

FINANCE COMMITTEE

Tuesday 27 January 2004
(*Morning*)

Session 2

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FINANCE COMMITTEE

3rd Meeting 2004, Session 2

CONVENER

*Des McNulty (Clydebank and Milngavie) (Lab)

DEPUTY CONVENER

*Fergus Ewing (Inverness East, Nairn and Lochaber) (SNP)

COMMITTEE MEMBERS

*Ms Wendy Alexander (Paisley North) (Lab)

*Mr Ted Brocklebank (Mid Scotland and Fife) (Con)

*Kate Maclean (Dundee West) (Lab)

*Jim Mather (Highlands and Islands) (SNP)

*Dr Elaine Murray (Dumfries) (Lab)

*Jeremy Purvis (Tweeddale, Ettrick and Lauderdale) (LD)

*John Swinburne (Central Scotland) (SSCUP)

COMMITTEE SUBSTITUTES

Mr Adam Ingram (South of Scotland) (SNP)

Gordon Jackson (Glasgow Govan) (Lab)

David Mundell (South of Scotland) (Con)

Iain Smith (North East Fife) (LD)

*attended

THE FOLLOWING ALSO ATTENDED:

Alex Neil (Central Scotland) (SNP)

THE FOLLOWING GAVE EVIDENCE:

Jim Cuthbert (Analytical Consulting Ltd)

Margaret Cuthbert (Analytical Consulting Ltd)

CLERK TO THE COMMITTEE

Susan Duffy

SENIOR ASSISTANT CLERK

Jane Sutherland

ASSISTANT CLERK

Emma Berry

LOCATION

Committee Room 1

Scottish Parliament

Finance Committee

Tuesday 27 January 2004

(Morning)

[THE CONVENER *opened the meeting at 10:00*]

Scottish Parliament Building Project

The Convener (Des McNulty): Good morning, colleagues. I open the third meeting in 2004 of the Finance Committee. We have not received any apologies, so I hope that Wendy Alexander will join us soon. I welcome the press and public to the meeting and I remind members and everyone else to turn off their pagers and mobile phones.

The first item on the agenda is consideration of the latest monthly report on the Holyrood building project, and correspondence that is dated 9 December 2003 from Paul Grice, which has been issued to members. The monthly report was sent to members yesterday by e-mail and copies have been made available today. The information on trade packages contract values that was sent out by e-mail yesterday contained an error. Under column 8, the information should read "column 7 minus column 2". A corrected version has been made available today, so members now have the correct information.

I give members the opportunity to discuss any issues that arise from either the monthly report or the correspondence. We should discuss how to proceed in relation to both this month's report and next month's report, which is due in time for our meeting four weeks from now.

Fergus Ewing (Inverness East, Nairn and Lochaber) (SNP): I am a bit disappointed and surprised that we do not have representatives from the Scottish Parliamentary Corporate Body, the Holyrood project director and the Parliament's chief executive before us to answer questions. That has been the practice of the committee, and the Presiding Officer has encouraged the use of this committee as the only means by which those who are in charge of the Holyrood project can be questioned. Can you explain why those witnesses are not here today? Without them, we cannot get answers to questions that arise either from the report or from matters that have come to light since the last time they were here, which I think was in November last year.

The Convener: In fact, the practice of the committee has been to take evidence from

witnesses when we think that it is appropriate to do so. We have not done that in relation to every monthly report. It is for the committee to decide whether it wants to take evidence on the monthly report that is before us today—we could do that next week or the week after—or whether it is better to wait until the February monthly report. I note that the February report will contain details of Davis Langdon & Everest's estimate of what the project will cost to complete in July. The indications are that when we have that report, the questions that members want to ask about the final cost and completion date will be clearer. We will want to take evidence from the witnesses as soon as that report is received.

It is, of course, open to the committee to take evidence on this month's report if it wants to do so. However, my view is that it would be better to wait until February and to take evidence then.

Do other members want to comment?

Fergus Ewing: Waiting for clarity in the Holyrood costs is a bit like waiting for Godot, if I may say so. I would certainly welcome the appearance of the witnesses at the earliest possible opportunity. They are not here today, but I will raise a matter that I have brought into the public domain since their previous appearance. It concerns the provision of a parent company guarantee by the construction managers. I ascertained that, although a parent company guarantee was always to have been provided free of charge by Bovis Lend Lease (Scotland) Ltd from its parent company, which was initially P&O and is now Lend Lease, such a guarantee was never asked for and has not to this day been sought. It seems to me that if, in respect of any building project, one is offered a guarantee that one of the wealthiest construction companies in the world will underwrite and guarantee the obligations of a local company, one should grab it with both hands and without question. I have made representations to the Presiding Officer that that should be done. I am not suggesting that Bovis Scotland is in financial difficulty, but before we heard the news about any recent liquidation, such as Lilley Construction Ltd, Ballast plc, or—

John Swinburne (Central Scotland) (SSCUP): Parmalat.

Fergus Ewing: John Swinburne suggests Parmalat. I would not make any comparison between Bovis and that particular company. The point is that companies do not tell the world that they are going out of business the night before it happens. Unless the corporate body can guarantee that there is no risk whatever to the Scottish taxpayer, failure to secure a parent company guarantee is an act of unpardonable folly.

If no one else has comments, there is another matter that I would like to raise.

The Convener: On you go, Fergus. Let us get your issues out and then we can respond to them.

Fergus Ewing: Now that I have put that matter firmly on the record, as well as having made private representations to the Presiding Officer, I trust that we will get a response immediately. It would have taken me a nanosecond to grab a parent company guarantee with both hands, and any right-thinking person would have done likewise. I should point out that the SPCB was never informed—I presume that that would have been done by the chief executive—that the decision had been taken not to obtain a parent company guarantee. It was only after my correspondence with Mr Jim Fairclough of the project team that the matter came to light. With that in mind, I trust that the SPCB will act swiftly.

The other matter that I want to raise—again, I do so on the record so that the witnesses have a chance to address it in detail during their next visit—is the fees that are payable to the architects. Specifically, I want to ask whether clause 1.5.2 of the contract between the Parliament and the architects has been applied. That clause was inserted on Mr Bill Armstrong's recommendation when he was project manager and it refers to schedule C, which provides that the architects' fees be paid in various portions on the completion of each stage. Ten per cent of the total fee would be paid on completion of Royal Institute of British Architects work stage C, 20 per cent on completion of stage D, 30 per cent on completion of stages E, F, G and H, 35 per cent on completion of stage J, K and L, and 5 per cent on

"Completion of Making Good Defects".

I will make the document available to the Official Report.

First, was that provision applied? Secondly, was the reduction in fees that the Presiding Officer negotiated in addition to the application of that formula? Thirdly, have the architects ever been paid in advance of their contractual entitlement? Bill Armstrong indicated in his evidence to the Fraser inquiry that payment was made before the architects were entitled to it and, in particular, before they had completed work stage C. If so, that would be wholly improper—I use that phrase advisedly. Has there been any payment other than in the terms of the contract? Can the SPCB assure us that in the period for which it has responsibility, the only payments that have been made to EMBT/RMJM have been proper, regular and in accordance with the terms of the contract?

The Convener: Some of the issues that Fergus Ewing raises are properly matters for the Audit Committee, rather than for the Finance

Committee. However, the questions that he has highlighted are on the record; we can bring them to the attention of the SPCB and suggest, as the member suggests, that early answers will be appropriate—especially to the first of the two questions that he has asked.

Do members have questions about the written report that is before us?

Dr Elaine Murray (Dumfries) (Lab): I am reasonably relaxed about the fact that representatives of the SPCB are not with us today, but there are a number of issues on which we need to seek clarification in February, when the required information may be available. In particular, I would like to know the cost implications of the slippage in work on the towers and of the delay in internal finishing. We also need to know more about the revised strategy for completion in July. That information will not be available until the middle of next month, but it is important that we receive details of it. The Presiding Officer's letter seems to indicate that we may eventually have an accurate estimate of how much money is required to complete the project by July. It is important that we take oral evidence from the SPCB when that information is available.

Jim Mather (Highlands and Islands) (SNP): I am trying to assimilate some of the data on the trade package schedule. It strikes me that quite a lot of information is missing from the schedule that could easily have been added. If I compare it with the schedule that I was able to produce in July from information that is in the public domain, it seems that we have lost the package contractor ownership of the various components of the project. In the first schedule that I produced in July, we were able to say that package A1510 was owned by Select Plant Hire Ltd and so on. Information of that sort was provided throughout the document. The element of ownership appears now to have gone.

In addition, the trade package spreadsheet indicates that there is a material difference between the "Difference" column, which shows the final total cost less the adjusted cost plan that was envisaged at the start, and those approved changes that have been made. There are approved changes costing £78 million, but the total for the "Difference" column is £89 million. That is a net difference of about £10 million, but within that figure there are many pluses and minuses. It would be well worth our getting an explanation of why those variations have taken place over the piece. A one-liner or separate schedule that cross-references this one would suffice. The figure of £10 million may be the minor number. In some aspects of the project, the major number may be quite significant.

The Convener: The committee should welcome the fact that we now have more detailed information. That marks a step forward. The cover note attached to the figures states:

“the Project Director has indicated that she will be happy to look at any further proposals for clarifying the presentation of this information.”

I would be happy, along with Jim Mather, to identify how that can best be achieved and to communicate that to the project director, if that is acceptable.

Jim Mather: That would be fine.

The Convener: Are there other issues arising from the report that members want to raise?

10:15

Mr Ted Brocklebank (Mid Scotland and Fife)

(Con): Fergus Ewing has raised issues that probably require attention before the end of February, although I accept that some of the items may be for the Audit Committee rather than for the Finance Committee. However, the latest report that we have received raises questions that might benefit from our attention before yet another month goes by. I do not know whether it is possible to arrange for evidence to be given either next week or the week after that. However, it would be slightly perturbing if we did not have an opportunity to ask questions before the end of February or the beginning of March. That would mean that we would not have had a meeting with the SPCB in the first two months of the year. To leave the matter until the end of February would be to leave it a little too long.

The Convener: I understand that the issues that Fergus Ewing has raised do not arise specifically from the report—he has raised them separately. It is possible for us to seek clarification of those specific issues in writing before we receive the February report.

A separate issue is when we can get more information about the matters that particularly concern the Finance Committee: an update of the financial cost of the project and the time scale for its delivery. The report that we have suggests that that information is unlikely to be available until the next report is issued. In that context, I recommend that we make it clear to the SPCB that we are expecting that information, and that we take evidence from witnesses when the next report appears. However, the committee may decide to hear from witnesses in advance of that, although it seems that the SPCB may not be able to answer the questions that we most want to have answered until the February report appears.

Fergus Ewing: I think that witnesses should appear before us at the earliest opportunity and am very anxious that the PCG be obtained

forthwith. The evidence that we have heard at the Fraser inquiry suggests that litigation may result from the selection of Bovis, which was chosen as the construction manager despite the fact that its bid was about £1 million higher than that of the lower bidder. I am concerned that if the issue flares up on resumption of the Holyrood inquiry next week, as I suspect it will, we might move into a potentially adversarial situation. I have received information from Mr Fairclough that if the PCG is asked for and demanded now, it will be obtained. Representatives of the SPCB should appear before us next week to explain whether it will secure that protection for the Scottish taxpayer—albeit that one expects and hopes that the risk of its having to be used will be minimal. However, unless the SPCB can reassure us that the risk is non-existent—0.000—we should not look a gift horse in the mouth.

Can the SPCB explain why even now we have not received copies of the priced contracts between the Parliament and the construction managers, the Parliament and the architects, the Parliament and the construction engineers and so on? Will we receive that information before the next meeting, as we expected to receive it long before now?

