# AUDIT COMMITTEE

Tuesday 1 November 2005

Session 2

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## AUDIT COMMITTEE
**15th Meeting 2005, Session 2**

**CONVENER**

*Mr Brian Monteith (Mid Scotland and Fife) (Con)

**DEPUTY CONVENER**

Mr Andrew Welsh (Angus) (SNP)

**COMMITTEE MEMBERS**

*Susan Deacon (Edinburgh East and Musselburgh) (Lab)
*Margaret Jamieson (Kilmarnock and Loudoun) (Lab)
*Mrs Mary Mulligan (Linlithgow) (Lab)
*Eleanor Scott (Highlands and Islands) (Green)
*Margaret Smith (Edinburgh West) (LD)

**COMMITTEE SUBSTITUTES**

Chris Ballance (South of Scotland) (Green)
Mr David Davidson (North East Scotland) (Con)
Marlyn Glen (North East Scotland) (Lab)
Mr John Swinney (North Tayside) (SNP)

*attended

**THE FOLLOWING ALSO ATTENDED:**

Mr Robert Black (Auditor General for Scotland)
Caroline Gardner (Audit Scotland)
Barbara Hurst (Audit Scotland)

**CLERK TO THE COMMITTEE**

Shelagh McKinlay

**SENIOR ASSISTANT CLERK**

Joanna Hardy

**ASSISTANT CLERK**

Clare O'Neill

**LOCATION**

Committee Room 5

# Scottish Parliament

## Audit Committee

*Tuesday 1 November 2005*

[THE CONVENER *opened the meeting at 10:30*]

## Items in Private

**The Convener (Mr Brian Monteith):** Instead of a bong, I say bula. Welcome to the Scottish Parliament Audit Committee's 15th meeting in 2005. I remind members and others present to switch off their mobile phones and pagers. We have apologies from our deputy convener, Andrew Welsh, who is attending a Scottish Parliamentary Corporate Body meeting and cannot be here, but we anticipate that everyone else will make it.

The first item on the agenda is for me to seek the committee's agreement to take agenda item 5 in private. Item 5 is consideration of the committee's approach to the reports from the Auditor General for Scotland that we are discussing under today's agenda. That is our standard business practice.

Are we agreed to take agenda item 5 in private?

**Members** *indicated agreement*.

## "Overview of the water industry in Scotland"

10:31

**The Convener:** Agenda item 2 is a briefing from the Auditor General for Scotland on his report "Overview of the water industry in Scotland", which has been circulated to committee members. I welcome the Auditor General and his team and ask him to give the committee his briefing.

**Mr Robert Black (Auditor General for Scotland):** Thank you, convener. Back in November 2002, I published an overview based on the audit findings for the three previous water authorities for the financial year 2001-02. My report identified some issues arising from the merger of the water authorities that Scottish Water needed to address, and I undertook to produce a further report on Scottish Water's progress.

In the latest overview, I examine the roles and responsibilities of the key agencies that are involved in the Scottish water industry. I also review the progress that has been made in integrating the three former water authorities and summarise Scottish Water's performance since it was established. In the report, I also describe how Scottish Water is regulated and review what the regulators have said about its performance.

Scottish Water is the fourth-largest water services provider in the United Kingdom and one of the 20 largest businesses in Scotland. Its annual turnover is almost £1 billion. It is also in the middle of a major capital investment programme that is expected to cost about £1.8 billion in the four years to April 2006, when a further investment programme will be started. So there is investment to come over a number of years.

Scottish Water is a public corporation with responsibilities to the Scottish ministers and, in turn, to the Scottish Parliament. It sits within a complex regulatory regime. Different regulators are responsible for regulating its economic and customer service performance, the quality of drinking water and the discharge of treated sewage to water courses. In reviewing what those regulators have said about Scottish Water's performance in its first few years, I take the opportunity to set out the roles and responsibilities that those various regulators have and how they relate to one another in the water industry.

The overall message from the report is that Scottish Water has made good progress in merging the three previous water authorities and improving the industry's efficiency and performance, but that there is scope for further improvement. In the report, I cover five main areas: Scottish Water's progress in merging the three previous authorities; improvements in its efficiency; customer service performance; water quality; and recent changes in the regulatory regime. I will comment briefly on each of those areas.

The first heading is Scottish Water's progress in merging the three previous authorities. Scottish Water has undertaken a number of projects to transform its business from the three previous water authorities into a single organisation. One example, which we give on page 9 of the report, is the rationalisation of three customer service centres into a single customer management centre.

Another significant consequential change in moving to the new business has been the reduction in staff numbers from 5,650 to 3,750. The auditor has reported that Scottish Water now has robust corporate governance arrangements in place, that its financial stewardship is sound, that it has met its financial targets in the first three years and that its financial surpluses have been reinvested in the business.

