



OFFICIAL REPORT
AITHISG OIFIGEIL

Public Audit and Post-legislative Scrutiny Committee

Thursday 28 January 2021

Session 5



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PUBLIC AUDIT AND POST-LEGISLATIVE SCRUTINY COMMITTEE
3rd Meeting 2021, Session 5

CONVENER

Jenny Marra (North East Scotland) (Lab)

DEPUTY CONVENER

*Graham Simpson (Central Scotland) (Con)

COMMITTEE MEMBERS

*Colin Beattie (Midlothian North and Musselburgh) (SNP)

Neil Bibby (West Scotland) (Lab)

*Bill Bowman (North East Scotland) (Con)

*Alex Neil (Airdrie and Shotts) (SNP)

*Gail Ross (Caithness, Sutherland and Ross) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Stephen Boyle (Auditor General for Scotland)

Graeme Greenhill (Audit Scotland)

Hugh Harvie (KPMG LLP)

Johann Lamont (Glasgow) (Lab) (Committee Substitute)

CLERK TO THE COMMITTEE

Lucy Scharbert

LOCATION

Virtual Meeting

Scottish Parliament

Public Audit and Post-legislative Scrutiny Committee

Thursday 28 January 2021

[The Deputy Convener opened the meeting at 09:30]

Decision on Taking Business in Private

The Deputy Convener (Graham Simpson): Good morning, and welcome to the third meeting in 2021 of the Public Audit and Post-legislative Scrutiny Committee. We have apologies from Jenny Marra and Neil Bibby, but we are lucky enough to have Johann Lamont in their place.

Agenda item 1 is a decision on taking agenda items 3 and 4 in private. Any member who objects to taking those items in private should raise their hand.

I am not seeing any raised hands, so we agree to take agenda items 3 and 4 in private.

Section 22 Report

“The 2019/20 audit of Scottish Water”

09:31

The Deputy Convener: Agenda item 2 is consideration of a section 22 report entitled “The 2019/20 audit of Scottish Water”. I welcome to the meeting Stephen Boyle, the Auditor General for Scotland; Graeme Greenhill, senior manager, performance audit and best value, Audit Scotland; and Hugh Harvie, partner, KPMG LLP.

I understand that the Auditor General wishes to make a brief opening statement.

Stephen Boyle (Auditor General for Scotland): Good morning. I am presenting this report on the 2019-20 audit of Scottish Water under section 22 of the Public Finance and Accountability (Scotland) Act 2000.

Scottish Water Business Stream is one of Scottish Water’s three main trading arms, and it operates in competition with around 30 other licensed providers of regulated water services to non-domestic customers. In 2019-20, it reported income of £477.5 million and operating costs of £491.5 million, leading to an operating deficit of £14 million. Much of the operating deficit is due to a provision of £13.2 million for doubtful debts attributable to the impact of Covid-19 on Business Stream’s customers.

The financial impact of the pandemic on Scottish Water’s domestic market has been limited to date. However, the impact on the non-domestic market is significant, with retail, hospitality and smaller businesses experiencing both reduced levels of water consumption and delays to customer payments.

Scottish Water Business Stream has undertaken financial modelling to assess the potential impact of some of its customers being unable to recover from the economic impact of Covid-19 and pay outstanding amounts due. That modelling indicates that Scottish Water Business Stream could require additional financial support of between £47 million and £88 million over the next 24 months.

There is not yet certainty that that financial support will be required. My report notes that Scottish Water expects that any additional funding that Business Stream requires will be found from existing cash balances within the Scottish Water group of companies. The money is expected to be repaid over five years, with no additional call on financial support from the Scottish Government.

Scottish Water is confident that, although Covid-19 might impact on the final cost of its

infrastructure investment programme as a result of social distancing and other measures, the delivery of the programme will not be affected by the need to support Business Stream.

The auditors of Scottish Water's accounts are satisfied that the process of considering Business Stream's financing requirements and agreeing next steps has been sufficiently robust and has been carried out in a diligent and professional manner.

As members will recognise, the overall financial and economic impact of the Covid-19 pandemic is currently unknown, but it is likely to be with us for a number of years. It will be vitally important for Scottish Water to continue to monitor the financial performance of its subsidiaries and debtors, including in relation to the payment of customer charges, and to adjust its business plans as necessary.

My colleagues and I are happy to support the committee's scrutiny of the report.

The Deputy Convener: Thank you, Auditor General.

The committee has a lot of questions about Scottish Water Business Stream. I will kick off. I would like some clarity on the figures that you mentioned relating to the additional support that might be required over the next 18 months, because the range seemed to be wide.

Stephen Boyle: I will start; Hugh Harvie can then say a little more about the steps that Scottish Water and its subsidiaries have followed in arriving at that range.

It is quite a broad range; it goes from £47 million to just under £90 million. That is driven by quite a detailed piece of scenario planning that the group has undertaken to anticipate the variables in play around what is quite a significant number. We think that doing that scenario planning was the right thing to do and that the variables that are in play make it difficult for Scottish Water and its subsidiaries to make predictions with the level of certainty that they might want.

