

# **FINANCE COMMITTEE**

Tuesday 29 February 2000  
*(Morning)*

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## FINANCE COMMITTEE

### 5<sup>th</sup> Meeting 2000, Session 1

#### CONVENER

\*Mike Watson (Glasgow Cathcart) (Lab)

#### DEPUTY CONVENER

\*Elaine Thomson (Aberdeen North) (Lab)

#### COMMITTEE MEMBERS

\*Mr David Davidson (North-East Scotland) (Con)

\*Rhoda Grant (Highlands and Islands) (Lab)

Mr Adam Ingram (South of Scotland) (SNP)

George Lyon (Argyll and Bute) (LD)

\*Mr Kenneth Macintosh (Eastwood) (Lab)

\*Mr Keith Raffan (Mid Scotland and Fife) (LD)

Dr Richard Simpson (Ochil) (Lab)

Mr John Swinney (North Tayside) (SNP)

\*Andrew Wilson (Central Scotland) (SNP)

\*attended

#### WITNESSES

Mr David Nish (Scottish Power)

Mr Ian Springett (BP Amoco)

Mr Donald McGougan (City of Edinburgh Council)

Mr Roddy McArthur (Perth and Kinross Council)

Mr Dave Roberts (Perth and Kinross Council)

#### CLERK TEAM LEADER

Sarah Davidson

#### SENIOR ASSISTANT CLERK

Callum Thomson

#### ASSISTANT CLERK

Alastair Macfie

#### LOCATION

Committee Room 2



# Scottish Parliament

## Finance Committee

*Tuesday 29 February 2000*

*(Morning)*

[THE CONVENER *opened the meeting at 09:53*]

**The Convener (Mike Watson):** I call to order the fifth meeting of the Finance Committee, and welcome members.

We have received apologies from John Swinney, Adam Ingram and Richard Simpson. Rhoda Grant sends her apologies for late arrival, as she is travelling from Orkney, but she will be here.

**Mr David Davidson (North-East Scotland) (Con):** On a point of order, convener. Further to your interview, broadcast yesterday, about possible private finance initiative funding for the new Parliament building and the general furore over the costs of the Holyrood project, will you accept a proposal to set up today a cross-party group from within the Finance Committee to investigate the whole issue and its likely effect on the Executive's budget in other areas?

**The Convener:** I was speaking yesterday as an individual. I cannot speak on behalf of the Finance Committee on matters that we have not discussed.

**Mr Davidson:** I appreciate that.

**The Convener:** I think that the committee will want to consider that matter, which is obviously of some interest at the moment. If you wish that to be an agenda item for next week's meeting, I would be willing to accept it—it is not on the agenda for today.

**Mr Davidson:** Thank you.

**The Convener:** Is it the view of members that we should consider the issue next week?

**Mr Keith Raffan (Mid Scotland and Fife) (LD):** I strongly support the view that we need to review the Holyrood project. An independent review is taking place, and I hope that it will be carried out speedily. Given the implications for the budget and the predicted overrun, it is important that the Finance Committee gets to grips with the matter. Whether it should be a cross-party committee, I am not so sure, but the issue must be investigated as a matter of urgency before it becomes—quite frankly—a scandal that does irreparable damage to the Parliament.

**Mr Davidson:** May I respond to that, convener?

**The Convener:** Yes—but before you do that, I

am checking the forthcoming agendas. We are not scheduled to receive any evidence next week.

For the benefit of Andrew Wilson, who has just arrived, there is a proposal to discuss the projected overspend on the Holyrood building. I have suggested that we do so at next week's meeting.

**Mr Davidson:** I deliberately did not make any political points; this committee, ultimately, should be the vehicle for all discussions on the Executive's budget. We ought to have a view on anything that will affect that and, because of the current uncertainty, it is particularly important that the committee be seen to take a grasp of the matter on behalf of the Parliament. I suggest that that be done on a cross-party basis, because we need to get to the facts.

**The Convener:** I do not want a discussion of the issue at the moment. I suggest that we put it on next week's agenda. The next seven days might indeed provide further information to that which we have now, which could inform our discussion. I do not want to have any more discussion on the matter now, other than to agree to put it on the agenda for next week's meeting.

**Mr Raffan:** There is not a meeting next week, is there?

**The Convener:** There is a meeting.

**Mr Raffan:** I thought that we were not taking evidence.

**The Convener:** We are not taking evidence, but there will be a meeting. There are other items which we will be addressing anyway.

I see that Kenneth Macintosh wants to add something, but we will put it on the agenda for next week—can we leave it at that? I would prefer to leave it at that and move on, because we are running a bit late.

Members will have received a revised agenda, containing item 1, "Preparation for evidence taking session". I felt it appropriate that we should have some preparation to decide on how we should take the evidence. At this stage, I propose that we go into private session to prepare us for the witnesses who are coming this morning. Is that agreed?

**Members indicated agreement.**

09:57

*Meeting continued in private.*

10:06

*Meeting resumed in public.*

## Executive Finance Functions

**The Convener:** I welcome the witnesses. Thank you for making the time to be with us today and to give us the benefit of your varied experiences. We believe that what you have to say to us and your responses to our questions will be valuable for our inquiry into the finance functions of the Scottish Executive. We have invited two witnesses from the private sector and three from the public sector—from two local authorities. We hope that that balance will make for a useful meeting.

I propose to invite Mr Nish and Mr Springett to make their presentations, after which we will take some questions. Mr Roberts has submitted a paper that we did not see until this morning, so I will invite him to speak to that. Unless Mr McGougan and Mr McArthur want to add something specific to their papers, we will move straight into the question-and-answer session. As there might be potential for cross-fertilisation, we might ask Mr Nish and Mr Springett further questions, if they are willing to remain. They are welcome to stay for as long as they are able.

I invite Mr David Nish, finance director of Scottish Power, to make a presentation to the committee on the finance functions of that company.

**Mr David Nish (Scottish Power):** I am delighted to be here this morning to give evidence to the committee. I would like to start with some comments on the size of Scottish Power, to put our operations in context. I will then discuss how we approach finance in the organisation and some of the changes that we have undergone.

Following the successful completion of our merger with PacifiCorp, Scottish Power is one of the top dozen investor-owned utilities in the world. Combined market capitalisation is now about £9 billion and we have about 7.5 million customers. Over the past five years, we have acquired businesses in the UK—first Manweb in 1995, and then Southern Water in 1996. We are now going through the process of deregulation of the gas and electricity markets, so we have moved from being a wholly regulated business to one that operates in fully competitive markets. We serve about one in five homes in the UK. We also own other businesses, including a retail chain that is the third-largest electrical retailer in the country, as well as contracting and technology businesses. We have a diverse range of activities where finance has to be managed.

We view the finance function as a key tool both in the development of the business and in ensuring that there is appropriate financial control across the group. I would like to highlight three challenges that finance functions now have to face and which are of particular interest to Scottish Power. The first is the increased rate of change in the environment. In our case, that is the result primarily of regulation and competition. The second is the need to supply management and investors with more relevant and increasing amounts of information on the future of the group. If we look back even five or 10 years, a great deal of the financial information that was produced about organisations was historical; people tended to base their judgments on what had happened. Now, by contrast, the information that we put out into the public domain sets the scene for the future, so that our financial performance can be benchmarked and evaluated as we deliver our results. Finally, we must respond to the pressure to make investment decisions that create long-term shareholder value. Scottish Power spends about £1 billion a year on capital investment, so we have to have rigorous processes and procedures for assessing the economic value that comes from that spend.

We believe that finance departments nowadays should no longer be spending a substantial proportion of their time focusing on processing transactions, which is how in the past finance functions tended to spend their time. They were accounting departments, rather than finance departments, and spent very little time on the interpretation of information and the identification of actions for improvement. The finance function has to be a key area of risk control in an organisation, in terms of both setting policy and monitoring its implementation.

I want to look back on how Scottish Power has responded to some of the challenges to its finance function. In the three or four years after privatisation, Scottish Power had a substantially centralised finance function, based very much on the South of Scotland Electricity Board model that it inherited. That had some key consequences. First, there was a lack of ownership of financial information by our business units; the centre came up with the figures, instead of the businesses owning them. Secondly, there was a poor appreciation of business and operating issues on the part of finance. We should remember that, at the end of the day, the financial performance score card is a reflection of the operations that give rise to it. Finally, the pace of change in our business outstripped the ability of the central finance functions to cope with management's need for information.

Following reviews that were undertaken a number of years ago, responsibility was delegated

to our business units, with the group central function taking charge of external financial reporting—that is to say, the management of the City—and setting and monitoring performance against plans. Through that, we have achieved improved ownership of financial data. We now have finance functions that are aligned to the businesses. It is key that they should be seen as business partners.

We have certain central functions. The first is in treasury, where we try to leverage the scale of the group to achieve financial benefit. The second is in taxation, where an overall picture of the group is needed. The third relates to internal audit.

10:15

We consistently benchmark our finance function performance against that of other leading organisations. My team has visited Ian Springett's group at BP Amoco, to see how it works. Scottish Power has now made its first overseas acquisition and BP Amoco is one of the largest global companies, which is used to dealing with issues such as foreign exchange and management quarterly reporting.

The finance model that we use has three key areas. The first is performance management, which links the targets from the strategy to performance. The second area is decision support, which is the interpretation and judgment of performance. The third area is transaction processing—we need an efficient platform to ensure that the correct information is being provided.