My final comment relates to the point that Jim Mather made. We now have a table that shows the difference in the trade packages between the original cost plan and the estimated final cost, but we have no explanation of how that difference has been arrived at. Some of the extra costs are quite staggering. In particular, has there been an explanation of whether the process of adjudication was used in respect of loss and expense? I understand that that process was introduced following legislation in 1998 and allows subcontractors to demand adjudication of their claims, appointment of an adjudicator within seven days and resolution of the adjudication within 28 days or, with the agreement of both parties, within a different shorter period.

That process essentially places subcontractors and trade contractors in a much stronger position than previously because they can, if they are in dispute with the construction managers, demand adjudication of a claim. Has that process been used? If so, are we to have an analysis of it and of the extent to which it has been used? Perhaps crucially for the task of teasing information out from the Executive—

The Convener: It is not from the Executive.

Fergus Ewing: I am sorry—the SPCB. For the task of teasing information out from the SPCB as to what the final cost will be—I fully understand that the Executive takes no interest in such matters—we need to know whether the loss and expense adjudication process might push the

Holyrood bill up even higher, possibly massively higher. I wanted to raise that to give the SPCB, the project director and the chief executive advance notice that we expect detailed and complete answers on all those matters.

I have one other point: I do not accept that the timeous payment of fees is a matter entirely for the Audit Committee. I say that because if bills have been paid before they were due to be paid on one occasion, perhaps that has been the practice on other occasions, and if it has been the practice on any other occasion, it would have the effect of paying money out before it is due, which would place an additional burden on the finances. It is therefore highly relevant for us to ensure that there has been no practice of payments' being made to help out, for example, with the cash-flow problems of creditors, whether they be architects or trade contractors.

The Convener: A number of those issues do not pertain to the report but are issues that Fergus Ewing wishes to raise. I am clear that some are audit issues, but in some instances, there is a link to issues with which the Finance Committee might legitimately be concerned. We need to bear that in mind.

Two proposals arise from the discussion. One—Fergus Ewing's proposal—is that we bring witnesses along next week to discuss the January report. There are issues that Fergus Ewing has said he wishes to raise with them. I make the alternative proposal that we hear from SPCB witnesses at our meeting following receipt of the February report, which should be about 24 or 25 February—four weeks from today. If we did that, we would have the cost information that is referred to on page 3 of the report.

Ms Wendy Alexander (Paisley North) (Lab): I propose an amendment to your proposal, convener. It is important that we do not lose the trail of issues in the process—Ted Brocklebank referred to the elapsing of time in that regard—and it would be useful if the clerks could draft two letters. One letter could go to the SPCB or the Presiding Officer—whatever is appropriate—and would simply list the outstanding issues that have arisen from our consideration so far, draw attention to the new issues that have been put on the agenda today and say to the SPCB or the Presiding Officer that they should appreciate the urgency of addressing those issues in writing to the committee at their earliest convenience.

Factual matters arise about the status of protection, the adjudication process and timings of payments. A separate letter could be sent to the Audit Committee because—as you said, convener—some of the issues are matters for that committee and our responsibility is to draw those matters to its attention.

If we look at the trade packages, we see that four have led to cost overruns in excess of a couple of million pounds, most particularly on windows and specialist glazing, which was originally costed at £4.5 million plus inflation and is now costed at in excess of £24 million. It seems to me that our letter should refer simply to the three or four major overruns rather than footer around with the small ones. That would get those four on the agenda for the next meeting.

My amendment to your proposal, convener, is that the SPCB come before the committee after the February report, but that we write to it in the next week. Perhaps the clerks might want to circulate to committee members two draft letters: one to the Audit Committee on matters that are appropriate to that committee and one to the SPCB outlining what is outstanding from previous progress reports and additional matters that have been put on the agenda today but do not arise directly from the report.

The Convener: I am happy to accept Wendy Alexander's amendment and to buckle the letters to what I had already suggested to Jim Mather about seeking clarification from the project director on the format and layout of the trade package report.

Fergus Ewing: Wendy Alexander's points are characteristically helpful. I note in particular the difference—the extra amount over the original estimate—for the assembly building concrete frame contract, which was granted to O'Rourke Scotland Ltd. It originally had a cost plan of £16.8 million but has an estimated final cost of £39.5 million, so the difference is nearly £20 million more for the assembly building concrete frame. How on earth did that happen? What on earth is happening on that contract?

Wendy Alexander's suggestion that we have a proper explanation of those contracts on which the overrun is massive is sensible. To be fair, that will take time to prepare; I think that a week would be enough. I therefore amend my proposal so that, instead of have the usual suspects on 3 February—when, I gather, we have a busy schedule, with the minister coming for our Scottish Water inquiry—we consider 10 February as a compromise. I hope that that might find favour with members.

John Swinburne: I second that proposal because the last thing that I want the committee to be seen to do is let people off the hook. Written questions and answers are all very well but, when we have somebody sitting in front of us, we can ask direct questions, even on something that arises from a written answer. It is important that we are not seen to be letting anyone off the hook and that we get the SPCB in.

The Convener: There is no question of anybody's being let off the hook. The issue is which date we choose: 10 February or 24 February. Those are the two proposals, but we are otherwise in agreement. If I understand Fergus Ewing correctly, he is happy to go along with Wendy Alexander's suggestion about the letters that we wish to write to the SPCB, so the real point of difference is whether we have witnesses on 10 February or 24 February. Perhaps the only thing to do is to put a question on the matter.

Who is in favour of our having the witnesses on 10 February?

Mr Brocklebank *indicated agreement.*

Fergus Ewing *indicated agreement.*

Jim Mather *indicated agreement.*

John Swinburne *indicated agreement.*

The Convener: Who is in favour of our having the witnesses on 24 February?

Ms Alexander *indicated agreement.*

Kate Maclean *indicated agreement.*

Des McNulty *indicated agreement.*

Dr Murray *indicated agreement.*

Jeremy Purvis *indicated agreement.*

The Convener: In that case, we will take evidence on 24 February and we will take the steps that have been recommended. In particular, I will write to the convener of the Audit Committee highlighting the issues that Wendy Alexander suggested we highlight and I will liaise with Fergus Ewing to ensure that I get the precise terms correct.

Scottish Water

10:29

The Convener: The second item on our agenda today is more of the committee's investigation into issues surrounding Scottish Water. In particular, we wish to explore the technical issues around borrowing limits that have arisen as a result of a paper that has been produced by Analytical Consulting Ltd.

I welcome to the committee Jim and Margaret Cuthbert of Analytical Consulting. I will let them take their seats.

Members have copies of the paper from Analytical Consulting, a briefing note and a letter that was received last week from the Deputy Minister for Environment and Rural Development. As I have indicated to members, next week we will hear from the minister and officials from his department. The Cuthberts have indicated that they wish to make a brief opening statement.

10:30

Jim Cuthbert (Analytical Consulting Ltd): I thank the committee very much for the invitation to appear before you and explain our concerns about the strategic review of charges. Perhaps first we should establish our bona fides and say a little bit about our background. I was an academic originally, but I spent the bulk of my career working as a civil servant and latterly I was the chief statistician in the Scottish Office. A relevant part of my career was spent as an official in the general expenditure policy division of the Treasury, when I was responsible for setting cash limits for half of voted expenditure and for monitoring that expenditure. The other point that I should mention is that over the past seven years we have between us published more than 20 papers, mainly on the Scottish economy, monitoring devolution and Scottish public finances. The bulk of those papers are published under our joint authorship, because we work as a team.

Margaret Cuthbert (Analytical Consulting Ltd): As far as my qualifications on the subject go, I was responsible for the piece on public expenditure in "The Laws of Scotland: Stair Memorial Encyclopaedia", and I have edited and contributed to a book on public expenditure.

The reason why we got into the area was nothing to do with our specific work. Just like everyone else, we heard comments on the television and in other parts of the media about the high charges that businesses faced when the effects hit in April. We have no financial interest in the matter, other than the bills that we pay. We carried out our work on the problem in our spare time.

The "Strategic Review of Charges 2002-2006" is not history. Although it was written up to the end of 2001, its effects will be with us until 2006. Therefore, although Scottish Water is producing outturn figures just now, we should remember that the figures that were used in the strategic review are those that affected revenue caps and therefore affect today's prices—they will affect prices until 2006.

We were asked to keep our introduction brief, so we will concentrate on what we believe is the most significant error in the strategic review, although it is not the only one; there are other issues that I hope will come out in the discussion. The timing of the strategic review was extremely important. The Government had been interested in introducing a new system of accounting called resource accounting and budgeting during the 1990s. The new system eventually came to fruition towards the end of the 20th century and was the accepted way of doing things when the strategic review was carried out. After the strategic review, the Government went back to using the former method of controlling public corporations. Before the strategic review, the control was on borrowing, but during the strategic review, the control was using the system of resource accounting and budgeting. That is where a great deal of the problem lies. People find it difficult to connect resource accounting and budgeting with borrowing—as I do myself.

Following the strategic review, we went back to the system of borrowing. Although borrowing was not controlled directly within the strategic review—as I said the system of resource accounting and budgeting was used—there is a clear line whereby if we know what the resource accounting and budgeting limits are, we can work back from all the other data to find out what level of net borrowing would be appropriate for a particular level of resource accounting and budgeting.

Jim Cuthbert: It is important to remember that although it was not controlled directly at the time of the strategic review, borrowing has been extremely important throughout. If we want to fund a given level of expenditure in the water industry, there are only two sources of funding: charges and borrowing. If we squeeze borrowing, charges must rise to compensate. That is why borrowing is of central importance, even though it was not controlled directly during the period of the strategic review.

As Margaret said, there is a link between resource accounting and budgeting limits and borrowing. One of the first things that we did when we started our investigation of water charges was to take the strategic review and unpick that link. We found that there is a simple relationship, which holds for every year of the review, between net

borrowing and RAB expenditure. That relationship is that net borrowing is equal to RAB expenditure less depreciation, less the capital charge element, plus interest payments, plus working capital. That is a formula or expression involving five terms for relating net borrowing and RAB expenditure.

The logic of resource accounting and budgeting is that the Government wanted to introduce a more realistic measure of and control on the operations and consumption of resources by Government and by industry. It brought into resource accounting and budgeting certain elements that do not involve the payment of cash. One of those elements is the notional part of depreciation that says that if we have a dam with a life of 100 years, we charge ourselves notionally one hundredth of the value of the dam each year.

The logic of the conversion from the RAB limits to borrowing is that we subtract from RAB expenditure all the notional items and add back in certain cash items that, for RAB, do not count but which contribute to borrowing, given that they are cash. The major one of those items is interest. The logic of the conversion is quite simple: we subtract off notional items and add back in any cash items that have not been counted in RAB.

Given that logic, when one looks at the formula that holds in the strategic review one sees immediately that there is a major flaw. Depreciation as counted in the strategic review is not just notional depreciation but includes an element called infrastructure renewal expenditure, which is expenditure on renewing pipes and so on during the year to keep them in operation. That meant that a cash element was being subtracted off in the conversion formula for RAB and net borrowing in the strategic review, which must be wrong. That was our first major discovery. There is a major logical flaw in the arithmetic of the strategic review. It is significant because infrastructure renewal is roughly £130 million per annum. The logic of what is happening is that for a given level of RAB control the arithmetic of the strategic review understates the level of borrowing that is possible by more than £100 million per annum, which is a significant amount of money.

Margaret Cuthbert: As you can imagine, when that realisation hit us, we could not believe the size of the figures involved. We tried hard to understand the tables in the strategic review, which, as members probably know, is an incredibly large document. In working through it, we found it very hard to work out what the water industry commissioner for Scotland thought would be the absolute maximum that Scottish Water could borrow.