My second heading is improvements to efficiency. The key benefits expected from the creation of Scottish Water were increased efficiency and competitiveness, better value for money from economies of scale and harmonisation of customer charges. The water industry commissioner had the main responsibility for regulating Scottish Water and set targets for improving its efficiency and performance. Scottish Water is on track to reduce its annual operating expenditure by £175 million to £265 million by 2005-06 through efficiency savings in its operations and as a result of the merger. The commissioner also expected Scottish Water to deliver its four-year capital investment programme to 2005-06 for £1.8 billion. That is some £500 million less than the figure originally estimated by Scottish Water. However, although Scottish Water has clearly made efficiency gains, a significant number of capital projects, worth about £250 million, are unlikely to be completed until after March 2006.

It appears from the audit evidence that we took that a significant challenge facing Scottish Water in delivering its capital programme in line with its plans relates to the requirement to get local authority planning approvals and Scottish Environment Protection Agency discharge consents in respect of individual projects. I understand from the auditors that, although Scottish Water has progressed many of its applications, many are still outstanding.

I should also point out that, as I am sure members of the committee are well aware, Scottish Water has now harmonised its charges for similar groups of customers across the country. In some areas, that has led to charge increases. However, in the north of Scotland, charges have fallen in real terms; they have gone up in money terms, but they have fallen in real terms. In exhibit 14 on page 18, we show the trend in the average band D charges between 2000 and 2006 for each of the areas—east, north and west—previously covered by the former water authorities.

Scottish Water measures how its customer services are performing over four areas: customer services; response to billing inquiries; asset performance; and debt collection performance. Scottish Water reports that it has met most of the customer services targets that it set itself in the first three years. However, the water industry commissioner used a different set of customer service performance measures, which he developed from the approach used by the Office of Water Services in England and Wales. Using those performance measures, the commissioner reported that Scottish Water's customer service was generally worse than that of water companies in England and Wales in 2002-03. Scottish Water, however, considers that the commissioner's comparisons did not put its performance fully in context. Both sets of performance indicators are described on pages 20 and 21 of the main report, in exhibits 16 and 17, so you can see the full range of indicators that each party was referring to. One of the recommendations that I have put in my report is to urge the water regulator to ensure that any customer service targets and performance indicators provide a full picture of Scottish Water's performance.

The fourth heading that I mentioned was water quality. My report summarises the available data from the regulators and confirms the quality of drinking water and surface water, and the finding is that the quality is improving. There has been a steady improvement in the microbiological quality of drinking water since the early 1990s. Overall, less than 1 per cent of tap samples now fail to meet the relevant standards. Significant improvements have also been made to the quality of water in rivers, estuaries and coastal areas. Those improvements are all closely associated with Scottish Water's investment in new water and waste water treatment works. Having said that, sewage discharges remain the most important cause of poor water quality in Scotland. Accordingly, ministers have set further targets to improve water quality through Scottish Water's next capital investment programme, which starts in 2006 and will run until 2014. That will involve further investment to improve the capacity and quality of sewage treatment works.

My final main heading relates to recent changes in the regulatory regime. As I have said, the regulatory regime for the water industry is complex. Scottish Water's monopoly position means that customers have little or no choice about who provides them with water and sewerage services, so economic regulation is needed to protect the interests of water customers. It is important that there is transparency in what the regulators do to provide clarity to stakeholders.

On page 13, in exhibit 8, there is a diagram describing the changes to the economic regulation that came into effect on 1 July this year. As a result of the recent legislation, the water industry commissioner was replaced last July by the Water Industry Commission for Scotland. Where the former commissioner recommended to ministers how much income Scottish Water could collect from charges to customers, the new commission will be responsible for determining Scottish Water's maximum charge limits, based on principles set by ministers, which is a significant change.

The Water Industry Commission has a new line of accountability to the Competition Commission. If a dispute ever arose about charging determinations between the Water Industry Commission and Scottish Water, the Competition Commission would have a duty to arbitrate.

Scottish Water has established a sound basis for strategic planning, business planning and performance reporting, but there is still scope for improvement. Robust regulation is appropriate for a public sector monopoly, but those involved need to co-operate to ensure transparency and the minimisation of regulatory costs.

Scottish Water's core costs need to be understood more clearly by all parties to ensure that accurate information is provided to the Water Industry Commission. Scottish Water has made significant improvements in its efficiency and performance, but there is scope for more. Its capital programme is essential to deliver future quality and efficiency improvements, but it will be challenging to achieve that within the timescales set. I have asked Audit Scotland to undertake a study of the issue of capital programme management, on which we will report before the end of 2006.

This is, in a sense, a form of stock-taking—a baseline for the new water industry. I hope that members find the report informative. As always, I am happy to answer questions to the best of my ability.