We see finance as core to any organisation—it is the nervous system. It must be staffed by high-quality individuals and must be commercially aware. Furthermore, its competencies must change as the organisation develops.

**Mr Ian Springett (BP Amoco):** Good morning. I, too, am delighted to talk to the committee.

The upstream part of BP Amoco, which I represent, manages performance and control. If that part of the company were extracted, it would have a market capitalisation value in excess of \$100 billion. We produce about 3 million barrels of oil and gas-equivalent each day. We have about \$35 billion-worth of capital employed and we spend about \$6 billion per annum on capital projects. It is very important to an organisation of our size that we have appropriate control and financial management. Since BP merged with Amoco in 1999, financial management has been important in bringing the two companies together. Like David Nish, I would like to stress that the financial process is integral to the process of the management of the business units.

Yesterday, I spent some time in a first meeting with distant colleagues of the committee at the Ministry of Defence. The ministry is considering similar initiatives to the committee. I will be working with the MOD one day a quarter for the next year or so, examining the implementation of performance management in the ministry. In BP Amoco, we like to share best practice between business units and peer groups. If the opportunity arises, I am sure that our work with the MOD would present a chance to share best practice.

BP Amoco is organised in a business unit model, which means that accountability, clarity and performance are at a level that allows people to understand what they personally deliver. We feel that it is important to have an organisational structure that fits with the performance management and control processes that we adopt. Having talked to the Ministry of Defence yesterday, I think that it is critical that the organisational structure lives and resonates with the performance process.

We have many mechanisms to exert financial control. Such mechanisms must support good business practice. It does not work if mechanisms get in the way of doing good business. Like Scottish Power, we set policy centrally, but there is a tremendous amount of decentralisation of accountability and implementation.

The committee asked to what extent our business activities cut across business units and whether we encourage that approach. The answer to that is both yes and no. We do many things together, because business units are similar, but that does not compromise the accountability of the individual business units. We also work in bigger units, called peer groups. The structure of BP Amoco is not dissimilar to that of Scottish Power and I am also sure that it would work in the public sector, if the committee decides that that is the best way to manage the finance functions of the Scottish Executive.

I refer members to the paper that I am passing round. The organisational model used by BP Amoco came into existence in 1995. Previously, we used a centralised structure; everything happened in Britannic House in London—which was where decisions were made and policy was set. There were also various regional structures in Aberdeen, Houston, Anchorage and so on. Now, we use an organisational model made up of about 50 business units. Those 50 business units have personal accountability and the business unit leader is effectively the chief executive officer. There is a financial and operational structure: the accountants, economists, engineers, geologists and so on report to the leader. The business unit leader is responsible for the total unit.

We also group similar business units together in a reinforcing structure called a peer group. Business units concerned with exploration—looking for oil—might be grouped together, as would be those concerned with developing discoveries. The peer group is used to challenge the business units to share best practice, to deliver improved performance and to ensure control, quality and reputation. It is a dynamic process and it has taken us four or five years to reach the point where we are proud of the structure. We believe that it gives BP Amoco an enormous competitive advantage.

The model also includes executive teams, which consist of four or five people who give advice, coaching and support to the business units and peer groups. That also takes place at a group level, where policies are set in context.

We have several organisational principles. We believe that the group is a single global organisation—we are all marching to the same tune. The building block is the business unit, the leader of which is similar to a chief executive. The process is very transparent, to allow Sir John Browne to see right down into any business unit that he cares to examine.

In the paper, the pentagon diagram represents the space to deliver performance that is given to each business unit leader. The unit leader has a lot of space to manage his or her own business, but there are boundary conditions—as shown on the points of the pentagon—such as finance and control, ethical conduct, how to manage employees, how to deal with relationships and, perhaps most important, health, safety and environmental performance.

Finally, the diagram “What We Stand for . . . on Control and Finance” contains several high-level strategic statements and outlines the many processes by which we manage and control the performance delivery of our financial affairs. That might look complicated on the page, but it works and the business units and teams believe in it. It ensures that we make the proper investment decisions, safeguard our assets and do everything right in terms of reputation and ethics as well as delivering the financial outcomes that we expect. That is a helicopter view of the way in which things work at BP Amoco.

**The Convener:** Thank you. I will now open up the discussion. I would like to begin by asking Mr Nish about Scottish Power. You mentioned that, when the company was formed in the 1990s, you moved from the centralised structure of the SSEB and that the pace of change in the industry drove that move. In what respect did decentralisation increase the effectiveness of the finance function, rather than just the business functions of the company?

**Mr Nish:** If a finance function is to support a business, it must have a clear understanding of the business strategy and objectives. Consider our energy supply division, which sells power to its customer base. The division's profit and loss account shows sales, costs and profit. However, those are not the important things that underlie that division. For that division, the finance function must have a clear understanding of the tariff structure; the different types of customers; the way in which the market is changing and what that means for future margins; how electricity is bought; the sources for buying electricity and the risks attached to those; and the costs to acquire and how those costs can be driven down. The only way to reach that understanding, in order to put in place appropriate monitoring systems and targets, is to have finance close to the business.

The main point in improving the quality of our finance function was to obtain that knowledge. The initial impact of decentralisation was to make the finance functions slightly more cost inefficient. We then took the opportunity to examine how to remove some of the functions that were not needed at individual locations, to regain cost efficiency. That meant considering the sharing of systems across the organisation and adopting communality. However, what we are not trying to disturb is the ownership of information and the proximity of the finance function to the business. We need to ensure that, when important decisions are made, finance is always at the table.

**The Convener:** You mentioned PowerGen, which had been taken over by Scottish Power.

**Mr Nish:** No, it was PacifiCorp.

**The Convener:** I am sorry. I appreciate that it is early days, but will that have an effect on the financial functions of Scottish Power? You have more information about what is happening on the other side of the Atlantic.

10:30

**Mr Nish:** Initially, much of the work that we do with PacifiCorp will relate to that company alone. It is a company in need of radical surgery, which is why we took it over.

PacifiCorp has developed a different model of a finance function, which is perhaps closer to that of BP Amoco. Over the past 18 months, PacifiCorp has installed a common computing platform, SAP, across the organisation and has established a central shared service centre. It has a limited finance function, but one which is close to the business. It has a more advanced model than Scottish Power has. We still have a degree of separation, which is driven by the need to maintain regulatory ring-fencing between our businesses. Our mix of businesses drives certain unique

factors that cannot be pulled together completely. We will learn from PacifiCorp how to run a finance department slightly differently.

**Mr Kenneth Macintosh (Eastwood) (Lab):** Both Mr Nish and Mr Springett talked about the importance of decentralisation and how it helps to empower business units. How much transfer of staff, in particular of finance staff, is there between different business units? Do they compete against each other? Mr Springett talked about ensuring that everybody has a BP identity and knows what the organisation's common purpose is. In Scottish Power, do staff transfer often between units, or do people stick in, say, the showroom side of the business for their whole career?

**Mr Nish:** We think of there being a finance community in Scottish Power. We try to ensure that people step through the group so that they get broad experience. It is very common for our finance function staff to move around the group.

**Mr Macintosh:** And BP?

**Mr Springett:** We operate a little differently. The business units that we set up are, in effect, self-sufficient. We do not regard ourselves as having a finance department, other than the guys who borrow money and so on. Business units are totally accountable for all things financial and many other matters, such as safety and production performance. That means that central functions are limited; they are mainly concerned with developing results for, say, the whole of the exploration side of the company.

Activity mainly takes place at a business unit level. For example, when I worked for BP in Alaska, heading up the planning and financial group, I had 35 to 40 people working for me. When we moved to the business unit structure in 1995, I ended up with three people working for me, because all the others went to work in the business units. I then had the opportunity to become a business unit leader—this will partly answer your question, Mr Macintosh. Although I am a chartered accountant by profession, I was in charge of three oilfields in Alaska for a couple of years, which was a different experience and very interesting.

For developmental reasons, people transfer between business units and sometimes to other disciplines, such as procurement or—as I did—general management. Members will know that in Scotland and other parts of the world we have outsourced parts of our finance function relating to transactions and accounting. That has been very successful in Aberdeen. Mostly, outsourcing has matched the aspirations of the people who want to be accountants doing transaction-type work in a hierarchy that allows them to succeed as accountants. However, the company still employs

many accountants and commercial people.

**Mr Macintosh:** Do you regard yourself as part of the financial side of BP Amoco? We discussed the idea of people going native in Government departments. We are interested in getting the best out of people, in a competitive spirit but ensuring that they stay loyal to the whole organisation and share best practice. It is maybe a consequence of the size of BP Amoco that it has different business units.

**Mr Springett:** We manage through the line—that phrase that means a lot to us—which means that we manage through the business units. Anyone who is an accountant or controller in the line also has a functional dotted-line relationship with people such as me. I think that that system gives the best of both worlds. People work in a business, rather than in a separate financial group. When the business unit makes decisions, the management team comprises the business unit leader, and maybe the subsurface engineer, the geologist, and the health and safety officer, as well as the commercial manager and the controller. Those people have much greater understanding of the business, feel more part of the business—they are not working in green eyeshades in back rooms—and can do their job much better.

**Mr Raffan:** In your Alaska anecdote, Mr Springett, the number of finance staff went down from 35 to three because staff went to work for business units, where they learned much more about the business. I do not want to call them your spies, but obviously they kept you much better informed at the centre. Although you were down to three people, you were far more powerful than you were before because you gained far more accurate information from the front line.

