FINANCE COMMITTEE

Tuesday 3 February 2004
(*Morning*)

Session 2

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FINANCE COMMITTEE
4th 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:

Professor Arthur Midwinter (Adviser)

THE FOLLOWING GAVE EVIDENCE:

David Reid (Scottish Executive Finance and Central Services Department)
Andrew Scott (Scottish Executive Environment and Rural Affairs Department)
Allan Wilson (Deputy Minister for Environment and Rural Development)
Aileen Wright (Scottish Executive Finance and Central Services Department)

CLERK TO THE COMMITTEE

Susan Duffy

SENIOR ASSISTANT CLERK

Jane Sutherland

ASSISTANT CLERK

Emma Berry

LOCATION

The Chamber

Scottish Parliament

Finance Committee

Tuesday 3 February 2004

(*Morning*)

[THE CONVENER *opened the meeting at 10:05*]

Scottish Water

The Convener (Des McNulty): I welcome members of the committee and members of the public to the fourth meeting of the Finance Committee in 2004. I remind everyone to turn off their pagers and mobile phones. We have received apologies from Ted Brocklebank, who is not able to attend the meeting. Jeremy Purvis is stuck in traffic and will join us as soon as he can.

Before we begin, I should tell members that three late papers have been tabled: there is a supplementary note on the budget by the committee's adviser which has, I think, already been circulated; there is a note on the Finance Committee's request for information on ministers' powers of direction over the Water Industry Commissioner for Scotland and over Scottish Water—we sought clarification on that last week; and there is a note from Scottish Water setting out the reasons for the phasings of Scottish Water's investment programme, what the balance is between funding and borrowing, and the water charges for 2002-06.

This morning, the Deputy Minister for Environment and Rural Development answered a parliamentary question from Alasdair Morrison on the level of water charges for 2004-05. That has just been published, so I draw it to members' attention. It might be appropriate to deal with that answer when we have the minister before us.

The first item on the agenda is the committee's investigation into issues surrounding Scottish Water. Following last week's evidence from Jim and Margaret Cuthbert of Analytical Consulting Ltd, we will have a briefing from Scottish Executive officials, after which members will be able to ask questions.

I welcome Andrew Scott, the head of division in the water services unit; Janet Egdell, team leader in the water services unit; Aileen Wright, head of audit and accountancy in the central services division, and David Reid, who is head of environment and rural affairs in the finance division.

Andrew Scott (Scottish Executive Environment and Rural Affairs Department): I have been the head of the water services division in the Executive since 1 April 2002, and there has never been a dull moment. Aileen Wright is responsible for the application of accountancy principles across the Executive and is an accountants' accountant, if you like. David Reid is the head of finance for environment and rural affairs and Janet Egdell works with me in the water services division.

Jim Mather (Highlands and Islands) (SNP): Could you speak closer to your microphone, please? I really cannot hear you over here.

Andrew Scott: I would like to begin by setting out in broad terms what is happening in the water industry with regard to borrowing and investment, and I want to argue that we have got the balance between charges and borrowing about right. Then I would like to turn to some of the technical issues—raised in evidence last week—related to the way in which we commission the strategic review of charges. I want to show that we have applied the Treasury rules properly and that Scottish taxpayers and consumers have not been disadvantaged. Finally, I would like to touch briefly on the way in which the Executive is handling the consequences of Scottish Water's decision to rephase its capital programme, and I want to explain how, in practice, the Executive will provide its share of investment in the industry.

Given all the technicalities of the subject, it will be worth our while to begin with a simple commonsense check on what is happening in the current situation. Scottish Water will invest more than £1.8 billion over four years, and that money will cover all aspects of its capital spending. For example, it will cover the cost of preventing the existing assets from deteriorating further. That is known in the trade as asset replacement, because you replace just what you use up on a daily basis. It is the amount that is needed to be spent just to stand still. It also covers the cost of buying new equipment to provide services that have not been provided previously. That is known in the trade as asset enhancement; an example of that might be enhancement of plant and equipment to treat water to a higher standard than hitherto.

At the committee's meeting on 2 December, you took evidence from Douglas Millican, the finance director of Scottish Water, who said that about two thirds of investment is being financed from revenue and about a third is being financed from borrowing. He also said that he thought that that split struck the right balance between keeping assets going and the funding that is necessary for new and higher standards of service delivery. That means that about two thirds of the investment programme is being consumed by the requirement to prevent assets from deteriorating further, while the remaining one third is the net value of the new plant and machinery that Scottish Water is buying over four years to bring about quality improvements.

Our general approach to public spending is that borrowing should be used to pay for new assets. It should not be used to pay the cost of replacing assets that are used up in the course of daily operations, which would mean that we would be allowing borrowing to pay for the routine costs of running the business. On that basis, the Executive should expect to lend Scottish Water up to £600 million over four years. You also heard Douglas Millican say, on 2 December, that Scottish Water expects to increase its borrowing from £2.1 billion in 2002 to £2.7 billion by 2006—an increase in borrowing of around £600 million over the period—which means that the amount of lending that the Executive is likely to provide to Scottish Water over the period is broadly equivalent to the net value of the new assets that are being created.

It is worth comparing that to the evidence that was presented to the committee last week. Last week, the committee heard the suggestion that the Executive could lend up to £300 million per annum to Scottish Water and still claim that its actions were consistent or in keeping with the spirit of the golden rule. Over four years—four times £300 million—that would mean that the Executive would lend Scottish Water £1.2 billion. That is about double what is likely to be lent and roughly double what Scottish Water thinks is prudent. Why is there such a difference? Here is why: I have just told you that Scottish Water will invest about two thirds of its investment programme in just replacing assets that are used up in the course of its daily operations, which is about £1.2 billion, or £300 million a year, just to stand still. Last week, the committee was told that, for infrastructure renewal, the amount that is needed to stand still is roughly £130 million per annum. That figure is cited in column 878 of the *Official Report*. Four times £130 million is £520 million over four years, which is about half the estimate that has been provided by Scottish Water. What can explain that difference?

The lower figure for replacing assets that have been used up in the course of daily operations, which was given to the committee in evidence last week, is based on the term "infrastructure". In the water industry, the word "infrastructure" has a particular meaning: it is used to describe the assets that are below the ground, which are mainly pipes and sewers. It does not for the most part include assets that are above the ground—pumping stations, sewage treatment works and water treatment works. The terminology might be a bit counterintuitive, but it means that last week's calculations of the amount of money that Scottish Water should set aside each year to cover the on-going cost of assets that are used up in its daily operations left out all the assets that sit above the ground—all the pumping stations, the water works and the sewage treatment works.

Scottish Water's evidence to the committee, on 2 December, tells us that if the Executive were to base its decisions on last week's evidence, we would lend Scottish Water up to £1.2 billion for the construction of new assets with a net worth of only about half that amount. That would not be prudent. Let us consider last week's evidence, taking into account all the assets above and below the ground. If we accept the premise that the industry should borrow prudently and meet its on-going costs from revenue, we need to deduct the cost of replacing the above-ground assets from the upper borrowing limit of £300 million, which was suggested last week. Very roughly averaged over the period, that will amount to an additional cost to the business of about £150 million a year. When we deduct £150 million from £300 million, we are left with a suggested borrowing maximum of about £150 million a year—the same as the Executive is likely to lend to Scottish Water, on average, over the period.

In short, taking into account all the investment, the broader arithmetic of last week's evidence and the real scale of lending to Scottish Water are fairly consistent with each other. That also means that the Executive has adopted a prudent approach to borrowing.

I will talk about the technical treatment of accounting matters. Much of last week's discussion was about technical matters. The committee heard three specific complaints about the way in which the Executive has set up the strategic review of charges. I need to tell the committee that all those complaints are unfounded because we applied the resource accounting and budgeting rules properly. If there is time, we can deal with each complaint in detail.

However, the first complaint about a combined total for capital and resources in the commissioning letter is the most serious of the three and I would like to deal with it now. As I understand it, the complaint is that the Executive was wrong to set the combined total for capital and resources in the commissioning letter. The criticism runs that, by setting a combined total, one double counts depreciation and therefore reaches the public spending limit more quickly than one otherwise should, thereby limiting the opportunity to borrow money for new assets.

10:15

Why is that complaint unfounded? To answer that question, I need to tell members a bit more about RAB and to set out the RAB rules as they affected the status of Scottish Water as a public corporation in the spending review 2000. Depreciation is not double counted in RAB. The term “double counting” makes it sound as if the accounting system is bound to create errors—that is not the case. The proper explanation is that, in the spending review 2000, RAB treated depreciation as a non-cash charge in the Executive’s resource budget within the departmental expenditure limit. Renewals—the amount required to keep the system going at a steady rate—is a cash item of expenditure within the Executive’s capital budget.

That is not double counting. The sums worked that way because in the spending review 2000, RAB was designed to account for the full cost of service provision and not just the cash cost. Members will remember from last week that the Treasury has already gone on public record to say that the Executive applied the RAB rules properly. As a result, if one compares the Government financing of the water industry under the former cash budgeting regime with the stated limit of resources of departmental expenditure under RAB, one discovers that the figure for the term resources under RAB is higher than that under cash budgeting. That is not because the Government has suddenly got more generous; all that has changed is that the Government has adopted a different way of measuring resource consumption in its budgets. The cash position of the industry—which affects borrowing—has been left entirely unaffected by the change.

One might say, “So what? We know all this.” Separate controls on renewals and depreciation are fine. It is when one adds them together that the trouble starts and that is the mistake that was made about the commissioning letter. There are two points in answer to the criticism that was made in that respect. First, remember that the limit on resource consumption has already been raised to deal with what some people would call double counting, and to deal with what is really to do with the treatment of renewals under RAB. We know that borrowing has been left unaltered by that treatment. Secondly and more specifically, it is because Scottish Water is a public corporation that raises revenue that there is no difficulty in adding the two together for the purposes of the Commissioner’s review. In fact, adding the two together protects customers’ interests. Normally, if a public body makes a bigger surplus than expected, it simply reduces its call on resources from the taxpayer.