The comment has come up often in the press and has been made by the Scottish Executive that the Executive was working to an absolute maximum limit and the commissioner was

considering what amount he should recommend should be spent—we considered that. The commissioner sets out exactly what he thinks net new borrowing should be and what he thinks is the margin of error that he must allow in order for there to be no breach of what he believes is a maximum target. After adding what he believes should be spent on capital borrowing and what he believes is a margin of error, he says, “I have used up entirely all public expenditure money available to me.” In other words, there is nothing left that he can use up. If he allows himself that variability in capital borrowing, there is nothing left from the Scottish Executive. We added the two together and found that that limit was substantially below what the Scottish Executive was saying about borrowing. Those figures, which are produced in our report, gradually increase as time goes by.

We would like to state clearly the fact that we are not comparing targets with limits; we have added in absolutely every margin of error—or flexibility—that the commissioner was allowing. That flexibility becomes extremely large as time goes on. That itself is a reason for wondering why one would allow oneself such enormous flexibility in an industry in which a big capital expenditure programme has been authorised.

Jim Cuthbert: So, by this stage in our process, we had uncovered two things. First, there was a logical mistake in the simple relationship that holds in the strategic review between the RAB limit and borrowing. Secondly, that was reflected in an inconsistency in the published figures between the maximum amount of borrowing that was possible, given the arithmetic of the strategic review, and the borrowing figures that the Scottish Executive published in its annual expenditure report in which it identified the borrowing that it thought was consistent with the RAB controls. That inconsistency rises latterly to substantially more than £100 million per annum.

There are many other issues, which we will briefly outline, but in many ways that is the nub of what we are talking about. Unless the Scottish Executive can justify the logic of that relationship and explain the inconsistency in the published figures, the arithmetic of the strategic review has fallen apart and, therefore, the whole strategic review has fallen apart.

There are questions of fact to be addressed, and the onus of dispelling our allegations rests with the Scottish Executive. We posed those specific questions to the Scottish Executive in a letter to the minister in November. It is possibly significant that we have not received any detailed reply. We have seen in the press a generalised rebuttal; however, these are matters of fact and unless those issues can be specifically addressed by the Scottish Executive, the arithmetic of the strategic review has fallen apart.

Can I briefly—

The Convener: I must hurry you up, Jim. We asked for a brief opening statement, and members are anxious to ask questions.

Jim Cuthbert: Okay. That is not the end of the issue. We have undertaken further work to find out how that inconsistency arose. As far as we can see, it arose because of three specific mistakes in the commissioning letter. The discussion of this matter in the press and in the previous meeting of the committee has also highlighted a significant degree of confusion on the part of the water industry commissioner and the committee's adviser in relation to the other factors that should bear upon the appropriate level of borrowing for the water industry. I hope that we will have the opportunity later to outline how that confusion arises. In addition, there are other significant issues.

Margaret Cuthbert: For example, we saw in the strategic review that, when the commissioner was asked to look at domestic harmonisation, he also brought in business harmonisation. This is a big problem for business in Scotland. We have also done some work on the fixed charges. The big problem that we found is that, when the capital expenditure programme is not followed—although it was the reason for the high charges in the first place—there is no system by which charges can be reduced while capital expenditure does not keep to its track. Finally, water is one of the major resources in Scotland, yet many decisions that we believe are vital to the Scottish economy have been left to the water industry commissioner.

The Convener: Thanks very much for that. I welcome Alex Neil to the committee.

The committee—especially through its two reporters—has done a substantial amount of work on a range of issues affecting the water industry, including the issues that you have raised about harmonisation, and a significant amount of other work on those issues is in hand. The specific issue that we are most concerned with today is the need to identify and clarify the matters that you have raised about confusion and inconsistency in accounting.

10:45

Dr Murray: I have a couple of questions. The first is quite a stupid question, I suppose, but you might be able to answer it for me. I was surprised to find that interest payments are not included in RAB expenditure.

Jim Cuthbert: The logic of that is that RAB is concerned with the real operation of the industry—the amount of real resources that the industry is consuming. Sometimes, interest payments are an

artefact of the history of borrowing and how capital was financed; however, interest payments in themselves do not say anything about how the industry is actually operating today.

Dr Murray: But, as you pointed out, they make a significant difference to the amount of finance that is available for investment.

Jim Cuthbert: Absolutely.

Dr Murray: That is why I was surprised. Interest payments are central to your calculation, and the fact that they are excluded from RAB expenditure seems to be a little bit strange.

The Treasury's golden rule suggests that borrowing should be used only for investment, not for the reduction of charges. Therefore, even if the mistake has been made, it has not influenced the level of charges that people are paying. That does not mean that I am relaxed about that, as I come from an area that requires a lot of investment and I would perhaps want to know why the water industry commissioner—or whoever—had made the decision not to invest money in much-needed infrastructure projects in Scotland. However, that would not have made any difference to the charges that people pay, would it?

Margaret Cuthbert: I am glad that you asked that question. In fact, in looking through the figures, we are perplexed by the water industry commissioner's evidence. The figures show clearly that one could borrow up to almost £300 million per annum and still be within the golden rule. We are also perplexed by the fact that, when the water industry commissioner gave evidence to the committee, he pointed out that the water companies in England and Wales were not in a borrowing position and that Scotland was unusual. Evidence from the Office of Water Services—Ofwat—shows clearly that, over the past six years, on only two occasions were two separate water authorities in a positive position and not borrowing heavily. The level of borrowing in England and Wales is substantially higher than it is here.

Dr Murray: I think that the water industry commissioner was trying to impress on us the fact that, at the time of privatisation, the debts of the water companies in England and Wales were written off and that the fact that the debt was not written off in Scotland has made a significant difference to our historical mode of interest payment.

Margaret Cuthbert: No, he said:

"To put the matter in perspective, we have examined the operation of the 10 water and sewerage companies in England and Wales in the past six years."—[*Official Report, Finance Committee*, 2 December 2003; c 670.]

That takes us back to 1997, whereas, with respect, the period that you are talking about is

1989-92, by which time the companies had used up the green dowry.

Dr Murray: My main point is that, had the water industry commissioner decided to borrow more—we do not know whether he decided not to do so on the basis of a mistake or on the basis of his decision that he did not want to incur additional debt—he would not have been able to use that borrowing to reduce the charges that are paid by either domestic or business customers.

Jim Cuthbert: I think that that is a red herring. If you are thinking purely in terms of the golden rule, you are talking about funding a capital expenditure programme of £1.8 billion over four years. Within that there is infrastructure renewal expenditure, which is not the acquisition of new capital assets. However, even knocking off infrastructure renewal expenditure, that leaves a maximum ceiling of roughly £300 million per annum that the industry could borrow up to, which is quite consistent with the golden rule. That figure is not a million miles away from—it is very close to—the sort of borrowing figures that the Scottish Executive has published. The golden rule says only that the ceiling is around the £300 million limit: that is a very long way from the type of statement about borrowing that was made by the commissioner. It is also a long way from the comments of the adviser to the Finance Committee, which were quoted in the *Sunday Herald*, that the golden rule implies "Thou shalt not borrow at all", or words to that effect.

We are not saying that any particular level of borrowing less than £300 million is the right level. We argue that, when we take into account the water industry commissioner's statement that all the available public expenditure was being used up, there is limited or no justification for the given level of borrowing. The determination of the appropriate level of borrowing needs to be considered in a much more detailed and careful way than that suggested by the confusing statements that have been made to the committee.

Dr Murray: I understood the golden rule to mean that borrowing was used only for investment.

Jim Cuthbert: That is right. That is exactly what we are saying.

Margaret Cuthbert: We are saying that, even if we exclude the infrastructure renewal expenditure, enough investment was taking place to justify £300 million of borrowing. However, we are not saying that £300 million ought to be the right level. That is a matter for other people.

John Swinburne: I congratulate you both on the eloquent way in which you have brought high finance down to my terms. I assure you that there

are pensioners all over Scotland who will look at their water rates and say, "Thank goodness someone has come up with a logical explanation for this attack on our income."

You stated that the strategic review was "an incredibly large document". Perhaps you should have altered that to "a deliberately large document". That is just a way in which inaccuracies can be buried in total verbiage.

The Convener: That is a statement rather than a question.

John Swinburne: I make statements. I do not ask questions.

Jim Cuthbert: My only comment is that Mr Swinburne's view has been repeated by people inside the industry.

Ms Alexander: On this complex issue, the Cuthberts have done us a great service by elucidating a fundamental policy issue surrounding the change in the water industry. Clearly, it is possible—and they make a strong case for this—that the strategic review contained a logical mistake that, in the old days, would have led to permissible expenditure's being lower than it should have been, given that permissible spending was what drove borrowing in the old days.

Interestingly, both the water industry commissioner and the minister have made the case in correspondence that, under the new regime of Scottish Water, instead of operating to permissible expenditure limits they are interested in prudent expenditure. The water industry commissioner is therefore seeking to operate on the basis of financial targets. That very technical point is interesting because it goes to the heart of the issue about the character of the governance of the water industry in Scotland.

Historically in the public sector, such a mistake would have mattered to the water industry because it spent to permissible levels of expenditure. The water industry commissioner and the minister appear to be saying that, in the circumstances, although we want the newly-created Scottish Water to be in the public sector, we also want it to operate in a way that is comparable to the way in which the English water authorities operate, so that it operates more as a utility under a financial regime in which financial ratios are what drive prudent expenditure.

In that respect, I have two questions. First, the Cuthberts have rightly said that, when the water industry commissioner was before the committee, he implied that his financial limits were not particularly stringent in light of what the English regulator did and in light of the sort of ratios that were achieved by water companies in the commercial sector in England and Wales.

Margaret Cuthbert has pointed out that the financial targets that the water industry commissioner has imposed on the Scottish industry are unduly restrictive and not comparable to those that operate in the industry in England and Wales. I accept that we should move to a regime that is driven by financial targets, but I suggest that it would be useful for the clerks to write to the water industry commissioner to ask him whether he is clear that he did not choose unduly restrictive financial ratio targets for the period ahead, given his evidence about England and Wales. I invite comment on that suggestion.

Secondly, in the papers that have been provided to the committee, one of the distressing things—which might explain why the water industry commissioner has chosen such strict targets—is the level of underspend in the water budget. In June 2002, end-year flexibility of £188 million was reallocated to other programmes. In the current year, an underspend of £148 million was brought forward. Those are extraordinarily high figures. I invite comment on that point, too.

Jim Cuthbert: I will deal with the point about the determination of the appropriate level of borrowing. As we said earlier, we are not proposing that any particular level of borrowing is right. Rather, we hope that we are highlighting the four major inconsistencies in the statements that have been made.

First, in the strategic review, the water industry commissioner said that he had used up all his available public expenditure. When he appeared before the committee, he said that public expenditure was not a constraint. That seems to be a clear contradiction.

Secondly, in the strategic review, the water industry commissioner said that he planned for the industry to move to substantial debt repayment in the medium term so that it would be debt free by around 2015. When he appeared before the committee, he said that there was no intention to move to substantial debt repayment. That is a clear contradiction.

Thirdly—we have been over this point before, but let me repeat it—when the water industry commissioner appeared before the committee, he said that only two of the 10 water companies in England had had occasion to borrow over the past six years. He specifically said that that set a context for his decisions in Scotland. However, the Ofwat figures show substantial borrowing by all the water companies over each of the past five years, apart from one company in one year.

The fourth element of confusion stems from the statement about the golden rule that was made by the committee's financial adviser, which was reported in the *Sunday Herald*. In effect, he said that Scottish Water cannot choose to borrow more

to keep charges down. That would also be my robust advice to the committee. However, we have shown that, in terms of the golden rule, the borrowing ceiling would be £300 million. We are not saying that Scottish Water should borrow up to £300 million, but we are saying that the contradictory evidence that has been given about how borrowing ought to be determined gives one no confidence in any target, especially in a target that goes down to zero borrowing in the short term.