**Mr Springett:** Absolutely.

**Mr Raffan:** Therefore you were able to exert far greater control, albeit from a diminished power base.

**Mr Springett:** That is an interesting point. People who are steeped in the idea of centralisation may not agree with you, but I agree 100 per cent that decentralisation is a much better way to do business. If it is implemented properly, there is much greater awareness and control—

**Mr Raffan:** How do you prevent people going native in business units?

**Mr Springett:** We have had the business unit structure for four or five years. At the start it made people feel quite competitive. When the question of how much capital would be spent in the forthcoming year was discussed, you can imagine that each business unit—I am sure it would be the same for Government departments—was competitive and tried to get as much as possible.

To offset that, the process is set up so that business unit leaders can wear a group hat—a BP exploration and production hat—as well as a business unit hat. We have the advantage, which I am not sure Government shares, that we can target our reward systems along those lines. We also manage the business through peer groups, which are set targets that are greater than the sum of the targets for the business units. Each business unit is expected to deliver at or above the peer group targets. That means that the units have to engage in constructive conversation to achieve them. If another business unit had a better investment opportunity than I had, I would back you to spend the money in your business unit rather than try to spend it in mine.

In capital allocation, for example, the governing body at the upstream exploration and production level will tell a peer group how much money it should spend in the year, given the strategic context, the current oil price and so on, and will leave it up to the peer group to decide on what to spend that money.

**Mr Raffan:** Did the business units resist the arrival of the people who were decentralised? Were they regarded as potential allies or as informers?

**Mr Springett:** We severed the link very effectively so that those people immediately became part of the business unit.

**Mr Raffan:** You say that you severed the link, but previously you told us that everything depended on management through the line.

**Mr Springett:** The line is now through the business unit rather than being a functional line.

It was very exciting for the people who were decentralised. Suddenly, after having worked centrally, they were involved directly with businesses. There was not a them-and-us feeling. They worked in the business units and worked effectively with the few people remaining at the centre.

**Mr Raffan:** To return from Alaska to the Ministry of Defence, you are now helping to translate some of those experiences and experiments, which seem to be working in the private sector, to government. Can they be translated, or will you find that the equivalent of business units in central Government will compete with each other? A different ethos prevails.

**Mr Springett:** There is a different ethos and the process will not be easy. It has taken us five years to reach where we are—it has not been a quick fix. It took us between 18 months and two years to begin to be quite effective.

**Mr Raffan:** It is a life's work to change the culture of Whitehall and, perhaps, the Scottish

Executive.

**Mr Springett:** It is phenomenal. We, too, had to change our culture. Unless the organisation is structured in a way that accommodates change, believes that the new system is the right way to do business, understands the context in which targets are set and participates in the development of those targets, change will not happen.

**Mr Davidson:** Both Mr Nish and Mr Springett run competitive businesses within groups. They have talked about the finance community, which means, presumably, that there is interchange of jobs in BP Amoco so that people understand the financial operation throughout BP Amoco, but that is not necessarily the case with Scottish Power.

I get the impression that asset deployment in BP Amoco is in the hands of business units and peer groups. Mr Springett said that one business unit will support another unit if it has the best investment opportunity in a peer group and that such decisions are to be made at a decentralised level, not at the corporate centre, but that the corporate centre is responsible for total asset management, taxation, consolidation of accounting and global strategy. We have not heard much about that from Scottish Power.

We are aiming at the same thing. The question is how we decentralise information flows and whether we gain by doing that. I have come across the BP Amoco model, in which very competitive cost centres are required to produce a return—the required outcome in government is perhaps a service. In the Scottish Power model, how does the finance operation deal with the competitive nature of the organisation but remain loyal to the core?

**Mr Nish:** Our model is consistent with much of what Ian Springett has said.

There are two or three important issues that are not directly related to core finance. First, the target setting in the organisation has to be appropriate—one has to have buy in from units. Secondly, one needs a measurement system that understands the appropriate measures on which to evaluate a business. One has to tackle those things for which a business is responsible, such as quality of service—it could be something other than a financial measure.

Thirdly—to return to the idea of there being spies in the camp—there has to be a balance between control and responsibility in the business. Ultimately, if there are proper control mechanisms, the strength of central control wanes. One ends up with an open situation in which one trusts one's management explicitly, so that it is understood that the targets that are agreed should be meaningful and stretching, and should be in line with the group's strategy and with value creation. One is

trying to let the businesses get on with things.

In Scottish Power, I have dotted-line responsibility for the finance directors in each business. That does not mean that I am on the phone to them every day—I will maybe see them for an update once or twice a month, although I am aware of what is happening from other sources. I am interested in how they are achieving the whole, for which I am responsible, rather than the piece, for which they are responsible.

We are trying to achieve a balance. There are people who are motivated by achievement of both business unit and group goals—in terms of remuneration. There has to be achievement of the greater goal before one can share in what a business unit achieves. It is important to have ownership of targets and a measurement system that focuses on individual businesses.

**Mr Davidson:** With the different models, have you seen any decrease in the ratio of investment in financial accounting services to turnover?

10:45

**Mr Springett:** From a BP Amoco perspective, we have achieved that partly through out-sourcing. Conventional thinking suggests that if financial services are provided centrally there are economies of scale and that it would take more people to do it in a decentralised way and cost more—but that has not proved to be the case. The company has continued to grow—partly because of a better way of doing business—and the number of people involved has decreased slightly.

**Mr Nish:** The focus has now shifted from the generation of information to its use. We now have a lot more computerisation and more reliable systems; compiling data is a lot more straightforward. Although the total spent may have gone down we find that we are investing more in individual financial resources because we are investing in higher quality financial resources. The level at which you expect information to be interpreted and the decisions made on that basis is far higher than it was even five years ago.

**Mr Davidson:** Is your budgeting process set within the business units or centrally, with the units given a brief on which to base their plans?

**Mr Springett:** First, at a group and stream level, we try to set an appropriate level of performance with reference to what we think best companies can achieve—we intend to be a very successful company. Next, each business unit works within the context of its peer group. We meet all the peer groups, together, once every quarter, part of which is the planning process for the next year, part of which is spent checking out how we are doing and part of which is spent on new or strategic

initiatives. We know what we need to achieve and the peer groups bring proposals to the meeting.

The intention is to create exceptional performance, which often means the business units saying, “This is what we can deliver right now” but the peer group taking on the challenge to do more. That is how it works. There is always reference to benchmarks for improvement, trying to achieve year-on-year performance improvements and being aware of the strategy for what we want to achieve in three or four years’ time.

**Mr Davidson:** If different business units want extra resources, who decides what they get?

**Mr Springett:** The peer group—a group of like business units—now determines, given an allocation of capital, where it will spend the money. If that group believes that allocation of capital is too high or too low, that case will be made at the meeting and we will consider it. Quite often we see that the initial allocation of capital between the peer groups was not quite right and we will spend more in one place and less in another, or maybe more overall.

**The Convener:** How does your forward planning take place?

**Mr Springett:** At BP Amoco, we plan forward three years in terms of the targets we talk about externally—that is our primary focus. We have very hard targets for the current year but we are also always looking up to 10 years ahead. The process begins with looking at where we need to be strategically in three, four, five and up to 10 years’ time and working back to next year’s implementation of that longer-term plan.

**Mr Nish:** The process in Scottish Power is very similar. We start with an annual strategy review, which is the three to five year view of where we want to position the group, and is aspirational. Financial input to that tends to be at a high level and about where we see opportunities for meaningful value creation—in other words, the next billion pounds of shareholder value. By doing that, we are setting a framework within which we set the brief for the businesses to develop their 10-year plans. We update those plans annually. We focus on modelling on a cash-flow basis because at the end of the day it is discounted cash flow that drives the economic value of the group, in addition to profit and loss reporting and how that message is conveyed to the outside world.

We have an annual budget process, which again is based on the 10-year plan. So the businesses are actively involved in developing their 10-year plans that set the short-term framework. Within that we work with the businesses to develop hard targets. Again similarly to BP, we do a lot of benchmarking in all our businesses because as a

substantially infrastructure business we have efficiency targets set by the regulator that we have to beat. We intend to benchmark all spending, such as interest through the cost of capital, tax and more efficient ways of structuring the business.

There must be 100 per cent ownership by the businesses. At the end of the day they have to deliver and you do not want a business saying, "That is a corporate number, we cannot deliver that and it is not our responsibility."

**Andrew Wilson (Central Scotland) (SNP):** The discussion this morning has been very useful. In an inquiry of this sort, our problem is drawing parallels with the public sector—although intuitively there are similarities, it is entirely different. For example, there is no equivalent in the public sector to the shared goal of shareholder value, other than the very general goal of good governance. It is difficult to see how the parallels can be drawn in a measurable, tangible way. Similarly, if we try to draw parallels with the Executive, we find that it is almost entirely a spend business.

Both Mr Springett and Mr Nish referred to the business units. The Executive is organised through departments, divisions and branches. I suspect that business units are at the department level. Since there are only five or six departments, the Executive is not as devolved as we might want. Could you say more about how discrete the business units are?

**Mr Springett:** I referred to the business units as human-sized but they vary in size for various reasons and might include anything between 50 and 1,500 people. Size relates, for example, to an oilfield. The Forties field and one or two satellite organisations nearby make up a business unit. It is a sensible combination of assets that can be self-contained and is of a manageable size. An advantage of different size units is that we can develop people, who can cut their teeth on smaller units and move up to bigger ones.