The water industry is unusual among public services, however, in that it raises a lot of income through charges. If we applied the normal rules to Scottish Water and it made a bigger surplus than expected, the benefit would come back automatically to taxpayers and not to water customers. We do not think that that would be fair. The Executive thinks that, if the industry does better than expected, the customers should benefit first. Therefore, we allow Scottish Water to keep any surplus and to allow that surplus to be offset against capital expenditure. That is why, in the commissioning letter, we add profits to the capital budget. That way of doing things is designed to ensure that water customers do not contribute more money than is necessary to fund the service that they receive and that they do not have to pay for more borrowing than is needed.

Where does all that leave us? I began by saying that the Executive will lend Scottish Water about £600 million over the period, which is consistent with the net value of its new assets. I went on to say that, when one includes the cost of renewing the above-ground assets in the evidence that was presented last week, one can go a long way towards reconciling our position and towards seeing why, on average, roughly £150 million a year is the right level of borrowing.

I have explained that we have applied the RAB rules properly and that the Treasury agrees with us on that. The borrowing for the industry has not been affected by the introduction of RAB.

Finally, I have explained that the way in which we handled capital spending and profit in the commissioning letter works in the interests of customers because it means that customers, rather than the Exchequer, benefit from better-than-predicted performance by Scottish Water. On the bases of common sense and of a full understanding of the technicalities, things look to be in order.

Let me make one final point. Last week, the committee expressed concern about the way in which the Executive is dealing with Scottish Water because the current level of new borrowing is rather lower than planned. It is true that Scottish Water is drawing a much lower level of new loans from the Executive than the Executive has budgeted for to date. If the Executive were to insist that the borrowing could be used only in one particular year, that would mean that more of the capital programme would have to be financed out of customer charges than was properly intended. However, we do not insist that borrowing must be used in one particular year. The Executive has agreed that Scottish Water will not forfeit any borrowing just because it does not draw down that borrowing in a particular financial year. The arrangement that we have come to with Scottish Water involves full end-year flexibility and ensures that the Executive keeps its side of the bargain. It means that the Executive will provide loan finance for around one third of the capital programme, as I outlined at the beginning of my remarks.

The Convener: I remind members that the acting minister will be present later to answer questions. It is appropriate that any questions that have political content should be addressed to the minister. The officials are able to deal with any technical questions now.

I want to ask about Andrew Scott's last point, which was about the phasing of borrowing. From the point of view of Scottish Water and its customers, is it financially prudent for Scottish Water to be allowed to phase in its capital spend by end loading it rather than front loading it? Can you give us any sense of the extent to which that end loading is projected to take place within the current cycle?

Andrew Scott: I will make two points. Scottish Water is required to improve substantially the value for money with which it delivers the capital programme. If the former three water authorities had delivered the capital programme, it would have cost customers and taxpayers about £2.3 billion—Scottish Water is required to squeeze the same outputs from only £1.8 billion. That means that there is a £500 million capital efficiency on the way. Scottish Water has had to rethink the way in which it delivers the whole capital programme to be sure of bringing about that improvement in value for money. Scottish Water is end loading the capital programme more substantially, because it has to get the new procurement mechanisms in place.

How much will that end loading be? I do not have precise figures with me, but my guess is that it will be quite substantial. My discussions with Scottish Water have been on the basis that the company is confident that it will deliver the capital programme in full.

The Convener: Can you quantify the extent of the delay in implementing capital projects—for example, new sewage and water treatment plants—that has resulted from the regrouping and rephasing exercise that you have mentioned?

Andrew Scott: We asked Scottish Water to pay particular attention to things such as the early delivery of bathing waters requirements. Scottish Water has done that. It is quite hard for me to quantify other than in money terms how far Scottish Water is behind the existing profile, but the company is sure that it will catch up and deliver the programme in full. That should not matter as long as we have that flexibility over the period.

The Convener: We have been joined by Wendy Alexander and Jeremy Purvis.

Dr Elaine Murray (Dumfries) (Lab): I am sorry if I am asking Andrew Scott to go over something again, but I want to reconcile what we heard last week and what we have heard today.

Last week, Mr and Mrs Cuthbert's argument seemed to revolve around the equation that net borrowing is equal to RAB expenditure plus interest payments. I am not sure whether working capital should also be in the equation, less depreciation and the capital-charge element. The Cuthberts said that there was double counting because the infrastructure renewals were counted twice: as part of investment and as part of depreciation. Are you saying that the renewals are not part of depreciation but part of the capital-charge element and that the two therefore cancel each other out? Is that the crux of your argument?

Andrew Scott: I turn to my accountant friend for a proper answer to that question.

Aileen Wright (Scottish Executive Finance and Central Services Department): The confusion about depreciation arises partly because Scottish Water's accounts talk of an infrastructure maintenance charge. The element that Scottish Water discloses in its income and expenditure is the depreciation charge on infrastructure assets. Scottish Water operates a renewals accounting methodology whereby, in relation to assets that it has undertaken to maintain in a particular state, it has agreed to spend a certain amount per year on maintaining them in that state. There is an asset management plan to support that. The amount that Scottish Water spends each year on that is part of the capital budget and is capitalised in fixed-asset terms. That amount is also the depreciation charge under financial reporting standard 15. That could be the same amount or it could be a different amount because Scottish Water has a sophisticated system of managing.

Dr Murray: Basically, one figure is positive and one is negative, which means that they cancel each other out rather than there being double counting.

Aileen Wright: In income and expenditure terms, the amount for the depreciation is a non-cash charge. When a body considers the amount that it needs to borrow, it takes the profit figure then adds back the non-cash charges to look at how much cash it has generated from its activities and how much cash it has available to fund capital. Obviously, if the amount that is available from the operating activities is less than the amount that it has committed to spend on capital, it must borrow to fund that.

Dr Murray: I will have to think about the maths again.

The Convener: We will all have to do that. One problem is that we have dense information that is hard to assimilate.

John Swinburne has a question. I remind him that the witnesses are officials and that the minister is still to come.

John Swinburne (Central Scotland) (SSCUP): We can get intae them as well—that is not a problem.

Andrew Scott has explained in great depth the financial aspects of Scottish Water. Last week, we listened to alleged experts—the Cuthberts—whose argument was diametrically opposed to Andrew Scott's argument. Has he met them to discuss the problem face to face instead of doing it through a third party—the Finance Committee? Has he discussed their theory to find out whether it has any credence? Above all, can he explain in layman's terms why everyone who uses water in this country is complaining about the radical increase in charges?

Andrew Scott: Jim and Margaret Cuthbert have spoken extensively with my colleagues in the water services unit. The Cuthberts sent their paper and conclusions to some members of the committee before they sent it to me. The paper also appeared in the newspapers before I had sight of it. The Cuthberts subsequently sent me a full copy of the paper and asked me to treat it on a restricted basis. I said that that would be difficult because I had seen so much of it in the newspapers.

John Swinburne: Are you trying to say that because you read about the paper in the newspapers, you cannot give it full consideration? We have advisers who speak on our behalf in the newspapers—unbeknown to us at times.

The Convener: Come on—there is a technical question.

Fergus Ewing (Inverness East, Nairn and Lochaber) (SNP): Mr Scott should answer the question: has he met the Cuthberts or not?

Andrew Scott: We had discussions with Jim and Margaret Cuthbert without having sight of the paper. The paper was subsequently sent to the committee without our having seen it.

John Swinburne: What about the charges? I will give a little example. Dr Murray and I talked to a group of people in Motherwell who said that one big disadvantage with Scottish Water was that, if people have a project, Scottish Water wants to be paid up front rather than the payments' being phased over a number of years. That policy retards progress. Does Scottish Water still demand payment up front rather than use the traditional method of phased payments?

10:30

Andrew Scott: The simple answer to the question of why charges have gone up is that we must put the industry on a financially sustainable basis—it was not on such a basis previously. Previously, it borrowed to repay its interest and the consequence of that was that interest as a proportion of a customer's bill expanded geometrically. It is not possible to put off until tomorrow what we have to pay for today, and one of the reasons why charges have gone up is that we have moved to a regime that is more properly financially prudent. For many customers, charges have also gone up because we have redistributed the burden of charges throughout the country: we have harmonised the differences that existed between the former three authorities; some customers' bills have gone up and some customers' bills have gone down because of that.

Fergus Ewing: As I understood Mr Scott's remarks, he places particular emphasis on the assertion that one third of investments should be funded by borrowing and two thirds by charges. In other words, the customers pay two thirds of investments and borrowing, which is the only other source of finance that is available to Scottish Water, covers one third. Is that correct?

Andrew Scott: That is right.

Fergus Ewing: Is it not the case that that is not what has happened in England?

Andrew Scott: It is a little bit difficult to compare private utilities with Scottish Water. English companies have borrowed quite extensively, and the proportion of Scottish Water's turnover that goes on debt servicing is similar to the proportion that English public limited companies in the water industry pay out separately in interest and dividends.

Fergus Ewing: That, of course, is because we inherited massive debts when the three quangos were created. The existing borrowing is about £2.1 billion, but will increase to £2.7 billion.

Andrew Scott: However, £700 million was written off on the creation of the three authorities in 1996.

Fergus Ewing: Yes—we can consider that later. The point that I want to make is that the one third-two thirds rule is far from being applied in England. As I read table 5 of the Office of Water Services report "Financial performance and expenditure of the water companies in England and Wales: 2002-2003 report", borrowing as a percentage of total investment—I presume that Ofwat gets its figures right—was 68 per cent in 1998-99, which is roughly two thirds, not one third, 43 per cent in 1999-2000, 49 per cent in 2000-01, 39 per cent in 2001-02 and 77 per cent in 2002-03, which is roughly three quarters. We are completely out of kilter with the method of funding in England, are we not?

Andrew Scott: I have not seen that Ofwat report, so I cannot comment on it.

Fergus Ewing: Well you should have, should you not? It is in your province.

The Convener: Fergus, come on. Let Andrew Scott answer the question.

Andrew Scott: I cannot comment on the Ofwat report because I have not seen it. If we were to adopt the position that two thirds of the investment programme was funded out of borrowing, we would be in the position of lending Scottish Water money to subsidise its on-going daily business, and the consequences of that would come back and hit customers in the medium term through much higher interest bills: instead of paying only 15 per cent of turnover in interest charges, we would quickly discover that we were paying a lot more, and a much higher proportion of turnover would go on interest.