Ms Alexander: On Jim Cuthbert's first three points, which all directly relate to what the strategic review says about the character of the new regime in Scotland and to the water industry commissioner's evidence on that, we should write to the water industry commissioner for clarification. Those are anodyne and technical points but, nevertheless, they elucidate the changing character of the governance of the water industry.

With respect, the fourth point is of a different character and order and perhaps it confuses the issue about the relationship between what was stated in the strategic review and the evidence that was given to the committee. It might be helpful to get clarity on that.

The Convener: Following a previous meeting, I wrote to the water industry commissioner. I will check the terms of my letter to ensure that we captured the precise points that have been raised today. We have not yet received a response from the commissioner, but we hope to get that clarification.

Margaret Cuthbert: Wendy Alexander's second point was about the outturns. Like her, we are slightly baffled by the way in which people have used outturns to justify the position that was taken in the strategic review.

I have before me Scottish Water's accounts for 2002-03—I know that the six-monthly figures are now available, but the problem with such figures is that one never knows what might happen in the other half of the year. For 2002-03, the Scottish Executive set a RAB limit—which, it must be remembered, is not the borrowing limit—of £314.3 million. Scottish Water was working within that figure. Table 3 in our submission shows that, on that basis of that £314.3 million, the Scottish Executive believed that the maximum borrowing limit was in the region of £277 million. However, when the water industry commissioner took that £314.3 million and did his sums, he worked out that the maximum that it would be prudent for Scottish Water to borrow was just £105 million. He allowed for a massive flexibility of £60 million-odd, so that meant that, in total, he thought that the limit—which the Scottish Executive thought should be £277 million—was just £199 million. In that year, the amount that Scottish Water actually borrowed was only £51.3 million.

Instead of saying to oneself that that was some justification for the strategic review, one might ask how the management of an industry with a £1.8 billion capital expenditure programme over four years is ever going to get anywhere with £51.3 million of borrowing in the first year and a very low capital expenditure programme.

11:00

Ms Alexander: That takes us to the heart of the political problem that water has created for everyone. It is clear that, under the old regime, in which the total permissible expenditure was spent, we would have been spending in excess of £300 million in return for the high water charges. I presume that, following the hikes in charges, people would at least have seen the beginnings of some improvement for their £300 million of expenditure. After a hike in charges and the setting of a more restrictive financial target, which was perhaps appropriate, we have seen that the industry has proved capable of spending £51 million out of £199 million—a quarter of what was available. That critical question about the operational efficiency of Scottish Water is a matter for the Environment and Rural Development Committee, not the Finance Committee.

The Environment and Rural Development Committee handed the water issue to us and I feel strongly that, with the help of the Cuthberts and others, we have more than acquitted our responsibility on the financial aspects. In my view, the question why Scottish Water is incapable of spending more than a quarter of the resources that are available to it within any one financial year is much more fundamental. The issue is in the public domain and, politically, we all take the flak for it and we manage it. We should at least initiate correspondence with the Environment and Rural Development Committee in which we suggest that it needs to examine the operational management of Scottish Water. That is not an issue for the Finance Committee in the first instance, so we should urge the Environment and Rural Development Committee to consider it.

Jim Cuthbert: I, too, think that that points to a failure in mechanism. In effect, in the strategic review, high charges were set to fund a large capital programme on a relatively small level of borrowing. If it turns out that all the financial resources available are not needed because the capital programme falls short, equity says that that bonus should be used to offset the high charges. What actually happened was that the bonus was used to further reduce the level of borrowing and to reduce the RAB limit at the end of the year by about £114 million. Surely there is a need for a mechanism that feeds such underspends back to the people who have been penalised—the people

who are paying the high charges—instead of using them to offset the RAB limit or to reduce borrowing.

The Convener: Our objective in preparing our report is to feed into the quality and standards III process. Wendy Alexander mentioned the Environment and Rural Development Committee; it is clear that what we report on underspend will be of interest to that committee and I would expect it to take up some of those issues.

Jim Mather: I have read what is in your paper and it seems that you are talking about a clear factual error. Some of the responses that our adviser has given on the issue have added to our confusion. Do you have a response to the points that Arthur Midwinter has made to the committee and to the press on your paper and your work to date?

The Convener: You should concentrate on what is before the committee, if possible.

Margaret Cuthbert: Paragraph 7 of the adviser's paper for the committee mentions the announcement about the reallocation of the £188 million. We took that amount of money into consideration in the calculations in our paper—it was already thoroughly enmeshed in our paper. We subtracted that £188 million from the Scottish Executive figures over the three years, so we were comparing like with like at all times. We are not talking about £188 million in one year; we are talking about something that we believe is much more significant to the Scottish people than Holyrood. The actual size of the error compounds as the years go by; the error is per annum.

Jim Cuthbert: I would like to pick up some other points in the briefing paper that has been sent to the committee. We were surprised to get first sight of what was in the paper in an article in the *Sunday Herald*. That raises the constitutional issue of whether it is the role of an adviser to the Finance Committee to float his points first in the *Sunday Herald*.

The briefing paper, which is an interesting and surprising document in many respects, contains about six points that are, if not actually wrong, at least questionable. For me, the most surprising statement comes in paragraph 5, which says:

“the commissioning letter made it clear that there were significant sums available, in terms of both borrowing limits and from profits”.

In my view, that is a fundamentally misguided statement, because the commissioning letter is not about borrowing limits at all; as we have explained this morning, it is about RAB control. One has to work back from that to find out what the implicit borrowing figures are—the letter makes no direct statement about borrowing. It is breathtaking for the briefing to make such a statement.

Paragraph 5 also says that the commissioning letter made it clear that there

“were separate controls, not a single control total as is inferred by the Analytical Consulting Ltd paper.”

It is true that, at one point, the commissioning letter says that, on water, there are separate controls on resources and capital. Members should have in front of them a handout that we passed round. Section C, which I think is the third page of that handout—

The Convener: We have the whole commissioning letter.

Jim Cuthbert: The second page of the commissioning letter is labelled C in our handout. It is probably better to look at the version of the letter that is in our handout, because we have annotated some of the passages in it. We have marked the first paragraph of the second page of the letter with a 3. It says:

“The water authorities are subject to separate limits on the minimum level of profits, in the resource budget, and on the maximum level of capital expenditure, in the capital budget.”

Fine—that is as it should be, according to the Treasury's guidance. However, the bullet point that we have labelled with a 1, which is the line immediately above the first line of the table, says that capital expenditure should not exceed—in 2003-04, for example—£299.7 million plus profit. That amounts to a combined control on capital and resources.

The logic of that statement can be seen by looking at section B on the second page of our handout, which is entitled:

“Illustration of How the Commissioning Letter implies a Combined Control on Capital and Resources.”

It simply points out that the commissioning letter's statement that

“the capital budget should be less than £299.7 million + profit”

is the same as saying that

“(capital budget – profit) must be less than £299.7 m”.

It goes on to say that—given that, in the arcane nomenclature of RAB, “resources is minus profit”—that is equivalent to saying that

“(capital budget + resources) must be less than £299.7 m”,

which represents a combined control on capital and resources. That is the fundamental error. The problem is that, because the cash element of infrastructure renewal appears both in capital and in resources, it is double-counted in that combined statement. That is the fundamental error that we are talking about.

Jim Mather: I am interested to know at what level you feel that borrowing should be. What are the implications of the error for water customers?

Margaret Cuthbert: We would not like to comment on what the actual level should be. From examination of the history of Scottish Water, it was interesting to note that in 1989, for example—as Wendy Alexander said—the amount that we were able to borrow every year in Scotland was very large, relative to what was happening in England and Wales. We must take an holistic view of the way in which efficiency may have run in the past; we may have been borrowing an awful lot in the past. There must be a consideration of history, as well as of what we want to pay in the future. If we go right up to the Scottish Executive limits, we will be well within the golden rule. As the issue is of primary interest to Scottish industry, it must be debated at parliamentary level.

Jim Cuthbert: I had not finished going through your adviser's briefing. For the record, I would like briefly to pick up some further points. Paragraph 4 of the briefing says:

"the two sets of figures have different purposes, the Executive provides a maximum limit for borrowing ... whilst the WIC provides a figure which is ... a financial target."

We have covered that point in our paper. We added to the financial target the commissioner's allowance for underspend, so we were comparing a limit with a limit.

Margaret Cuthbert: In paragraph 2, the adviser says:

"The paper seeks to address two related concerns – the gap between the Executive's borrowing limits"

which, as we said, was RAB controlled

"and the Commissioner's figures".

There is a view that the commissioning letter sets a definite limit. As far as we can see, the trail that leads to that view begins when Sarah Boyack was in charge of the water industry. She wrote to the commissioner at the time setting out the definite borrowing limit that applied under the old regime and stating clearly that the limit could not be exceeded.

When the Executive moved to RAB, the Treasury was fully cognisant of the fact that RAB was a new system and that some flexibility had to be allowed because people were bringing in depreciation and capital stock, which had never been included in the calculations until then, for the first time.

Exhibit E of our handout shows an extract from the Treasury's "Planning Budgeting and Parliamentary Authority" statement. I ask members to look at the paragraph that is highlighted as number 1. You will see that, from

the spending review of 2000 until the next spending review in 2002, which is the exact period in which the strategic review was written, there had to be flexibility. Items such as the cost of capital charges and depreciation were to be included in annually managed expenditure; they would not be subject to the rigorous limit of the departmental expenditure limit. That bit of the commissioning letter was wrong.

The Convener: I want to be clear about that. In a sense, there is a difference between what you are saying and not only the adviser's paper but, perhaps more significant, the minister's letter. The minister says that the Executive's figures are absolute figures that could not be breached, whereas the water industry commissioner's figures set targets for achieving financial sustainability. You say that the targets are akin to limits as far as Scottish Water is concerned.

Jim Cuthbert: Once the allowance for flexibility that the commissioner allowed is added in. We added that into our paper.

The Convener: But the question that I am coming to is whether the water industry commissioner set the correct targets. The real issue is not the different limits, but whether the water industry commissioner, in choosing the figure to set for the financial sustainability target, made the right judgments. I would be interested to have your views on that.

Margaret Cuthbert: Our view is that, when the commissioner set the target—despite the fact that he said that he was setting it in relation to the future sustainability of the industry—the target figure plus his flexibility figure added up exactly to the figure in the commissioning letter. We have to be absolutely clear that the commissioner used the entire amount of available public expenditure and yet, when the Scottish Executive did its calculations using the same figures, it came to a very different borrowing figure.

The Convener: I think that you have established clearly in my mind that the water industry commissioner's statement about using all the available public expenditure was probably factually inaccurate.

Jim Cuthbert: He was accurate in one sense, in that he was following to the letter the instructions in the commissioning letter. It is absolutely true to say, from looking at the letter, that the £130 million was squeezed down because of the introduction of RAB. That is the double-counting point. Given that the commissioning letter said that the commissioner had to treat the public expenditure limits as limits, he had to allow a substantial margin for flexibility. In essence, the commissioning letter forced the water industry commissioner down the route that he took.

The issue arises whether the commissioner should not have gone back to the Executive and queried the commissioning letter. That point was raised initially at the meeting of 2 December. The water industry commissioner followed the instructions in the commissioning letter. The trouble is that there are two mistakes in the letter: the double-counting and the instruction to treat the public expenditure limits as absolute limits at a time when Treasury advice was for them not to be treated in that way.

Margaret Cuthbert: When the document went to the officials in the Scottish Executive who dealt with the water industry, why did they not go through the detail of the financial statement? Somebody should have said, "Hey, wait a minute. The figures that we provided to the water industry commissioner in the commissioning letter mean that it is impossible for him to have arrived at the borrowing limits that are included here."