**Mr Nish:** Could I challenge the comment about the applicability of private-sector models to the public sector? I will give the example of one of our businesses, Southern Water, which is one of the largest water and waste businesses in England. It is 100 per cent regulated. It has a profit and loss account and makes more than £200 million of profit, but if we compare it with a business that is cost-driven, we find that the regulator sets the revenue, so it is not competitive. We are given that number at the beginning of the year. Value comes from maximising the efficiency of costs, in terms of operating and capital expenditure, so every pound of spend must be justified. You focus on the output received for every pound put in because that is how you control value.

Compare that with the public sector. There are cost departments, but how do you relate output to the spend coming in? It is all about the appropriateness of the measures that are used. If you look at some of the measures we have to comply with in a water business, such as the quality of supply, the number of properties at flood risk and the amount of environmental dispersion, you will see that they are comparable. Those measures are non-financial but you try to relate them back through the appropriate mechanisms to make them financial because that is how you drive the value within the organisation. It is about thinking in terms of inputs and outputs.

If you look at how we drive budgets—I am sure it is the same in BP—you will see that it is done down to the level of the person who incurs the spend. You want to make them 100 per cent responsible for everything under their control, because that is the only way they will really appreciate the consequences of writing the cheque. In organisations where spending responsibility is at a higher level, you find that the person incurring the spend says they are not accountable for a budget of a million pounds so it does not really matter whether it is £1.1 million or even £900,000. An underspend may mean not delivering on outputs—it may be a great financial performance but cause great problems for the organisation.

**Andrew Wilson:** That is very useful and I am sure we can learn a lot in terms of quality goals in service delivery, but I was thinking about one level up from that. You could have the business units in the Executive reaching their targets, but there is no clear common goal. For example, if you are in an education or health business unit, there are common goals that we can and should tease out, but there is not one single aim, equivalent to increased shareholder value, that one person can buy into the next person achieving. We have been thinking about how health and housing have common goals. There is a role for a peer group model there, but how do we tease out a common overall goal?

**Mr Springett:** BP Amoco or Scottish Power may have more commonality, but there is also diversity within them. We try to have a strategic context that is not necessarily summed up in a single sentence, but people are familiar with the strategy. We spend a lot of time on that—for example, the senior leadership of the upstream business meets us to talk not just about its own business units but about all the assets. The most important task of the business unit leaders is then to go away and localise that strategy in terms of what their unit does. If you get to that point, everyone is not necessarily on the same page but at least they are in the same book.

**Mr Nish:** I will take Mr Wilson's example of education. I am no education expert, but you can look at the overall quality of education and what goes into it. For example, capital expenditure on the physical locations of education and the ratios of pupils to teachers can be converted into some form of measurement that can be linked to the kind of goal Ian was talking about, which you can set as the quality of education, the number of students who come out with highers, or whatever.

11:00

That is what we try to do in our businesses. Much of what we deal with when we develop a new area is not something in which we can say immediately there will be £100 million profit at the end. For example, a key area for our businesses nowadays is the environment. Most people would say that the environment is a cost and a burden on an organisation, but it can provide a competitive advantage. One has to sit down and work through what green fuel, tree management and so on mean. The thinking has to be changed slightly.

**Andrew Wilson:** I have a final, quite separate question. When control is devolved, how does one go about sharing best practice and ensuring that all the departments of the organisation are speaking to one another? Does each person have to ensure that that happens, or is there a unit charged with ensuring that everyone is talking to each other?

**Mr Springett:** There are two or three things. At a basic level, we have control manuals, so people have a central reference point. We also have control networks in each major location, which generally meet monthly to discuss issues of the day, new initiatives or whatever. I go on a road show every year and visit three or four locations. The aim is not only to talk to people, but more important, to hear what they have to say about how things are going and what is happening.

If you are controller of a business unit that has a performance contract that needs to be delivered, one question that is often asked is, what happens when the business unit leader effectively asks the controller to do something with which the controller is not happy? Another reason I go to different locations is that it is a release valve in the system. If there is an issue like that, the controller can speak to the local network and to me.

We tend to identify a big player—an uncle so-and-so—in every location, to whom people can talk. There are quite a lot of support processes that enable best practice to be shared. If a new initiative was launched from the centre, for example—although these days it does not feel so much as if new initiatives come from the centre; they are always more of a joint decision between

the business unit and the centre—people would meet to work out how best to implement the initiative on a regional or peer-group basis.

**Mr Macintosh:** I am conscious of the time and of the fact that there are other guests here to give evidence, but there are a host of questions. Earlier, both of you talked about the speed of decision making. One of the problems in government is that the process is not particularly fast. What do you do that government does not, and how can we adapt that to improve our processes?

Secondly, both of you mentioned the fact that, within the company, information is accessible to all and can be shared openly. I do not think that that is the case in government. How can we learn from you? How can we apply what you do in business to government?

**Mr Nish:** I will deal with the point about planning. I think that Ian Springett should answer the second question, because in my business I am not allowed to share information across certain barriers because of regulation.

Key to the speed of decision making is the quality of planning—being aware of the strategy and having an appreciation of how it might be delivered. Let me take our acquisition of PacifiCorp as an example. For the two years prior to that acquisition, we analysed every United States utility. We had worked with many of them and had our hit lists. We knew them better than they knew themselves. The opportunity to take over PacifiCorp arose only six weeks before we made the bid, but everything was ready to go.

If people have a clear understanding of what they are trying to achieve, are aware of the criteria against which to assess any situation and know how to access the necessary resources, they can shorten lead times. That is a continuous process. In business, opportunities come out of the woodwork all the time. If such an opportunity arises, people need to have in place a process that will enable them to make a decision.

In Scottish Power, if a business gets a new opportunity that was not included in a strategic plan or a budget, there is a central forum called an investment committee, which I chair and whose job is to facilitate quick decision making. The aim is for the ultimate decision makers to be able to understand the components of the decision without having to go through a long formal process.

**Mr Springett:** I agree with everything that David Nish has just said. The most important thing is to know, in the context of what is being proposed, who is able to make the decision. We try to define the space that exists within the business units, so that they understand to what level they can make

decisions. If plans, strategic context and so on are clear, it is much easier to make decisions. It is not necessary to convince the audience of what one is trying to do, because everybody already knows about it. We spend a great deal of time sharing context, because that is more important than almost anything else.

We have a process that makes clear who is allowed to make investment decisions. A business unit leader is allowed to make decisions up to a certain amount of money, a group vice-president can make decisions up to a certain amount above that, and some things have to be decided at board level.

In the digital age, we are looking at how far we can go with information systems and sharing. We, too, are subject to regulation, but we have what we call a common operating environment. Everyone in BP Amoco has the same desktop computer system, although that is not to say that there are not different reservoir evaluation models throughout the world. I could plug the laptop that I have in my bag into any BP office and be up and running in about 30 seconds, which is a good way to work.

We have many servers, allowing information that is okay to be looked at—I think that that is the best way of describing it—to be accessed by anyone who has the authority to do so. That authority extends to quite a large number of people. We are trying to widen access via the intranet, because we believe that when people have good information, they do good business.

**Mr Raffan:** Mr Nish spoke about driving budgets down to the person who incurs the spend. As he said that, I thought about the 19 health trusts in Scotland that are currently in deficit. This is a problem of this Government. In a sense it is a devolved structure, but there is no control other than when the Minister for Health and Community Care decides, as she did 10 days ago, to send a task force to Tayside because their budget deficit is £12 million this year and will be £20 million next year.

I am worried, too, by the fact that the chief executive of a health board can say to me that the trouble is that it is too complex to change the finance director of a trust because of NHS and health economics—because such directors need a year to learn their job and they are on a steep learning curve and because a new director might add to the deficit in that year by a million or two, but learn from it. Something is far wrong in that situation. Does that mean that the loss must be driven down to the clinicians in the health service? They incur the spend and they do the treatment.

How can what your businesses do be applied to the Government and the problems that it faces?

Local financial management of schools has been tried and that works in some ways. The NHS problem is the result of central Government and a devolved structure that does not work.

**Mr Nish:** I challenge whether the right measurements are being used in such a situation. A financial target cannot be isolated from what actually happens. Health services must work under certain allowances and they must be available to serve. I would go into a health board and first try to understand what the remit of the organisation is. I would ask whether it was achieving its aims and try to break down the problems from there. I would not try to stop spending straight away. It is important to establish the strategic intent of a health service unit.

There is a difficulty of mismatching of targets with expectations of delivery by the business unit. That goes back to some of the issues that I must address at work. I might go to my generation director and ask for £20 million more profit, which he cannot deliver because of the work that is being done. If he can show me the benchmarking that is being used, it does not matter if I come along at the end of the day to point out that he is £20 million short. My focus would be wrong in such a situation. The starting point must be to have a clear understanding of what is expected and then to put a measure of that in place.

Ownership of spending must be at the level where that spending is incurred, but that spending must be matched against a proper target.

**Mr Raffan:** Do you agree, Mr Springett?

**Mr Springett:** Yes, I agree whole-heartedly. We set up our business units within a substructure in which a lot of best practice is shared. Accountability for spending resides where the spend is incurred.