Fergus Ewing: We can all accept that the notion that it is prudent to borrow at a certain level is wise, but to make that as a general statement does not take us much further. I will ask you one further technical question before we have the pleasure of the minister's company. I will quote from Mr Cuthbert's evidence to the committee on 27 January, when he talked about the evidence that we had from the water industry commissioner, which I am sure you have read. It was important evidence, because the water industry commissioner said that the observation that he made set the context for his decisions in Scotland. Mr Cuthbert said:

> "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 year, but the Ofwat figures—which I cited—

> "show substantial borrowing by all the water companies over each of the past five years, apart from one company in one year."—[*Official Report*, *Finance Committee,* 27 January 2004; c 884.]

Who is right: the water industry commissioner or Jim Cuthbert?

Andrew Scott: Have you not written to the commissioner on that point? Perhaps you ought to allow him to clarify what he said.

Fergus Ewing: That is another matter. I am simply asking you the question, because—

The Convener: Given that Mr Scott has not read the Ofwat report, it is difficult for him to answer your question.

Fergus Ewing: With respect, the question is highly relevant—I see Wendy Alexander nodding in assent—as it goes to the root of the problem. The water industry commissioner gave factually incorrect information—information that is so wrong that it baffles me that we have not heard from the Scottish Executive, confirming that he got it wrong and saying that it is taking steps to put it right. Surely, between the four witnesses, someone must know whether the assertion that only two of the 10 water companies in England had occasion to borrow over the past six years is correct. I open the question to any of the four witnesses.

Andrew Scott: I think that you should allow the commissioner to answer that in his own words.

Fergus Ewing: Are you saying that you do not know the answer, or that you are not going to give me the answer?

Andrew Scott: The water industry commissioner is a minister's adviser and you should allow him to offer his advice clearly and without my second-guessing it.

Fergus Ewing: The commissioner is not an adviser to the minister; he is supposed to be the customers' champion. That is the problem. His statutory role is not to be a minister's adviser. You are an adviser and if we cannot get an answer to the simple question whether the water industry commissioner has made a blatant error, which goes to the root of the borrowings, I do not see how anyone witnessing this meeting could feel that the Scottish Executive has got a grip on the issue. The water industry commissioner has plainly made a fundamental error, which has resulted in massive overcharging of the water rate payers in Scotland.

The Convener: I am not sure that that is necessarily true. However, we have written to the commissioner seeking clarification of a number of issues, including the one that you raised. I presume that we will get a response from the commissioner in due course.

Jim Mather: I want to take this from the top again. The Cuthberts' paper is in the public domain; I understand that it was published in the quarterly review of the Fraser of Allander institute for research on the Scottish economy. I find the absence of a detailed reconciliation, on paper, of some of the key numbers almost an affront. I also find the rebuttal of the Cuthberts' argument by complex last-minute verbal explanation an affront. I have serious concerns about what you have said today. We are now counting in all replacement investment, including above-ground investment. When we spoke to Douglas Millican, we heard that only below-ground investment was covered by the repairs and renewals issue and therefore was liable to come under the double counting.

I detect an element of rebuttal by assertion, or rebuttal by new news, in the suggestion that the application of the rules that created the surplus will benefit the consumer. I suggest that the consumers whom we have met, such as the Forum of Private Business in Scotland, the Scottish Council for Voluntary Organisations and the Scottish Trades Union Congress, would disagree with that suggestion strongly. It has been stated that if the Executive could insist that borrowing could be used only in one specific year, more would have to be funded by charges. That is just unbelievable, when we have seen the charges fund loan finance at a level of 86 per cent and 68 per cent respectively in the past two years. Do you think that mistakes have been made and that we should have had a detailed reconciliation on paper?

Andrew Scott: I am sure that there have been no mistakes. On the question of detailed reconciliation, I hope that my remarks in the *Official Report* of the meeting will go some way to providing reassurance.

Jim Mather: Have you changed the ground rules—no pun intended—here, given what Douglas Millican told us about the assets applying to repairs and renewals methodology being those below ground?

Andrew Scott: Absolutely not. Before coming to give evidence today, I consulted Douglas Millican very closely. He is entirely content with the nature of the remarks that I made.

Jim Mather: You checked what you said with Douglas Millican.

Andrew Scott: Yes, I did.

Jim Mather: Do you realise that what you have said is entirely contrary to what Douglas Millican told Jeremy Purvis and me, in the company of Susan Duffy, the clerk?

Andrew Scott: I do not know whether it was contrary or not. I was not party to that conversation. Douglas Millican is content with the nature of the statement that I made today.

Jim Mather: Okay.

We have had a submission from Douglas Millican, telling us that the Scottish Water borrowing limit for the period to 2006 is some £610 million. I find it impossible to reconcile that figure when I go back to the numbers. When I look at the Scottish Executive approved borrowing limit for 2002-03 to 2005-06, I come up with a figure of £913 million. When I look at the strategic review and see the water industry commissioner's recommendation for the borrowing limits for the same period, I come up with the dramatically lower figure of some £293 million.

I suggest the following sequence to you. The water industry commissioner set a much lower target and, once that target had been set, there was a need to set water charges to make up the available cash. On top of that, there was the defining of the water charging principles, which was followed by the raising of individual bills. Those bills are higher than they ought to be, because the borrowing was available to mitigate that.

Andrew Scott: I will try to respond to that in stages. First, the water industry commissioner set an upper borrowing limit of £300 million, with a margin of £200 million on top. The Executive is lending £600 million and in various published budget documents there is about £900 million. This is a difficult point to get across, but if Scottish Water is to live within its revenue cap and if it is to borrow what is prudent, which is £600 million, it has to achieve operating cost efficiencies that are worth around £250-plus million over four years. It must also achieve capital efficiencies of £500 million during that period.

If Scottish Water does not achieve those savings, it cannot raise its revenue requirement because it is capped. The only place for the slack to go is in extra borrowing. That is why ministers set a margin. That explains the difference between £600 million and £900 million.

Jim Mather: That explains it?

Andrew Scott: It is a prudent limit.

Jim Mather: You are telling me that we have a prudent limit, on top of which we have this extra prudent approach to capital expenditure. Can you tell me why this generation deserves to have so much prudence dumped on it?

Andrew Scott: What I said earlier was that the expenditure on maintenance was designed to stabilise the condition of the assets. It is not designed to improve it.

Jim Mather: How do you reconcile that with the water industry commissioner's opening statement to the committee? He said that his top priority was to look after consumer interests.

Andrew Scott: It is in consumer interests that we do not put off until tomorrow what we have to do today. The suggestion that we are paying for all the mistakes of the past is not borne out by the fact that about two thirds of the capital programme is being spent on above and below-ground assets to stabilise their condition. We are not improving the assets, and there are a lot of them.

The Convener: I think that that line of questioning may be getting into the area of the political questions that we want to put to the minister. Do you have other technical questions that you want to ask, Jim?

Jim Mather: I will recharge my batteries for a moment.

Ms Wendy Alexander (Paisley North) (Lab): I do not want to address the detail of the commissioning letter other than to make an observation on one aspect of the process on which the officials might wish to comment. I share

Jim Mather's view that a written reconciliation would be helpful in allowing us to reconcile the issue. Given the complexity of the matter, I am not sure that the process was compatible with the principles of openness and transparency that are laid out in the recommendations of the financial issues advisory group and to which the Executive is apparently committed. FIAG recommended that, if a matter of such complexity were to drag on for this length of time, the written record should speak for itself. I make no judgment on what the written record might say; I simply make an observation.

As you know, the second matter that detained us last week was whether it was appropriate for the water industry commissioner to seek to use financial ratios and not permissible borrowing in reaching a judgment. I understand exactly why he did so; indeed, I share his view.

10:45

I do not think it unreasonable for the lead policy adviser to the Executive to be asked about the accuracy of his statement about borrowing, which is in the *Official Report* and is a matter of controversy. I am more worried that Andrew Scott appeared to be unfamiliar with the Ofwat report. I find that extraordinary, given that you are the lead official on water and that we are trying to manage the industry in a way that is compatible with the management of the water authorities in England. You might just wish to say that you are familiar with the report, but that you do not wish to comment on it in this context.

A substantive issue that I raised last week was the underspend and the extent of any discretion on the part of Scottish Water to back load it to the end of the programme. It would have seemed sensible for the water industry to take the opportunity to re-examine its capital programme and to back load it when Scottish Water was formed. In an advice note that came to the Finance Committee on Tuesday 27 January—I hope that you have seen it—our expert adviser stated:

> "There has been significant underspending of the water budget. In the EYF announcement of June 2002, some £188m was reallocated to other programmes, and attributed to efficiency gains from reorganisation. In the current year, the underspend was £148m, as in the Minister's letter to the Convener of 29 September 2003, mainly from the 2001-02 budget."

Why is the language of EYF and redistribution to other budgets used repeatedly in what is apparently ministerial correspondence, when Scottish Water appeared to be arguing that it was capable of ring fencing any underspend through the existence of the £600 million limit? It is interesting that the information appears to be sufficiently obscure for our own expert adviser to be unaware of it. Why are we using the language of EYF to describe what happens when there is an underspend in the water budget?

Andrew Scott: David Reid will answer that question.

David Reid (Scottish Executive Finance and Central Services Department): Once I have spoken, I will have to pass back to Andrew Scott on the management of the investment programme for water.

On the point about EYF, there have been underspends in successive years against the water budget. The sums available have occasionally been redeployed, as was the £188 million that your adviser picked up on. It is a matter of moving sums around between budgets and sometimes between portfolios in individual years. The working arrangements for investment in water are that, as the need crystallises, the funds will become available again for redeployment in the water programme.

I am not sure that I followed what Ms Alexander was saying about the use of EYF language in ministerial statements.

Ms Alexander: The critical issue is whether money that people are paying in water charges is being used to improve the water infrastructure and whether it is being reallocated or attributed to other programmes if it is not spent in year. Are the full sums of £188 million and £148 million available to Scottish Water to spend in subsequent years, or are they being redeployed to other programmes? If the full sums are available, money that is nominally raised through water charges can be used for water, albeit in the subsequent year or two years.

