotland would have three self-evident losses. First it would lose the assistance provided by the Barnett formula which funds a higher percentage of central expenditure in Scotland than in the UK. Second it would have higher government funding costs, being unable to borrow on the same fine margins as the sovereign UK does possessing its own monetary system and central bank and with an established undoubted credit rating. What premium will be required of a small new country with a high debt/GNP ratio, low growth, high budget deficit and an oil industry depleting rapidly? 1%, 2%, 3% or 4%? The UK's 2013 GDP is estimated at £384,732m and if Scotland has an 8.5% share of both the 65m population and of the debt and if the debt is 85% of GDP, then each 2.3 person Scottish household has a debt of £11,571. A 3 percentage point premium would cost each household about £350 per annum. An additional consequence would be that once the inherited UK debt was redeemed then, if debt equalled GDP, Scotland would have to grow its economy more than the UKr by that percentage by which its borrowing costs exceeded the UK's just to keep the debt to GDP ratio the same!

The third self-evident disadvantage would be that economic uncertainty would be greater – a separate Scotland would be smaller, less stable, with a shorter track record, and therefore inherently riskier. Greater risk results in higher compensatory returns being required by investors, both inside a separate Scotland and outside it, reducing investment and economic growth. The higher cost of capital would also increase investment yields and reduce the value of existing investments in Scotland. If the yield increased by only a marginal 0.5 percentage points, then the average property or other investment normally valued at, say, 6.0% would quickly decline in value by 7.7%.

"It's Scotland's oil" a patriotic, vocal and significant rallying call, may have once been both true and significant, but any economic meaning is passing quickly. Scotland seems to be entitled to some 90% of the UK's oil but very little of its gas. However, the current oil output is only 38% of 2002 output and is declining quickly with only nine years supply proved at current output. More importantly, shale gas prospects which appear highly prospective in the UK, seem disproportionately highly located in England. In summary, the next energy boom will not be in Scotland nor will it be replaced by plentiful supplies of renewable energy as even at present the cost greatly exceeds the value: will the UK subsidise expensive Scottish energy sources? I think not. The energy balance is moving away from Scotland's favour. In conclusion I see no *a priori* reason for Scotland to benefit economically from separation.

The economic disadvantage of separation does not mean that separation could not and should not happen. A vote in favour will depend on the extent to which voting is determined by ideological considerations. Of those swayed by economic argument it is difficult to predict that a high proportion can make an informed judgement given the complexity and uncertainty of the arguments; moreover, after weighing all the evidence and adducing it correctly, many may still vote for separation – overwhelmingly the vote will be of the heart not of the head. Scotland is entitled to determine to pay an annual subscription to be "free": that is where Scottish nationalisation originated and it is an absolute entitlement of the people to make that choice. Unfortunately Scotland has a history of heroic failures and of their celebration, re-labelled as "successes", and this choice might give Scotland an excuse for another such celebration.

Property Prospects

In the previous property investment cycle the CBRE All Property Yield Index peaked at 7.4% in November 2001 and fell steadily to a trough of 4.8% in May 2007 before rising in this cycle to a peak of 7.8% in February 2009, a yield surpassed only twice since 1970, on brief occasions when the Bank Rate was over 10%. The yield fell rapidly from the 7.8% peak to a low of 6.1% in 2011 from which it had risen by 0.2 percentage points to 6.3% last year, before dropping again to 6.1% this year.

Similar changes occurred in the Office and Industrial components of the Index which dropped from 6.2% to 5.9% and from 7.5% to 7.2% respectively, but the Retail Index was unchanged over the year at 5.8%, having moved up 0.1 percentage point to 5.9% in the spring. What is most noticeable last year is that, within each component of the All Property Index, the largest falls in yield have taken place in the London area. Central London shop yields fell 0.39 percentage points, shop yields in the rest of the UK rose 0.14 percentage points; office yields fell about 0.5 percentage points in the City, South Bank, and Thames Valley but elsewhere apart from West Midlands were little changed; industrial yields in London fell 0.59 percentage points, significantly more than most other locations.

A remarkable feature is the widening gap in the yields between the geographical areas, compared to ten years ago. The main yield difference in every case is between lower yields in London, including the South East, and all other areas in both 2003 and 2013 and the growth in that difference in 2013 compared with 2003. In the
Shop Index in 2003 the average yield on the highest yielding quartile was only 0.3 percentage points above the 6.7% average and the lowest quartile only 0.3% below the average. In 2013 the highest yielding quartile was 1.4 percentage points above the 5.8% average and the lowest 0.6 percentage points below the average. The 2003 range was 0.6 percentage points; the 2013 range was 2.0 percentage points. The distribution in the Industrial Index was not dissimilar. However, in the office sector the position was even more marked. In 2003 the average yield on the highest quartile was 0.8 percentage points above the 7.6% average and the lowest quartile only 0.4 percentage points below the average, but in 2013 the highest yielding quartile was 2.4 percentage points above the 6.1% average and the lowest was 1.0 percentage point below the average. The 2003 range was 1.2 percentage points; the 2013 range was 3.4 percentage points. In the office sector the yield of 4.7% on Central London offices compared with over 8.0% in some areas of northern England encapsulates the underlying difference, essentially that between the "London" area and those outlying it.

The peak yield of 7.8% in February 2009 was 4.6 percentage points higher than the 10 year Gilt Yield, then the highest "yield gap" since the series began in 1972 and 1.4 percentage points higher than the previous record in February 1999 and last year's yield of 6.3% was a record 4.8 percentage points higher than the then exceptionally

low 10 year gilt Yield of 1.5%. The yield gap now has narrowed to 3.7 percentage points, primarily as the 10 year Gilt Yield has increased from 1.5% to 2.4%, significantly higher than last year, but still strongly influenced by the current monetary policy.