**The Convener:** Thank you. The floor is open to members to ask questions on the report.

**Mrs Mary Mulligan (Linlithgow) (Lab):** Mr Black, you say in the report that staffing has been reduced by about a third, and you just said that customer service centres had been reduced from three to one—I suspect that that might give me the answer that I am looking for. Can you tell us confidently that in reducing staffing Scottish Water has lost staff in areas where there was duplication rather than staff at the sharp end, who should be delivering the kind of service that we are looking for? You said that there were issues about getting planning permission. Have problems been caused because the people who were working on specific projects have been lost, or has the reduction in staff been well managed?

**Mr Black:** I apologise, but I cannot give you a specific answer about the nature of the staffing reductions; you would have to put that to the management of Scottish Water. However, as my report describes fully, the performance of Scottish Water has continued to improve in all the key matters that are important to the people of Scotland, not least of which are water quality, progressing a major capital investment programme and responding to customer queries. Your concern about the reduction in staff numbers and the particular categories of staff involved have to be considered in the context of clear evidence of significant improvements in how the water industry is managed and the services that are delivered, in general terms.

**Mrs Mulligan:** Can you say a bit about Scottish Water's problems in getting planning permission from local authorities?

10:45

**Mr Black:** We do not have the detail on that, unfortunately. However, Scottish Water gave us a clear indication that one of the constraints facing it was getting planning permission and discharge consents in time. I have reason to believe that part of the problem is Scottish Water's capacity to progress the programme as quickly as it would like, and obviously planning applications need to be clearly specified. However, to an extent, that is conjecture; I do not have robust evidence on that point. That question would best be put to the management of Scottish Water.

**Margaret Jamieson (Kilmarnock and Loudoun) (Lab):** The report has a chapter on the impact of new building developments. I would like to ask a follow-up question on the point to which Mary Mulligan alluded. Most of the enquiries that I receive about Scottish Water are about connection to clean water supplies and the sewerage system. Developers who have been involved with local authorities and who have subsequently been included in the local community plan are being held to ransom in certain areas—they cannot get planning permission because Scottish Water has been one of the objectors.

Given that you are satisfied with the internal processes of Scottish Water since its amalgamation, would it not be appropriate to look at the future to see how Scottish Water can be part of the community planning process? Scottish Water should no longer be able to hide behind the position that it did not know that local authorities A and Y were going to be building X amount of houses over a 10-year period. Such a move would reduce the burden on local authorities, developers and the purchasers of houses or commercial properties. Scottish Water gives no assessment of economic impact.

**Mr Black:** It might help if I summarise the background to the programme for connections and the evidence that we have gathered. When the quality and standards II programme, amounting to £2.3 billion, was set, it allowed for £50 million to be spent on new developments and first-time connections. Some might argue that that is a comparatively small sum relative to the size of the programme. That gave rise to concerns from housing developers and others, including SEPA, which believed that the network did not have the capacity to cope with new development. It was recognised as an issue.

Scottish Water's next capital investment programme, Q and S III, which will run from 2006 to 2014, includes greater provision for Scottish Water to provide connections to new housing. On that basis, Scottish Water's second draft business plan, for 2006 to 2010, proposes an investment of £221 million to meet demand for new network capacity and a further £70 million for first-time connections to existing properties.

The balance of the different elements in the programme is, of course, a policy matter for the water industry, together with ministers, to determine. As the committee will understand, I do not want to comment on whether that is entirely appropriate. However, it is clear that significantly more money is available to address the issue.

The picture is changing, and perhaps we should monitor developments in future. I will note the point, but the context is changing.

**Margaret Jamieson:** Would it not assist Scottish Water in its involvement in the community planning process to be at the table? Would it not be helpful for Scottish Water to say whether it has capacity problems in a given area? That would avoid the situation in which a developer or householder gets hit with a huge bill for a connection.

**Mr Black:** You raise issues that are worth serious consideration. Given the significant expansion in the provision for connections, there is a need for Scottish Water to interact well with others involved in the development process so that—[*Interruption.*]

**The Convener:** Can I ask you to hold on for a second, Auditor General? We may have an audio problem. I suspend the meeting until the problem has been addressed, as it will affect our recording of the meeting for the *Official Report*.

10:50

*Meeting suspended.*

10:50

*On resuming—*

**The Convener:** The system has been rebooted and we are able to use the microphones again.

**Mr Black:** I will conclude my previous response.

We have recorded in our report that, as part of the Q and S III investment programme, ministers set Scottish Water the objective of providing sufficient strategic capacity to meet the requirements of estimated new development. We also understand that Scottish Water will now publish annual information on its network capacity and plans to develop it. From March 2006, Scottish Water will also monitor sewage works that are at risk of overload. Scottish Water is addressing some of the issues.

**Margaret Jamieson:** That is good.

**Eleanor Scott (Highlands and Islands) (Green):** I must ask my colleagues to bear with me, as I want to ask about things that members who have been on the committee longer than I have probably know about. Having read the report, I am a bit more sure of who is who. I knew what SEPA is and where it came from; I now know what the Water Industry Commission is and where it comes from, and who the drinking water quality regulator is and where he, she or it comes from. However, I am not sure about the Competition Commission. Can somebody tell me in one sentence what it is and where it comes from?