The existence of that arrangement is something of which our expert adviser appears to have been wholly ignorant, yet it goes to the heart of our understanding the financial arrangements that are operated with Scottish Water. I say that having had the benefit of a discussion with Douglas Millican, who said, "Oh no, we can spend that full money. It is not really EYF and it shouldn't be called EYF." We are trying to find out whether the full proceeds that are raised—that is, the £188 million and the £148 million—can be back loaded, or whether some will be clawed back for other programmes.

David Reid: The investment programme is regarded as a multi-year commitment, and it will be funded as the investment requirements fall. There was a particular characteristic of the EYF underspend that was carried forward from 2001-02, which created the £188 million figure in 2002-03. It was affected by the change in the way in which resource budgeting figures were recorded for spending review 2000, and by the way in which public corporation spending was recorded in spending review 2002, when there was another change. The issue arises of how that transition is handled, which means, in effect, that Scottish Water does not need to get that £100 million EYF back, because in the year in question the £100 million referred to capital expenditure, whereas in the budget we now score the lending of the Executive to Scottish Water, or the borrowing of Scottish Water from us.

Ms Alexander: I will have one more attempt at resolving the issue, before I turn to the wider corporate governance issue.

Andrew Scott: It is prudent for the Executive to lend Scottish Water £600 million, and that is what we are going to lend it. If Scottish Water does not make its efficiency targets—on either operating costs or capital expenditure—we will have to lend it more money, if we do not put prices up and if we keep the revenue caps. Between £600 million and £900 million there is a big buffer. Ministers can alter the size of that buffer according to other priorities, but they have said that they will provide the £600 million with full EYF. That is why customers are not being short changed. Do not forget that customers are allowed to keep any additional surplus that Scottish Water makes above plan. That goes straight back into the water industry.

Ms Alexander: That is helpful. Let me try to simplify for myself and, no doubt, for others. Will the full proceeds of EYF—the £188 million and the £148 million—be available to Scottish Water to spend without further reference to the Executive between now and 2006, so long as it does not breach the £600 million limit? Are the full proceeds available to Scottish Water within the cap of £600 million?

Andrew Scott: Yes. In so far as the £188 million and £148 million are part of padding, and as long as the £600 million is not breached, the answer is yes.

Ms Alexander: That is helpful clarification.

I turn to the wider policy question, and return to the point about transparency. If our expert adviser is unaware of the arrangement that I described earlier, how can we ensure that the corporate governance relationship between Scottish Water and the Executive is transparent? Scottish Water undoubtedly has incredibly difficult decisions to make in the period ahead. It will be difficult for Scottish Water to take customers with it and to win a commitment to higher levels of investment funded through charges. Given that context, it is not optimal in terms of corporate governance relationships, or in terms of the relationship that the Executive is—rightly in my view—trying to build with Scottish Water as an arm's length body, for Scottish Water to have fewer degrees of freedom than the average local authority in terms of its ability to accumulate surpluses beyond a forecast horizon of two years.

Scottish Water has fewer degrees of freedom than an average local authority. Within the next month, it will set charges that will pertain for the period 2004-05 while being unaware of the arrangements that will pertain post-2006. That is not compatible with the sort of governance relationship that we are trying to establish. How do we get a clean, long-term corporate governance relationship around the ring fencing of moneys, so that moneys that are raised for water are used for water?

Andrew Scott: First, the planning horizon is four years, not two; that is the length of the regulatory period. End-year funding is available between all of the four years and Scottish Water can use its borrowing allowances in that period.

We allow Scottish Water great freedom in the way in which it makes its decisions, but we do not allow it much freedom in relation to the requirement that it hit its targets. That is because the capital expenditure efficiency targets and operating efficiency targets will have a big impact on prices from 2006 onwards. If we want to keep prices low and ensure that customers get a good deal, we have to make the industry efficient. That is the purpose of our policy.

Ms Alexander: I am not against efficiency and I will not have my position characterised in that way. I am simply saying that, as of next year, people will have no guarantee that the water charges that they are paying will be invested in water, or whether the EYF arrangement means that the money will be clawed back and there will be an as-yet unknown borrowing arrangement. That would be a continuing source of anxiety among payers—

Andrew Scott: You are talking about the situation from 2006 onwards.

Ms Alexander: The planning horizon is four years initially but, as we have shown, we are already close to that. I simply point out—this is a matter for the minister—that I do not think that our justified commitment to efficiency is incompatible with securing a corporate governance arrangement that gives some certainty that money that is raised through water charges will be used to pay for water services in the long term.

Andrew Scott: I understand.

The Convener: We can take that issue further at another point, because I think that it is relevant to the Minister for Finance and Public Services.

I am anxious to get the minister into the discussion, but I said to Fergus Ewing that he could ask a technical question.

Fergus Ewing: I have a simple question. Can Scottish Water borrow more cheaply?

Andrew Scott: More cheaply than a private utility?

The Convener: More cheaply than it does at the moment.

Andrew Scott: The Government offers quite competitive rates in comparison with any other form of finance.

Fergus Ewing: So it could borrow more cheaply.

Andrew Scott: It borrows very cheaply at the moment.

Fergus Ewing: But it could be cheaper.

Andrew Scott: It borrows as cheaply as the Government can enable it to, and the Government is a very cheap lender.

Fergus Ewing: So there is no possibility that Scottish Water's borrowing—past, present or future—could be cheaper.

Andrew Scott: Not on the present basis, no.

Dr Murray: I have a technical question as well. Although I, too, would like to see the figures in writing, I found some of the verbal information quite useful. However, I became confused towards the end with regard to the £188 million and the £148 million that were returned through EYF. Is that money from unused borrowing consents or is it income generated by revenue that is not used because of efficiency savings that result from reorganisation?

Andrew Scott: The money is unused borrowing consents.

Dr Murray: How does that reconcile with Scottish Water's statement that the money is the result of efficiency savings? I would have thought that any efficiency savings that were made as a result of a more streamlined structure would be part of Scottish Water's operating costs, funded by revenue. If 88 per cent of Scottish Water's funding comes from charges, surely that is being paid for by the water charge payer and not by borrowing consents that have not been used.

Andrew Scott: As ever, it depends on the precise context in which words are used.

When the statement was made about adjusting the water line in the budget to take account of greater efficiencies, it was made in the context of the efficiencies that were set by the strategic review and the expectations that were placed on Scottish Water with regard to the resources that it would consume. Scottish Water had not yet made the efficiencies, but it was going to have to make them as a result of the strategic review. What was being adjusted was the margin of error that ministers would have if Scottish Water could not subsequently make those efficiencies. Money from customers has not gone into EYF.

Jim Mather: I have another technical question relating to the £610 million borrowing limit from the Scottish Executive.

Andrew Scott: It is an additional borrowing limit.

Jim Mather: When was the limit intimated to Scottish Water and what is the reconciliation of the £610 million over the separate fiscal years?

11:00

Andrew Scott: The reconciliation will depend on the way in which Scottish Water draws down the borrowing, and it has discretion to do that according to when it thinks it can get the best price for delivering its capital programme. On the question of when the limit was intimated to Scottish Water, we raised the limit this summer by about £100 million to take account of the fact that the price of capital goods had risen more steeply than was anticipated at the time of the strategic review.

Jim Mather: The strategic review states a total of £293 million during the four years—that is, from 2002-03 until 2005-06. If that figure is raised by £100 million, the total is £393 million, not £610 million.

Andrew Scott: That is right. We have been lending Scottish Water more than the amount that was suggested in the strategic review for the first period.

Jim Mather: But the amount is considerably less than was suggested in the Scottish Executive data.

Andrew Scott: It is considerably less than the public expenditure maxima that you have derived from the Scottish Executive data. The difference is the margin between what can be achieved if one hits the targets and the buffer if one does not.

Jim Mather: So we have an amalgam of prudence—the prudence of replacing assets that have been neglected for years; of replacement from charges, including assets above ground; of low borrowing compared with what is feasible in an era of low interest rates, as we have just identified; and of a capital underspend that has generated high charges that the consumers still live with.

Andrew Scott: The capital underspend has not generated the high charges; the revenue cap was fixed from the outset. All that varies is the proportion of capital that is being delivered that comes from revenue. At the moment, the proportion is high because Scottish Water is drawing down a relatively small amount of borrowing each month. As its capital programme increases above the original profile to reach £1.8 billion, the proportion of capital that comes from revenue will fall substantially. If Scottish Water hits its targets, the plan is that will we will reach a point at which there is a split of two thirds and one third.

The Convener: I suggest that we stop there and invite the minister to join the meeting; we are half an hour behind schedule. I understand that three of the four officials are staying with us for the next part of the meeting.

I welcome Allan Wilson, acting Minister for Environment and Rural Development, to the committee. As I indicated earlier, members should have a copy of a short briefing that has been sent by Scottish Water and a note from the Scottish Executive on ministerial powers of direction. Those papers were e-mailed yesterday and they have been tabled today. Members also have a copy of a response to a written parliamentary question on the level of water charges for 2004-05, which was published today.

We will take an opening statement from the minister and then there will be an opportunity for members to ask questions.

The Deputy Minister for Environment and Rural Development (Allan Wilson): I should perhaps point out at the outset that I remain the Deputy Minister for Environment and Rural Development. Mr Finnie remains the minister, albeit that he is indisposed, and I am deputising for him. That is a technical but nonetheless important point. Basically, it means that I do the extra work without getting any extra pay. As someone who formerly worked in local government, the convener will be familiar with that concept.

Anyway, thanks for inviting me along today. I am glad to have the opportunity to answer your questions—at least, I will do so as best I can, given the complex nature of what you have been discussing. I did not catch all your discussions, but I caught the tail end.

I suspect that it will be self-evident that we have set Scottish Water a formidable task in delivering a very large capital investment programme—that is what my notes say, but "massive" would be a better term to use—at the same time as becoming much more efficient. Scottish Water has achieved much in its first year since the previous three organisations were merged into a Scotland-wide service, and its operations have become 10 per cent more efficient over that period. That is evidence that we are on the right road.