11:15

The Convener: The commissioner has said, pretty consistently, that his judgments are made by his assessment of what is needed to produce a financially sustainable water industry rather than by borrowing limits. The driver in that situation is not borrowing limits, but the commissioner's economic judgments. I think that it would be hard to argue against that. If that is the case, what is your view of whether the commissioner made the right judgment?

Jim Cuthbert: We do not pretend to say what the right level of borrowing should be. We are saying that the justification that has been given, for a borrowing profile that goes down as steeply as that which is shown in the strategic review, does not look sound. As we have pointed out, that is because of the various contradictions in the rationale for the profile.

My instinct on the matter is that, at a time when there is a heavy requirement for capital investment and when interest rates are very low, one would imagine that the water industry would want to take the opportunity to borrow at low interest rates. We could take the example of George Bush, who has opened the printing presses for dollars in America. Ultimately, it is likely that interest rates will rise, in which case the water industry will look back with regret at the opportunity that it has lost to borrow at cheap rates.

Determining the borrowing profile involves making a judgment about longer-term global issues, the movement in real interest rates and so forth. The judgment that has to be made is inherently complex. We are not making that judgment today; we are saying that factors that should have been taken into account in the justification for the decision were not taken into account. We are also saying that the decision to

reduce the borrowing profile as steeply as it was reduced in the strategic review looks extremely surprising in the light of all of the circumstances.

The Convener: I am trying to get at whether we can work out what is the driver for the charge increases—that is what interests people. I want to return to two issues, one of which you highlighted in your paper. The first of those issues is the harmonisation of domestic and non-domestic water charges within a very short space of time. It is arguable that the harmonisation process was a political judgment. There is no doubt, however, that it led to significant increases across most of Scotland. Although there may have been a benefit to the north of Scotland, there is a sense that the east and west lost out. The fact that harmonisation was not phased in over a considerable period is a major factor in the increases in charges.

I also want to be clear about the issue that you raised in your paper, which has also been raised by others, about the targets for repayment that the water industry commissioner set, his judgment of the amount of debt that should be repaid in the medium term and his identification of the periodicity of the medium term. It seems to me that that is a major driver in respect of water charges. Do you agree with those two propositions?

Jim Cuthbert: Yes.

Margaret Cuthbert: I have something to add on your first point about harmonisation. When the three water boards—East of Scotland Water, North of Scotland Water and West of Scotland Water—were in operation, it seemed reasonable on social justice grounds to look at domestic harmonisation. However, the way in which harmonisation was introduced is much more open to comment.

In one tiny paragraph in the strategic review document, the commissioner moves from looking at domestic harmonisation to say that because few domestic customers have meters, it is difficult to deal only with the domestic market and that he will therefore go for business harmonisation as well. However, business harmonisation could mean—indeed, it does mean—two different things. Although one might want the same type of pricing policy for the east, west and north of the country, it is an unusual nation that would take a strategic asset like water and say that, no matter whether someone lives in Rannoch moor or on top of the Cairngorms, the same pricing policy will exist for all. We have shot ourselves in the foot with our business harmonisation policy. It is not enough to say that large customers can negotiate their own deals—we have all seen in the papers how those deals can be rather secretive and difficult. In any case, the businesses that we have been trying to encourage recently are the indigenous small and medium-sized enterprises.

Jim Cuthbert: I have nothing to add to that, other than to say that there seems to be a logical issue of fact and what we regard as a mistake. There is a question about the second mistake in the commissioning letter, setting an absolute limit, which further depressed borrowing. There also seem to be wider issues about fixed charges and harmonisation. Another issue that has been raised today is the lack of any mechanism to feed back to consumers, in immediately reduced charges, any underspend in capital expenditure.

On the basis of all that, it seems to us that the case is very strong indeed—we would say that it is inescapable—for conducting a review of water charges. However, that review should not just be a further strategic review looking from 2006 to 2010. The damage that has been done by the mistakes in the previous strategic review is with us now; people and industry are suffering and there needs to be a mechanism to correct that. We must not just review charges, but improve the very mechanism for handling those reviews.

The Convener: There is a technical debate about limits and targets, but I am not convinced by what you have said about mistakes. There are some issues about what the water commissioner has said at different points in time; perhaps there are some inconsistencies there. What I am trying to say is that I see there being two major issues in relation to increased charging. The first is the precipitate decision, which affects businesses in particular, on the harmonisation of charges across Scotland. That has been a major financial driver for increased business charges. The second issue concerns decisions that were made on the way in which debt will be repaid. From a financial point of view, those two issues seem to be the two biggest packages of change in the system. Do you agree?

Margaret Cuthbert: You said that you were not sold on the idea that an error had been made. That is a very simple, factual thing, which could be cleared up if the minister would answer the questions that we put to him. The water industry commissioner says that he used all the public expenditure, and he cites two ways in which that has been used up—on new borrowing and on the margin of flexibility that he allowed himself. It is clear from all the arithmetic in the review that those two things add up to what the commissioner has from the commissioning letter, and yet the figure produced by the Scottish Executive is £100 million more.

The Convener: My view on that is that the water industry commissioner made a political judgment about borrowing, rather than a technical judgment.

Jim Cuthbert: That is not what the water industry commissioner says.

The Convener: I agree that it is not what he says.

Jim Cuthbert: The commissioner said in his review that he used up all the public expenditure. We did not necessarily expect you to be convinced by what we said but, as Margaret said, the key question is whether the Scottish Executive can justify the logic of the simple relationship that holds in the strategic review, relating borrowing to RAB expenditure. Our view is that the Executive cannot possibly justify that, because it is logically incorrect. The second question is whether the Executive can produce figures that feed into that relationship and which relate the RAB expenditure limits in the commissioning letter to the borrowing figures that the Executive has published. Our view is that it cannot possibly do that.

Unless the Executive can come up with positive answers to those two questions—and we would argue that it is impossible to answer either of them positively—there is a logical mistake. The minister must answer that. It is not for us to convince you; it is for the minister to answer those two factual questions. If he can answer them positively, we go away, but he cannot answer them positively.

The Convener: We shall hear from the minister next week.

Mr Brocklebank: I am reluctant to enter the rarefied field of high economics. We have professional economists with us and they are much more qualified than I am. However, I suppose that ordinary observers such as me are entitled to ask why, despite the fact that you say you have had no response from the minister, the minister appears in his response to this committee totally to rebut any claim that customers are worse off. He says that

“there was no error in the application of the public expenditure rules known as RAB ... nor was there any misunderstanding by the Water Industry Commissioner of the levels of public expenditure available.”

He goes on to say:

“The important point is that none of the changes in the public expenditure rules reduced the levels of borrowing available to the industry. I can therefore reassure you that charges were not adversely affected by these changes.”

You disagree totally with the minister's reading of the situation.

Margaret Cuthbert: Let us look at the separate elements of the process. The Scottish Executive issues its public borrowing limits today. In fact, under RAB, it has had an idea all the time of what the borrowing limits would be. Scottish Water is the entity that does the borrowing, so all the time that the exercise has been going on, that level of borrowing has been available from the Scottish Executive. However, those were not the figures that went into the strategic review. The figures that

were used in the strategic review were not the public borrowing figures as given by the Scottish Executive, but the ones that came out of the RAB process, which were considerably lower. It was those figures that fed first of all into revenue caps and then into charges. The line that the Scottish Executive had that was actually available for borrowing was not the line that fed into the determination of charges.

Mr Brocklebank: Why does Allan Wilson say that there was no error in the application for public expenditure?

Jim Cuthbert: That comes back to something that we have already pointed out—a complete inconsistency in the commissioning letter. At one point, in what I shall call a white statement, the commissioning letter says:

“The water authorities are subject to separate limits on the minimum level of profits ... and on the maximum level of capital expenditure”.

That is a categorical statement that the limits are separate. If the minister is relying on that statement—which is, as it should be, consistent with the Treasury guidance and with every other published RAB limit that we can see in Government—he is factually correct.

The trouble is that that statement in the commissioning letter is contradicted by what I shall call a black statement lower down the page, which says:

“Capital expenditure does not exceed the budget set out in the table below”.

and the table shows a figure of £299.7 million plus profit. That is a combined statement, which contradicts the statement further up the page. In other words, there is a black-and-white contradiction on that page of the commissioning letter. Unfortunately, it is the black version that drives the strategic review of charges. The strategic review of charges incorporates the error that is in the second bit of the commissioning letter, which I have just quoted. It does not follow the white statement at the top of the page.

The nub of the confusion is that the minister is founding his statement on one part of the commissioning letter, which is correct, whereas the strategic review was driven—as it had to be—by another part of the commissioning letter, which is plainly wrong. It is that dichotomy between two different parts of the commissioning letter that underlies an awful lot of the confusion and which enables the minister to write a blatantly wrong letter, as he has done.

Jeremy Purvis (Tweeddale, Ettrick and Lauderdale) (LD): I am now fully aware of why Wendy Alexander did not want ministerial responsibility for this matter. [*Laughter.*]

I am trying to get clear in my own mind the relevance of the issue for my constituents, who are among the people who you say are being penalised. There is no free money, I would have thought. If there is to be more borrowing, the Government could change the rules. We could borrow considerably more to invest now—that would be a political decision. There is an argument that there is a reduction in the investment that is being made currently and that the bills are too high because of the current revenue and borrowing caps. How are those connected to a disagreement over the budgeting system? Ultimately, if the Government wished to invest £500 million more in the water industry in Scotland, it could make the political decision to do so. However, it has chosen not to do that on the basis of the evidence that the committee has received.

11:30

Margaret Cuthbert: The Government made the decision that it was willing to invest in public sector borrowing, which is shown in the amounts in the spending review. Those amounts are all over £250 million per year. The Government gave its consent to that amount of spending and I presume, therefore, that it was quite happy about it. Subsequently, however, as those high charges come in, they are bound to have an effect on the competitiveness of Scottish business. That will have a long-term dynamic effect on the economy.

Jeremy Purvis: With the charges that are being levied on domestic and business customers, the investment programme that is under way, the reasons for the underspend and the efficiencies that the companies are putting in place, would the situation be quantifiably different today if the budgeting system had been different? Does rearranging figures on a bit of paper make a quantifiable and tangible difference to what is happening at the moment?

Margaret Cuthbert: We suggest that, on average, bills would be 20 per cent less if the full amount of public sector borrowing had passed through in an efficient capital spend programme.

Jim Cuthbert: In other words, if the industry had decided—entirely consistently with any golden rule—to borrow up to the level that the Scottish Executive had said was acceptable and consistent with its limits, bills could have been 20 per cent lower. We are not saying that there should be a 20 per cent reduction in bills, because, as we have made clear, we are not arguing for what the exact profile of borrowing should have been.

If one took a prudent profile of borrowing, one is unlikely to say that the industry should have borrowed up to £250 million or £300 million. However, it is extremely unlikely that one would

have said that the borrowing profile should have been reduced as steeply as it was in the strategic review. At a best guess, and by splitting the difference, one might be tempted to say that, almost certainly, water bills were 10 per cent too high and possibly more, but that depends on a proper justification of the actual borrowing profile.

The reasons that are being given for driving the current, restrictive borrowing profile—such as that the profile is determined by public expenditure in the first instance—are a load of nonsense, as we demonstrated. A second reason is that the profile was determined by the commissioner's advice. The rationale for coming up with a borrowing profile has not been given. That could matter to your constituents. Taking a different view on borrowing within the golden rule could have the effect of reducing charges by up to 20 per cent. In other words, we are not just dealing with a technical accounting matter that has no effect in the real world; it could have a massive effect on your constituents' pockets and on the viability of the water industry in Scotland.