Hugh Harvie has been tracking the process closely, so I invite him to say whether we can give any more details about how those scenarios have unfolded in the few months since the completion of the audit.

Hugh Harvie (KPMG LLP): I will take a step back to explain the scenarios for the benefit of the committee.

As part of my audit, I must consider whether Scottish Water Business Stream is able to continue as a going concern. In doing so, I have to be able to satisfy myself that it has the ability to meet its liabilities as they fall due. That requires

forecasts to be prepared. In the current environment, we are requesting all entities to prepare scenarios that demonstrate not only a base case, which is what the company might be targeting as its business strategy, but what our regulator describes as severe but plausible downsides, which involves taking a pessimistic view of what things might look like.

The variables that are at play within Business Stream include the potential non-recovery of debts, which Stephen Boyle mentioned, but there is also the impact of the reduction in volumetric business—that includes fresh water supplied and waste water services provided—because of the potential downturn in the economy. The range of figures is wide because of the many variables that are at play. As has rightly been pointed out, that wide range has resulted in scenarios that go from £47 million to £88 million.

I have not carried out any audit work on the position at the moment but, as I understand things, at the end of December, cash in Scottish Water Business Stream stood at £56 million. A number of reverses are anticipated in relation to that, and there will be timing differences. Taking account of that factor, the underlying cash stands at £19 million, which is £30 million ahead of the mid-case scenario.

I will remind members of the three scenarios for the cash that might be required. There was a low-case scenario of £47 million; a mid-case scenario of £59 million; and a worst-case scenario of £88 million. Currently, Business Stream is tracking £30 million ahead of the mid case.

The Deputy Convener: So what would that make the figure?

Hugh Harvie: Forgive me, but I am not quite sure that I understand the question.

The Deputy Convener: You said that Business Stream is £30 million ahead. Ahead of what?

Hugh Harvie: Sorry—pardon me. It is £30 million ahead of the mid-case scenario. That is the scenario that predicts that the support might be £59 million. If Business Stream continues to track ahead, the level of support would be £29 million.

The Deputy Convener: I see—and £29 million is even lower than the lowest figure that you have given us.

Auditor General, your report details what you describe as doubtful debts arising in Scottish Water as a result of the temporary relaxation on wholesale pre-payment charges. Is Scottish Water confident that it can avoid bad debt arising out of that temporary relaxation, and is it possible that it will be unable to recoup that money if business fails to recover from Covid-19?

Stephen Boyle: It is probably too early to give you a definitive answer to that question. We captured in the report that the financial performance of Scottish Water Business Stream shows that it had a deficit of £14 million during 2019-20 and that £13.2 million of that is a result of its creating an accounting provision for those doubtful debts, which reflects the level of uncertainty that the business is experiencing. It is fair to say that that is not a factor that is unique to Scottish Water Business Stream among the licensed providers. All of the market that provides services to non-domestic customers will be in the same set of circumstances.

Across the economy, we have seen that small and medium-sized enterprises and leisure and hospitality businesses have benefited from the reduction in payment demands, and we have seen the increased likelihood of default or doubtful debt. However, there has also been a reduction in demand for water services during the pandemic while businesses have not traded as they normally would. We cannot say definitely what that will look like, but it is clear that that is a very important part of the Business Stream audit that Hugh Harvie and the team will undertake during the current financial year.

The Deputy Convener: I want to ask a question about Scottish Water Business Stream's expansion into the English market. It bought Yorkshire Water Business Services and Three Sixty Water in 2019-20 as part of that expansion. You have given the figures; Scottish Water Business Stream is losing money. As part of its recovery plan, has it considered reducing the number of businesses that it provides for?

Stephen Boyle: I will start, and I will ask Hugh Harvie to come in again, because he will know the current position and the thinking within Business Stream.

Scottish Water Business Stream operates as a commercial entity, so its business choices will be designed to manage the risk of business success and challenges. We have seen volatility in its customer base in recent times—even before the pandemic. Although it started as a large provider of water services to public bodies on a commercial basis in Scotland, it lost that contract and subsequently re-won it in April. Therefore, there is more certainty around its business model. In particular, that comes from having the stability of a large public sector client base.

The timing of its acquisition of the two companies that you mentioned will have been a factor in its financial position—Hugh Harvie can say more about that—but it is not the key determinant of the financial challenges that it is experiencing at the moment. We think that they

are driven by doubtful debts and demand across the wider aspect of its customers.

I will pause there to see whether Hugh Harvie wishes to add anything to that.

The Deputy Convener: When Hugh Harvie answers that question, can he also tell us whether he knows how the Yorkshire Water Business Services and Three Sixty Water arms of the business are performing?

Hugh Harvie: I do not have details on how they are performing, but one number comes to mind. The Yorkshire acquisition was made part of the way through the financial year that has just finished, and it generated a gross profit of £5.4 million. I know that the Yorkshire arm and the earlier acquisition of the customer list from Southern Water both generate a gross margin.