The All Property Rent Index, which, apart from a brief fall in 2003, had risen consistently since 1994, fell 0.1% in the quarter to August 2008 and then fell by 12.3% in the year to August 2009. Since 2009 there have been small increases of only 0.9%, 0.1% and 0.6% in the years to August 2012, but in 2013 rental growth improved slightly to 2.6%. Shop rents increased by 1.9% heavily influenced by a rise of 12.6% in central London, but offset by a fall of 2.5% for the UK, excluding the London area where rents have fallen by 6.1% pa for five years or by 27.0%. Office rents increased by 5.5% almost wholly due to increases in the various London markets, as rents fell in some provincial markets and rising only 0.73% in key provincial cities. Over the past five years office rents have fallen on average by 1.1% pa. Industrial rents were unchanged over the year, and, like offices, have fallen on average by 1.0% pa for the last five years.The small increase in rents in recent years together with the substantial fall in rents in 2008/09, especially when combined with the large increases in RPI inflation, have reduced real rents. Since the peaks of 1990/1991 the CBRE real rent indices have fallen: All Property 33%, Offices and Industrials 40% and Shops 27%.

Property Investment, as measured by the IPD All Property Index, returned 7.4% in the year to 31 October 2013, of which the income return was 7.0% and the net capital return 0.4%, falls in capital values of 0.5% per month in November 2012 easing until small monthly gains occurred from June 2013 as yields started to fall. Office and Industrial property returned 9.9% and Retail 4.9%. The retail index return was calculated after a negative capital return of over 2.0%.

This time last year the reported All Property Index return was 3.1% of which the income return of 6.8% was offset by a fall in capital values of about 3.6%. Previous returns in the years to 31 October were 8.7% (2011) , 20.4% (2010) and minus 14.0% (2009), and minus 22.5% in the calendar year 2008 when in December alone the index fell a record 5.3%. In the year to 31 October 2013 the All Property Index return of 7.4% was significantly lower than the return of 23.8% from property equities, presumably a "geared play" on property prices, and of 20.7% from equities as measured by IPD. In contrast bonds had a negative return of 2.4%.

Property returns in 2013 are forecast at about 8.0%, also the current return implied by the derivatives market, and significantly better than the IPD Index return to December 2012 of 2.4% where the income return of 6.8% was partially offset by a capital loss of 4.2%. Last year's forecasts for 2013 were for a return of around 5.6%, although the derivatives implied only 1.75%, as almost all forecasters expected capital values to continue to fall and rental increases, if any, to be small. In Q4 2012 it was feared that the economic downturn then might lead to a double-dip recession in 2013, but the economy started to grow from Q1 2013 and capital values, according to IPD, stopped falling in Q2 2013 and rose in Q3.

In 2014 all forecasters expect capital values to continue to rise even in the depressed retail sector and forecasts for returns in 2014 vary between 7.9% IPF, 8.3% Cluttons and 8.7% Colliers, although the return implied by the derivatives index is only 4.0%, but this index has provided the least accurate forecast in recent years! Three to five year forecasts are for returns to continue at around 8.0%.

The improved forecast for property returns results from the improving economic conditions. The recession, the long (and continuing) depression and the reduction in real incomes, all contributed to a reduction in demand for occupational property except more recently in the booming South East. Reduced demand led to
lower rents or longer vacancies and lower investment values, a trend particularly evident in the retail sector where a secular change is taking place as the pattern of demand is changing with the strong growth of purchasing on-line. Lower rents, shorter leases and prospectively higher vacancies and/or even lower rents have reduced investment demand and raised yields appreciably, especially for properties at risk from these deleterious trends. However the prospective rental growth will counter such a downward spiral, especially as rental growth is now more common in some areas in the worst affected retail sector. Last year I said: "I see no recovery in the
investment property market until there is a prospect of "normal economic growth"". Fortunately the UK economy is at that stage.

Investment conditions are improving appreciably. Transaction volume in the last quarter was over £10bn, the highest figure since before the commercial property peak in Q2 2007, apart from Q4 2010. Cushman & Wakefield report that the UK property market continues to build momentum, with gains being seen in both prime and secondary markets as demand from expanding overseas and domestic occupiers and investors increases.

Investment demand is growing assisted by the increased supply and availability of credit and by the reduced cost of such credit. New lenders are entering the market, LTV levels are generally 60-65%, up from 55-60%, as recently as Q3 2012, and loan margins are 190 - 250 bps, down from 250 - 300 bps in Q3 2012. While these terms represent a considerable improvement they are still much "tighter" than the halcyon (and subsequently disastrous) days pre-2008 when LTVs were 80-85%, margins *c* 1.0% and repayment terms, fees and covenants much more benign! Moreover, because of decreasing supply of suitably-priced investment property in London, lenders are increasingly prepared to fund investments in the regions. With increased debt support and, as the prime investments become more limited, demand has increased for second tier and secondary markets where yields have started to decline. Prime office yields have been static recently, but regional office yields have declined in the last quarter and in Edinburgh dropped from 6.25% to 6.00%. Yields on secondary office markets also fell 0.25 percentage points, and regional out-of-town office yields fell 0.50 percentage points to 8.00%.

The improvements in the investment market, while likely to continue, will be limited by the supply of delinquent or non-refinanceable loans held by the banks, estimated at approaching £100bn. Improving investment conditions will increase the supply to the market although an increasing proportion of that supply will either be suitable only for occupational use or be of non-investment grade. The prospects for the investment market are better than at any time since 2007.

This time last year forecasts of house prices in 2013 varied widely! The average December forecast in HMT Forecast for the UK economy was for a rise of 0.4% but City forecasters within the sample, notably Capital Economics and Merrill Lynch, were less optimistic forecasting -5% and -4% respectively. Surveyors, Cluttons, JLL, Knight Frank, expected prices to fall slightly but the OBR Halifax and Nationwide expected little change and LSL said there is "little likelihood of sustained growth until 2014 at the earliest".

Given these forecasts, 2014 seems to have arrived early – or at least in most parts of the UK. In their December report LSL say: "The housing market is almost unrecognisable from twelve months ago. Not only have average prices climbed to a new record high – with an annual rise of £11,219 (4.9%) and a monthly increase of £1,394, but we have also seen an increase in every region for the second month running – a true sign that the nationwide recovery is really taking off". Halifax and Nationwide report greater annual increases of 7.7% and 6.5% respectively.