Jeremy Purvis: Yes, but what I am trying to get at is that, if the Scottish Executive chose to borrow £300 million, £400 million or £500 million more for investment or to have reduced charges, it could do so. The point is that the political decision has been taken. Through advice from the water industry commissioner, the debt profile has been decided. If a different political decision had been taken, there would now be a different and considerably higher debt profile that could be paid off over a longer period.

Margaret Cuthbert: We are suggesting that the political decision is as shown in the spending review, which highlights the fact that the Executive was willing for the industry to borrow up to between £200 million and £300 million per annum. The Scottish Executive does not lend or borrow the money; the industry itself is given permission to go out into the market and raise it. The Executive's own spending plans show that it was willing to give such a consent.

Jim Cuthbert: That is absolutely right. It is interesting that when our paper became public the Executive's initial response was that it had made available £200-odd million of borrowing a year. As Margaret said, that political decision had been made. However, the Executive had missed the fact that, because of an accounting error, it was not possible to make that level of borrowing available within the strategic review. As a result, ministers made no political decision that would justify the stringent borrowing profile in the strategic review, because they came out and said that their political decision had been much more generous.

Jeremy Purvis: Would the 20 per cent

reduction in bills that you have estimated apply to domestic and business customers across the board?

Jim Cuthbert: We are not saying that that reduction should happen. Instead, we are saying that it could happen if, within the golden rule, the industry utilised all the borrowing that should have been available to it.

Jeremy Purvis: And the borrowing would be used to offset lower charges to customers instead of being vested in the infrastructure.

Jim Cuthbert: That statement is not meaningful. After all, there is one pot here. If the industry were fulfilling its investment programme, the new capital assets being created would amount to about £300 million a year. As a result, any level of borrowing that is lower than £300 million a year is entirely consistent with the golden rule that one should borrow only to fund the creation of new capital assets.

The Convener: I call Alex Neil.

Alex Neil (Central Scotland) (SNP): Thank you for allowing me to come to the table and for giving me the opportunity to ask a question.

When we cut to the chase, has this accounting mistake not affected three separate aspects of borrowing and investment? The first is the level of permissible borrowing, which has been wrongly defined as a result of the mistake that was made in the transition from RAB back to cash accounting. The second aspect is the question of prudent borrowing and the third involves actual spend on investment.

I want to deal with the last point first. Wendy Alexander raised one of the most substantial points of immediate concern when she mentioned Scottish Water's continuing underspend and the organisation's apparent lack of capacity to invest and spend its money—which is a fairly modest amount, compared to what might be permissible—at a time when the industry and customers are crying out for investment in infrastructure. We need to address that major issue.

Secondly, what is prudent is informed by what is permissible as well as by the policy framework of the golden rule and so on. By definition, anything that is not permissible is not prudent and anything that is less than permissible would be well within the bounds of being prudent. The difficulty in this regard is that not only could charges have been up to 20 per cent lower but investment could at the same time have been much higher. As a result, we would have been better off on both sides of the account.

I do not have time to go into all the issues that have been raised. However, is it not the case that this paper, which has highlighted the error—and I

am convinced, convener, that there was an error—that was made in the transition back from RAB to cash accounting and this discussion, especially Wendy Alexander's point about underspend, have underlined the need for an urgent and fundamental review of all aspects of how we fund the water industry in Scotland? Perhaps the committee should consider referring the whole issue to the Auditor General for Scotland for a thorough, comprehensive and urgent review of borrowing and investment levels, pricing policy, underspend and all the other issues that we have discussed.

I am worried by figures from business organisations in Scotland that show that something of the order of £500 million of commercial investment is being held up for several reasons but primarily because of the lack of progress of investment in the water industry.

Jeremy Purvis asked how this would affect our constituents. It affects our constituents in two ways: they are not getting the investment that they could and should be getting; and they are potentially paying too high a charge for their water. My question to Margaret and Jim Cuthbert is this: is there a need for a fundamental and comprehensive review of the whole funding and financing of Scottish Water?

The Convener: Before you answer that, I would say that our inquiry has focused on all those issues. You may be at a disadvantage in coming along to this meeting without having been at previous meetings.

Alex Neil: I have been following the discussions closely.

The Convener: The committee has been discussing those issues. Our discussions have arisen not only from the Cuthberts' work but from our whole process. The Cuthberts have been given an open-ended invitation to set out the situation, but they may want to answer the particular factual points that Alex Neil has raised.

Margaret Cuthbert: We are aware that the committee has done a lot of work. We have concentrated on a specific part but, in doing so, we have found difficulties in the relationships between the Scottish Executive, the water industry commissioner and Scottish Water as to who is taking responsibility. We have asked a simple question, but the buck has been passed backwards and forwards, and has gone all the way to the Treasury and back. We have found glaring difficulties at all stages in the strategic review of charges. We are being led into fixed charges and there have been long economic chapters on why charges should be fixed. However, the committee has comprehensively dealt with that point. We think that it is not just another strategic review that

is required but an examination of the whole process.

Jim Cuthbert: I could not agree more. I do not have much to add other than to say how much we, as members of civil society, welcome the fact that the committee, as an organ of the Parliament, is there to scrutinise the somewhat murky dealings of the Executive. We trust, and we are confident, that the committee will deliver on its responsibilities as an organ of the Parliament to scrutinise the Executive. If it does that stringently, that will be a real step forward for the operation of devolution, which we very much welcome.

The Convener: The committee is certainly minded to scrutinise things carefully.

Ms Alexander: The only question that I want to ask goes back to Alex Neil's point about significant levels of underspend. Are there comparable examples from other parts of the public sector where there is a mechanism for paying back rather than simply redistributing the underspend?

Margaret Cuthbert: Local authorities used to give a rebate.

Jim Cuthbert: A related point is that if one looks at the documents produced by Ofwat—although I am afraid that I cannot give you a direct reference—one sees a standard feature that Ofwat has recognised in England, where equivalent strategic reviews tend to handicap the performance of the industry in delivering capital expenditure. That is no doubt built into the figures. One can have a mechanism post hoc, which would say, "We've got an emerging financial surplus; what are we going to do with it? We should pass it back to the consumers," or—or rather and/or, because the two are not inconsistent with each other—one can be wise enough to say that capital programmes tend to be underspent. Ofwat has recognised that they tend to be underspent when there is a periodic review mechanism. One should build that into one's figures in advance. We would suggest that both those things should be done: there should be a proactive mechanism that allows for the tendency of capital programmes to underspend and that allows for the abatement of charges; and there should be a proactive mechanism, if one has got the figures wrong and there are more financial resources available, for handing money back to consumers after the event.

Ms Alexander: But the prerequisite for both of those is the ring fencing of the resources arising from charging and the decisions made about capital spending. No ring-fencing mechanism of that kind exists at the moment, as has been evidenced by the way in which end-year flexibility is reallocated to other programmes.

Jim Cuthbert: Yes.

11:45

Fergus Ewing: There is no doubt that the massive error—larger than Holyrood—that has been exposed by the Cuthberts' excellent work will affect everybody in Scotland directly. In Newtonmore and Kingussie, the community councils believe that no development at all will be possible for 10 years because of the lack of sewerage capacity. If Scottish Water had even spent the money that is available to it, instead of allowing the massive underspends that Wendy Alexander has correctly referred to, which amount to £148 million a year, at least my constituents would have been moved further up the queue if not to the head of the queue.

I want to ask about a couple of documents. Next week, the Deputy Minister for Environment and Rural Development will come to give evidence to us. You will have seen his response, which is dated January 2004—for some inexplicable reason the exact date has not been put on the letter. Could you please talk us through your responses to that letter? It starts off substantively in the second paragraph, saying:

"As I have said previously, there was no error in the application of the public expenditure rules known as RAB".

What is your reply to that point? There are also three points over the page on which I would be grateful for your comments to help us when we question the minister next week.

Jim Cuthbert: We have already covered that point, but I will restate our position. The minister's statement is factually correct when one looks at the part of the commissioning letter that says that the controls on resources and capital are kept separate. However, it is factually incorrect when one looks at the operational part of the commissioning letter, which sets a combined limit, combining resources and capital. I have taken you through the algebra in part B of our handout, which explains how that arises.

Margaret Cuthbert: Although there was a mistake in the commissioning letter, with regard to that, had it been in respect of an industry in which depreciation is only on book values, it really would not have mattered; however, depreciation in the water industry has a cash element. It is a slightly unusual industry in that part of the depreciation is book-value stuff, which is all notional, and part of it is real cash going out. Because of the formula that was used, there was a double counting. Many people who are unfamiliar with the industry would not even have appreciated that such a terrible mistake had been made. It was bad because it was made in respect of the water industry.

Jim Cuthbert: To amplify what we have just said, I refer you to another part of our handout. Part D is the letter that we received from the

Treasury, describing the operation of RAB. You will see that two parts of that letter are highlighted. The first part is a reflection that an element of capital expenditure appears within both the capital and resource budgets. The second is the key part. It says:

"However I feel I should emphasise that the Scottish Executive is controlled on the basis of two entirely separate budgets and expected to manage them with a clearly defined framework. Therefore in terms of control there is no double counting."

That letter is a clear recognition by the Treasury of the potential for double counting because there is a common element between the resource and capital budgets. It quite correctly says that, as long as the resource and capital budgets are kept separate, it does not matter. However, if the two are brought together, there is double counting. That highlights as clearly as possible the nature of the error in the commissioning letter, which is inconsistent with the Treasury's opinion.

The Convener: Fergus Ewing also asked about the second page of Allan Wilson's letter.

Margaret Cuthbert: The second paragraph on that page is quite clear and true in stating that

"the level of public expenditure available has not been a constraint on the industry."

However, the reason why it has not been a constraint on the industry has nothing to do with the strategic review, nor with any comments that we have made in our paper. Our paper is to do with the way in which the RAB control totals were used to determine charges. What the minister is speaking about in that paragraph is outturn, and we have already heard very clearly that Scottish Water has not invested its money to the potential limit, to the detriment of many of your constituents. What the minister says is not relevant to the points that we raised in our paper: it is a red herring. It is perfectly true that an awful lot more could have been borrowed, but that had nothing to do with the setting of charges or with the revenue calculations, which is what our paper is about.

Jim Cuthbert: In fact, the statement in the minister's letter is subject to two interpretations. Margaret is quite right to say that the level of public expenditure has not been a constraint on the industry. However, it has been a constraint on the level of charges that were set, because of the mistake. The fact that the level of public expenditure that was available fed into the incorrect formula that had been determined by the commissioning letter meant that, inevitably, charges would be increased more than they needed to be. As far as charges were concerned, public expenditure was a constraint. Ministers did not think that that was the case, because they had taken a political decision to make around £250 million-worth of borrowing available and they did

not realise that it would not be possible to reach those levels of borrowing in the strategic review because of the mistake in the commissioning letter.

Fergus Ewing: I want to raise one other aspect of your paper, which I do not think has been mentioned yet. On fixed charges, you refer to the paper by Sawkins and Dickie, which makes clear how high the fixed-cost burden is in Scotland relative to the position in England. You say that that is potentially severely damaging and you argue that the fact that small users pay particularly high average charges per unit of water consumed creates an entry barrier to setting up in business. Are you concerned that the water industry commissioner has conveyed proposals to Scottish Water and that, as we speak, the man whom you have identified as having made three errors in his evidence to the committee—which is quite extraordinary—is being permitted by the Executive to carry on regardless and set charges that, I presume, will not take account of your analysis and might well not deal with the problems of fixed charges that you have identified.