I think that your original question was about whether Business Stream has plans to reduce the level of business. That is not quite how I see it. Assumptions are made in its forecasts about business that might be lost when contracts go out to tender, but I do not know whether a conscious decision has been made to look across the entire book of customers and pick ones out that perhaps it does not want to work with any more. I am sorry—I do not have that detail.

09:45

The Deputy Convener: Okay. No problem. Other committee members want to follow up on that point.

Johann Lamont (Glasgow) (Lab): I am working on the assumption that when the decision to purchase Yorkshire Water Business Services was being made, it was not possible to risk assess against the pandemic, because no one could have predicted that. However, I am interested in whether you are confident that a reasonable risk assessment was carried out before the purchase.

Auditor General, I am not sure whether I have picked you up correctly. When you said that there was a degree of security because of the public sector base, does that mean that Scottish Water Business Stream was able to venture into the private sector, or to go into competition in England, precisely because it is a public sector organisation? Will that risk be accrued by the public sector now that we are in the position that we are in?

Stephen Boyle: Good morning, Ms Lamont. I will start, but I will let Hugh Harvie answer the point about Scottish Water Business Stream's acquisition of Yorkshire Water Business Services and the risk assessment processes that it went through.

I will clarify my earlier comment about the customer base and the public sector. I meant that Scottish Water Business Stream's customer base includes public sector bodies. The inference that I was looking to make is that, because of that, there is less doubt about doubtful debts. Instead of having a much broader base of smaller businesses dispersed across different parts of the economy, having a public sector client base is a more predictable revenue stream for Business Stream. Our assessment is that there is less risk around the level of debt that might accrue than if did not have such a client base.

Johann Lamont: Does that mean that, in having such a base, it has created risk, or that it thought that it could manage such risk because it would have a public sector base? It seems that it has created a vulnerability for itself, in circumstances that it could not have predicted. It is now difficult to see how that will work out. If it were to withdraw, presumably there would be consequences, but might it try to move back out of that market, as the deputy convener suggested?

Stephen Boyle: If I might refer to the recent history of Scottish Water Business Stream, even before it won back the public sector client base, it traded successfully before the pandemic and delivered profit margins that it returned into the Scottish Water business group. Therefore I do not see its public sector client base as a vulnerability; it is trading as a commercial entity, which it has done successfully.

As you suggested, like many other parts of the economy and the public sector, it had not necessarily anticipated the financial impact that the pandemic would have on its business model. However, from what we have seen from the audit work and its financial modelling, it has taken proper account of the risks that it faces and it has taken appropriate steps towards financial recovery and the security of the revenue position across the wider group.

Johann Lamont: Does that mean that the suggestion that it might choose to withdraw from the English retail market and from competition would make sense? Would such a pulling back incur a cost? I am not explaining myself very well, but to me it feels as though it has moved into a market around which some financial risk has been created simply because of the pandemic. To put it in layman's terms, would there be false economy in pulling back from engagement in the retail sector in England as a consequence of the short-term massive challenges created by the pandemic?

Stephen Boyle: We do not expect Scottish Water Business Stream to respond to the pandemic by retreating from particular geographic markets in England or other parts of the non-

domestic market in Scotland. The organisation exists to provide non-domestic water services.

It is worth mentioning one other factor about Business Stream. As part of its designation, it is known as the provider of last resort by the Water Industry Commission for Scotland. An important factor about it is that, in the event that other providers are in financial difficulties, there is a potential call on Business Stream to provide services where others choose not to. All that is factored into its planning, forecasting and risk assessment. However, it might be worth having Hugh Harvie update us about some of the specifics of the thought process and the risk analysis that Scottish Water Business Stream undertook before it ventured into the arrangements with Yorkshire Water Business Services and Three Sixty.

Hugh Harvie: Ms Lamont, in your original question, you asked about the risk assessment that was carried out. At the time of the decision to acquire the Southern Water and Yorkshire Water customer lists, scenario planning was carried out, which covered things such as what would happen if the number of customers reduced or there were changes in the pricing. As you rightly said, scenario planning for a pandemic was not within the thinking at the time.

Johann Lamont: Thank you.

Alex Neil (Airdrie and Shotts) (SNP): I have two points about Business Stream and one about Scottish Water. First, with regard to Business Stream and funding any potential shortfall—*[Inaudible.]*

Obviously, if required, Scottish Water, the main body, can lend to Business Stream or invest the money in equity in Business Stream. What is the current cash reserve in the holding body Scottish Water? I presume that it has the money to bail out Business Stream if required.

Stephen Boyle: You are right, Mr Neil; within the range that we set out in the report, Scottish Water has the money within the group to provide the financial support that Scottish Water Business Stream is looking for. The structure of Scottish Water is set out in exhibit 1 in the report. A number of trading arms and holding companies sit below Scottish Water as the main group company. The options around debt, equity and loans to the group, in order to provide financial support, have been thoroughly explored. As we understand it, if and when Scottish Water Business Stream makes the call, the cash resources within the group—which, at the end of the financial year, were sitting at £391 million—have been identified as the most likely source with which to provide that financial support.