**Mr Raffan:** Do health trusts need peer groups?

**Mr Springett:** Possibly.

**Mr Raffan:** They could compete against one another and share best practice.

**Mr Springett:** Yes. David Nish's point is key. If there is a cost target, it is easy to focus solely on that cost target, and to spend not a penny more and not a penny less. That is not necessarily good business for us nor, I am sure, is it for the Executive. It is not the best way to provide services to patients or to anybody else. David hit the nail on the head. One must establish what one wants to achieve and how to measure it.

The trick in developing such a process is in ensuring that doctors and anybody else in the front line can identify with it and believe in it. They must think that it is right. If that resonance exists, the process will work.

**Mr Raffan:** So there must be integration between clinicians and management.

**Mr Springett:** Absolutely.

**The Convener:** Thank you, gentlemen. You are welcome to stay for the rest of the meeting, should you wish to do so.

I will move on to our local government witnesses. We have received submissions from Edinburgh City Council and from Perth and Kinross Council. Mr Dave Roberts has provided a further paper, which we received late yesterday. Please—for the benefit of the committee—speak to your paper, Mr Roberts.

**Mr Dave Roberts (Perth and Kinross Council):** Thank you for the invitation to attend today. I found it interesting to hear from Scottish Power and BP Amoco. What they have been saying has much resonance in regard to what local authorities need to address.

I am from Perth and Kinross Council, which is very different from the private sector in that we cover an area of about 2,000 square miles with a population of around 130,000. Our revenue budget is £170 million, our capital budget is around £10 million, and we employ around 4,000 staff.

I would like to talk briefly about my principal challenge, which—along with the director of finance—is integrating budgets, policies and plans. There are three elements to that: one is internal to the council; the second is external and involves our partners, who include Tayside Health Board and the trusts, and with whom there is an issue at the moment because of overspend; and the third involves responding to Scottish Executive initiatives and being clear about its priorities.

The practice in local government is to produce council corporate plans and three-year departmental service plans. That practice is well established and we have regularly reviewed and updated the process, which we see as evolutionary. I would like to echo the point made by BP Amoco that there are no quick fixes. We are learning as we go along, and we are adapting and changing to meet circumstances, but that takes time.

11:15

It is essential that we have a service planning process if we are to have detailed, action-oriented service plans that reflect the strategic priorities and aims of the council. To assist us in achieving that, we have not only reviewed the process regularly ourselves, but have brought in external consultants. We are learning from experience from elsewhere, which is always very important.

Internal to the council, the strategic planning process is the essential tool in determining clarity of purpose; in setting an overall vision; in achieving best value—which we are very familiar with now, with the new process of benchmarking and costing all our services; in measuring performance; and in focusing on resources. We also have to listen to the needs and aspirations of the people of Perth and Kinross.

Having established that process in the council, the next challenge is what is called the community planning process, in which we are one of the five pathfinder councils, along with Edinburgh. That involves working with our public sector partners to deliver high-quality public services using existing and often diminishing resources. I will again mention the problems facing Tayside Health Board and the trusts.

We are addressing particular policy and budget issues in community planning. How do the different public sector agencies, which cover different geographical areas, as they do not have coterminous boundaries, come together to review the impact of budget decisions? I will give you a small example of what can arise. Our council is trying to save £12.5 million. One of the proposed cuts was to the support given to children with special needs in schools; yet, at the same time, the health board has made that support a priority. We are considering cutting a service and the health board is considering increasing it. We always have to consider the impact of any decisions not only on the local authority but on our public sector partners.

A second community planning issue that we are addressing concerns the different ways in which we can deliver services jointly with other agencies. For example, in a project with the health board at the moment, we are looking at integrating the services offered to old people. We have carried out a survey, and people want a one-stop service—they do not want to go to the health board for some services and to the local authority for others—and they want clarity of purpose. We are looking into different ways of delivering those services. That is a huge challenge in terms of gathering information, of budgeting, of staffing conditions, and so on. We are not sure how we will resolve it, but we are working on it at the moment.

Having looked internally at the council, and externally at the way we work with our public sector partners, the third challenge—which goes back to what was said earlier about the meaning of strategic intent—is to look at the various initiatives and priorities of the Scottish Executive. To be honest, that can be confusing. In the period from September 1998 to March 1999, we carried out a survey for the Scottish Executive. We received in that period 100 different Government

initiatives and 48 different consultation papers. Since that time, the rate at which initiatives and consultation papers come out has not slowed down. Sometimes, determining the strategic intent of the Scottish Executive is difficult, and therefore prioritising our budgets can also be an issue for us.

In conclusion, we have to look internally at the way we work, we have to look externally at the way we work with our public sector partners and we have to be aware of the Executive's priorities and of how we can respond to them.

**The Convener:** In the paper that was submitted earlier, you mentioned the length of the budgetary process, which seems to involve three-year planning. To what extent is that a benefit to you? How long has that length of planning been used?

**Mr Roddy McArthur (Perth and Kinross Council):** The best-value task force, which comprised officers from the then Scottish Office and from the Convention of Scottish Local Authorities, encouraged all authorities to embrace three-year budgeting at a meaningful service delivery level. We have tried to tie that in with our service planning process.

We have difficulties with three-year budgeting, mainly because of the financial regime under which we operate. The annuality of local government financial settlements causes us difficulties in determining our forward years' likely resources. It also causes difficulty in deciding how much flexibility we can build into our expenditure planning process.

For example, I am keen to encourage budget holders to find efficiencies and economies. At the moment, there is no real incentive for them to do so because it is likely that they will lose that money this year and probably next year too. An incentive would be to offer them some of that money back to help them to develop their service. Depending on the timing, additional funding may be carried forward and built into next year's budgets, with the risk that we may exceed guideline figures and be exposed to the potential for capping.

The annuality problem tends to militate against effective three-year budgeting. The increased hypothecation of resources from the Scottish Executive also causes problems in determining the initiatives that we must embrace and how we deal with them. It seems far better for an agreement between local government and the Scottish Executive to concern the desired outcome so that we can work towards those outcomes, rather than having money ring-fenced for specific initiatives.

Three-year budgeting is at an early stage in Perth in Kinross and is bedevilled by the problems

of the local government regime under which we work.

**The Convener:** I would like to ask a similar question of you, Mr McGougan. You have moved to a three-year framework on capital and I understand that you are moving towards the same framework on revenue. What benefits or problems do you foresee for City of Edinburgh Council?

**Mr Donald McGougan (City of Edinburgh Council):** It has been interesting to hear the evidence of our colleagues in the private sector. We have been on a three-year budgeting process for capital projects for almost three years now and it has worked well. Major projects need a long lead-in time, proper evaluation and comparison in investment terms against competing projects in the authority, so we find the system useful. The move to enable local authorities to carry forward the capital receipts generated has taken away some of the annuality problems that Roddy mentioned. It works well for capital, but there is an annual review of the three-year programme on a rolling basis.

In revenue, we have the same difficulties as Perth and Kinross Council has, but we are committed to the process that David Nish has outlined. We now have a city plan that is agreed not just with the local authority but with the other agencies such as the health board, the police, the local enterprise company and the private sector. We are evolving a process of driving the objectives in that city service plan into departmental service plans, which are also on a three-year basis. We are by no means there yet, and I am not suggesting that we have cracked the problem, but we are trying to ensure that those service plans are used in the annual revenue budget round.

We are still very much fixed to that annual revenue budget round, but the value of the service plans lies in focusing us on outputs rather than on inputs in terms of objectives for the council and for individual departments. It also helps us to identify areas in which we can develop joined-up working and go on to set performance targets. As we discussed earlier, the objective is not just to say that those are the resources that have been allocated to that particular service, but to say that for that level of resource, after we have benchmarked the service and everything else, we expect these objectives and outputs.

That is the road that we are on at the moment. We have not got to the end of it, and I do not suppose that we ever will. It will be a developing process.

**The Convener:** You mentioned service plans. What about the council's cross-cutting initiatives to develop joined-up government? Do they require

special budgeting, or do they have special requirements attached to them?

**Mr McGougan:** Yes, they do. There are cross-cutting issues with other agencies, such as with the health board and the reprovisioning of Gogarburn hospital. So far, we have come at these issues on a horses-for-courses basis. We have examined each one and determined the appropriate way to set in train budget provision, monitoring and financial control.

Within the council there are different ways to do that. For a number of initiatives we have identified lead departments and simply transferred the budget from other areas to those lead departments, giving the lead department the responsibility for delivering the service. One example is open space maintenance and litter collection, which brings together grass cutting and picking up litter.

In other cases, there are working groups within the council which deal with matters on a corporate basis. For some initiatives that have capital implications, it may be that specific capital or revenue budgets are placed in different departments during the budget round.

There is also a third way of cross-cutting issues, in which we set corporate targets for specific initiatives, such as energy efficiency or year 2000 compliance. Targets are imposed from the centre and are agreed with departments, because, as David Nish said, it is important that the departments sign up to them. It is then the departments' responsibility to deliver them within the budget.

**Rhoda Grant (Highlands and Islands) (Lab):** Looking at this issue in the wider sense, the council would form a business unit of the bigger organisation that is delivering services, which would be the Scottish Executive. One of the comments that was made was that there was no motivation for departments within the council to give up funding, because that funding would be lost.

How can councils see themselves as part of health education service delivery? How can they have ownership of the process, so that they feel that they can hand money back if it will benefit health services in another area? How can we shake out the money that is being hung on to, because in the public sector that is the only sign of success? The bigger the budget, the more you hang on to it. That is the only motivation. How do we change the motivation, and how do we give people ownership of the process?