Margaret Cuthbert: The problems of fixed charges and business harmonisation are, as the convener pointed out, the sharp problems that will affect the performance of the Scottish economy. That does not mean that the work that we have done is not fundamental, as it concerns the overall level of revenue gaps. The fixed charges and harmonisation determine where the burden then falls. We strongly believe that whereas the strategic review leads people along the path of believing that because there is a huge, fixed infrastructure, there must be a high element of fixed charge, that is not borne out in any economic textbook or thinking. It is an unbelievable view of economics to think that a fixed infrastructure means that individuals must pay fixed costs.

Fergus Ewing: Do you think that the water industry commissioner can act differently within the parameters of his existing powers, or do you think that the WIC's role needs to be altered to bring in a real element of accountability, involving the Parliament, for example?

Jim Cuthbert: There is plenty of scope for the WIC to take different decisions within the current set-up. However, the current set-up may not be conducive to taking good decisions. It was very noticeable at the Finance Committee meeting on 2 December that responsibility was passed between Scottish Water, the commissioner and the Scottish Executive. That exactly mirrored what we found during our research. We asked people in the water industry commissioner's department about double counting and they said, "We were just following what the Scottish Executive told us to do." We spoke to the people in the Scottish Executive, who said, "We were just following what the Treasury

told us to do."

The current set-up is clearly not optimal, as it is conducive to buck passing and means that errors might not be sorted out. However, within the current non-optimal set-up, the commissioner could have made quite different decisions, if he had wanted to.

Fergus Ewing: I have a final suggestion, because obviously our inquiry will look at accountability and ways of improving the current system, which I think that we all—in different ways—think is a boorach. Would it be sensible to introduce a statutory power of direction, to enable the Executive to intervene, not just to take or leave a whole package, but to give directions, if so advised, to the WIC about how he exercises his powers? In the absence of such a power of direction, it seems to me that Scottish water ratepayers really are in the hands of the WIC. From what I have seen and heard of the WIC, I do not want to be in his hands.

The Convener: I am not entirely sure that the Scottish Executive does not have that power at present.

Fergus Ewing: It does not have a specific power of direction. As I understand the matter, the Executive has a general power to be consulted on the whole package, but it does not have a specific power to tell the WIC to take measures to reduce fixed charges. I am not aware of such a power and I have studied the Water Industry (Scotland) Act 2002. Would such a power be a sensible way in which we could increase accountability?

Margaret Cuthbert: To our surprise, we found that there was nothing in the commissioning letter on, for example, business harmonisation. The decision on that matter was taken further down the line. Given the precariousness of some aspects of the Scottish economy, that issue might be better addressed and the Scottish Executive might give better guidance, within the limits of its power under the European Union. Water could give us a good competitive edge, but at present we are not looking at it strategically from the point of view of the economy. That must be an issue for Parliament.

Jim Cuthbert: The trouble with seeking to solve the matter by giving the Executive a positive power of direction is that the Executive made fundamental errors in the commissioning letter. If a criticism can be made of the commissioner, it is that he followed that mistaken advice too slavishly and did not question it. Neither of those problems would be solved by giving more powers to the Executive. The committee must consider the quality of the policy and technical advice from the Executive before it looks to the Executive for a solution.

The Convener: We have had quite a lengthy evidence session. Two other members have questions, but I intend to bring this part of the meeting to a conclusion.

Dr Murray: I want to ensure that I understand some of the additional information that you have given us today in your handout. As I understand it, the algebraic example that you gave really tells us that the capital budget is linked to the revenue so that one cannot outstrip the other by more than a certain amount. That is basically what the commissioning letter says.

Jim Cuthbert: Yes, but I would put a gloss on that. Profit is not the money coming in, because in RAB terms, profit is profit after allowing for certain non-cash items. To get back to borrowing, one must adjust it on a money basis, which leads one to the formula that I mentioned, that borrowing equals RAB expenditure, minus the notional items that are in RAB but that will not contribute to borrowing, plus the cash items that are not counted in RAB.

Dr Murray: Right. The two are linked in that sense. What exactly is the mistake in the commissioning letter? There might have been a mistake in the way in which the letter was applied, but what is the error in the letter that went out in 2001? What should have been said in the letter?

Jim Cuthbert: There are three mistakes in the letter. The most important one is at sidenote 1 in our handout and amounts to a combined control on capital and resources.

Dr Murray: It just says that they are linked together in a particular way. It does not mean that one goes up and the other goes down or whatever; it means that they cannot get out of step.

Jim Cuthbert: No. As our handout shows, the letter states that the sum of capital plus resources should be less than a fixed, pre-specified amount. That involves double counting infrastructure renewal expenditure because that is in both capital and resources. The fundamental mistake in the commissioning letter is to combine capital and resources in a single limit.

Alex Neil: That is contrary to Treasury guidelines.

Jim Cuthbert: Yes.

Margaret Cuthbert: The Scottish Executive's spending plans are meticulous in always showing capital and resources separately. In fact, when we started out, we could not see what the source of the error was. Our logic told us that there was an error, but when we looked at the spending plans, we could not see how one could possibly have arisen because everything was meticulously laid out. It was only when we got the commissioning

letter, and saw for the first time ever that people had added the two separate limits together, that we realised that that was where the main problem lay.

The Convener: That is helpful clarification, because the minister and officials are coming here next week.

Jim Cuthbert: I repeat that Margaret is absolutely right. What the Scottish Executive published in its annual expenditure report—although it is not clear—is a correct statement of separate resource and capital limits. What it fails to do is show the link between those and borrowing. It also gives a borrowing figure, but the borrowing figure is what we would expect in terms of the historic run of borrowing. The mistake is in the commissioning letter, where capital and resources were added together.

I ask Dr Murray to look at section B of the handout. Do you see that the capital budget should be less than £299.7 million plus profit, which is taken from the table in the commissioning letter?

Dr Murray: Yes.

Jim Cuthbert: The algebra then works out.

Dr Murray: I am a scientist, not an economist. I am going through the calculations stage by stage.

12:00

Margaret Cuthbert: I will inform the committee how I got to grips with the capital budget and what is wrong with it. I went back to, of all things—and I hope that this is not recorded—first year at school, when we were taught set theory. Is A plus B always the sum of all the items in A and the sum of all the items in B? If there is an intersection between the two, then that is double counting. When we explained about capital and resources, we said that the water industry is an industry in which infrastructure renewal is depreciating as a cash item but is also the capital spend. That is the bit that is double counting.

Dr Murray: So one of the figures should not be here.

Jim Cuthbert: Exactly.

Can we go back to the commissioning letter and the other two mistakes? The second mistake, which is at sidenote 2 in section C of the handout, is this statement:

"As you are aware, the public expenditure figures are absolute limits, and not targets."

As we pointed out, in terms of the Treasury guidance that was then in force, that is wrong. Depreciation should have been counted as annually managed expenditure, not as an absolute limit.

The third mistake that we have covered today is at sidenote 3 in section C. The commissioning letter correctly states that resource and capital limits should be separate. I take it that that is what the minister referred to in his letter, which explains why he was able to make his statement. However, the operational part of the commissioning letter contains one limit. That is driving the strategic review, and that is what contains the error.

The Convener: That is helpful clarification of your position.

Jeremy Purvis: My first question is on the power of direction. Paragraph 8 of the explanatory notes to the Water Industry (Scotland) Act 2002 states:

"Subsection (3) gives the Scottish Ministers a power of direction over the Commissioner, equivalent to that provided in the 1994 Act".

Could our clerks give us some background on how that might be applied? It may well help the work of the committee.

Your report has strong comments on fixed charges and harmonisation of business charges, an element of which we touched on. The evidence that we have received is clear that the WIC received approval from Scottish ministers on harmonisation of domestic and business customers, so although the matter may not have been in the commissioning letter, it received ministerial approval. I am not sure about the distinction, as far as the committee is concerned, with regard to that technical point. We will be debating the speed of harmonisation and the principle behind it, but I am not sure about your point.

Margaret Cuthbert: In that particular case, we did not have any information on the ministerial approval. If there has been ministerial approval, instead of saying that it was unfortunate that business harmonisation took place within the strategic review, the argument has to be moved further on to ask why the minister agreed to business harmonisation and what economic justification he used?

Jeremy Purvis: Those are the questions that we are asking.

Finally, you also used strong language on fixed charges, which the committee is considering. All committee members are aware of the burden on very small businesses, such as those whose representatives I meet, as well as the development constraint, which was rightly pointed to. I met the social landlords in my constituency yesterday who talked about raising that specific point with the minister.

We also received evidence from Scottish Water on the make-up of the funding, which shows that

the fixed-charge element raises only 21 per cent. Were you aware of that?

Margaret Cuthbert: Yes.

Jeremy Purvis: If only 21 per cent of funding is from the fixed-charge element, how does that have a massive effect on competitiveness within Scotland?

Margaret Cuthbert: I think that that statement was made in the way that all statements about averages are made, which not only confuses everyone, but masks the variation involved and the effect that that has on enterprise and competitiveness. The fixed charge in relation to the marginal charge varies tremendously throughout the country. I am sure that many members are aware of that from constituents' letters in their mailbags. The principle of fixed charging, and its sensitivity, must be thoroughly investigated. Statements such as the fixed-charge element raising only 21 per cent of funding do not help.

The Convener: The committee will consider that issue. I said that I would allow two more members to ask questions, but because I cut across Jim Mather earlier I will let him in as the final questioner.

Jim Mather: In mitigation, I inform the committee that there are people in my constituency who pay 70, 80 and 90 per cent in fixed charges.

I am keen to pull matters together in order to get a clear understanding of what we are saying today. Essentially, we are saying that, given that the industry has deviated from the original planned and approved levels of borrowing and from planned levels of capital expenditure, and that it has pushed ahead with harmonisation and fixed charges and stuck to the revenue targets, there is a pressing need for a reappraisal of charging. We especially need a reappraisal that includes an open, published and understandable procedure or mechanism for redistributing financial surpluses, which could build into the charging formula recognition of the underspend. It is a bit like airlines anticipating that not everyone will turn up for a particular flight.

Jim Cuthbert: Absolutely—I agree with that. I would add a further requirement to a review, which is that it should be more open than existing procedures. At present, there is the opacity of the 600-page strategic review, which I am sure few people have read and fewer still have understood. The long stop for mistakes in the strategic review is the Executive's advice to ministers when they approve the review's recommendations. However, there should be a further stage that ensures that the public are better informed about what decisions are being made and on what basis, and that they are able to comment on that.

Given that the basic errors in the procedure seem to stem from the Executive—in terms of the three errors in the commissioning letter—and its presumed failure to pick up the implications of the WIC's recommendations on fixed charges and harmonisation, one must question the competence of the Executive's advice to ministers on the issue. Therefore, more openness and evidence that the Executive has given better advice to the minister would be required in a proper review of charges.

Fergus Ewing: I want to ask the convener for guidance on a matter that has arisen from the oral evidence that the Cuthberts have given today. According to the Cuthberts, the committee's adviser—who unfortunately has not been with us yet this year—made comments to the *Sunday Herald*, which were reported on 28 December. Obviously, we will discuss the matter with Professor Midwinter when he returns, but I want to ask about a general principle rather than about the specific substance of his comments.

There are two points. First, should committee advisers make any comments to the press at all? It seems to me that that role is for the committee convener, or perhaps other members, after a mandate has been given. Secondly, if I am wrong and committee advisers can comment to the press about committee work before committee members have been approached or consulted, can the committee adviser comment without having a specific mandate and prior authority from the committee? I would have thought that, at the very least, there should be no comments from a committee adviser unless those comments have first been cleared with the committee as a whole. That is particularly the case when we are in the early stages—as we were when Professor Midwinter made his comments—and middle stages of an important piece of work about which, I am sure, none of us had formed conclusions.

The Convener: At one level, I think that any individual has the right to make any comments that they wish on an issue that they are asked about. As far as I am aware, there is no stipulation that committee advisers should not make comments. I am happy to seek guidance on Parliament's procedures on those issues and to communicate that to members.