LSL November figures for the different English regions and for Wales vary greatly, showing annual increases from a high of 9.2% in Greater London to the two smallest increases of 2.0% in Yorkshire and 1.4% in Wales. In Scotland LSL reports prices fell by 0.1% in October but rose by 1.0% for the year to October, only the second time two consecutive months have shown an annual increase in price since January 2011. Given the greatly improving trend, LSL estimates that Scottish prices will rise 2.5% in 2013. Other surveys of the Scottish market, including Nationwide and ROS, produce similar results, showing a small annual gain, except Halifax which reports a large 8% gain, probably because of sampling differences.

HMT's forecasters are much more optimistic than this time last year and forecast price rises of 6.7%, 6.3%, 5.6% and 4.9% for 2014 and the next three years. The OBR, published on 5 December, says: "OBR concurs with a view that house prices and transactions will continue to rise in 2014/15 and 2015/16". It comments: "Our house price inflation forecast has been revised upwards significantly, reflecting the momentum in houses prices this year and supportive mortgage financing conditions. We expect house price inflation to be above 5 per cent in 2014 and 7 per cent in 2015. Relative to our March forecast, we have revised the level of house prices up 10 per cent by 2017-18".For the Scottish market LSL says that: "While we can be optimistic for 2014, we should not imagine that market recovery is going to look like a runaway train – it won't". Rettie & Co report "never witnessing such a strong finish to the year" and predict that prices will rise by 3% in 2014 and by 21.7% over the next five years a figure similar to the 19.3% rise forecast by Savills. Such rises would still not compensate for inflation as the inflated value of the Halifax peak price of £199,600 in August 2007 is £242,740 and the Halifax index in October stands at £174,910 a drop in real prices of 27.9%.

House prices depend on the balance between supply and demand. The long-term supply of houses is inelastic and responds slowly to changes in demand, due to the long production cycle time which includes negotiating land purchases, securing planning consents, so often delayed for years, and construction. The long-term demand for houses, according to the currently used econometric models, is likely to continue to grow at a rate which may have been reduced, but is unlikely to have been appreciably altered, even by a depression of such continuing length as at present, which will cause a cumulative supply shortage by 2022 of 1.4m houses in England and 400,000 in Scotland, according to a forecast by Savills. Demand will also increase as time, convenience, amenity and quality of location all become more valued as incomes grow. Thus there will be a persistent imbalance between the supply and demand, leading to higher long term prices.

The short-term market is supplied by recycling existing houses from owners exercising their discretion to move house - larger, smaller, smarter, relocation. Additionally, a "non-discretionary" supply comes from estates,

household "Break-ups" and repossessions. The volume from the first two should be relatively steady, but supply from repossessions varies with economic conditions, particularly with unemployment. In spite of the continuing depression unemployment levels remain very low, two to four percentage points below those of previous recessions and house repossessions are currently at a five year low. The low prospective interest rates, increasing economic growth and rising house prices will reduce supply from repossessions considerably. New houses form an important short-term supply source, but this supply has been greatly reduced in recent years.

Short-term demand is determined by mortgage cost and credit availability. Over the last year mortgage costs have reduced considerably and the supply of credit increased, especially to first time buyers. The equity share and other Government "help to buy" schemes are providing an increasing supply of credit or shared equity at favourable prices, and these factors have greatly added to demand. The increased demand has resulted in a large increase of sales of houses but without a commensurate increase in price as the short term supply elasticity of the discretionary supplies – sellers biding their time – is very high. Once this overhang on the market is cleared prices could rise quite rapidly, as may have already happened in certain niche markets in Edinburgh.

Last year I wrote: "The housing market is a paradox: demand rationed by credit is the major influence on short-term prices and supply rationed by institutional factors is the major influence on long-term prices. Credit rationing is a major contributory factor to the current house price falls and, when it eases, probably coincidental with stronger economic growth, then supply will again become limiting. Thus the key determinant of the long-term housing market will be a shortage of supply resulting in higher prices." For most UK markets that position has now been reached.

Future Progress

The Group has positioned itself to take advantage of a housing market which I expect to improve over the next two years. We have completed major investments in long planning processes and although larger schemes are still being promoted, the majority of the required investment has already been made. Our emphasis is now on the completion and realisation of development opportunities which can be marketed shortly, and within our development portfolio there are sufficient opportunities to allow several years of such sales. As these sales take place other development opportunities will be brought forward to provide replacements for these realisations. This, together with the income from our investment portfolio, will provide stability as the economy emerges from this long depression.

We will not commission any major development until market conditions improve further,
until the possibility of a final glitch in the economy is insignificant and until after the referendum. We do not depend on a recovery in prices for the successful development of our sites as most of these sites were purchased unconditionally, i.e. without planning permission, for prices not far above their existing use value, and before the 2007 house price peak. A major component of the development value lies in the grant of planning permission, and in its extent, and it is relatively independent of changes in house values. For development or trading properties no change is made to the Group's balance sheet even when improved

development values have been obtained. Naturally, however, the balance sheet will reflect such enhanced value when the properties are developed or sold.

The policy of the Group will continue to be considered and conservative, but responsive to market conditions and opportunistic. The mid-market share price on 20 December 2012 was 67p a discount to the NAV of 54%. The Board does not recommend a final dividend, but will restore dividends when profitability and consideration for other opportunities and obligations permit.

Conclusion

The UK is emerging from the longest depression since 1873-96. Policy interventions by Governments have alleviated the worst possible outcomes, especially for unemployment and social conditions, as the measures in the New Deal did for the US in the 1930s. The US economic policies have assisted the economy in expanding well beyond the pre-recession level. In the UK the restrictive fiscal policies have delayed a return to the pre-recession level and the long depression may have damaged the long-term supply capability. The recent alleviation of fiscal policy`` "Plan A minus" together with the stimulative housing measures, contemporaneous with long overdue changes at the Bank, are at last establishing "normal" growth in the economy.