Alex Neil: Okay; thank you. Therefore, in reality, there is no existential threat to Business Stream.

Stephen Boyle: The financial strength of the group is such that Scottish Water has been clear that it does not expect a scenario in which it would have to make a call to the Scottish Government to provide the financial support, because the size of the cash balances within the group are more than sufficient to cover the worst-case scenario of £88 million that was originally forecast.

Alex Neil: It is important to get that message out this morning, in case any customers of Business Stream are listening to the meeting and start to worry about the supply, as well as competitors thinking that there might be some pickings there.

I will raise a more general point with regard to my experience as an MSP—and that of others—down the years with Business Stream’s treatment of small businesses.

In my view, and in the view of many others, the number of small businesses that Business Stream takes to court for unjustifiable reasons is outrageous and flies in the face of Scottish Government policy to encourage small businesses. Auditor General, have you done—or are you planning to do—any kind of survey work to identify the level of customer satisfaction with Business Stream among small businesses?

If I may say so, I am delighted that it won back the public sector contract, but my worry is that it becomes focused on large, public sector organisations at the expense of treating small business customers even worse than it has in the past.

Stephen Boyle: Customer experience is a huge part of service provision both for public sector bodies and their commercial trading arms.

I am very mindful that Scottish Water is a regulated entity in that environment. Therefore, there is an important role for the Water Industry Commission for Scotland in its economic regulation of Scottish Water. In both its annual report and accounts, Scottish Water set out in considerable detail the importance that it places on customer service and so forth.

I need to think quite carefully about what role I would play as Auditor General and what role Audit Scotland would play in the experience of Scottish Water Business Stream, especially given that I do not have any direct locus into what is a trading organisation. Nonetheless, I think that we would treat it very carefully as part of our wider awareness around how we might factor that point into our thinking on the audit work on Scottish Water. Hugh Harvie takes a close look at the

disclosures that Scottish Water makes in terms of its performance report. It is probably one for us to keep an eye on just now.

Alex Neil: The commission has no power or remit to look at individual cases; its power is more general. However, could you provide the committee with detail on how many times in the past three years Business Stream has gone to court against a small business and how many of those cases it has won? That would be a good proxy to indicate how big a problem that issue is. As I said, I and many other MSPs have direct experience of helping small businesses to deal with Business Stream. It is not an easy organisation for small businesses to deal with.

That information would be useful, because although I accept that overall it is—and was before the pandemic—doing well as a business on paper, we do not want a situation in which big customers are well looked after at the expense of small ones. If you could provide that information, Auditor General, it would be very helpful.

On Scottish Water more generally, let me say, as a former minister for Scottish Water, that I think it is probably the most efficient publicly owned and controlled business in Scotland, if not the United Kingdom. Its performance on charging, investment and a whole range of things consistently far outperforms the privatised water industry south of the border year on year. Therefore, I am speaking as a general fan of Scottish Water’s performance.

However, the one stain on its character is the bonus system for the senior management team whereby some of them can receive a bonus that takes their total package to between £300,000 and £400,000 in some cases. I accept that a number of them have refused to take the bonuses during the pandemic, and I am not attacking the individuals; I am saying that the system is wrong.

Even when compared with companies of a similar size, there is absolutely no justification for that level of remuneration. When compared to other public sector organisations in Scotland that have even bigger budgets, it is way out of kilter.

The current management team will all have legally binding contracts. However, it might be time to have a look at their pay. As you will know, Auditor General, the issue of remuneration at senior level across the public sector has been a major theme in the committee’s concerns. At what stage will you consider whether such remuneration levels at Scottish Water are in any way justified? I suspect that if you were to ask most people they would say that they absolutely are not.

10:00

Stephen Boyle: First, on your initial point about court proceedings involving Scottish Water Business Stream, we will see what information we hold on that aspect. I suspect that it will not be terribly much, so the committee might wish to explore that directly with Scottish Water or Business Stream to obtain the most up-to-date information.

On the remuneration arrangements for Scottish Water's executive team, you will know that as part of the annual audit work that Hugh Harvie and his team conduct we look closely at the disclosures made in the remuneration report so that we can be satisfied that they are accurate. However, you are right to say that the quantum aspect of the pay arrangements is large for a public sector organisation.

In a moment I will ask Graeme Greenhill and Hugh Harvie to come in to describe our analysis of those matters. First, I point out that although Scottish Water is covered by the public sector pay arrangements, those afford public bodies some flexibility to benchmark in order to have successful recruitment and retention arrangements through market comparators, particularly for chief executive positions around which there is risk. It is therefore clear that bodies such as Scottish Water can deploy such flexibility as might be necessary.

On the wider position, as you have said, Mr Neil, contractual arrangements are in place. However, there is clearly also a role for Scottish Water's remuneration committee through the performance assessments that it undertakes and its analysis of what, if anything, those mean for the organisation's existing bonus arrangements.

That is an aspect for us to reconsider carefully, to see what further steps we might want to take. However, it is clear that the circumstances that have led to the disclosure in the accounts are accurately described, albeit that they are unusual in a public sector context.