Fergus Ewing: Is that something that the Conveners Group might want to consider?

The Convener: I will seek guidance from the relevant source. I thank the witnesses very much for attending what has been a fairly lengthy evidence session. It is not easy to be at the witness end of the table, particularly when we are dealing with technical matters.

Alex Neil: May I excuse myself?

The Convener: Yes.

Budget Process (Memorandum of Understanding)

12:11

The Convener: Item 3 is to consider a draft protocol between the Scottish Parliamentary Corporate Body, the Scottish Public Services Ombudsman, the Scottish Information Commissioner and the Finance Committee. Members have a note from the clerk and a copy of the draft protocol. As the note says, the protocol has been drawn up to regularise the arrangements for the annual budget process; we are being asked to approve it. If it is approved it will be signed by the SPCB, the ombudsman, the commissioner and by me, on behalf of the committee. Do members have questions on the draft protocol?

Fergus Ewing: The note states:

"the SPCB will pay the salaries and allowances of the Ombudsman, the Deputies and their staff and all expenses of the Ombudsman".

Who fixes the salaries and allowances? Are they fixed by reference to the civil service pay scale? By what means and processes are they arrived at?

The Convener: I do not have an answer to that. I can write to the Presiding Officer to seek clarification from him, on behalf of the SPCB.

Jeremy Purvis: We are carrying out an inquiry into relocation policy. Given that the Scottish Public Services Ombudsman is a new body, it would be appropriate to establish that there are no agreements or contracts that would determine a permanent location for it. It is the Parliament's creature and it would be appropriate for it—as well as other bodies—to be located outwith Edinburgh.

The Convener: I suspect that the horse might have bolted in that case, but you make a fair point. My intention is to introduce a paper on relocation at our meeting next week or the week after. Perhaps we could discuss the issue in that context.

Jeremy Purvis: Given that we are contacting the bodies that you mentioned, would it be in order to ask that no agreement be entered into that would be binding for the future of the ombudsman?

The Convener: Perhaps I could ask the Presiding Officer that; he might then reroute the matter to the ombudsman. I could attach your point to the letter outlining the point that Fergus Ewing made. Subject to those points, are members prepared to agree the draft protocol?

Members indicated agreement.

Committee Work Practices

12:14

The Convener: Item 4 is consideration of a paper that sets out a possible protocol for dealing with the media. From time to time the committee will have press conferences associated with reports. I wanted to introduce a draft protocol at this stage so that members could agree in principle on how we will handle such things, rather than have arguments about it in relation to specific matters.

Fergus Ewing: The paper seems to set out the approach that has always been followed. Normally the committee convener will issue a press comment on behalf of the committee, having regard to the views of members and to the work of the committee, rather than comment in a partisan way. Sometimes a press conference might be held and there might be a political-balance requirement, which we have had in the past.

However, the paper makes no mention of the role of advisers. With great respect, convener, it seems to me that it is wholly inappropriate for committee advisers to speak as if they were elected members. Committee advisers are here to advise committees rather than to give their views to the press. If that is right, it is especially right when committee advisers speak to the press without consulting the committee. Of course, I am speaking in general terms—

The Convener: I think that you are not speaking to the paper. The paper is about committee working practices and the way in which we handle media work as a committee.

Fergus Ewing: With respect, convener, we have seen an instance in which our adviser has decided to deal with the media and was reported as being the committee's adviser. That should not have happened. You have said that people should be able to speak out in general terms: of course they should, but they should not do so wearing their committee adviser hat. The paper is fine as far as it goes, but it should contain a clause that states that the committee's adviser should not speak to the press about matters that are before the committee.

John Swinburne: The adviser should not speak to the press unless he gets full approval from the committee.

The Convener: I have already said that I will seek guidance, as the issue might need to be reflected properly in the contracts that are given to advisers. However, the paper that is before us deals with how the clerks and I will handle publicity matters that come before the committee.

Mr Brocklebank: It seems to me that there is a difference between the adviser's talking to the press prior to giving information to the committee and the adviser's talking to the press subsequent to giving advice to the committee. I think that, on reflection, Arthur Midwinter might agree that, if he has pertinent information to give to the committee, it is better that it be discharged to the committee before he comments on it to the press. However, I certainly do not advocate that committee advisers should never be able to talk to the press, because they will be able to explain their views and thoughts much more clearly than committee members could. We need to consider the important distinction that I have mentioned.

The Convener: That is a fair point.

I think that members are broadly content with the paper that is before us. Is the paper agreed to?

Members indicated agreement.

Items in Private

12:17

The Convener: The final agenda item is to consider whether to deal with the draft reports on the Antisocial Behaviour etc (Scotland) Bill and on the Local Governance (Scotland) Bill in private at our next meeting. I propose that we agree to do that.

Fergus Ewing: The Antisocial Behaviour etc (Scotland) Bill has been correctly described as the Executive's main piece of legislation. In our work on the financial memorandum, the bill has been the subject of a great deal of criticism from all sorts of organisations. We should be mature enough to have a discussion about our draft report in public, so that all those who voluntarily submitted evidence to assist us in our efforts will be able to see the arguments that we adduce and the conclusions that we reach in our report on the Executive's flagship policy.

On every previous occasion on which I have made such arguments, the contrary view has been taken by the Executive parties' members and, if I am not mistaken, by the Conservative member on some occasions. If I am mistaken about that, I apologise. On all those occasions, Executive parties' members have shown marked reluctance to discuss the matter: there has simply been a wall of silence. If, as I suspect will be the case, the Executive members do not agree with me this morning, I hope that they will say why.

John Swinburne: Personally, I object to anything being done in private. I would need people to explain to me why our discussion on the bill in question should be held in private. I do not see anything in the make-up of the bill that might mean that we will damage the economy or cause a terrible blip such that anything major will happen. The bill is a bit of an artificial flagship policy for the Executive. There are more important things in life than antisocial behaviour—believe you me. Why should we discuss the matter in private rather than discuss it openly?

Kate Maclean (Dundee West) (Lab): I want to respond to Fergus Ewing's point. Previously in this committee, I have said why I think that draft reports in particular should be discussed in private, but I will reiterate the point. I think that we have far more chance of reaching consensus on a report if we discuss the draft report in private. The evidence-taking sessions have been in public and the report will be published, so there is nothing secretive about having the discussions in private. It avoids the temptation that some people might have to grandstand for the press. We will end up reaching far better decisions and making much

better legislation if we have that particular discussion in private. I am not saying that there should be a general rule that we always discuss such items in private. Each case should be taken on its merit. However, with regard to the two pieces of legislation under discussion, I cannot see why we should not have the discussions in private.

Mr Brocklebank: I, too, have thought that it is better to consider the cases on their merits and I have voted different ways on different occasions.

I am not totally persuaded by Kate Maclean that we should always strive for consensus. Sometimes, it is rather better to air matters and to disagree about them. I am not sure that better legislation always comes from being consensual. To that extent, I would like to hear arguments why elements of the Antisocial Behaviour etc (Scotland) Bill should be considered in private. Like John Swinburne and Fergus Ewing, I think that we should normally be perfectly happy for our work and discussions to be conducted in public unless there are good reasons to do otherwise. If I am convinced that there are good reasons for holding our discussion of a bill in private, I will vote that way, but I do not think that there are in this case.

Jim Mather: In the interests of doing the best possible job and of maintaining the credibility of the Finance Committee and Parliament, it would be useful to take this opportunity to show the Finance Committee being genuinely robust and to demonstrate that we are taking full cognisance of the evidence that all the various groups have submitted. That would prove that the scrutiny and the report generation is robust and that—hopefully—the report will be worth reading.

The Convener: Anyone who has read the reports on financial memoranda that have been produced by the Finance Committee or has seen the level of inquisition that has taken place during the evidence-taking sessions will be in no doubt that we take the scrutiny process extremely seriously. In the stage 1 reports that have been produced so far, the Finance Committee's reports have often been the key elements that subject committees have highlighted as having been important in relation to their scrutiny of the legislation.

The exercise that we are engaged in is a process of technical analysis of the financial memoranda of bills. We are not concerned with the policy thrust and sometimes I have some difficulty in reining in members who start to stray into policy areas. That is not our job; that is the job of the subject committees. Important issues arise from our consideration both of the Local Governance (Scotland) Bill and the Antisocial Behaviour etc (Scotland) Bill and it is important

that the Finance Committee do the most robust job it can do. Executive and non-Executive members want to share in that process. The process by which we reach consensus on a report is important to the way in which we conduct ourselves and to the credibility and substance of our reports, which have previously been hard-hitting and will, I anticipate, continue to be so. We have nothing to be ashamed of in relation to how we have conducted ourselves. Probably the worst time for us to move into open session to discuss our draft reports is in relation to bills that deal with controversial policies because, as Kate Maclean said, the temptation will be for members to grandstand on policy issues when our job is to scrutinise the financial statements of the Executive and to hold it fully to account, which I believe we have done.

I think that we have to move to a vote. I think that Fergus Ewing had no objection to our consideration of the Local Governance (Scotland) Bill's being taken in private—

Fergus Ewing: That is not correct. I do not understand why that should be discussed in private, either. I entirely disagree with the arguments that you have advanced.

The Convener: In that case, I suggest that we vote on my proposal that we deal with the Local Governance (Scotland) Bill and the Antisocial Behaviour etc (Scotland) Bill in private at—

Fergus Ewing: Should not we vote on the bills individually?

The Convener: I sought to discover whether you wanted to take them together or separately. Do you want to vote twice, Fergus?

Fergus Ewing: I think that that would be correct. For all I know, Ted Brocklebank might take a different view about the Local Governance (Scotland) Bill: he has not opined on it.

The Convener: Procedurally, Fergus, you are absolutely correct.

The question is that we take the draft report on the Antisocial Behaviour etc (Scotland) Bill in private at our next meeting. Are we all agreed?

Members: No.

The Convener: There will be a division.

FOR

Alexander, Ms Wendy (Paisley North) (Lab)
Maclean, Kate (Dundee West) (Lab)
McNulty, Des (Clydebank and Milngavie) (Lab)
Murray, Dr Elaine (Dumfries) (Lab)
Purvis, Mr Jeremy (Tw eeddale, Ettrick and Lauderdale)
(LD)

AGAINST

Brocklebank, Mr Ted (Mid Scotland and Fife) (Con)
Ewing, Fergus (Inverness East, Nairn and Lochaber) (SNP)
Mather, Jim (Highlands and Islands) (SNP)
Sw inburne, John (Central Scotland) (SSCUP)

The Convener: The result of the division is: For 5, Against 4, Abstentions 0. We will discuss the draft report on the Antisocial Behaviour etc (Scotland) Bill in private.

The next question is that we discuss the draft report on the Local Governance (Scotland) Bill in private at our next meeting. Are we all agreed?

Members: No.

The Convener: There will be a division.

FOR

Alexander, Ms Wendy (Paisley North) (Lab)
Maclean, Kate (Dundee West) (Lab)
McNulty, Des (Clydebank and Milngavie) (Lab)
Murray, Dr Elaine (Dumfries) (Lab)
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Brocklebank, Mr Ted (Mid Scotland and Fife) (Con)
Ewing, Fergus (Inverness East, Nairn and Lochaber) (SNP)
Mather, Jim (Highlands and Islands) (SNP)
Sw inburne, John (Central Scotland) (SSCUP)

The Convener: The result of the division is: For 5, Against 4, Abstentions 0. We will discuss the draft report on the Local Governance (Scotland) Bill in private.

Jeremy Purvis: Out of interest, could the clerks provide us with information about how many divisions have taken place in other committees and where this committee stands in relation to other committees in this regard?

The Convener: I am sure that that can be looked into.

I thank members for their attendance.

Meeting closed at 12:26.

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