**Mr McGougan:** That would be a long process, which would need a cultural shift. There are examples whereby councils and enterprise companies in particular have shared budgets for

successful joint projects in the Edinburgh area. It would be easier if expenditure constraints were less rigorous. Given the overall envelope that we have to work in, where a large proportion of pay awards each year have to be met from efficiency savings, much of our activity is taken up with the annual budget round and seeking to drive costs down in particular areas.

Having said that, the publication of the Scottish Executive's clearer targets and objectives, and perhaps, as has been said, less targets and objectives, and the agreement of those targets with the Convention of Scottish Local Authorities and local government generally, could help to deliver joint priorities and objectives over a period of time. For example, in capital planning, areas of investment priority are agreed between COSLA and the Scottish Executive. To a greater or lesser extent, local authorities are responding to that exhortation.

**Mr Roberts:** As Roddy McArthur and Donald McGougan have said, the three-year budgets from the Scottish Executive will help us to plan more effectively for the future. Exit strategies will allow us to cut back in some areas of work and make progress. We have to make short-term decisions every year and that poses difficulties.

11:30

**Mr Raffan:** I do not want to go into the problems that you are facing, although the budgeting process obviously impacts on you. You mentioned the annuality of Government financial settlements and the increasing hypothecation of funding such as the excellence fund. There is also the problem of absorbing locally salaries that are negotiated centrally. In addition, central Government is introducing a spate of legislation with which you are expected to comply without having the extra resources to do so. Meanwhile, you are caught in a pincer movement, as the people whom you serve locally, in Perth and Kinross, also expect a higher standard of services.

Then there are the crucial problems of the formulae. I have heard the Auditor General say that there is a structural problem. I have heard the minister say that there is a structural problem. Under the old system of local government, 85 per cent of Government funding went to the regional authorities. The different formulae worked better in a bigger unit, where a city and a rural area were balanced. A prime example was the old Tayside region, which contained Dundee and the rural areas; another example is Aberdeen and Aberdeenshire. It just so happens that Perth and Kinross and Aberdeenshire are the two areas that are having the most problems.

Does that structural problem impact seriously on

your budgeting process? How will that be resolved—by an independent review?

**Mr McArthur:** I have yet to be convinced that there is a structural problem. The problems that local government has faced since reorganisation have concerned the robustness of the data that inform the distribution process. It takes time to build up sufficient data to make valid decisions on the distribution of resources and spending power to local authorities.

The issue that bedevils us and Aberdeenshire Council, and perhaps City of Edinburgh Council, is coping with a growing population. We must provide a service to the population as it is now, but the distribution of resources is based on the population as it was two years ago. The problem is particularly acute regarding school pupil numbers. The school census is carried out each September and the school pupil numbers influence about 36 per cent of the distribution of resources. With a growing population, we have to provide teachers, classrooms and materials for the pupils who will be in school next August, not last September. We hope that we will be allowed some flexibility to address those difficulties.

Public bodies are good at identifying expenditure pressures and the ways in which priorities drive their spending needs. We are not so good at establishing exit policies, or saying "One, two or three years down the line, we are going to reduce our service level or we are going to stop providing a service entirely." I recognise the political dimension in that, and the fact that that decision can be difficult to make. Some authorities have discovered, through procedures such as school rationalisation, that there is a lengthy lead-in period between deciding that there is to be a school closure and actually making it happen. For several areas, planning ahead and planning exit strategies in order to begin to change the focus of resources is very important.

**Mr Raffan:** Will Mr Roberts elaborate on his interesting paper? I am not sure that I understood all the jargon, although I tried. The point about policy-led budgeting is basically about matching priority need to resources; in other words, policy-led budgeting is a product of the pressures from the Scottish Executive. I am not trying to make a political point; I am concerned about how the policy has come about. Is it about financial constraints—force of circumstance—or is it about innovation and making the most of the available resources?

**Mr Roberts:** I came to the council in 1996 and—for the reasons that you suggested regarding the council becoming a unitary authority—it was important that the new administration had a clear sense of purpose. One of the first things to emerge was the issue of population growth, to

which Roddy McArthur referred; his point about the need for proper information is related to that. For some time, there had been a perception that people were moving to Perth and Kinross to retire. In fact, what the planners euphemistically call breeding pairs have been moving in—young couples, who then have children. The council had to determine whether that was an issue and if so, how it should be dealt with.

That was one of the first drivers we had for considering the need for corporate planners to establish priorities. Beyond that, the council wanted to be clear that it was addressing issues of social inclusion and so on. We had to consider what that meant for services that had had a narrower focus in previous administrations. The purpose of the corporate plan was to change slowly the council's strategic direction. In the past, for example, we may have always provided caravan parks, but the plan was designed to make us question whether that could be done by the private sector and whether we should be concentrating on other areas.

The politicians needed clear priorities and wanted to pass on that clarity to the service departments and the public in Perth and Kinross, so that everyone was clear about what the council was trying to achieve.

**Mr Raffan:** There has been some controversy about the structure of councils and the streamlining of departmental heads. It may be difficult for you to comment on that, but perhaps we can speak in broad terms. You have a large work force of 4,000 people. Is that structure top heavy or not integrated enough? What is the motivation behind streamlining? Is it to produce better policy-led budgeting?

You seem to be taking the reverse approach to Mr Springett's business units and his generous devolvement of control; you seem to be moving towards a more centralised model.

**Mr Roberts:** That is a difficult question to answer entirely honestly. You would have to ask some of the politicians about the real reasons behind the restructuring. I think that it was driven by two factors. First, it was perceived that we had relatively high management costs and that restructuring would be one way of streamlining those costs. However, we have the lowest number of lower grade staff per thousand head of population. Secondly, we were addressing some of the Scottish Executive initiatives from our own perspective. For example, to provide a holistic service for children, it makes sense to bring together the education service and that part of the social work service that deals with children. We hope that that will create a more integrated service for children and allow us to address initiatives such as community schools. There may be other

ways of doing it, but that is the approach that we have taken.

**Mr McArthur:** The McIntosh report required us to examine decision-making structures; inevitably, that relates to management structures. The revised structure has probably brought a more strategic focus to the way in which we are set up. It allows us to deal with some of the cross-boundary issues, for example by bringing child care and school education together in a department of children's services.

As part of the restructuring, we are also examining what we have termed the non-core activities of departments, such as property, human resource and finance activities. We want to establish whether it is better that they be managed and directed centrally or within the departments. Our aim is to consider the size of some of the departments. Education takes up 44 per cent of our budget and that figure will increase when the child care element is added.

**Mr Raffan:** So, in a way, your structure is similar to Mr Springett's. In your submission, you say:

"The function of outposted financial services staff is to ensure compliance with financial regulations".

That is a lovely sentence. Basically, it means that the financial services staff are spies. How many such spies do you have?

**Mr McArthur:** That sounds like one of my phrases. I apologise for that.

All of the major departments contain accountancy staff who have been outposted from the centre. They are accountable to me for the work that they do.

**Mr Raffan:** They do not go native, presumably.

**Mr McArthur:** Up to a point, I do not think that their turning native is a bad thing. The centre can become insulated and if some of my staff become involved in, and perhaps act as advocates for, those services, that may be no bad thing. It is also no bad thing if they act as advocates for finance within the services.

Their role is not simply to be watchdogs who ensure that the financial regulations and guidelines are applied. They also have a proactive role in supporting the services in any way that they can. In my experience, the role that they play is appreciated by their colleagues.

**Mr Raffan:** Is there a small core department with outposts, similar to the Alaskan model?

**Mr McArthur:** There is a corporate finance core that deals with some insurance and risk-management functions that are authority-wide, treasury-management functions. There is also a financial policy and planning function, from which

many of the guidelines and budget strategies stem.

In the services, there is an outposted team, in charge of which is a team leader. That team delivers the finance service to the customers and acts as the liaison between finance and the services.

We are examining ways in which the central and the outposted functions can be brought closer together in the hope of encouraging more of an interface with our customer departments.

**Elaine Thomson (Aberdeen North) (Lab):** We heard about one kind of financial model from Mr Springett and Mr Nish. To what extent do you think it would be possible to apply effectively to the public sector much of what they described regarding devolved financial management, performance indicators and benchmarking?

BP Amoco or Scottish Power's structure seems to be underpinned by their having quality data that is distributed throughout the structure by quality information systems. You said that one of your problems when dealing with population growth is that the data with which you are working is out of date. Do the information systems throughout local government need to be upgraded?

**Mr McArthur:** Before I come to that, I would like to make the point that the information for the distribution process is determined not by us but by the Scottish Executive. The information on population comes from the General Register Office for Scotland. We would like to check it to see whether we agree with it; fundamentally, it is not our information.

We would far rather receive population projections than statistics that are two years out of date. I could not agree more that good management information systems are the key. After local government reorganisation, most authorities inherited a diverse range of systems that were not compatible. Most of us have spent the past three or four years trying to replace or improve our management information systems. That is a key to the effective management of the organisation.

The information that we get out is only as good as the information that we put in. I think that that is what Elaine Thomson was alluding to. Our problem with the robustness of the information is that, previously, it was gathered regionally for most services, because the regions provided the bigger services. Disaggregating that information for the new authority areas has led to the information perhaps being less robust. Only time will improve that.

11:45

**Mr McGougan:** Investment in new technology and better information systems is fundamental to making progress in local government. That relates to my activity in financial and management information, but more to our role in interface with the customer.