I will pause there to see whether Graeme Greenhill wishes to add anything on the point that we have reached and the judgments that we have made.

Graeme Greenhill (Audit Scotland): As the Auditor General said, Scottish Water has a remuneration committee that is responsible for agreeing the salaries of senior staff. It is also required to follow the Scottish Government's pay policy, although that includes measures that allow senior staff to be paid more than the range that is specified there, if there is strong market evidence that that is justified.

In determining salaries, the remuneration committee conducts benchmarking studies that

consider comparable salaries in other organisations, particularly other water companies. From the figures that I have seen, the base pay for Scottish Water's senior staff appears to be at the lower end of the range that applies in such comparator organisations.

Hugh Harvie might be able to say a bit more about the remuneration committee's functions and how it goes about its work.

Hugh Harvie: I will be happy to do so. The remuneration committee spends a fair amount of time scrutinising the pay arrangements. One of its key roles is to benchmark pay against available external analysis, on which it takes advice to ensure that it stays within its stated policy of paying within 95 per cent of the market median. However, as Graeme Greenhill pointed out, there is evidence that indicates that Scottish Water is paying below that.

The remuneration committee has oversight not only of base salaries but of the bonus arrangements to which Mr Neil referred. It is worth noting that there are two key elements to those arrangements. The first relates to an outperformance incentive plan, which is designed to reward performance against the financial determination of the Water Industry Commission for Scotland. It is a balanced plan, so assessment is made against financial measures and Business Stream's customer service—customers' experience and benefit—to which Mr Neil referred.

Secondly, there is a long-term incentive plan, which was agreed with the Scottish Government and is funded from outperformance of the plan. Performance is contractually measured, and objective measurements are used, and all bonuses can be withheld by the remuneration committee, in performing its role. In my view, there is a lot of oversight in that area.

Alex Neil: Our job is to look for value for public money. I guess that every water consumer in Scotland would consider it unacceptable for total remuneration to be between £300,000 and £400,000, given the challenges that people face, particularly at the moment. When the committee meets in private, I would like to dig deeper into Scottish Water's bonus scheme. In my view, that level of remuneration is unseemly for a public sector organisation that owes the taxpayer a lot of money. What is Scottish Water's outstanding debt to the Scottish Government?

Stephen Boyle: I will see whether I can quickly find the page reference in Scottish Water's accounts. I will check that and come back to you in a moment or two. As you said, Scottish Water has a very significant capital borrowing programme that it uses to invest in its infrastructure asset programme.

Alex Neil: That programme is, obviously, funded by the taxpayer. We need to delve further into that, because that level of remuneration is way out of kilter with what taxpayers should reasonably expect.

Graeme Greenhill: Scottish Water's accounts for 2019-20 show that, as of 31 March 2020, Scottish Water's borrowing from the Government was at £3.9 billion.

Alex Neil: Scottish Water owes the Scottish Government £3.9 billion.

Graeme Greenhill: That is correct.

Alex Neil: We can see the taxpayer's very heavy investment in Scottish Water, which is all the more reason for us, as the watchdog of public money, to ensure that we are getting value for money. I am not at all convinced that that is the case, so the committee needs to pursue that issue.

The Deputy Convener: That borrowing figure would wipe out Scottish Water's balances many times over.

Alex Neil asked about the bonuses and the number of businesses that are taken to court. Are we able to get those figures and find out that information?

Stephen Boyle: I am fairly sure that we do not have information on the number of businesses that have been taken to court by Scottish Water Business Stream. The committee would probably have to ask Business Stream directly for that. I expect that the organisation would have that information at its disposal and be able to provide it to the committee.

The Deputy Convener: Do you mean information on remuneration?

Stephen Boyle: The quantum of the remuneration is set out, and the history of and background to that are also available in the public domain. As Graeme Greenhill said, public sector pay policy applies to Scottish Water, but there is flexibility within that for senior executives. On the specifics of the bonus system, some detail is set out in the accounts, including the performance measures that the remuneration committee applies with reference to the determination from the Water Industry Commission for Scotland, which informs bonus arrangements. We can support the committee's understanding of that; if there are any gaps we can have further conversations, on your behalf, directly with Scottish Water.

Alex Neil: I have a final point. I will compare Scottish Water with other public services in Scotland. The national health service in Scotland has a budget of about £13 billion and the chief

executive is paid, including bonuses, less than 50 per cent of what the chief executive of Scottish Water gets, which I think is an issue. The current position is, quite frankly, indefensible.

The Deputy Convener: That is certainly something that we can look at and chat about later. I will move on to questions from Colin Beattie, then from Gail Ross.

Colin Beattie (Midlothian North and Musselburgh) (SNP): I would like to explore one or two issues around financial support. Your statement in paragraph 16 stands out. It says that

"there is no certainty at the moment that financial support to Scottish Water Business Stream will be required."

On what basis has Scottish Water decided to inject £10 million when there is "no certainty" that it "will be required"?