**Mr Black:** The Competition Commission is a United Kingdom body that is statutorily charged with ensuring that fair competition is applied across the whole of the British economy—primarily in the private sector. The legislation that has been passed by the Scottish Parliament provides for the Competition Commission to have a power to arbitrate between the Water Industry Commission and Scottish Water if there is any dispute over charge determinations that cannot be resolved between them.

**Eleanor Scott:** Are there any implications for the Scottish Parliament's scrutiny of something that is partly regulated by a body that is not a Scottish body?

**Mr Black:** This is speculative. It is certainly unusual for the ultimate arbiter in these matters to be outwith Scotland. Having said that, in that hypothetical situation, the Water Industry

Commission would have issued a determination of the maximum charge limits within the principles set by ministers. Those maximum charge limits would be an issue of contention between the commission and Scottish Water. I suggest that it would not be a case of Scotland losing control of the issue; the question would be whether the determination by the Water Industry Commission was reasonable and fair, all things considered. In other words, the Competition Commission would not have a role in setting a different maximum charge limit; it would have an arbitration function.

**Eleanor Scott:** The report mentions the water customer consultation panels. That is the first that I have heard of them. I wonder how effective they are and how local they can be thought to be if there are only five in Scotland. Is there any objective measure of customer satisfaction? I have had discussions with Scottish Water about people's complaints about the chloramination process, which has replaced chlorination. People say that it has affected the taste of the water, but Scottish Water's reply is that there is no standard for taste. Are there any objective measures, such as the figures for sales of bottled water as a surrogate for tap water for dissatisfied customers?

**Mr Black:** The customer consultation panels' powers were expanded to allow them to make recommendations to the Water Industry Commission, and they will probably have a higher profile in the future as a result of that. They can also make recommendations to ministers, the drinking water quality regulator and SEPA. All those bodies, including Scottish Water, must have regard to the panels' recommendations.

Moreover, the panels have now assumed the water industry commissioner's responsibility for investigating customer complaints that Scottish Water has not resolved and, henceforth, the annual report by the convener of the panels must refer to his complaints investigation work. As a result, that aspect of the complex regulatory regime will become more transparent to the public. With the new requirement on the various parties to have regard to the panels' recommendations, the power of the panels will be enhanced.

I apologise, but I find it difficult to answer your question about bottled water.

**Eleanor Scott:** Perhaps I was not being fair.

**Susan Deacon (Edinburgh East and Musselburgh) (Lab):** I have three questions but, in light of the previous exchange, I want to comment briefly on the water customer consultation panels. Although I am in no doubt about the need to increase public transparency, I should note for the record that, in my experience, the panels have been pretty proactive in communicating with MSPs about their work.

My first question concerns creating greater clarity and understanding with regard to measuring Scottish Water's performance. I am somewhat concerned by the disparity that you have identified between the commissioner's views and Scottish Water's views about how that should be done. I realise that the situation has moved on, but in the report you urge the Water Industry Commission to produce a full range of performance indicators. Given the complexity of this area, it is all the more important that we have clarity and that all those who are involved agree on how best to measure and publish performance indicators. The fact that it has proved difficult to reach agreement at that level does not bode well for us as parliamentarians—or, for that matter, for Scottish Water's customers—in understanding how well the organisation is performing. In light of the report, how do you expect to monitor improvements in performance measurement and the publication of Scottish Water's performance either at its own hand or through the Water Industry Commission?

I have two more questions, but I will pause and let the Auditor General deal with that big area.

**Mr Black:** Exhibits 16 and 17 on pages 20 and 21 of the report describe Scottish Water's different customer service targets and the water industry commissioner's comparison between those targets and targets in England and Wales. Scottish Water and the Water Industry Commission should be encouraged to enter into a good dialogue on the importance of the various customer targets to ensure that we have a comprehensive set. It seems that, in the past, although Scottish Water reported high performance against its own targets, the commissioner challenged it on other targets that he considered to be appropriate to the water industry.

Because, in recent years, the water industry commissioner expressed a lack of confidence in some of Scottish Water's information, the Scottish Executive brokered an understanding between the commissioner and Scottish Water that resulted in the new appointment of a reporter with the specific responsibility of ensuring that reliable and relevant information was prepared and made available to what is now the commission. Clearly, there is quite a long way to go on that matter. However, from informal conversation with the chairman of the new commission, I know that the commission will give serious attention to the matter.