The flow of credit to companies continues to be a major restriction on growth but prospective recoveries in banks' equity bases, together with some possible relaxation of ill-timed and misdirected regulatory tightening, should alleviate this restriction. Additionally, further measures by the Bank, other than exhortation, are likely to promote the re-establishment of prudent normal credit supplies. The restoration of a competitive market in banking and credit to replace the long-established oligopoly market, while highly desirable, is equally unlikely. The economic advantages the UK enjoys from controlling its monetary system and from an independent currency have been overwhelmingly demonstrated, if only by the continuing unresolved underlying crisis in the Eurozone where political ambition battles economic reality. The Eurozone, and its trading partners, may yet pay a big price for these political ambitions. It is ironic that the value of the achievement of such political ambition has in part passed, is passing and, with the rise of other empires, will continue to pass.

The Scottish vote will be decided on political and ideological grounds and independence will have a large, but for many an acceptable, economic cost. Post the vote, but until the details are negotiated, there will be a difficult interregnum whose economic cost will be greater than its settled condition. The UK has the prospect of a major economic boost – a *deus ex machina* – from the possible exploitation of high gas reserves.

The Group continues to negotiate the worst economic crisis for over a century. The implementation of considered strategies should permit us to operate on a cash-neutral basis as we emerge from the Second Great Depression. The prospects, contrary to the last six years, are good, or possibly very good.

I D Lowe
Chairman
20 December 2013

Group income statement for the year ended 30 June 2013

	Note	**2013 £000**	2012 £000
Gross rental income		**312**	348
Service charge income		**22**	23
Property charges		**(203)**	(310)
Net rental and related income		**131**	61
Administrative expenses		**(726)**	(821)
Other income		**120**	85
Net operating loss before investment property disposals and valuation movements	5	**(475)**	(675)
Loss on disposal of investment properties		**-**	(362)
Valuation gains on investment properties		**620**	-
Valuation losses on investment properties		**(110)**	(225)
Net valuation gains/(losses) on investment properties		**510**	(225)
Operating profit/(loss)		**35**	(1,262)
Financial income	7	**1**	22
Financial expenses	7	**(98)**	(184)
Net financing costs		**(97)**	(162)
Loss before taxation		**(62)**	(1,424)
Income tax	8	**-**	-
Loss for the financial period attributable to equity holders of the company		**(62)**	(1,424)
Loss per share			
Basic and diluted loss per share (pence)	9	**(0.52p)**	(11.98p)

Consolidated statement of comprehensive income for the year ended 30 June 2013

	2013 £000	2012 £000
Loss for the year attributable to the equity holders of the parent company	**(62)**	(1,424)

Consolidated balance sheet as at 30 June 2013

	Note	2013 £000	2012 £000
Non current assets			
Investment property	10	**8,635**	8,125
Property, plant and equipment	11	**24**	28
Investments	12	**-**	4
Total non-current assets		**8,659**	8,157
Current assets			
Trading properties	13	**11,771**	11,365
Trade and other receivables	14	**176**	140
Cash and cash equivalents	15	**6**	691
Total current assets		**11,953**	12,196
Total assets		**20,612**	20,353
Current liabilities			
Trade and other payables	16	**(431)**	(324)
Interest bearing loans and borrowings	17	**(3,000)**	(2,725)
Total current liabilities		**(3,431)**	(3,049)
Net assets		**17,181**	17,304
Equity			
Issued share capital	21	**2,357**	2,377
Capital redemption reserve	22	**175**	175
Share premium account	22	**2,745**	2,745
Retained earnings	22	**11,904**	12,007
Total equity attributable to equity			

holders of the parent company	**17,181**	17,304

The financial statements were approved by the board of directors on 20 December 2013 and signed on its behalf by

ID Lowe
Director

Group statement of changes in equity as at 30 June 2013

	Share capital £000	Capital redemption reserve £000	Share premium account £000	Retained earnings £000	Total £000
At 1 July 2012	2,377	175	2,745	12,007	**17,304**
Share buyback	(20)	-	-	(41)	**(61)**
Loss for the year	-	-	-	(62)	**(62)**
At 30 June 2013	**2,357**	**175**	**2,745**	**11,904**	**17,181**
At 1 July 2011	2,377	175	2,745	13,431	18,728
Loss for the year	-	-	-	(1,424)	(1,424)
At 30 June 2012	2,377	175	2,745	12,007	17,304

The movement in the valuation of investment properties has been reflected through the revaluation reserve as the directors are of the opinion that such increases are temporary.

During the year, the company bought back 100,000 (*2012: nil*) shares for a consideration of £61,000 (*2012: nil*).

Consolidated cash flow statement for the year ended 30 June 2013

	2013	2012

	£000	£000
Cash flows from operating activities		
Loss for the year	**(62)**	(1,424)
Adjustments for :		
Loss on sale of investment property	**-**	362
(Gains)/losses on fair value adjustment of investment property	**(510)**	225
Depreciation	**13**	12
Net finance expense	**97**	162
Operating cash flows before movements in working capital	**(462)**	(663)
Increase in trading properties	**(406)**	(234)
Increase in trade and other receivables	**(36)**	(70)
Increase/(decrease) in trade and other payables	**9**	(170)
Cash absorbed by the operations	**(433)**	(1,137)
Interest paid	**(14)**	(207)
Interest received	**1**	22
Net cash outflow from operating activities	**(446)**	(1,322)
Investing activities		
Proceeds from sale of investment property	**-**	2,938
Acquisition of property, plant and equipment	**(9)**	(5)
Cash flows from investing activities	**(9)**	2,933
Financing activities		
Repayment of borrowings	**-**	(1,497)
Share buyback	**(43)**	-
Increase in borrowings	**275**	-
Cash flows from financing activities	**232**	(1,497)
Net (decrease)/increase in cash and cash equivalents	**(685)**	114
Cash and cash equivalents at beginning of year	**691**	577
Cash and cash equivalents at end of year	**6**	691

Notes to the consolidated financial statements as at 30 June 2013

1 Reporting entity

Caledonian Trust PLC is a company domiciled in the United Kingdom. The consolidated financial statements of the company for the year ended 30 June 2013 comprise the company and its subsidiaries (together referred to as "the Group"). The Group's principal activities are the holding of property for both investment and development purposes.