The modernising government agenda, which has been distributed nationally, is of great interest to a number of local authorities. We need to find investment for that. In the past, investment in systems and technology has not necessarily been a high political priority, but the move towards longer-term budgeting will help to identify the investment resources for longer-term improvements in the service.

To a significant extent, City of Edinburgh Council already works on the basis of business units and devolving budgets. A sports centre, residential home or, through the national scheme, a school would all have their own devolved budgets. The person in charge of the facility would have responsibility for spend within those budgets. Within financial rules, they would have a fair degree of discretion to move expenditure from one budget head to the next.

Having said that, responsibility for financial management and control lies mainly at departmental level. As director of finance, I have responsibilities for pulling that together at a council level, so that we do not experience the situation that might apply to the health board trusts. In their case, overspend in a particular area of the budget can lead to overspend in the budget as a whole. Within that system, there is an element of financial management and control being imposed at departmental level, and, I would have to confess, of some second guessing and duplication of effort at the centre because of the overall requirement to keep the organisation's corporate budget under control.

I hope that we can address that in the future, partly through a review of how we exercise financial management and control, but mainly through investment in systems and new technology.

**Mr Roberts:** I want to pick up on the point about the need for clear strategic intent—we have to be very clear about what we are going to do. The challenge is not only for the councils to get their own house in order. I return to community planning—to working with the local health board, the police or local enterprise company. The challenge is to get a clear, collective vision of what we are trying to achieve in the local authority area that we cover. That is sometimes hindered by a difference between our partners' agendas at a national level and our agendas at a local level.

Achieving that clear vision is important, not only for ourselves but for the public and for our strategic partners.

**The Convener:** This might not be an issue for the committee, but I am intrigued by the extent to which population figures are important in relation to your budgeting and your ability to spend. You may have noticed that in *The Scotsman* today, there is a detailed article on population projections across Scotland for the next 15 years. You said that you are dependent on figures going two years backwards. In a local authority with a growing population, such as Perth and Kinross Council or City of Edinburgh Council, what effect would the ability to plan on the basis of population figures five years ahead have on your budgeting process?

**Mr McArthur:** It would be of enormous benefit. Perth and Kinross, and other areas with growing populations, have argued that distribution should take account of population projections, because we have to provide the service to the increasing population. Local authorities with declining populations are on the other side of the coin and are not as seized of that notion as we are. I recognise that authorities with declining populations need time to revise their services to take account of a declining population—it cannot happen overnight. Population is a main driver of the distribution of local government resource, so it is of key importance for the authorities that have an increasing population.

**Mr Macintosh:** I was interested in the point that Mr McGougan made about how he spends an awful lot of time looking for cuts and how to drive down costs. When you do that, it is at the expense of using your financial expertise to use finance in a strategic way. Is the situation getting better or worse? Have you found ways of moving away from looking for cuts, or is it one of the continuing obsessions of the local government budget process in its relations with central Government?

**Mr McGougan:** That might depend on the position in each local authority. It depends—to an extent—on how much one can transfer one's attention to looking forward and having reviews on a proper basis, rather than responding on an annual basis. The process within City of Edinburgh Council is becoming better, for two reasons. First, the savings that we are required to make for next year—and for the year just past—are less than they were in the first two years of the council's existence. Secondly, in our council, we are gearing ourselves up—through the process that we described earlier—to focus on priorities and we direct attention and resources to those priorities.

I agree with what my colleagues from Perth and Kinross Council said about exit strategies, and that it can be a problem in local authorities to stop doing things and stop providing services as it

brings longer-term policy priorities into conflict with short-term democratic requirements. However, City of Edinburgh Council is managing to redirect its resources in a more proactive fashion. The process in Edinburgh is becoming easier than it was two or three years ago.

**Mr Macintosh:** Mr Nish and Mr Springett both said that the more control that you have over your finances, the better you can perform. That happens in the private sector. Given the impositions that central Government places on you, do you have anything like 100 per cent control?

**Mr McGougan:** Once we have set the budget, it is clearly the local authority's job to ensure that the budget for that period is properly controlled and managed. Given that we generate only 20 per cent of our income through the council tax, the gearing impact of an overspend is critical for local authorities. Although we take responsibility for control of the budget once we have set it, we cannot look any more than two years ahead because of issues of the quantum and distribution of central support. The three-year framework provided by the comprehensive spending review has been of some use; however, we are still bedevilled by the problems of annuality.

**Mr Macintosh:** Sharing happens in the private sector. For example, if you control your budget and see the best return on it, you use that best return in your own department or in another department. Does that happen at all, or is it a case of someone else getting the money if we do not, and we are damned if that is going to happen?

**Mr McGougan:** Are you asking whether that happens within councils?

**Mr Macintosh:** I am asking whether it happens between councils.

**Mr McGougan:** Far too much effort is spent on arguing about the distribution of resources instead of on directing our attention to the quantum of resources. That is an unfortunate by-product of the system within which we all have to work.

However, the process of distribution is becoming politicised locally and nationally, which is dangerous for the future progress of local government. Within our council, we are trying to create a very small, earmarked allocation of resources that is almost like challenge fund bidding money and which allows departments to plan for the future, to restructure and to use resources for change management purposes. We can do that only through reserves that we have built up through past control of budgets; we are just at the start of that process, which will help towards three-year budgeting.

I will give you an idea of the scale of that. In a

budget of £600 million, we would have a fund in Edinburgh City Council of £3 million to £4 million for such a restructuring process.

**Mr Davidson:** Some interesting comments have been made. On the previous point about trend analysis by the Scottish Executive, people would be surprised by the number of ministerial responses that say that figures are not held centrally. Everyone active in the public sector should learn a lesson from that. Obviously, in private business, much decision making is based on trend analysis, but such a tool has not transferred easily to the public sector.

Comments were made about annuality, the loss of budgets and the effect of that on the next year; there were also comments against ring-fencing. In private business, ring-fencing is known as a project budget. In other words, people have agreed to do something and a budget has been set; furthermore, it does not matter whether the time scale for the project overlaps at the end of the year, because it is reserved. I feel that you might be happy to accept ring-fencing on such a basis, as long as the money was not lost at the end of the financial year, which can cause panic spends and bad decision making. One of the witnesses mentioned democratic input; although everyone smiles at that phrase, it simply means that decisions must be made before the next election. That is a problem with the democratic process.

Do you have a model for how annual budgets could be dealt with by the Executive, and how far ahead can long-term budgeting be practical?

**Mr McGougan:** For the public sector, there is an old saying: a week is a long time in politics. There is an element of truth in that. It would be helpful if the public sector could get the CSR process properly bedded in and have a three-year view of resources in local government. That is the most that I would ask for, or would expect, at this stage.

12:00

Part of the reason why I do not like ring-fencing is that another organisation such as the Scottish Executive is doing it. Local authorities and the Scottish Executive should decide in partnership on overall objectives, but local authorities as democratically elected institutions should be allowed to take responses from the public and from other agencies within the community planning processes, as well as the Scottish Executive's view, and then use the total allocated resources in the best possible way. Ring-fencing represents a concentration on inputs rather than outputs.

**The Convener:** David, the function of the inquiry is to consider budgeting arrangements rather than to investigate the relationship between local

authorities and the Scottish Executive. I am not keen to pursue that road.

**Mr Davidson:** I am keen to find out, in another democratic situation, which I presumed we were in here, the longer-term view of local authorities and the lessons that they can convey to us.

**Mr McArthur:** In the longer term, what would ideally suit us would be an expenditure planning process over a rolling three years, in an environment in which we had some certainty about what our resources were likely to be in two or three years. Even in the comprehensive spending review process that the Scottish Executive has gone through, the figures have been at the level of Scotland rather than local authorities. Therefore Donald McGougan and I, and our colleagues, have to make educated guesses about what the situation will be for individual authorities.

If there could be greater certainty over three years and settlements over three years, there could be flexibility between years so that there would not be the end of the financial year rush to spend money in case it was lost. We could get proper planning through such a process and could encourage economies and efficiencies on the basis that savings could be invested in services in the following years rather than be lost for ever. That would help our expenditure and strategic planning process tremendously.

**Mr Raffan:** I do not want to get into the relationship between local authorities and the Scottish Executive, but it is important. I will be the devil's advocate for ring-fencing. Let us regard you—I dread to say this—as the territorial branch unit of the Scottish Executive. The Executive might feel that there is a need for spending in a specific area such as education, but if the money for that is not ring-fenced, you might use that money to offset a deficit that arises in another area, and the policy priority of the centre would be neglected. I know of a recent case in which a health board that was allocated £176,000—

**The Convener:** I will stop you there, because what you are asking about is not the function of this committee. The Local Government Committee will shortly have an inquiry on local government financing. I am not keen to get into the relationship between the Executive and local authorities.

**Mr Raffan:** I am not trying to do that. I am following David Davidson's point, which is crucial. I do not want to get into policy. Local authorities do not like ring-fencing, but it is the control that the centre has—whether the centre be Donald Dewar or Mr Springett. There is a conflict because the Executive wants resources to be spent in a specific way and local authorities want greater freedom.

**Mr McArthur:** Nobody denies the right of the

Scottish Executive to determine its priorities and how they are implemented. We would like to think that priority areas for spending were agreed between local authorities and the Scottish Executive. From the finance point of view, it is the detail that is applied to the ring-fencing of additional resources that is important. We would rather that there were agreement on the expected outcomes and that we were then allowed the flexibility to utilise resources to meet those outcomes.