11:00

**Susan Deacon:** I for one am very pleased that the Auditor General has indicated to the committee a number of times that it is his intention to examine generic themes across various aspects of public sector management. Two of the areas that you have mentioned today strike me as being particularly fertile terrain in that respect. One of those areas is capital project management; there are also issues to do with expediting the decision-making process around matters such as planning and SEPA approvals. To what extent does Audit Scotland intend to weave in the analysis that has been done following the report that is before us with any wider work that you are undertaking on some of the common themes around the public sector? We recognise that certain aspects or dimensions are specific to Scottish Water, but others have a wider resonance.

Appendix 2 of your report covers Scottish Water's transformation programme, which is, by any measure, one of the most wide ranging that any public sector body in Scotland has undertaken in recent years. We would all agree that, as your report identifies, there is room for further improvement—there are always things that could be done better. However, it is fair to say that Scottish Water's performance—in terms of both managing the programme of change and marrying that with the maintenance of high standards of operational and financial performance—compares most favourably with that of other organisations. There must be aspects of good practice to be identified in the management of the transformation programme. Having examined Scottish Water's practices, has Audit Scotland applied its observations to other areas of its work?

**Mr Black:** As I think I have mentioned, we have a commitment in our programme to continue examining Scottish Water's capital project management. The main focus will be on how the new vehicle, Scottish Water Solutions, operates. I hope that we can do two things as a result of that work: first, to give an objective account of how efficiently and effectively that programme is being developed and, secondly, to draw out the lessons from that. One of the reasons for undertaking that study was that we considered, given the sheer scale of Scottish Water's capital programme, that there must be a good chance that we could draw some lessons from it that would be relevant across the public sector. We will present those lessons in a way that is helpful and relevant in that context.

Audit Scotland is considering whether it would be helpful—although it is not part of our formal, published programme—to do a piece of work on best practice in the development and management of major capital projects. As committee members are well aware, quite a number of major projects are going on, not just in the water industry; the other major sector that springs to mind is the transport industry. We might be able to make a contribution there by considering best practice and, in a sense, laying down a baseline for it. That work will be relevant to our forthcoming overview of the transport sector as a whole, which we are due to publish in the course of next year.

I turn to the second part of Susan Deacon's remarks and her question about the transformation project. I very much agree with her comment that the transformation project has been a significant undertaking on the part of Scottish Water. We have not considered the detail of it at all, but it may well be that there are lessons for the rest of the public sector. I would caution, however, that the Scottish water industry is a rather unique set of bodies, considering the three historic water authorities' transformation into one, so the transposition of best practice might not be quite so easily seen in the transformation project.

**Margaret Smith (Edinburgh West) (LD):** You may have covered this point in your earlier remarks. I note from the report that the key area of efficiency savings within the operation appears to be staff costs, as Mary Mulligan said. In relation to potential efficiency savings, a figure of just under £23 million is given for unidentified costs. The report tells us that £23 million of savings were unidentified at the time of the business plan because of the risks that would be involved in cutting costs too quickly. Can you tell us whether any of those potential savings have become more clearly identified in the course of time? They appear to amount to about 20 per cent of the operating costs.

**Mr Black:** I cannot give you a definitive answer to that question, which would probably best be answered by the management of Scottish Water. As you say, the £23 million was unidentified because of the risk that cutting costs too quickly could affect service delivery. I think that the figure was a result of the continuing negotiations between the regulator and Scottish Water. The regulator set some quite robust and challenging targets for efficiency savings and, as you might imagine, there was a process of dialogue. Given the scale of the business, which is very large indeed, an understanding was eventually reached that, in order to meet the regulator's performance targets, Scottish Water would have to find another £23 million of efficiency savings, but those savings were not explicitly identified up front. As the transformation programme continued, it became clear to Scottish Water that it could achieve those savings of £23 million, but I am not in a position to say exactly where those savings came from.

With regard to your first comment, the savings in staff costs were significant. Having said that, there has been an enormous efficiency gain between the initial figure for the cost of the planned capital investment programme—some £2.3 billion—and the figure that was ultimately agreed, of £1.8 billion, so the regulator's work with Scottish Water has generated significant efficiency improvements.

**The Convener:** You mentioned that Scottish Water's completion of some of its capital investment procedures, such as getting consents from local authorities and from SEPA, might delay matters. Is that delay simply procedural, or could Scottish Water do more to achieve those consents sooner and therefore to complete its investments?

**Mr Black:** I indicated in my response to an earlier question that there may well be a factor involving the planning of individual projects. Specifying the nature of the capital works that are to be undertaken is essential before a planning application can be made, and there is evidence that there may be bottlenecks in the system in Scottish Water in terms of its capacity to plan all that work thoroughly and effectively according to a timescale that would allow completion on schedule of the entire, very large investment programme.

**The Convener:** In your briefing, you mentioned exhibit 16 on page 20. If one looks at "Asset management" and at the line for "Number of properties affected by unplanned interruptions", one sees the target coming down from 4,000 to 3,500 and then to 3,350. The actual performance varies within that band, although it has been below the target on every occasion. Do you have a view on whether those targets are challenging enough?