2 Statement of Compliance

The group financial statements have been prepared and approved by the directors in accordance with International Financial Reporting Standards and its interpretation as adopted by the EU ("Adopted IFRSs"). The Company has elected to prepare its parent company financial statements in accordance with UK GAAP.

3 Basis of preparation

The financial statements are prepared on the historical cost basis except for available for sale financial assets and investment properties which are measured at their fair value.

The preparation of the financial statements in conformity with Adopted IFRSs requires the directors to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

These financial statements have been presented in pounds sterling which is the functional currency of all companies within the Group. All financial information has been rounded to the nearest pounds thousand.

Going concern

The group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Chairman's Statement. The financial position of the group, its cash flows, liquidity position and borrowing facilities are described in Note 18.

In addition, note 18 to the financial statements includes the group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

The group and company finance their day to day working capital requirements through a related party loan.

The Directors have prepared projected cash flow information for the period ending twelve months from the date of their approval of these financial statements. These forecasts assume the group will make property sales in the normal course of business.

Should these sales not complete as planned, the directors are confident that they would be able to sell sufficient other properties within a short timescale to generate the income necessary to meet the group's liabilities as they fall due.

For these reasons they continue to adopt the going concern basis in preparing the financial statements.

Areas of estimation uncertainty and critical judgements

Information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amount recognised in the financial statements is contained in the following notes:

- *Valuation of investment properties (note 10)*
  The valuation of properties is subjective and based on similar transactions in the market, rental yields and development potential. The company's directors are experienced in dealing with such properties. Valuations at the balance sheet date are based on independent external valuations as at 30 June 2013. The Executive Directors have respectively over 40 years and 30 years experience in commercial property. RJ Pearson is a Fellow of the Royal Institution of Chartered Surveyors and has practised as a surveyor in Scotland for 32 years during which time he has specialised in commercial property.

- *Valuation of trading properties (note 13)*
  Trading properties are carried at the lower of cost and net realisable value. The net realisable value of such properties is based on the amount the company is likely to achieve in a sale to a third party. This is then dependent on availability of planning consent and demand for sites which is influenced by the housing and property markets.

- *Taxation (note 8)*
  As noted in note 8, in a prior year the company had treated a dilapidations payment from a tenant as a capital receipt and accordingly no taxation had been provided in previous financial statements. The dispute with HMRC was resolved in the company's favour during the year to 30 June 2013.

The accounting policies below have been applied consistently to all periods presented in these consolidated financial statements.

Basis of consolidation
The financial statements incorporate the financial statements of the company and all its subsidiaries. Subsidiaries are entities controlled by the group. Control exists when the group has the power to determine the financial and operating policies of an entity so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date it ceases.

Revenue
Rental income from properties leased out under operating leases is recognised in the income statement on a straight line basis over the term of the lease. Costs of obtaining a lease and lease incentives granted are recognised as an integral part of total rental income and spread over the period from commencement of the lease to the earliest termination date on a straight line basis.

Revenue from the sale of trading properties is recognised in the income statement on the date at which the significant risks and rewards of ownership are transferred to the buyer with proceeds and costs shown on a gross basis.

Other income
Other income comprises income from agricultural land and other miscellaneous income.

Finance income and expenses
Finance income and expenses comprise interest payable on bank loans and other borrowings. All borrowing costs are recognised in the income statement using the effective interest rate method. Interest income represents income on bank deposits using the effective interest rate method.

Taxation
Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case the charge / credit is recognised in equity. Current tax is the expected tax payable on taxable income for the current year, using tax rates enacted or substantively enacted at the reporting date, adjusted for prior years under and over provisions.
Deferred tax is provided using the balance sheet liability method in respect of all temporary differences between the values at which assets and liabilities are recorded in the financial statements and their cost base for taxation purposes. Deferred tax includes current tax losses which can be offset against future capital gains. As the carrying value of the group's investment properties is expected to be recovered through eventual sale rather than rentals, the tax base is calculated as the cost of the asset plus indexation. Indexation is taken into account to reduce any liability but does not create a deferred tax asset. A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised.

Investment properties

Investment properties are properties owned by the group which are held either for long term rental growth or for capital appreciation or both. Properties transferred from trading properties to investment properties are revalued to fair value at the date on which the properties are transferred. When the Group begins to redevelop an existing investment property for continued future use as investment property, the property remains an *investment property, which is* measured based on fair value model, and is not reclassified as property, plant and equipment during the redevelopment.

The cost of investment property includes the initial purchase price plus associated professional fees. Borrowing costs directly attributable to the acquisition or construction of qualifying assets are capitalised during the period of construction. Subsequent expenditure on investment properties is only capitalised to the extent that future economic benefits will be realised.

Investment property is measured at fair value at each balance sheet date. External independent professional valuations are prepared at least once every three years. The fair values are based on market values, being the estimated amount for which a property could be exchanged on the date of valuation between a willing buyer and a willing seller in an arms' length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

Any gain or loss arising from a change in fair value is recognised in the income statement.

Purchases and sales of investment properties
Purchases and sales of investment properties are recognised in the financial statements at completion which is the date at which the significant risks and rewards of ownership are transferred to the buyer.

Property, plant and equipment
Property, plant and equipment are stated at cost, less accumulated depreciation and any provision for impairment. Depreciation is provided on all property, plant and equipment at varying rates calculated to write off cost to the expected current residual value by equal annual instalments over their estimated useful economic lives. The principal rates employed are:

Plant and equipment	-	20.0 per cent
Fixtures and fittings	-	33.3 per cent
Motor vehicles	-	33.3 per cent

Trading properties
Trading properties held for short term sale or with a view to subsequent disposal in the near future are stated at the lower of cost or net realisable value. Cost is calculated by reference to invoice price plus directly attributable professional fees. Net realisable value is based on estimated selling price less estimated cost of disposal.

Financial assets

Trade and other receivables
Trade and other receivables are initially recognised at fair value and then stated at amortised cost.

Financial instruments

Available for sale financial assets
The group's investments in equity securities were sold during the year.

Cash and cash equivalents

Cash includes cash in hand, deposits held at call (or with a maturity of less than 3 months) with banks, and bank overdrafts. Bank overdrafts that are repayable on demand and which form an integral part of the Group's cash management are shown within current liabilities on the balance sheet and included with cash and cash equivalents for the purpose of the statement of cash flows.