Stephen Boyle: We capture that in the previous paragraph, which says that a decision has been taken to provide

"an additional equity injection of £10 million"

as part of the contingency arrangements that Scottish Water provides support to Scottish Water Business Stream.

The reference to there being "no certainty" seeks to capture the variability of the circumstances that we are in, which is probably best exemplified by the fact that quite a broad range of financial support has been identified, with there being many variables and uncertainty about the level of debt. Ultimately, it is within the gift of the group of companies to determine the flow of funds. As we touched on in relation to previous years, we have seen that Scottish Water Business Stream has returned profits back to the group; what we are seeing now is financial transactions going the other way in order to secure the cash flow and operational requirements of Business Stream.

Colin Beattie: The equity injection will help Business Stream's working capital and so on, but it has not really quantified the loan facility. I presume that that will be according to need. How will that work? The actual level of support is uncertain. For funding over and above the £10 million, has a mechanism been set up to trigger payments to Business Stream?

Stephen Boyle: I will start, then invite Hugh Harvie to come in, in a moment. We understand that there has been a thorough analysis of the mechanism and of the options that are available to Scottish Water and the group to provide support. We recognise that, at times, there is an arm's-length nature to that. Business Stream and Scottish Water have received separate financial

and legal advice about how best to take that forward.

It can be distilled down to a two-stage process. The first stage is about securing the available options and ensuring that the holding company and the subsidiary are aware of how they might work. The second stage, which will take place during 2021, will involve wider considerations about financial viability and management and assessment of risk in Business Stream.

Hugh Harvie might want to say a bit more about the specifics of how funding and transactions might flow, if that is required.

10:15

Hugh Harvie: It is important to make it clear that the loan would be on commercial terms. Advice has been taken on that, because it is important that the loan facility be in line with state aid rules.

There has been a lot of consideration of the process for monitoring drawdown requests to ensure that they are appropriate, because it is important that Scottish Water provides only the minimum amount of funding that is required. A monitoring mechanism will be put in place, and that will go hand in hand with consideration of Scottish Water Business Stream's ability to repay.

Colin Beattie: You might be able to put at rest my anxiety in relation to one of my concerns. We do not know the level of the loan that will be drawn down, but Scottish Water must have some idea about what the cap would be. It cannot just be a never-ending loan; consideration must be given to whether the group can afford what is being injected. It is not clear to me whether there is a cap.

Stephen Boyle: That relates to our understanding of the two-stage process that Scottish Water has identified. The first stage involved securing Scottish Water Business Stream's financial position and making wider arrangements about availability of the loan facility and the equity dimension to it. The second stage involves a wider look at financial viability as the pandemic progresses, and at what that means not just for Business Stream but across the group. It is our understanding that the cap arrangement will be part of that consideration.

From Hugh Harvie's earlier comments, we know that a range up to £88 million has been identified. If the tracking is considerably lower than that, there will be a degree of comfort that there are no concerns about financial viability. Nonetheless, we take some reassurance that the thinking is being done and that the level of due diligence that has

already been undertaken is appropriate in order to secure long-term viability.

Colin Beattie: In relation to the financial commitment, is there a trigger point at which the Scottish Government would have to step in and inject money?

Stephen Boyle: I do not think that we are in that situation. From what we have seen, the Scottish Water group has considerably more financial resources than it would have in the worst-case scenario, in which the Scottish Government would need to provide additional revenue investment to support Scottish Water and Business Stream. That seems to be quite an outlying scenario.

One of our key recommendations and findings in the report is that Scottish Water needs to keep a close watch on and to do careful analysis of the trigger point, given the variabilities of the pandemic and the uncertainty about debt levels and recovery among non-domestic customers. However, it does not feel as though we face that scenario, in terms of Government support.

Colin Beattie: To be clear, is it the case that Scottish Water has not quantified the trigger point at which it would have to call on Scottish Government support?

Stephen Boyle: I will ask Hugh Harvie to say whether a figure, or ceiling, has been set. The Scottish Government has been kept well informed, and it is our understanding that that number will not be called on. However, I ask Hugh Harvie whether the number has been quantified.

Hugh Harvie: That is my understanding. I do not believe that the required support would get to the level at which Scottish Water would require onward support from the Scottish Government.

Colin Beattie: Obviously, that is a financial hit to the Scottish Water group. Will it result in any impact on its investment programme?

Stephen Boyle: We touch on that briefly. We think that those two points are unrelated to the delivery of the investment programme. A key part of Scottish Water's operation is the delivery of a hugely significant, large-value investment programme, and we know that Scottish Water is closely monitoring that. Social distancing and other risk mitigation steps in light of the pandemic will potentially extend the timing of the programme, but that is not connected to Scottish Water Business Stream and securing its financial circumstances. As you would expect, Hugh Harvie is closely tracking that through the audit and, in its public reporting, as well as that of the regulator, that is a key part of Scottish Water's analysis.

Colin Beattie: I assume that those Scottish Water assessments do not include increases in

cost to clients or customers down the line in order to recoup the loss.