**Mr Black:** I am sorry, but I do not have that information. That matter would be best addressed by the water industry commissioner.

**The Convener:** Okay.

I refer you to exhibit 17. Under the heading "Asset performance", I note that where a performance comparison is made—I accept that comparisons are not always possible—Scottish Water comes off worst only once. Scottish Water fares less well in the comparison on customer service. Would it be a fair judgment to say that the problems that are identified in the commissioner's performance comparisons are mainly in customer service rather than asset management?

**Mr Black:** The water industry commissioner is concerned about both areas. Scottish Water has a view about the relevance of the water companies' targets in England and Wales and how directly applicable they are in Scotland, but its clear view is that the customer service targets are entirely appropriate.

Similarly, the water industry commissioner has done a great deal of modelling work on efficiency. As a result of that, he has settled on the figure of £1.8 billion rather than £2.3 billion for the delivery of the programme. The water industry commissioner's work is based to a significant extent on his analysis of the efficiency of the delivery of the capital programme in English water authorities. Not all that analysis would have been fully accepted in the past by Scottish Water.

**The Convener:** That leads me to my final point. The first bullet point on page 24 of the report says:

> "The asset performance comparison does not reflect the poor state of the water industry's assets in Scotland compared with England and Wales".

It goes on to say:

> "The WIC contends, however, that there is no evidence that Scotland's water assets are in any worse condition than those in England and Wales".

How do we square those two points of view?

**Mr Black:** They reflect a difference of judgment on the available evidence. The water industry commissioner has done a lot of analysis in that area and he has been confident in his conclusion. However, again, that matter might be best addressed by the water industry commissioner.

**The Convener:** As there are no further questions, I thank the Auditor General for his briefing and his full answers to our questions. The committee will discuss its response to the report and the briefing under agenda item 5, which we will take in private.

## Section 22 Reports

11:13

**The Convener:** Item 3 is a briefing from the Auditor General and his team on section 22 reports on a number of NHS boards.

**Barbara Hurst (Audit Scotland):** There are section 22 reports on the 2004-05 accounts of five NHS boards. The reasons for undertaking section 22 reports vary between the boards.

Both Argyll and Clyde NHS Board and Lanarkshire NHS Board were the subjects of section 22 reports last year. I am sure that committee members remember taking evidence from NHS Argyll and Clyde. The board acknowledged then that it would not achieve in-year balance until 2007-08 and that clearing the cumulative deficit would be a significant challenge for it. The Minister for Health and Community Care then announced the planned dissolution of the board and said that the cumulative deficit would be cleared when the services were taken over by NHS Greater Glasgow and NHS Highland. The latest section 22 report updates NHS Argyll and Clyde's position and shows that although it is still in deficit by just under £59.5 million, its position at the end of 2004-05 was slightly better than that forecast in its financial recovery plan.

Lanarkshire NHS Board also has a large brought-forward deficit from previous years of just under £20.5 million. During 2004-5, the board managed to make a small in-year saving by making savings and taking other measures totalling around £48.4 million, although £38.3 million of those savings and measures were non-recurring. The board forecasts the elimination of its underlying recurrent deficit by 2007-08, but that depends on the sale of a surplus hospital.

Grampian NHS Board's deficit rose over the past two financial years from £4.8 million in 2003-04 to just under £11 million in 2004-05. The board's financial recovery plan does not show recurring in-year balance until the end of 2006-07, with the elimination of the cumulative deficit largely dependent on the sale of assets totalling some £28 million.

11:15

Western Isles NHS Board has a section 22 report for two reasons. First, it has a deficit this year of just under £750,000. Although that sounds relatively small, for that board it is as significant a percentage of revenue resource limit as NHS Grampian's deficit is for it. Like NHS Lanarkshire, the Western Isles NHS Board does not forecast elimination of the deficit until 2007-08. The other reason why the Western Isles NHS Board has a section 22 report is that its accounts were qualified in 2004-05 because the board did not comply with European Community procurement regulations.

The section 22 report for the Highland NHS Board is to do with a different issue. It is very similar to an issue that the committee discussed in relation to Kilmarnock prison in 2002. It concerns the accounting treatment of an asset under a private finance initiative, in this instance a primary care resource centre. At present, the asset does not sit on the balance sheet of the board or of the contractor. The auditor's view is that the asset should be on the board's balance sheet, because the risks are substantially with the board. The auditor qualified the accounts for that reason. The board and the auditor are in discussion on how to deal with the matter in future.

We will be publishing an annual overview report on the health service in December. All those issues will be picked up in the wider context of the financial performance of the health service as a whole. In the meantime, we are happy to answer any questions that you may have on the section 22 reports.