Financial liabilities

Trade payables

Trade payables are non-interest-bearing and are initially measured at fair value and thereafter at amortised cost.

Interest bearing loans and borrowings

Interest-bearing loans and bank overdrafts are initially carried at fair value less allowable transactions costs and then at amortised cost.

New Standards and interpretations not yet adopted

The International Accounting Standards Board (IASB) and International Financial Reporting Interpretations Committee has recently issued the following new standards and amendments which are effective for annual periods beginning on or after 1 January 2014, unless stated otherwise, and have not been applied in preparing these consolidated financial statements.

- *IFRS 9 Financial Instruments: Classification and Measurement* which is the first phase of a wider project to replace IAS 39.

  Financial Instruments: Recognition and Measurement, replaces the current models for classification measurement of financial instruments. Financial assets are to be classified into two measurement categories: fair value and amortised cost. Classification will depend on an entity's business model and the characteristics of contractual cash flow of the financial instrument. The standard is effective for annual periods beginning on or after 1 January 2015.

  As at the time of publication of these financial statements, the IASB is re-deliberating the requirements for classification and measurement in IFRS 9 while the requirements of latter phases of IFRS 9 are in development and therefore remain uncertain.

- *IFRS 10 Consolidated Financial Statements* revises the concept of control to relate it to whether an investor has exercisable power over an investee and consequently has exposure or rights to variable returns. Consolidation procedures remain unchanged.

- *IFRS 12 Disclosure of Interests in Other Entities* consolidates and enhances disclosure requirements relating to interests of an entity in other entities. It includes the disclosure requirements for all forms of interests in other entities, including joint arrangements, associates, special purpose vehicles and unconsolidated structures.

  The new standard is likely to result in increased disclosures regarding interests in other entities particularly in respect of significant judgements and assumptions made in determining control and the nature of, and changes in, the risk associated with such interests.

The following new standards which are relevant for the Group are not expected to have a material impact.

- Amendment to IAS 32 *Financial Instruments: Presentation* provides additional guidance for offsetting financial assets and liabilities while amendments to IFRS 7 *Financial Instruments: Disclosures* set out corresponding new disclosure requirements. The amendment is effective for annual periods beginning on or after 1 January 2013.

- IFRS 11 *Joint Arrangements* requires joint ventures to be accounted for using the equity accounting method while joint operations are accounted for based on the rights and obligations of each party in the arrangement.

- IFRS 13 *Fair Value Measurement* aims to improve consistency and reduce complexity by providing guidance on how to measure fair value where fair value is required or permitted across IFRSs and enhances disclosures requirements (effective for annual periods beginning on or after 1 January 2013).

Operating segments

The Group determines and presents operating segments based on the information that is internally provided to the Board of Directors ("The Board"), which is the Group's chief operating decision maker. The directors review information in relation the Group's entire property portfolio, regardless of its type or location and as such are of the opinion that there is only one reportable segment which is represented by the consolidated position presented in the primary statements.

5 Operating loss

	2013	2012
	£000	£000
The operating loss is stated after charging :		
Depreciation	**13**	12
Amounts received by auditors and their associates in respect of:		
- Audit of these financial statements (Group and Company)	**13**	20
- Audit of financial statements of subsidiaries pursuant to legislation	**7**	15
- Tax advisory services	**24**	15
	======	======

6 Employees and employee benefits

	2013	2012
	£000	£000
Employee remuneration		
Wages and salaries	**385**	373
Social security costs	**45**	46
Other pension costs	**52**	58
	482	477
	======	=======

Other pension costs represent contributions to defined contribution plans.

The average number of employees during the year was as follows:

	No.	No.
Management	**2**	2
Administration	**2**	2
Other	**4**	4
	8	8

Remuneration of directors	**2013 £000**	2012 £000
Directors' emoluments	**250**	250
Company contributions to money purchase pension schemes	**45**	52

Director	Salary and Fees £000	Benefits £000	Pension Contributions £000	**2013 Total £000**	2012 Total £000
ID Lowe	110	5	20	**135**	142
MJ Baynham	125	2	25	**152**	152
RJ Pearson	8	-	-	**8**	8
	243	**7**	**45**	**295**	302

7 Finance income and finance costs

	2013 £000	2012 £000
Finance income		
Interest receivable:		
- on bank balances	**1**	22
Finance costs		
Interest payable:		
- Bank loans and overdrafts	**3**	71
- Loan stock repayable within five years	**95**	113
	98	184

8 Income tax

There was no tax charge/(credit) in the current or preceding year.

	2013 £000	2012 £000
Loss before tax	**62**	1,424
Current tax at 23.75% *(2012 : 24%)*	**(14)**	(342)
Effects of:		
Expenses not deductible for tax purposes	**15**	12
Losses carried forward	**87**	220
Deferred tax asset not recognised	**-**	54
Other deferred tax charges related to properties	**(104)**	87
Timing differences	**-**	(31)
Effect of rate change	**16**	-
Total tax charge	**-**	-

In the case of deferred tax in relation to investment property revaluation surpluses, the base cost used is historical book cost and includes allowances or deductions which may be available to reduce the actual tax liability which would crystallise in the event of a disposal of the asset.

Reductions in the UK corporation tax rate from 26% to 24% (effective from 1 April 2012) and to 23% (effective 1 April 2013) were substantially enacted on 26 March 2012 and 3 July 2012 respectively. Further reductions to 21% (effective from 1 April 2014) and 20% (effective from 1 April 2015) were substantively enacted on 2 July 2013. This will reduce the group's future tax charge accordingly.

Factors affecting the tax charge

As reported in prior years, the group received a damages payment from the former tenants of an investment property amounting to £2,100,000 during the year ended 30 June 2005. The payment was made to compensate the group for the tenant's breach of obligations in relation to, principally, dilapidations under the repairing lease held by them.

The receipt was treated as a capital receipt for taxation purposes on which basis no taxation was payable or was provided. HMRC had queried the tax treatment of this receipt and, following a tribunal, this has been resolved in the company's favour during the year to 30 June 2013 and no tax is payable.