The convener referred to a parliamentary question on the announcement of water charges that I answered today. I apologise for the short notice. All things being equal, I would have preferred to answer it on Friday, but that proved not to be the case. My answer is now in the public domain and I am happy to answer any questions that the committee may have on that or on any other aspect of the debate that you have had with colleagues.

The Convener: Thanks very much, minister.

Fergus Ewing: On a point of order, convener. An announcement about water charges is a decision that is of such obvious importance that it should surely have been made in the form of a statement to Parliament, so that not only members of the committee but all members who have a considerable interest in this controversial topic would have had the opportunity to ask questions of the minister. I regret the fact that the announcement has been made in response to a written question, although I note the fact that the minister has said that he will answer our questions. One obvious reflection is that we are in the middle of an inquiry into these matters, and the minister's decision on them has pre-empted and perhaps usurped the function of the work that we are doing.

Allan Wilson: I do not believe that I have broken any parliamentary protocol. I believe that I am following customary practice. I was conscious of the fact that I was going to attend this meeting. I would much prefer to be in this position than in the position of not having made the announcement, then being accused of being duplicitous after the event. I took steps to ensure—albeit belatedly—that my announcement was in the public domain prior to this meeting because I did not wish to incur the committee's wrath, as I would have done if it had been made public immediately after I had left the committee meeting.

The Convener: That, at least, is welcome. The committee also welcomes the decision to consult on the principles of charging as recommended by the water customer consultation panels. Several witnesses have raised that issue with the committee. A debate not just about charges but about the principles that underpin the way in which charges should be levied is overdue. Is it your intention that that consultation on the principles of charging will be timed in such a way as to feed into the whole quality and standards III exercise, which is the subject of consultation at the same time?

Allan Wilson: The short answer is yes. The two things are separate but connected. The extensive discussions on quality and standards III that we will have with the parties involved and the wide-ranging public consultation that we have announced today will dovetail with the strategic review that will take place coincidentally. The consultation on Q and S III is about deciding how different groups of customers can contribute fairly to meeting Scottish Water's costs. The purpose of the strategic review is to identify the lowest possible cost at which Scottish Water can realistically meet its targets, including—critically—the Q and S III targets.

The Convener: I have a further comment before I bring in members. One problem, of which members have been apprised, is that people have difficulty in understanding the decisions that have been made. People feel that there is a lack of transparency, which means that unless they have detailed expert knowledge they cannot understand how ministers and the WIC have arrived at decisions. Given that perception, is it your intention that not only the result of your consultation on the principles of charging but future decisions about borrowing and charging issues and the water industry's investment programme will be made available to the public in a more comprehensible way? That would mean that, with a reasonable amount of intelligence and a decent amount of effort, people could understand the system, as opposed to the present situation, in which it seems that even the experts often find it difficult to understand the figures and the decisions that are eventually arrived at.

Allan Wilson: I sympathise entirely with your objective. I came in at the tail-end of Wendy Alexander's contribution and I was struck by the telling need for more effective communication with the general public as well as with stakeholders on strategic investment decisions and how they affect customer charges at the bottom line, which is ultimately what concerns people most. I hope that you will agree that the consultation that I announced today on the principles that underpin the quality and standards III exercise will go some way towards meeting the public's concerns.

As somebody who personally has had to go through a steep learning curve in the past four weeks on the matter, I sympathise with anybody who is trying to come to terms with the difficult issues that are involved. Therefore, I undertake to do anything that I can to make the process simpler and easier to understand. If you do not mind my saying so, I believe that your own inquiry adds value to the process and I will look upon your deliberations and findings with extreme interest.

The Convener: I have probably foreshadowed one of them.

Jeremy Purvis (Tweeddale, Ettrick and Lauderdale) (LD): I want to touch on the Executive's answer to our queries and the wider issue of consultation accountability. I am afraid that I missed Andrew Scott's earlier presentation on the Cuthberts' paper, but I will read the *Official Report* of today's meeting with interest. The committee chose not to convene a meeting between the Cuthberts and Scottish Executive officials and Scottish Water and chose instead to have the Cuthberts provide evidence to the committee. That was not my choice, but that of the committee. You cannot be particularly happy with how the process has been handled: a serious paper is in the public domain and there has not been an adequate response that we can all understand. I am not sure what the way forward is. There are now two sides, each of which is claiming that the other is wrong. What do you propose as the way forward?

11:15

Allan Wilson: As I just said to the convener, I will await the outcome of the committee's deliberations with interest because the committee is probably in a better position than most to judge the accuracy or, dare I say, inaccuracy of some of the submissions that have been made to it. As I said, the controversy started during Mr Finnie's period of tenure and has continued into mine.

During the past three weeks, I have sought explanations about the charges that have been levelled at various parties. I have also sought assurances that the advice that Mr Finnie received accurately reflected the position, and I am satisfied that that was the case. Obviously, if the committee comes to a different conclusion or requires further evidence to help it to reach a conclusion, I would be happy to assist.

The fact that some of the debate has been conducted in the columns of national newspapers does not help us to get to the bottom of the issue, but that is just a personal opinion.

Jeremy Purvis: A letter from the minister to the newspapers contributed to that debate. The process of trying to get to the bottom of what is a serious issue has not been very constructive.

Allan Wilson: From our perspective—and from anybody's perspective—if letters or articles that contain facts that the Executive considers to be less than accurate are published in newspapers, we are under a public obligation to draw that to the attention of the relevant publications and the wider public who might read them. That accounts for our response.

Jeremy Purvis: The answer that has been published today to parliamentary question S2W-5936 contains welcome news for the many constituents who fall into the categories that will benefit from the low-user tariff and the reduction scheme. However, it also raises issues about how such decisions are made, about the processes that operate between the WIC and Scottish Water and about how public their discussions are. Ministers have been put in a position in which they finally had to decide on the matter. Was there a deadline for making that decision, after—I presume—the commissioner or Scottish Water informed you that they had not reached an agreement?

Allan Wilson: There was no deadline per se, but we are obviously required to work to a timetable that meets local authority billing stipulations. That deadline was the end of last month, although in the event it took slightly longer to reach agreement and the decision was delayed by a couple of days. We had to ensure that sufficient time was allowed for local authorities to set up their billing arrangements, to ensure that consumers could be billed with the new charges.

Jeremy Purvis: I want to come back in a moment to the quality of the advice that you receive.

I assume from the answer to the parliamentary question that you have overruled the commissioner. We have received both written and oral evidence from the commissioner, and today's announcement does not seem to fit with his philosophy.

Allan Wilson: As I was at pains to point out when I was asked such questions in relation to last year's charges, in the first instance it is for the company—Scottish Water—and the water industry commissioner annually to agree a scheme of charges. Only in the event that they fail to come to an agreement are the Scottish ministers called on to determine either the overall scheme of charges or an individual charge element. The division of responsibility between the parties is quite clear and the Scottish ministers become involved only if the commissioner and the company fail to agree. I suppose that, by definition, if there is a failure to agree, the Executive will ultimately favour one party over the other when it comes to make its decision.

Jeremy Purvis: Why did you come to that decision?

Allan Wilson: It was a finely balanced judgement. There were competing arguments from the parties and I fully understood the commissioner's overriding interest in relation to the protection of the consumer. I also recognised Scottish Water's considerations and concerns relating to its customer base. Furthermore, we must have regard to representations that we receive from external parties. Few MSPs have not received representations in the past 12 months on charging, the division of charges between large and small business customers and between domestic customers and business customers and the relationship between the charging regime and the company's borrowing requirements. All those factors compete.

We concluded that introducing the low-user business tariff, allied to a below-inflation increase for all commercial premises—large or small—would be the optimum way forward and would help to redress criticisms from the small business sector in particular. Small businesses with only a single toilet and a washhand basin thought that they were being charged too much. We must take account of the fact that, in respect of the infrastructure, 70 per cent of such charges are fixed. We had discretion over what is a small amount of money in relation to the totality of the charging regime and, on balance, we came down in favour of low-user business charges.

Jeremy Purvis: Is there scope for having a more public debate about the discussions between the commissioner and Scottish Water, or at least a clearer understanding in the public domain of the decision-making process that you have outlined? What you have said is interesting, but we are hearing about a decision after it has been made.

Indeed, a twofold repudiation of the commissioner's principles is implicit in the answer that we are considering. First, there should, in effect, be uniformity. Secondly, you want to go back to the drawing board and have a full consultation, which I am sure many people would welcome. However, if you are 100 per cent content with the advice that has been provided by the commissioner, you would not want such a wholesale review.

Allan Wilson: You raise a number of issues. Obviously, we set the company's strategic direction in relation to the revenue cap and so on, and we set the strategic remit for the commissioner's review of charges. We set very high targets for Scottish Water on drinking water quality, environmental standards and bathing water quality, for example, and in the light of the commissioner's advice, we consider the total resources that are available to Scottish Water. The principle of cost reflectivity adheres to all those considerations.

On the transparency of the process, this year's circumstances are unusual. I think that what has happened has happened once before in the past eight years, which makes it difficult for ministers to be the arbiter. I am considering the matter in another context and am not sure whether we are proceeding in the optimum way.

Jeremy Purvis: The quality of information that you receive from the commissioner is dependent on an individual with strong views and—he would say—strong principles, which can be slightly chipped away when agreements cannot be reached.

As well as reviewing the role of ministers in making such decisions, do you have any scope for reviewing the structure of the office of the water industry commissioner, such as looking south of the border where commissioners' offices have a more corporate structure? Such bodies take a wider view and are not structured in a way that puts ministers in an invidious position.

Allan Wilson: I have already explained ministers' powers of direction over the water industry and the commissioner. On the question whether we would consider a body corporate for the commissioner's office or some other means of addressing issues of wider public accountability, the answer would be yes. Indeed, I was partly referring to that when I said that I was not wholly satisfied with the current system of arbitrary determination by ministers following the parties' disagreement over strategic charges. However, I have to say that that is only one part of the matter.

Jeremy Purvis: When do you expect to reach a conclusion? Do you intend to include that matter in the consultation?

Allan Wilson: I hope that we will reach a conclusion shortly. It might be opportune to deliberate on the matter after the committee publishes its report, because I do not want to pre-empt the outcome of that. After all, I obviously want to consider any view that the committee expresses on the matters at hand. That said, I have very strong views about where we should be going on the issue.