**Margaret Jamieson:** What is Audit Scotland's thinking on boards such as Grampian, and Argyll and Clyde, which made savings in non-recurring areas that do not address the issues that will continue to affect them after they are back into financial balance? If those boards use assets to get themselves back into the black without addressing recurring issues, are we just letting them earn another section 22 report later?

**Barbara Hurst:** We share your concerns about the use of non-recurring savings if costs are not looked at properly so that savings are made on a recurring basis. We will be going into that in more detail in the overview report.

**Eleanor Scott:** The issue of the PFI in NHS Highland seems odd to me for two reasons: first, there is no standard practice; secondly, the recommendation is that the risk should lie with the board. I thought that the point of the PFI was that that would not happen.

**Barbara Hurst:** I will kick off on this, although I am not an expert on the technicalities of the PFI. Each of our appointed auditors, when faced with a PFI issue, looks very closely at the assumptions that are made about where the risk lies. Judgment is made case by case. Because the auditor is able to comment only on treatment by the board, not on treatment by the contractor, we might get some variations in interpretation.

**Caroline Gardner (Audit Scotland):** I should add that we are not recommending that the risk should sit with the board. That is the auditor's interpretation of the contract; the auditor thinks that, in practice, the risk lies more with the board than it does with the contractor and that, therefore, the asset should be on the board's accounts. That is the reason for the qualification.

**Margaret Smith:** Like Eleanor Scott, I was surprised by this part of the report. I try to have a naive view of the PFI, because if I had anything else, I would be completely lost. Indeed, from what you have said, it appears that experienced auditors are also lost, with different people reaching different opinions on this important issue.

Could we not suggest some common practice or best advice to boards before they sign such contracts and enter into such situations? That might allow us to level the playing field a little bit and to find out where the risk will lie. After all, the PFI is being sold to the public on the basis that risk will be transferred from public bodies to the private sector and that that is why we might sometimes have to pay over the odds for those services. If that risk is not transferred, what is the benefit of such an approach?

**The Convener:** Of course, we should avoid mentioning any policy issues.

**Margaret Smith:** Okay. In that case, I ask the Auditor General whether we could progress this matter by coming up with helpful guidance for boards on common practice or on ways in which they can take this matter forward.

**Caroline Gardner:** I will take a first stab at that question.

The Treasury and organisations such as Partnerships UK have already produced a fair amount of guidance to all public bodies on the construction of PFI deals. I should note two points in that respect. First, decisions on where the risk lies are very often not all that clear cut. As a result, each contract might contain clauses that set out how payment goes from—in this case—the health board to the contractor that provides the hospital and when that income will not be paid. Such clauses depend on a number of factors including availability of the service and breakdown of facilities that, together, lead to a judgment on whether the risk lies primarily with the contractor or with the health board.

Secondly, when this specific deal was closed in 2003, the contractor accepted, after discussions with the trust at the time, its advisers and the auditor, that the asset would sit on its balance sheet. The auditor accepted that position in order to avoid the asset being on both balance sheets. However, since the original agreement was reached two years ago, the situation has changed; the resource centre has opened and the contractor has not placed the asset on its balance sheet. That has brought the matter to our attention this time round.

Bob Black might want to say a little more on whether there is a role for more guidance, but I must stress that the problem lies not with the availability of guidance but with the difficulty of interpreting where the asset sits in each PFI deal. After all, each deal tends to be different, sometimes for good reasons and sometimes as a reflection of negotiations that have taken place.

**Margaret Smith:** Could—indeed, should—the contract not include a clause that stipulates the balance sheet on which the asset should sit?

**Caroline Gardner:** Although agreement was reached on the matter at the time, it did not form part of the contract. Indeed, it might be worth taking a closer look at that to see whether such agreements can be made more binding. That said, accounting treatment has to reflect the realities of the situation as they come into being in fact rather than as they were agreed in principle in the first place.

**Mr Black:** If we go back to first principles, the purpose of a PFI contract is not to transfer an asset off the public sector balance sheet but to provide a vehicle that gives best value for money to the public sector in delivering a service. The accounting treatment is a consequence, not a criterion, of determining a PFI. We expect the appointed auditors to monitor the deals, as they have been planning to do quite carefully, and to provide an independent assurance that the planning procedures are being competently undertaken and that, before a contract is signed up to, proper arrangements have been put in place so that the purchasing body is satisfied that it is getting value for money. The accounting treatment of the asset follows as a consequence of that, and it is quite a separate issue.

The fact that a particular PFI project is on or off the public sector balance sheet is not strictly relevant to the question of value for money. As Caroline Gardner has said, a lot of guidance is available from the Treasury and elsewhere about the considerations that the management of a public body must take into account when it is determining the accounting treatment.

As Caroline Gardner has outlined, in this case the auditor had doubts on the basis of the limited evidence that was available as to whether a sufficient degree of risk had been transferred for the asset to appear on the balance sheet of the provider body. It has subsequently emerged that the provider is taking a clear view that the risk resides mainly with the health board. It is as a consequence of that that we find ourselves in the current position.