Stephen Boyle: The charges for domestic customers in particular are determined by the Water Industry Commission for Scotland. Most recently, it set those out in its six-year determination of the Scottish Water charging regime. They were set and consulted on before the pandemic. We do not expect a change in charges to domestic customers in light of increased costs or changes to Scottish Water's cost base as a result of the pandemic.

Colin Beattie: However, Business Stream is the one that I am concerned about.

Stephen Boyle: Ultimately, that is a question for Business Stream with regard to its commercial operations and what it wishes to charge its customers. As we have touched on, this is a competitive utility market, in which there is an option for customers to make business decisions about who provides their services. At the moment, it is difficult for us to say with certainty what choices Business Stream will make about its customer charging regime, but it will continue to report publicly on that through its operations.

Gail Ross (Caithness, Sutherland and Ross) (SNP): Good morning to the witnesses and thank you for coming back in.

The report notes that Scottish Water held a cash balance of £391 million at the end of March last year, but the commission's final determination forecast that it would have just £70 million. How did Scottish Water manage to exceed that forecast by such a large margin?

Stephen Boyle: Good morning, Ms Ross. I will start and then invite Hugh Harvie to come in with more detail.

The cash balance of £391 million, which is higher than the Water Industry Commission anticipated. There are three strands to that. First, at the end of the 2019-20 financial year, the balance was £105 million higher; that relates partly to the timing of its investment programme, aspects of which were interrupted by Covid. The £216 million assessment relates to outperformance against the determination in previous years, and Hugh Harvie might wish to focus on how Scottish Water has got itself to that point. If we add those amounts to the original £70 million, we arrive at £391 million. Part of the reason for the higher amount relates to the lower risk appetite that was needed to give Scottish Water the liquidity to deliver its operations. Hugh Harvie might want to add something specific about the circumstances that led to the accumulation of that figure.

Hugh Harvie: There are two key elements. The first relates to savings in the capital programme. I

cannot provide much detail on how the savings have been arrived at, but I know that a significant amount of planning goes on to ensure that there is maximum value for every pound that is spent through the capital programme. Secondly, in the financial determination, assumptions were made relating to interest charges and finance costs. Savings have been made through careful management of cash during the determination period.

Gail Ross: I go back to the £3.9 billion that Scottish Water owes the Scottish Government. What was that £3.9 billion for? I think that the committee and anyone who is watching will be quite interested in that.

Stephen Boyle: The £3.9 billion was borrowing from the Scottish Government in the round to support investment in Scottish Water's capital works. The committee will have seen that Scottish Water has undertaken a significant programme of investment, largely to replace what we would regard as Victorian water infrastructure across the country. That prolonged modernisation programme included investment during the determination period that has just come to an end, and the investment will continue in the new determination period.

Gail Ross: How does the investment programme look? Will Scottish Water require more capital from the Scottish Government in the future, or will it be able to start repaying the money? What does a repayment plan for £3.9 billion look like?

Stephen Boyle: I will pass over to Hugh Harvie, who can say how the financial forecasts relate to anticipated debt over future years, and how the balances will, ultimately, be reinvested or repaid to the Government.

Hugh Harvie: I am sorry, but I do not have the answer to how the £3.9 billion will be repaid in the long term. In each year of the determination, the capital investment is funded from customer receipts and borrowing so, as I understand it, there is additional borrowing, but there is also repayment of borrowing. Within the £3.9 billion, various tranches of debt come up for repayment periodically, so there is a programme of repayment and drawdown. I am sorry, but I do not know whether there is a plan to repay the full £3.9 billion.

Graeme Greenhill: In Scottish Water's accounts for 2019-20, there is a repayment schedule that says that £2.7 billion of the £3.9 billion is repayable 10 or more years hence, £500-odd million is repayable within the next six to 10 years, £430 million is repayable within the next three to five years, £125 million is repayable within the next one to two years, and £135 million is repayable within the next year.

Gail Ross: That sounds nice and straightforward then. We have been talking about an issue in the Scottish Water group. Will those repayments be possible?

Stephen Boyle: There is an analysis of the loans on page 178 of Scottish Water's accounts, to which Graeme Greenhill referred. The loans come from public borrowing from the Scottish consolidated fund, the national loans fund and the Public Works Loan Board. As with any borrowing, there is an expectation that amounts will be repaid within the timescale, and all that will be factored in by the provider of the loans and Scottish Water as part of long-term business planning.

10:30

To answer your question directly on whether we think that it is possible for Scottish Water to make those repayments, yes, we think that it is. It is a factor in our audit work that Hugh Harvie and his team will think about, as they do every year in relation to going concern and the ability to repay debt that has been borrowed. Bear in mind that almost all the borrowing that relates to capital investments is supported by a revenue stream from the payments that are made by all of us for our water charges each year.

The Deputy Convener: I will bring in Bill Bowman. Are you there, Bill?

Bill Bowman (North East Scotland) (Con): I am here, but perhaps only in sound, as my connection has been a bit flaky.

The Deputy Convener: We can see you, so we are lucky.

Bill Bowman: I cannot see you, so it is a win-win situation.