The Convener: We are keen to publish an early report so that we can feed it into the quality and standards III exercise.

Fergus Ewing: Perhaps I can offer you a few simpler questions on the same theme, minister.

The Convener: I hope that it will be a few.

Fergus Ewing: As Scottish Water and the water industry commissioner have failed to reach an agreement, the statutory process for setting charges has also failed. Such an event is hugely significant. The minister has stepped in and the Scottish Executive has basically taken over the functions of Scottish Water and WIC.

I suspect that the committee does not have a great deal of confidence in the water industry commissioner; indeed, there is a great deal of concern about his proposals, which I believe were conveyed to Scottish Water a few months ago. Will the minister make public those proposals, which he has explicitly criticised, in the public interest that the WIC should be seen to be accountable for what he proposes, or will they be kept secret?

Allan Wilson: Yes.

Fergus Ewing: So they will be kept secret.

Allan Wilson: No—that is not the question that you asked. I see no reason why the proposals cannot be made public.

Fergus Ewing: I very much welcome that response, minister. We are making progress.

Do you agree that stepping in and taking the decisions that you have announced today amounts to a vote of no confidence in the current water industry commissioner?

Allan Wilson: No, that would be unfair. That is not what I said and no one should take that view from what has been said. The parties failed to agree on what I have already said was a very small sum of money in comparison with the totality of the regime. However, the matter required a ministerial decision and I have taken a decision that I think is in the best interests of all stakeholders. I found that difficult to do, because of the very fine balance involving representations from the commissioner, the company, the committee and the small and large business communities. It is not easy to square all those circles and I think that we need to re-examine how to improve the process. Although I do not want to pre-empt the committee's report, I will say that we might be able to make such improvements by introducing a greater element of accountability or ensuring that there is greater professionalism in the decisions that are taken.

11:30

Fergus Ewing: Are you satisfied that the approximately £2 million that is spent on the Office of the Water Industry Commissioner could not be saved simply by the Executive taking over the responsibility and decision-making powers? In any event, the Executive has now done that, thus rendering the WIC's role somewhat superfluous. Are you aware that the WIC, in his evidence to the committee, gave information about borrowings of water companies in England that he said was key to his decisions about the level of prudent borrowings, whereas that information was factually incorrect?

Allan Wilson: Obviously, we would be concerned if there were factual inaccuracies in the information flow between the parties, but the matter would need to be pursued directly with the commissioner, as I believe that the committee is doing—and properly so, I hasten to add.

I think that you are being a bit unfair, if you do not mind my saying so, to the Office of the Water Industry Commissioner. The efficiency targets that the commissioner sets for the industry have saved the taxpayer hundreds of millions of pounds and potentially significant sums in revenue charges. That is an important element of independent arbitration that should not be discarded quite as easily as you perhaps suggest.

I am not saying that the system could not be improved—in fact, I am saying that it could be—but that is different from saying that we should simply discard the independent advice on targets and efficiencies that has been made in the interests of the consumer. That would be a retrograde step.

Dr Murray: I preface my remarks by welcoming the answer to the parliamentary question. In particular, I welcome the continuation of the reduction scheme, which many of us were lobbied about, and the continuation of the low-user tariff. Obviously, we do not know how much the reduction scheme will benefit small businesses that have only a kettle and a toilet, but the fact that their representations have been taken on board is welcome. When we questioned the water industry commissioner, he did not seem to have much sympathy for those small businesses, so I am pleased that ministers seem to have recognised the genuine concerns.

Do you recall meeting me and representatives from Dumfries and Galloway Council back in 2002, when we discussed development constraints that had been caused by sewerage problems in Dumfries and Galloway, in areas such as Langholm, Canonbie and Dumfries? Those constraints caused genuine problems for the development of settlements in those areas. At that time, you said that you had similar problems in your constituency. Are you also concerned, therefore, that Scottish Water's accounts for 2002-03 show that it borrowed only £51 million, rather than the £150 million that the strategic review suggested as the amount that Scottish Water could borrow in that year?

Allan Wilson: By and large, I share your concern, as will most members who represent constituencies in which development constraints are a problem. Indeed, Fergus Ewing and I discussed the matter only last week.

The quality and standards II programme contained circa £200 million, to which £40 million or thereabouts has been added in the interim, to address development constraints. In the short period for which I have had responsibility for the matter, it has been clear to me that, under Q and S III, the prospective bill for removing development constraints and renewing and replacing Victorian infrastructure will be considerable—hence the commitment to consult on Q and S III and on how those constraints might best be tackled in the next investment period.

That is an important commitment. I expect that all stakeholders and other parties, including the committee and other MSPs, will want to make a valuable input into that process. That gets to the heart of those development issues across the country, which in my opinion were not properly addressed in Q and S II. We can address those development constraints in 2006-10. I have announced a consultation sufficiently well in advance of that period to enable everybody to make a contribution, not simply about what is necessary but, critically, about how it could be paid for. I know that the committee will welcome that.

Dr Murray: Although I accept what the Executive officials told us, which was that borrowing consent can be carried over to future years and that the investment can be made later, the problem is that there is currently development constraint on many communities.

Allan Wilson: That is the argument about front loading versus back loading. We had a three-hour meeting with Scottish Water a couple of weeks ago in which I sought assurances that it would be able to deliver on the capital consents that we are granting to it for future investment, as opposed to funding for depreciation and routine maintenance.

There is another constraint. The industry and I are conscious of the capacity of our civil engineering industry to deliver on this massive and unprecedented public investment, born, dare I say it, of the prudence of the Government. There is an obvious capacity question. If demand outstrips the capability of the civil engineering industry to deliver, inflation will be added to the costs of delivering infrastructural improvement. That would constitute bad value for money for the public purse. It is clear to me from discussions with the industry and others that, whether or not one believes in the prudential approach, value-for-money limits are imposed by the capacity of our civil engineering industry to deliver infrastructural improvement, as well as timescale limits. Those are serious considerations because we do not want inflation to enter into the equation, although one might argue that it has already done so.

Dr Murray: We have seen examples of that fairly close at hand. I accept that as a valid point.

Allan Wilson: Absolutely. Most constituency members will have seen that situation in relation to individual programmes and developments in their areas. I think that I am correct in saying that Scottish Water currently accounts for something like 50 per cent of total civil engineering investment in the country—at least it will do over the period of the programme.

Dr Murray: We also heard that two thirds of current investment is from revenue and one third is from borrowing, because two thirds is necessary to stop the deterioration of the system. Perhaps this is more of a technical question than a political one, but is it a reflection of the lack of investment in Scottish Water that we are at the stage where our infrastructure is so poor that we have to spend two thirds of our investment on keeping it going? I presume that the ultimate intention is to bring the infrastructure up to such a standard that more of the investment from borrowing will go into enhancement rather than just keeping things going. Are we way behind what is happening in England and Wales and is that the explanation for the increase in borrowing from one third to 77 per cent?

Andrew Scott: If one has a lot of assets, one has to spend a lot of money to keep them going. Table 14 on page 9 of the commissioner's strategic review demonstrates the way in which assets in Scotland compare with assets in England and Wales. You will discover that we have a lot of assets that are in very poor condition. Those assets are in condition 4 and 5, which means that they are within 10 to 15 years of the end of their life.

If members remember, when Jon Hargreaves, the chief executive of Scottish Water, attended the committee's meeting on 2 December, he said that for the foreseeable future—the next 10 years, at least—we would have to spend more than £300 million a year simply on keeping the system going. There are many assets and we are gradually improving our knowledge of where they are and how they perform, as well as developing more sophisticated measures of what it takes to keep them going. The figure will be large for the foreseeable future.

Allan Wilson: There are two ways of investing. As well as dealing with depreciation and the need to maintain the capital value of existing and new assets, one can invest in new assets in such a manner as to reduce subsequent revenue charges. That important consideration is tied to the capacity issue, which I mentioned earlier.

Jim Mather: For the record, I would like to say that we did not preclude a meeting between the Cuthberts and officials. We agreed to take evidence from the Cuthberts on the first pass and to wait for a proper arithmetic response from officials, which has not yet been forthcoming.

Today, we have had what I consider to be an inadequate rebuttal of the double-counting allegation. There has been some new news that new above-ground assets are now included in repairs and renewals cash depreciation, which deviates from what we have been told by Douglas Millican. We are told that surpluses can and should be portrayed as a benefit to consumers and have been given the assertion that the Scottish Executive could have clawed back unused borrowing, which seems unbelievable to me. We also have evidence that there is a major deviation between the borrowing for asset replacement of Ofwat water companies and what is happening here in Scotland.

I put to you the proposition that courtesy, the materiality of the Cuthberts' questions and their implications for water users demand a much fuller, more open arithmetic reconciliation by way of reply.

Allan Wilson: I am happy to assure you that, if there are any outstanding questions about which you or any other member of the committee remains dissatisfied, we will endeavour to provide—in writing—whatever additional information is required to answer those questions. It is a moot point whether that will resolve the disagreement between the parties, but I certainly assure you that if you or your colleagues have any outstanding questions for me, my officials or, indeed, any official, we will endeavour to answer them. I suspect that it will then be for the committee to determine, on the basis of the evidence that has been submitted to it, which accounts in the parties' submissions are accurate.

The Convener: We will need to read over the information that we have been given today in the *Official Report* and, if there are outstanding issues that require clarification, I presume that members can work with me to produce an appropriate letter to you.

Jim Mather: I want to go back to first principles. Surely it was the borrowing that the water industry commissioner specified for the period 2002-03 to 2005-06 that dictated the charges.

Allan Wilson: The requirement to maintain existing assets and to deal with depreciation of those assets would dictate the level of charges. The golden rule here is that one would borrow only to invest in new assets, not to pay for depreciation or maintenance of existing assets, because down that road would lie ruin. We would want to ensure that Scottish Water used whatever capital it wished to access to finance investment in much-needed new capital assets.

Jim Mather: The key point that I am making is that that was a key variable and that, if it was different, that would have had a knock-on effect on charges. We are getting to the nub of the issue. Do you accept that it is impossible to produce figures—it certainly appears that officials cannot do that—that reconcile the formula relating net borrowing and RAB expenditure that holds in the strategic review and the expenditure limits in the commissioning letter with the borrowing figures for the water industry that are published in the Scottish Executive's annual expenditure report?