**Mrs Mulligan:** The question that I had intended to ask was on the change of liability. You have answered on most aspects of that, but I would also like to know whether it is unusual for it to be suggested to begin with that the liability rests with one party, but for that to change and for the liability to rest with another party later. That would cause us some concern when it comes to the development of contracts. There is an uncertainty there.

**Mr Black:** It is fair to say that we are talking about a minority of cases, but it is not unknown for that to happen. There are two points that must be borne in mind. First, many of the issues that are arising now—albeit not the present one—about the balance-sheet treatment of assets that were procured or created under a PFI relate to contracts that were entered into quite a number of years ago. There has since been a steady process of learning and development, and people are getting better at it.

Secondly, and particularly in relation to some of the larger, more complex projects, as experience develops in providing the service that the asset supports, the view of where the risk lies might change. One significant manifestation of that relates to some of the refinancing deals for major PFI contracts that are now coming through. Originally, when the asset was being constructed, the cost of money was very high, because of the high risk premium. Under refinancing, as the market becomes generally more confident about how the services are being delivered, the risk premium is reduced, so the situation stabilises somewhat. In a sense, the assessment of the level of risk and where it lies changes somewhat. It is therefore possible to refinance and obtain cheaper money. One of the current issues is to ensure that a new deal is entered into. If there is refinancing, the public sector payer sees some of the benefit. There has been a significant development and refinement of thinking in that area over the past few years.

**Mrs Mulligan:** You have already said that you think that there is quite a lot of guidance on PFI contracts, structures and so on. Is there sufficient guidance on that changing process?

**Mr Black:** There has certainly been a great deal of guidance. I think that the industry understands the issue very well now.

**The Convener:** I would like to ask a question on the same issue. Is it possible that accountancy treatment of contracts could change in future, because the Treasury may decide that the treatment by which it works should be updated or is not accurate enough? Might that result in some contracts being brought on to the balance sheet that were previously off the balance sheet?

**Caroline Gardner:** I am struggling to think of any situations where that could be the case, because the accounting standards that the profession applies are based, as Bob Black said, on reflecting the substance of the deal that is in place, so that the person who holds the risk holds the asset on their balance sheet. You will be aware that, in the early days of the PFI, much of the controversy was about how that decision was being made, but the principle itself still holds and it would require a change in global accounting standards to bring that change about, which looks unlikely.

**The Convener:** Thank you. That is helpful. There are no other questions on the section 22 reports, so I thank Barbara Hurst for her briefing and I thank the Auditor General and Caroline Gardner for answering our questions.

## Visit (Denmark)

11:31

**The Convener:** Item 4 is consideration of a report about the committee's recent visit to Denmark. The report has been circulated to members, so I will speak only briefly to it. Those members who had the good fortune to go on the trip found it quite useful to see how an entirely different audit system works. The Danish system is quite unusual in the way in which it uses lay members. Although many of the lay members had political experience, only one of them was an active elected politician. It was useful for the committee to learn about how the Danish audit system had evolved over some 150 years and about how it differed from the Westminster model, to which we normally look to for comparison.

The paper suggests that there are a number of other issues that we might want to investigate, which might require future visits, and suggests where we might go to establish how other working practices impinge on what we do. The recommendation is that a visits paper be put together for consideration at a future date.

Do members have any comments?

**Susan Deacon:** I want to comment on the recommendation, although I am obviously happy to wait for the paper to be prepared for discussion before we debate the matter more fully. I seek clarification that agreeing to such a paper would not mean working on the presumption that there would necessarily be further visits as a consequence. Although I am conscious that I missed the early part of the away day discussion—and I am sure that the matter was explored more fully then—I am concerned that there is still a great deal of learning, and application of learning, to be done following the visits that have already been conducted. Indeed, we can also learn from our own experience in our own unique context in Scotland over the past six years. I am happy to agree to the recommendation, but I would not like us to presume that there will necessarily be further visits as a consequence of the paper being drafted.

**The Convener:** I would not seek to prejudge the outcome of our discussion on that paper either. It may be useful to use the paper to discuss how we benchmark such working practices so that we can then apply them and ensure that our visits are not perceived to be jollies and that some benefit comes out of them.

**Susan Deacon:** Might it therefore be helpful to reposition the title of the proposed paper? Is the paper necessarily about visiting other legislatures, or is it about learning from other legislatures? There may be other information and lessons that we can draw on from international experience, which I am all in favour of, short of the committee having to go and visit other places.

**The Convener:** The paper will consider where there are areas that we can learn from and whether visits will be required. The paper has not been written yet, but I am sure that the clerks will bear your comments in mind.

Do members agree that that paper should be drawn up?

**Members** *indicated agreement*.

11:35

*Meeting suspended until 11:48 and thereafter continued in private until 12:07.*

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