For example, under the excellence fund, there is a drive to reduce the ratio of pupils to adults in schools, the result of which is that we have been required to start employing classroom assistants, although there might have been other ways of changing the ratio. Donald McGougan and I have to sign a form to say that that is exactly what we have done. It seems bizarre to many of our staff that we have placed advertisements in the paper so that we can employ more classroom assistants while we are considering potential budget cuts that will reduce the number of visiting specialists in music, arts or physical education or that will reduce the amount of behavioural support.

**Mr Raffan:** I do not want to upset the convener, so I will switch tack. Mr McGougan made an interesting comment about devolved budgeting to sports centres, schools and so on. In Mr McArthur's written evidence, he talked about activity-based costing, which, as I understand it, analyses spending by department, or breaks down spending by activity. That may be the approach that we discussed when we took evidence from the minister, in terms of breaking down the Scottish Executive's budget to level 2 or level 3. The further one breaks spending down, the more one can move money around. Is that correct?

**Mr McArthur:** Like most authorities, Perth and Kinross is at an early stage of activity-based costing, which we have carried out so far in a fairly crude way. We did so to address the issue that Mr Raffan raised. Traditionally, authorities have budgeted in terms of cost centres, but the budget for primary or secondary schools would be made up of staff costs, property costs and the costs of supplies and materials. However, it was not clear which activities those budgets delivered and councillors complained that they did not know which services a particular budget helped to deliver. We must start to change that approach so that we can understand which activities those budgets deliver and what drives our costs.

At present, because of the way in which we are required to account, the education budget is broken down into primary schools, secondary schools and special schools. We have a service plan that reflects the national situation to a certain extent, as it talks about a five-to-14 curriculum and

higher still. We must begin to reconcile those approaches and understand how the curriculum drives our costs—that is, what the cost is of delivering the five-to-14 curriculum or higher still. If we can understand better what drives our costs, we might be able to consider activities that add value—and those that do not add value—and how to make savings by changing the structure of the curriculum in schools.

We are at an early stage. So far, the work that we have done has been fairly crude, but at least we have identified a range of activities within each service, so that when we consider policy-led budgeting, we can decide which activities are high priorities and which are low priorities.

**The Convener:** That seems to echo Mr Nish's comments about Southern Water. As he said, one can always find a unit of measurement on which to base improvements to performance.

Are there any further points that members wish to put to Mr Nish or Mr Springett, in the light of what we have heard from the local authority witnesses?

We have had a thorough two-hour session, which has been illuminating in different ways. I hope that each of the witnesses has benefited from the experience—they seemed to suggest that they had, which is pleasing.

We have taken a lot from today's evidence, which will play an important part in the report that we will produce at the end of our inquiry. I thank the witnesses for giving their time and their answers so freely.

12:07

*Meeting adjourned.*

12:10

*On resuming—*

## European Union Funding Arrangements

**The Convener:** Last week we discussed European Union funding arrangements but, as members may know, the European Committee did not consider whether there should be an inquiry, although it took evidence from the Commission. After that, I had a meeting with Hugh Henry, the convener of the European Committee, Bruce Crawford from the European Committee and Andrew Wilson from this committee. Sarah Davidson and Stephen Imrie, the respective clerks, were also present. We considered a number of issues relating to European funding, and following the meeting the two clerks produced a paper outlining some of the issues and options.

The European Committee does not meet again to take a decision until a week today, so we could not reach agreement on whether there should be a joint committee inquiry, individual investigations by the two committees or some sort of parallel investigation in which one committee would take the lead. In such a situation, it would be for the Parliamentary Bureau to decide which committee took the lead. That would, in any case, come under the heading of a joint investigation.

The issue raises a number of fundamentally finance-related matters, although they are tangentially European as well: for example, how the funds are operated, whether they are additional to the budget and what their net impact is. There was general agreement that there were sufficient grounds for an inquiry. At issue is how it should be conducted. I believe that there are issues that need to be investigated, although at last week's meeting of the European Committee I noted that, when Mr Meadows of the European Commission was asked whether Scotland had lost out, he was quite clear that it had not and that the Commission was not unhappy about the way in which the funds had been operated. However, we are talking about transparency and there are questions that might usefully be considered.

To sum up, we can decide what we as a committee want to do, but we are no further forward on the mode of the inquiry, because the European Committee has not yet pronounced on the issue. Would you like to add anything, Andrew?

**Andrew Wilson:** With the greatest respect, Mr Meadows did not say what you have just reported. He was entirely unclear on Scotland's position and

said that the Commission was happy with arrangements because it was concerned with state and project levels. He said that the question of whether the Scottish budget gains or loses was a matter for the internal workings of the Treasury and that we would never find the answer to it. That is for us to determine in the inquiry.

At the meeting with Hugh Henry and others, I was seeking to focus on whether funding is additional to the Scotland budget, which is clearly a matter of direct relevance to the Finance Committee. Where would you advise us to take the discussion, convener? Should the Finance Committee take the lead? I am unclear what specific ideas Hugh Henry thinks the European Committee should be considering, beyond the general policy questions of what structural funds do.

**The Convener:** A number of issues have been identified that seem to fall more into the financial framework than the European one. My view was that if the two committees were to do something jointly—not necessarily a single inquiry—we should be the lead committee. I repeat, however, that that would not necessarily be our decision. The emphasis on the issues means that that would be the logical conclusion, although I am not sure that Hugh Henry would agree.

**Mr Davidson:** I agree that this is a financial issue rather than anything else. I am never quite sure what the European Committee wants to do with it. I can understand its role in screening and examining documentation, but I feel that the matter belongs with this committee, if only to lay ghosts—I am not taking sides.

There is such public interest in the issue that we need to have an understanding of it. The way forward may be for the clerks to produce ideas for an inquiry, which we can consider next week if we do not have a heavy agenda.

**The Convener:** The difficulty is that we will meet again before the European Committee meets, as it meets in the afternoon.

12:15

**Mr Raffan:** I agree with David Davidson that a paper would be helpful. There is a problem with a joint committee inquiry. I can see why different committees might be involved in taking evidence at stage 1 of the legislative process, with one committee as lead committee, but straightforward inquiries should be done by one committee.

As Andrew Wilson said, this is a highly complex issue. Mr Meadows said that we would never find out the answers. We probably will not if two committees are involved in the process; it would be easier to have one.

We will come up against this issue time and again, particularly when we consider the financial aspects of an issue for which another committee has responsibility. For example, the Local Government Committee is considering local government finance, but sooner or later we will need to examine that.

**Mr Macintosh:** Last week, we talked about the possibility of including European funding arrangements in our report on the Barnett formula. What is our thinking on that? It is a question of timing and when we get round to doing either or both of those reports. European funding is intrinsic to the Barnett formula, so it should perhaps be part of that report, but I do not want to delay the inquiry unnecessarily, as we have not yet agreed what we will do about Barnett.

**Andrew Wilson:** We had a brief discussion on that point. The issue is seen as being distinct and discrete, although—you are correct—one report would inform the other. There is a desire for an inquiry on European funding, even though, much to my dismay, we do not yet have agreement on a formal inquiry into the Barnett question. My suggestion is that we push ahead on the European front and allow ourselves to be informed by that as to how we should examine further the Barnett question.

**The Convener:** We are committed until the Easter break due to our present inquiry. The plan was to move into briefings on Barnett after that, but if we want to institute an inquiry into European funding, that would take precedence. David Davidson suggested that the clerks could give us a report next week, which would include timings. If the clerks are happy to do that, we would welcome such a report.

**Rhoda Grant:** The two issues—European funding and the Barnett formula—are closely linked. Will we get a clear understanding of the issues if we consider them separately? The clerks should consider in the paper that they produce which inquiry would come first or whether they could be done together.

**The Convener:** One of the suggestions is that we have a briefing on Barnett as part of an inquiry into European funding arrangements.

**Mr Raffan:** I would like to go back to what you and Kenneth Macintosh said, convener—that time will become a major problem. We are going into the full budgeting process after Easter for the first time. We have not been through that process before, so we do not know how long stage 1 will take. We will send out a questionnaire to the Parliament's committees and await responses and we must process all that data by the end of June. We need to know how much time will be available for an inquiry and we need to know what our

priorities will be.

I do not want to introduce something new, but I will—where might we have the most impact? We must examine local government finance before next year's local government finance settlement. We should try more to influence the Scottish Executive's direction than to examine European funding.

**The Convener:** I am keen to maximise impact, but the newspapers have reported that the Local Government Committee will initiate an inquiry into local government finance.

**Elaine Thomson:** I support what Rhoda Grant said. The Barnett formula and European funding are closely linked. If we were to examine European funding, it would be useful to have one or two joint briefing sessions so that we understand the subject.

**The Convener:** That would be part of the inquiry. I hope that will we have a clear idea of how the European Committee is likely to approach the issue, but I think that the preference is that this committee should undertake the inquiry.

**Members** *indicated agreement.*

**Andrew Wilson:** We should communicate with that committee to ensure that we relate what we do to it. This is a first for that committee as well and we want to make a good diplomatic move. I suggested a joint inquiry, but I am persuaded by some of the other arguments—especially those relating to logistics and having a committee of more than 20 people—that we should not. However, we must maintain a relationship with colleagues in the European Committee who understand European structural funding.

**The Convener:** The matter is on the European Committee's agenda for next week. The clerks, the convener of that committee and I will liaise.

*Meeting closed at 12:21.*



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