11:45

Allan Wilson: I do not think that that is impossible to do, but it is difficult, given the changes in the accounting methodologies, which make things much more complex than they would otherwise be. There are a number of variables, not least the varying requirement on Scottish Water to draw down on its borrowing limits in order to finance its investment in new capital assets. Scottish Water has had to set up Scottish Water Solutions to secure improvements in its capital investment programme, as demanded of it by the water industry commissioner, and in addition to efficiency savings on the revenue side. That is not a particularly easy position to be in. When we also take into account inflation on the civil engineering side, which has been brought about by limitations in capacity there, it is all the more difficult.

I have a degree of sympathy with Scottish Water. When I challenged Scottish Water officials on precisely those points less than a month ago, they assured me that not only were the capital limits sufficient for their purpose, but that Scottish Water was confident of delivering—on time and on budget, and on the balance of its outstanding capital assets—the new investment that everybody here wants to be made.

The Convener: I think that Wendy Alexander wishes to raise a point of clarification.

Jim Mather: I have just one question that must be posed to follow on from that response. I recognise that there are changing circumstances, but surely, under devolution, it is only reasonable for there to be a rolling reconciliation that factors in those changes and that offers us an audit trail, such that this important industry is understood by more than just a handful of individuals—most of whom disagree with one another.

Allan Wilson: I have sympathy with that view. We are charged with ensuring value for money for the public purse. There are a number of variables in relation to that, which I have just mentioned. Following serious internal discussions, I am assured that we are doing everything that we can to ensure not only that the capital programme is delivered on time and on budget but that it delivers value for money for the taxpayer. If I were to achieve that, I would be doing my job. The finer details of accountancy law are better left to the accountants.

Ms Alexander: I have some sympathy with the idea of leaving the finer points of accountancy law to the accountants. As I hinted earlier, I think that there is a corporate governance issue for the Executive to consider. Since the establishment of Scottish Water, charges have risen sharply. Although they are needed to cover infrastructure and investment in the future, those sharply rising charges account for the public's anxiety. We have now established that very little of the money was spent on infrastructure in year or during the following year. Surpluses of £188 million and £148 million have been generated, and those are, appropriately, being rolled over so that they can be used at some point in the future. However, that applies only until 2006, so there will potentially be a rush to spend the money if nobody knows what is going to happen afterwards.

Those sums of £188 million and £148 million were described at the time as EYF; they were described in ministerial correspondence as being redistributed around other projects. The existence of the £600 million borrowing limit was not made clear in the strategy review. That is a recipe for public confusion. It does not mean that the fundamental choices are necessarily wrong, but it does mean that it is impossible for any interested member of the public to understand what is going on in what is a publicly held utility, or what the relationships are. With regard to corporate governance, we need to fix things for the future.

Allan Wilson: That is a self-evident truism, I suspect. I would not wish to comment much beyond that in what is a complex area. The one thing that the public would understand is that the sums of money remain the same over the period. How they are spent in the short term as opposed to the long term has not been transparent. Many people in Renfrew, my area, and throughout west-central Scotland will see the improvements that are being made in the infrastructure for the delivery of water supply and sewerage services in their area. There is tangible evidence of that programme of investment, which will be reflected in better water quality, is being reflected in better bathing water quality and ultimately will be reflected in greater efficiency in the delivery of service. I cannot possibly disagree that that is not immediately transparent.

The Convener: One of the points that Jim Cuthbert made with which I agreed was that there is a risk that the periodicity—moving from 2002-06 to perhaps 2006-07—creates tensions within the water industry, given the potential requirement to spend money before the period comes to an end and the interruption of the roll-over of the moneys to which Wendy Alexander referred. Can you give us any assurances about what happens at the end of the current period in relation to the roll-over of unspent moneys into the next period?

Allan Wilson: I made an oblique reference to that, but I shall be more specific. I raised that very point in my discussions with Scottish Water two or three weeks ago. I said that I would not consider it acceptable to reach the end of 2006 and be told that the capital sums were outstanding. Scottish Water told me that through Scottish Water Solutions it had confidence in its ability to deliver on the full programme of capital investment between now and then. Much of that capital investment is necessary in the short-to-medium term in order for us to meet our targets on improving water quality, which is vital to service delivery. Scottish Water tells me that it will deliver the capital investment programme within the timescale set out in the strategic review. Moneys that have not been utilised to date will be utilised between now and then. This is where some of the capacity issues originate. That is why we have to watch that we do not overstretch the civil engineering industry and introduce runaway inflation into the equation, as that gives bad value for money in return.

The Convener: I just want to probe that a bit further. I have asked Mr Finnie a number of parliamentary questions about Scottish Water Solutions.

Allan Wilson: One or two.

The Convener: I have to say that the answers that I have got have not been particularly revealing. I am unable to find a detailed statement about how Scottish Water Solutions will work and how it offers advantages over the previous system of procurement. Do you see that as a transparency issue for the Executive? If Scottish Water is making so much of that vehicle, there should be more information in the public domain about what it is, how it is going to work and how the system will be accountable.

Allan Wilson: We are talking about a delivery issue. Reference was made earlier to the requirement that we have imposed on Scottish Water to deliver within a restricted capital allocation as well as produce the revenue savings that we require over the same period. The company believes Scottish Water Solutions to be the optimum means for that. In conversations with me, representatives of Scottish Water have given me assurances that it will deliver on that capital programme. We are talking about issues that could influence civil engineering contracts for example. If there are unanswered questions or specific issues of detail around how it intends to deliver that that are appropriate to put in the public domain—given that we are talking about issues that could influence civil engineering contracts—I am happy to do that.

I have asked Scottish Water the relevant questions and received assurances. Scottish Water Solutions is the delivery mechanism that the company has established after a year-long review of its capital programme to deliver that programme between now and the end of the strategic review period. I cannot do more than that, other than to monitor the company closely between now and then to ensure that it is delivering its programme and to return to the committee if there were any hint that the programme would not be delivered.

The Convener: One of my abiding concerns is the differentiation between operational issues, which are for Scottish Water, and policy issues, which are for the Scottish Executive. Some major operational issues, such as the creation of Scottish Water Solutions, are inevitably conditioned by the policy environment in which the options are being considered and developed. Without breaching the commercial confidentiality of purely operational issues for Scottish Water Solutions, we can discuss why the mechanism is appropriate for progressing procurement.

Given the huge amounts of public money that the organisation is supposed to spend and the impact that the vehicle will have on charges and other matters that have political weight, we should have more information than we have. Another issue is the culture. Too much is wrapped up on a need-to-know basis. Perhaps all parties need to take a more transparent approach to the process.

Allan Wilson: I hear what you say. I repeat that I have asked the company in the recent past about some of the issues that you have raised and received the requisite assurances that Scottish Water Solutions will deliver on time and on budget and will give the taxpayer value for money on a massive programme of public investment in improving our water services infrastructure.

The Convener: We have a short period left for questions.

Jeremy Purvis: I am not sure whether the minister has seen the paper that Scottish Water submitted to the committee today, but paragraphs 7 and 8 of that briefing address the points that we have discussed. Paragraph 7 says:

> "Scottish Water has now secured through SWS both the capacity and the commercial rates to deliver the agreed programme efficiently",

but paragraph 8 says:

> "The main risks to the programme remain the ability to secure circa 500 planning permissions, 75 environmental impact assessments and purchases of the land required for construction of new assets. These factors together with unforeseen ground conditions and price escalation"—

you mentioned that—

> "are the main risks to any investment programme."

Have those risks been mapped and monetised? You say that you are keen to keep a close eye on the programme. How do we keep a close eye on the programme?

Allan Wilson: I have not seen the briefing to which you refer, but I included such considerations in the discussions that we had with the company comparatively recently. I know from experience that planning constraints have been a major factor in the slippage of the company's investment programme. Anybody who knows anything about the process knows that planning constraints—properly instituted to ensure that local people have a say in developments in their areas—inevitably result in delays to the capital programme.

That said, such has been the slippage that many of those planning considerations are being ironed out. In the ensuing two years, that will leave the way free for the capital investment to be made in accordance with planning decisions. Planning has been a consideration and will be in any public investment programme.

Jeremy Purvis: As this is a massive programme of investment for Scotland, have the risks been monetised?

Allan Wilson: Sorry—have they been what?

Jeremy Purvis: Have they been monetised?

The Convener: Have numbers been put next to the risks?

Jeremy Purvis: Any Executive transport infrastructure investment programme under the Scottish transport appraisal guidance process, for example, has quite a clear mapping of risks and the associated percentages and figures. Has any such mapping been carried out in this area, which is the biggest infrastructure programme of them all?

12:00

The Convener: I wonder whether it is worth seeking a written answer to that question, because it might be a matter of the extent to which you can supply us with information.

Allan Wilson: I assure committee members that we are cognisant of any problems that might ensue. I do not know whether matters have been documented precisely in the format that Jeremy Purvis highlighted, but we will find that out.

Fergus Ewing: Minister, are you satisfied that Scottish Water Solutions has been set up in a way that gives Scottish civil engineering companies a fair and level playing field and an opportunity to secure the business? In particular, are you satisfied that the works packages will be offered by Scottish Water Solutions in a way that is consistent with Scottish companies' capacity? In other words, will the specifications and size of the works packages be consistent with what Scottish companies are able to provide? After all, down the road at Holyrood, Scottish companies in effect were put out of the running because some of the works packages were so large that none of the companies could bid in their own right for one or two of them.

Allan Wilson: On inquiry, the requisite assurances have been sought and received from Scottish Water and from Scottish Water Solutions, as the delivery mechanism. Obviously, both comply with all relevant European Union procurement rules. Those rules apply equitably across the EU and make it impossible to discriminate against companies because of their nationality or indigenous base. However, I am aware of the point that the member has raised. We want to ensure that, as far as is possible within the rules, Scottish companies and their employees benefit from the massive expansion of public investment in the water and sewerage infrastructure. I know that the company is particularly concerned to ensure that that is the case. I have to say that the procurement rules in this case are different from those that applied to Holyrood, but that is another story.