9 Loss per share

Basic loss per share is calculated by dividing the loss attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period as follows:

	2013 £000	2012 £000
Loss for financial period	**62**	1,424

	2013	2012
	No.	No.
Weighted average no. of shares: for basic earnings per share and for diluted earnings per share	**11,814,045**	11,882,923
Basic (loss) per share	**(0.52 p)**	(11.98p)
Diluted (loss) per share	**(0.52p)**	(11.98p)

The diluted figure per share is the same as the basic figure per share as there are no dilutive shares.

10 Investment properties

	2013	2012
	£000	£000
Valuation		
At 30 June 2012	**8,125**	11,650
Revaluation in year	**510**	(225)
Sold in year	**-**	(3,300)
Valuation at 30 June 2013	**8,635**	8,125

The carrying amount of investment property is the fair value at the balance sheet date as stated in external independent valuations at open market value made by Montagu Evans and Rettie & Co, independent property consultants, at 30 June 2013. The properties have been valued individually in accordance with the definition of market value and good practice guidelines set out in the 6th Edition of the Royal Institution of Chartered Surveyors valuation and appraisal manual. In this regard, market value is defined as "the estimated amount for which a property should exchange between a willing buyer and willing seller in an arm's length transaction after proper marketing wherein the parties had acted knowledgeably, prudently and without compulsion". The values have taken into account rental values and development potential.

Investment properties comprise a number of commercial properties, some of which are leased to third parties with an initial rental period. Subsequent renewals are negotiated with the tenant.

The cumulative amount of interest capitalised in respect of the group's investment properties is £476,000 *(2012: £476,000)*.

11 Property, plant and equipment

	Motor Vehicles £000	**Fixtures and fittings £000**	**Other equipment £000**	**Total £000**
Cost				
At 30 June 2011	21	53	66	140
Additions in year	4	1	-	5
At 30 June 2012	25	54	66	145
Additions in year	-	9	-	9

At 30 June 2013	**25**	**63**	**66**	**154**
Depreciation				
At 30 June 2011	18	51	36	105
Charge for year	2	2	8	12
At 30 June 2012	20	53	44	117
Charge for year	3	2	8	13
At 30 June 2013	**23**	**55**	**52**	**130**
Net book value				
At 30 June 2013	**2**	**8**	**14**	**24**
At 30 June 2012	5	1	22	28

12 Investments

	2013	2012
	£000	£000
Available for sale investments		
At the start of the year	**4**	4
Sold in year	**(4)**	-
Available for sale financial assets	**-**	4

13 Trading properties

	2013	2012
	£000	£000
At start of year	**11,365**	11,131
Additions	**406**	234
At end of year	**11,771**	11,365

14 Trade and other receivables

	2013	2012
	£000	£000
Amounts falling due within one year		
Other debtors	**21**	24
Prepayments and accrued income	**155**	116
	176	140

The company's exposure to credit risks and impairment losses relating to trade receivables is given in note 18.

15 Cash and cash equivalents

	2013	2012
	£000	£000
Cash	**6**	691

Cash and cash equivalents comprise cash at bank and in hand. Cash deposits are held with UK banks. The carrying amount of cash equivalents approximates to their fair values. The company's exposure to credit risk on cash and cash equivalents is regularly monitored (note 18).

16 Trade and other payables

	2013	2012
	£000	£000
Accruals and other creditors	**431**	324

The Group's exposure to currency and liquidity risk relating to trade payables is disclosed in note 18.

17 Other interest bearing loans and borrowings

The Group's interest bearing loans and borrowings are measured at amortised costs. More information about the Group's exposure to interest rate risk and liquidity risk is given in note 18.

Current liabilities

	2013	2012
	£000	£000
Floating rate unsecured Loan Notes	**2,725**	2,725
Unsecured loan	**275**	-
	3,000	2,725

Terms and debt repayment schedule

Terms and conditions of outstanding loans and loan stock were as follows:

	Currency	Nominal interest rate	**2013** Fair value £000	**2013** Carrying amount £000	2012 Fair value £000	2012 Carrying amount £000
Unsecured loan	GBP	Base +3%	**275**	**275**	-	-
Floating rate unsecured loan stock	GBP	Base + 3%	**2,725**	**2,725**	2,725	2,725

	3,000	**3,000**	2,725	2,725

18 Financial instruments

Fair values

Fair values versus carrying amounts

The fair values of financial assets and liabilities, together with the carrying amounts shown in the balance sheet, are as follows:

	2013		2012	
	Fair value	**Carrying amount**	Fair value	Carrying amount
	£000	**£000**	£000	£000
Available for sale financial assets	**-**	**-**	4	4
Trade and other receivables	**176**	**176**	140	140
Cash and cash equivalents	**6**	**6**	691	691
	182	**182**	835	835
Loan from related party	**(3,000)**	**(3,000)**	(2,725)	(2,725)
Trade and other payables	**(431)**	**(431)**	(324)	(324)
	(3,431)	**(3,431)**	(3,049)	(3,049)

Estimation of fair values

The following methods and assumptions were used to estimate the fair values shown above:

Available for sale financial assets – as such assets are listed, the fair value is determined at the market price.

Trade and other receivables/payables – the fair value of receivables and payables with a remaining life of less than one year is deemed to be the same as the book value.

Cash and cash equivalents – the fair value is deemed to be the same as the carrying amount due to the short maturity of these instruments.

Other loans – the fair value is calculated by discounting the expected future cashflows at prevailing interest rates.

Overview of risks from its use of financial instruments

The Group has exposure to the following risks from its use of financial instruments:

- credit risk
- liquidity risk
- market risk

The Board of Directors has overall responsibility for the establishment and oversight of the company's risk management framework and oversees compliance with the Group's risk management policies and procedures and reviews the adequacy of the risk management framework in relation to the risks faced by the Group.

The Board's policy is to maintain a strong capital base so as to cover all liabilities and to maintain the business and to sustain its development.

The Board of Directors also monitors the level of dividends to ordinary shareholders.

There were no changes in the Group's approach to capital management during the year.