The Deputy Convener: Good—carry on.

Bill Bowman: I hope that I am not repeating any of the questions that I missed earlier. I have a couple of questions, first for Hugh Harvie then for the Auditor General. I will just say hello to Hugh, as he and I were colleagues 20-plus years ago at KPMG. Long time no see; it is nice to see you again—except that I cannot see you at the moment.

I usually ask a question about audit committees, Hugh, and I know that you will have a broad experience of audit committees from your large company clients. Are you content that there is a good audit committee at Scottish Water and, given some of the issues that Alex Neil has raised about business practices, is it getting into the nitty-gritty areas that it should be looking at? Were there any significant adjustments to the figures after you started your audit? You mentioned that you had looked at the forecast for Business Stream; did

any adjustments to that forecast come about from your work?

Hugh Harvie: On the first question, about whether I am content with the robustness of the audit committee in relation to the challenge that it has and its ability to get into and around the detail, I can say that I am absolutely content. I have no issues with that whatsoever.

On the question of significant adjustments to the forecasts, we started our audit work in mid to late April, only a month into the pandemic, and we had long discussions with the boards of Scottish Water Business Stream and Scottish Water on the issue. The situation with the forecast developed over the period and continued to develop up until the date of signing, which was in late November, in effect in reaction to the various changes in relation to lockdown as more information came out. It was an iterative process. As to whether the changes were a result of my challenge, I do not think that I would take the credit for that; it was more of a process of them working with us as auditors to ensure that we remained comfortable with the assumptions that were being made.

Bill Bowman: I take it from that that the projections got worse as you went on.

Hugh Harvie: If I recall correctly, there was a projection that was worse during the process, and then there was some improvement when some of the forecasts were refined, which was when metering information started to come through that highlighted that the reduction in water consumption was not as severe as had initially been forecast.

Bill Bowman: It is good to hear your view on the audit committee. I will ask the Auditor General a slightly different question, but maybe it is a bit too simplistic. We are probably going to hear from the Cabinet Secretary for Finance that public sector finances are under pressure, but there is £391 million of money sitting around in Scottish Water. Is there no way that the Scottish taxpayer could benefit from that?

Stephen Boyle: We would have to think a little about the mechanics of that and how that flow of funds might operate. I am sure that, ultimately, that will be a factor of consideration for the Government and Scottish Water. Between them, they will want to decide.

The other important player in all this is the Water Industry Commission. As the economic regulator of Scottish Water, its key role is to ensure the value for money and effective delivery of safe, reliable water services. That will be a long-term plan. We have seen Scottish Water outperform the determination in the current six-year period, but Hugh Harvie mentioned the volatility of that and the expectation that much of

the £391 million will be reinvested. As we have covered, some of it might go to Scottish Water Business Stream, but other parts will be reinvested within Scottish Water's operations. However, the wider point is for Scottish Water and the Scottish Government to consider future funding allocations and how best to ensure that the cash balance is at an appropriate level to support the business, because it is higher than both would have anticipated at the end of the last financial year.

Bill Bowman: Is the Auditor General aware of other public organisations that are sitting on cash stashes as big as that?

Stephen Boyle: As Mr Bowman knows, there is inevitably a degree of volatility about cash balances at year end, so any balance sheet will be a snapshot of the number at year end. Scottish Water is a very large organisation, which is dealing with a very significant investment programme, and that is part of the reason that has led to this point. I do not have to hand the detail on where that balance sits relative to that of other organisations, but all other public bodies will be responsible for managing their cash needs and liquidity, as they draw down necessary funds to make sure that they strike the right balance between being able to meet their obligations as they fall due and not drawing down excessively. I do not have benchmark information for the committee on how Scottish Water's balance at the end of March last year is relative to that of other public bodies, but we can take that question away and come back to the committee.

Bill Bowman: The response to Gail Ross's question was that the amount had built up, so Scottish Water obviously had not planned to pay down or return it in any way to the Government. That is an interesting point; thank you.

The Deputy Convener: To follow on from that, Auditor General, given the size of the cash balance, can we be sure that private and business consumers are paying a fair price for their water?

Stephen Boyle: With regard to domestic consumers, that is clearly a role for the Water Industry Commission for Scotland, following its consultation and regulatory activity with Scottish Water to determine the water charges that we all pay as domestic consumers. For the next six-year determination, the commission set out that increases in water prices have been capped at inflation plus 2 per cent. It determined that that level strikes a balance that will allow Scottish Water to deliver its services and its significant investment programme to modernise the infrastructure.

With regard to non-domestic customers, we touched a few minutes ago on the fact that that is

a business decision for Scottish Water Business Stream, as it is for the other licensed providers. It has to set a price that the market will bear; it must be affordable and allow it to grow and sustain its business as well as manage risk around debt and customer choice, because customers might go to another provider. All those licence providers need to manage that very carefully.

The Deputy Convener: As committee members have no final questions, I thank the Auditor General and his colleagues for their evidence this morning.

10:40

Meeting continued in private until 11:00.

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