Neither the company nor any of its subsidiaries are subject to externally imposed capital requirements.

The group's principal financial instruments comprise cash and short term deposits. The main purpose of these financial instruments is to finance the group's operations.

As the group operates wholly within the United Kingdom, there is currently no exposure to currency risk.

The main risks arising from the group's financial instruments are interest rate risks and liquidity risks. The board reviews and agrees policies for managing each of these risks, which are summarised below

Credit risk

Credit risk is the risk of financial loss to the Group if a customer or counterparty to a financial instrument fails to meet its contractual obligations and arises principally from the Group's receivables from customers, cash held at banks and its available for sale financial assets.

Trade receivables

The Group's exposure to credit risk is influenced mainly by the individual characteristics of each tenant. The majority of rental payments are received quarterly in advance which reduces the group's exposure to credit risk on trade receivables.

Other receivables

Other receivables consist of amounts due from a company in which the group holds a minority investment.

Available for sale financial assets

The Group does not actively trade in available for sale financial assets. The Group's investments were sold in the year. *(2012: £4,000)*.

Bank facilities

At the year end the company had no loan facilities available *(2012: Nil).*

Exposure to credit risk

The carrying amount of financial assets represents the maximum credit exposure. The maximum exposure to credit risk at the reporting date was:

	Carrying value	
	2013	2012
	£000	£000
Available for sale investments	**-**	4
Other receivables	**21**	24
Cash and cash equivalents	**6**	691
	27	719

The company does not have an allowance for impairment on trade receivables as, based on historical experience, management does not consider that such an impairment is required.

Credit risk for trade receivables at the reporting date was all in relation to property tenants in United Kingdom.

The company's exposure is spread across a number of customers.

Liquidity risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due without incurring unacceptable losses or risking damage to the Company's reputation. Whilst the directors cannot envisage all possible circumstances, the directors believe that, taking account of reasonably foreseeable adverse movements in rental income, interest or property values, the group has sufficient resources available to enable it to do so.

The group's exposure to liquidity risk is given below

30 June 2013 £'000	**Carrying amount**	**Contractual cash flows**	**6 months or less**	**6-12 months**
Unsecured loan	275	280	5	275
Floating rate unsecured loan stock	2,725	2,774	48	2,726
Trade and other payables	431	431	431	-

30 June 2012 £'000	**Carrying amount**	**Contractual cash flows**	**6 months or less**	**6-12 months**
Floating rate unsecured loan stock	2,725	2,774	48	2,726

Trade and other payables	324	324	324	-

Market risk

Market risk is the risk that changes in market prices, such as interest rates, will affect the company's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return.

Interest rate risk

The Group borrowings are at floating rates of interest based on LIBOR or Base Rate.

The interest rate profile of the Group's borrowings as at the year end was as follows:

	2013	2012
	£000	£000
Unsecured loan	**275**	-
Floating rate instruments – financial liabilities	**2,725**	2,725
	=======	=======

The weighted average interest rate of the floating rate borrowings was 3.5% *(2012: 4.10%)*.

A 1% movement in interest rates would be expected to change the Group's annual net interest charge by £30,000 *(2012: £27,000)*.

19 Operating leases

Leases as lessors
The group leases out its investment properties under operating leases. The future minimum receipts under non cancellable operating leases are as follows:

	2013	2012
	£000	£000
Less than one year	**176**	168
Between one and five years	**503**	495
Greater than five years	**362**	328
	1,041	991
	=====	=====

The amounts recognised in income and costs for operating leases are shown on the face of the income statement.

20 Income tax and deferred tax

At 30 June 2013, the group has a potential deferred tax asset of £1,199,000 (*2012: £1,216,000*) of which £412,000 (*2012: £516,000*) relates to differences between the carrying value of investment properties and the tax base. In addition the group has tax losses which would result in a deferred tax asset of £787,000 (*2012: £700,000*). This has not been recognised due to the uncertainty over the availability of future taxable profits.

Movement in unrecognised deferred tax asset

£'000	Balance 1 July 11 at 28%	Additions	Balance 30 June 12 at 26%	Additions/ reductions	**Balance 30 Jun 13 at 23%**
	£000	£000	£000	£000	**£000**
Investment properties	488	28	516	(104)	**412**
Tax losses	519	181	700	87	**787**
Total	1,007	209	1,216	(17)	**1,199**

21 Issued share capital

	30 June 2013 No	**30 June 2013 £000**	30 June 2012 No.	30 June 2012 £000
Issued and fully paid				
Ordinary shares of 20p each	**11,783,577**	**2,357**	11,882,923	2,377

Holders of ordinary shares are entitled to dividends declared from time to time, to one vote per ordinary share and a share of any distribution of the company's assets.

22 Capital and reserves

The capital redemption reserve arose in prior years on redemption of share capital. The reserve is not distributable.

The share premium account is used to record the issue of share capital above par value. This reserve is not distributable and can only be reduced with court approval.

23 Related parties

Transactions with key management personnel

Transactions with key management personnel consist of compensation for services provided to the company. Details of this are given in note 6.

Other related party transactions

The parent company has a related party relationship with its subsidiaries. The group and company has unsecured floating rate loan stock due to Leafrealm Limited, a company of which ID Lowe is the controlling shareholder. This is on normal commercial terms.

Leafrealm received £95,000 *(2012: £113,000)* interest in respect of its holding of Floating Rate Unsecured Loan Stock. The balance due to this party at the year end was £3,000,000 (*2012: £2,725,000*).

Annual Report and Accounts

The Annual Report and Accounts will be posted to shareholders together with a Notice of Annual General Meeting on or before 31 December 2013 and further copies will be available, free of charge, for a period of one month following posting to shareholders from the Company's head office, 61A North Castle Street, Edinburgh, EH2 3LJ.

AGM

The Annual General Meeting of the Company will be held at 61A North Castle Street, Edinburgh EH2 3LJ on Friday 31 January 2014 at 12:30pm.

A copy of this announcement and the Company's annual report and financial statements for 2013 will be made available on the Company's website http://www.caledoniantrust.com shortly.

For further information please contact:

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