Fergus Ewing: I was not going to mention that. [*Laughter.*] There is a first time for everything.

The minister has made repeated references to bathing water requirements. I understand that the impositions of the bathing water directive and legislation are absolutely horrendous in monetising terms. We have not had much discussion of this in the current inquiry, but from discussions with senior executives of Scottish Water, I gather that they are concerned that the legislation will impose huge burdens. Quite frankly, I wonder about the benefits that the directive will bring us, if it brings any at all. Can you provide a detailed statement of the financial implications of the legislation; any implications that it might have for Scottish Water's work programme; how much of its budget the legislation will cost; and some forward planning figures? Finally, do you think that the legislation will achieve much good?

Allan Wilson: That is a very good question and I will be pleased to lay out that information in writing for the committee. I—and the UK Government—share some of Fergus Ewing's concerns about the prospective outcome of European discussions on changes to the bathing water quality regime and about ensuring that any changes at the margins are not made at an inordinate cost to the public purse, which I think is Fergus Ewing's point. I assure him that the Scottish Executive via the United Kingdom Government is making the necessary representations along those lines and is pointing out not least that geographical, geological and climatic factors in the process impact differently in different parts of the EU. In any case, I welcome—and am happy to comply with—the suggestion that we should lay out that information in writing.

The Convener: It would also be useful to have an advance profile of the water services issues, which fall into the same category.

Allan Wilson: I am not sure whether we could monetise that.

The Convener: Those issues will arise in the next cycle, in the period of quality and standards III. It would be useful to get that information.

Allan Wilson: It is inherent in the consultation on quality and standards III that we will consider how the revised European Union directive on bathing water quality is liable to impact on the bill for infrastructure improvement.

Jim Mather: I am keen to return to the borrowing limits. When was the water industry commissioner's borrowing limit of £293 million, which was to run from 2002-03 to 2005-06, countermanded and changed to £610 million?

Andrew Scott: The agreement to allow borrowing of £600 million, which includes approximately an additional £100 million for capital inflation, was concluded in the summer of last year.

Jim Mather: Can you give me a date?

Andrew Scott: July.

Jim Mather: Why did the new level not extend to the Scottish Executive's original permitted level of borrowing of £913 million for 2002-03 to 2005-06, which has been documented?

Andrew Scott: It would not have been prudent to lend the company that much because we would have been subsidising its on-going business costs on a daily basis and customers would have had to bear the costs of the additional interest.

Jim Mather: That was in spite of the fact that the percentage of capital replacement and expenditure from revenue moved from 86 per cent to 68 per cent last year.

Andrew Scott: The proportion of capital spend that comes from revenue will fall during the period to the two thirds to one third split that I suggested. The figure is a moving average. We took account of the fact that we thought that capital inflation would be higher in the period than we had allowed for in the strategic review.

Jim Mather: My fundamental concern for the Executive and the Parliament is that, when the general public carries out a value-for-money audit, we will be in for a tough time. I see three components in value for money. One is having properly managed projects, but there are delays and there is a lot of dependence on the hope that the new consortium pulls through—we have heard the caveats and the questions about that. The second element is the proper use of financing options. It is clear to me that there has been no attempt to make full use of the permitted borrowing levels. The third component is the value that users perceive in charges. That has been conditioned by the excessively low borrowing level set by the water industry commissioner, over which is the unexpurgated spectre of the double counting of depreciation. How will that situation stand audit?

Allan Wilson: I did not hear all the earlier evidence, but it is my understanding that there was no double counting and that the process will stand audit. You pose a number of questions, but it is equally relevant to pose questions to you about why you think that loading future customers' charges with the interest from unnecessary debt would be in the interests of consumers. I do not believe that to be the case.

Jim Mather: In the absence of an arithmetic reconciliation, that spectre will continue to lurk over the issue, even though we were given a raft of news at the last minute, when we arrived at the meeting.

To answer your question, my suggestion is that the level of prudence—the level of burden that we are putting on the present generation—is excessive, given that assets have been neglected for a long period, that you now factor in above-ground assets and that the level of borrowing is palpably low.

Allan Wilson: I reiterate what I consider to be the golden rule—Scottish Water should borrow only to invest in new capital, not to pay for depreciation and maintenance of existing capital assets, which should be done from revenue. Otherwise, we put an undue burden on future generations to meet those costs, which would inevitably be reflected in charges.

Jim Mather: Do you understand how disconcerted we are? We interviewed Douglas Millican at length and heard him say that the only element of assets that would be replaced from revenue—

The Convener: To be fair, that was at an informal meeting. It was not a formal committee interview.

Jim Mather: So he only gives fulsome, accurate answers in formal sessions.

The Convener: I am just saying that we need to be fair to the people to whom we speak.

Ms Alexander: I have two questions. We have just heard that the agreement about raising the borrowing limit to £610 million was concluded in July this year. Was it made public and, if so, how?

Andrew Scott: No. It was simply an agreement between the company and the commissioner about what was reasonable in the circumstances, and the Executive was—

Ms Alexander: Why was it not made public, given that it involved doubling the borrowing of a public utility?

Andrew Scott: First, the agreement did not breach the public expenditure limit. That is one reason why it was not made public. Secondly, it did not double the borrowing requirement, but raised it from £500 million, which was the upper limit that the commissioner gave in the review, and included his margin to take account of the fact that another £100 million was being applied for capital goods inflation that was not thought to be present when the review was commissioned.

Ms Alexander: Is it usual financial practice not to make it public when we change borrowing limits for non-departmental public bodies or Executive agencies by a figure of that magnitude?

Andrew Scott: The difference with Scottish Water lies in the fact that it raises revenue from customers. Its charges are capped and it has to make enormous efficiencies of about £250 million in its operating costs and about £500 million in its capital budgets, so there is a margin of uncertainty about when those efficiencies will show up and how much they will be. There has to be a margin around the public finances that are reported to Parliament. In raising the borrowing limit to £600 million, we were simply making a judgment about that margin. We were not in danger of breaching the limit that Parliament set for the industry.

Ms Alexander: Is Scottish Water a non-departmental public body?

Andrew Scott: It is a public corporation.

Ms Alexander: Right. Are there any other public corporations in Scotland?

Allan Wilson: That relates to what I want to say to supplement Andrew Scott's remarks. Parliament chose to formulate this particular public sector model and, as we have said in the chamber, it is unique. In my view, it is not replicated anywhere else in the UK or, for that matter, in water service delivery anywhere else in the world.

Ms Alexander: Fair enough, but it seems that we have ended up with a public corporation, which may or may not be unique, whose financial arrangements are such that we do not make it public when we change its borrowing limits. I am not suggesting that there is a great mystery here, but it does not seem to me to be good financial practice to change by a nine-figure sum our relationship with a body—which we take great pains in other circumstances to suggest is an arms-length body—without inspiring a parliamentary question or writing a letter about it. That applies particularly if the change is not covered in, or supersedes, information in the strategic review that is meant to characterise a transparent relationship. I observe that in the hope that it will not happen again.

Allan Wilson: The observation is valid and, to a certain extent, goes back to our earlier discussion. The process whereby I arbitrate between the parties on the strategic review of charges is not, in my view, the best way to do that. The logic of what you say would introduce a third party into the process. That third party would probably be better positioned to come to conclusions than I am.

Ms Alexander: Can I ask one final question?

The Convener: Okay.

Ms Alexander: What period does the £600 million limit relate to?

Andrew Scott: It relates to the first regulatory period, which is the four-year period ending in 2005-06. That is the period of the strategic review of charges.

12:15

Ms Alexander: Was the EYF announcement of June 2002, in which £188 million was reallocated to other programmes publicly by ministerial letter, covered by the agreement on the £600 million? Were those resources covered by that arrangement and not lost to the industry?

Andrew Scott: No. The agreement on £600 million was concluded after that point, because it was reached in July.

Ms Alexander: That is a significant observation. You are saying that the agreement was reached in July, so it did not cover the period from 2002, which was when £188 million was reallocated to other programmes.

The Convener: Maybe you could give us a written explanation, not just of the £188 million—

Ms Alexander: But of the £148 million. The implication is that we are talking about a sum of something like £320 million that is not covered by the agreement and so has been lost to the industry—and so is properly described as EYF that has gone to other programmes, which is what we started trying to explore at the beginning of the meeting. I realise that we are at the end of a lengthy meeting, but it would be helpful to clarify in writing whether those sums, covering the first two years of the four-year strategic review, have been lost to the industry or not.

I am surprised that we are discovering that although we have an arrangement going forward, it does not cover the sums that were drawn to ministerial attention before, and that that coincides with a period of anxiety about rising charges and questions about whether the sums would go into water investment or be redirected elsewhere.

Allan Wilson: I am happy to give that assurance. It gets to the nub of the problem, which is for what purpose we use borrowing, and for what purpose that borrowing was used.

The Convener: We will try to clarify the issue in writing and perhaps have an exchange of correspondence.

John Swinburne: There has been talk of a 10 per cent increase in efficiency, value for money, how we cannot compete with Victorian civil engineering projects, and how we are 150 years behind what the Victorians could do. Then we come to the water commissioner being surplus to requirements. There is no point in having one if he does not have the muscle to get his point across and if he is just pushed to the side and people can do whatever they want to do.

We are talking away up in the air about figures, but let us get our feet on the ground for a minute or two. People on fixed incomes get their water rates bills through the post and every year the increase is greater than the cost-of-living increase that they get in their pension. The Labour Party is placing a further burden on people and dragging them from virtual poverty into absolute poverty. What is the world coming to when senior citizens in this country cannot be offered a concession? What they are made to pay should at least be capped.

Allan Wilson: I did that today. You may yet have to catch up with that, John.

John Swinburne: I will catch up with it.

Allan Wilson: I announced a continuation of the transitional relief scheme, which does precisely that. As a Labour politician and a minister, I am acutely conscious of the burdens that can be imposed on people on fixed incomes—such as pensioners and the unemployed—by increased water charges, hence my decision, which we announced today, to continue the transitional relief scheme. That will put something like £15 million extra into the system to alleviate the charge increase for all people on council tax benefit, among whom are the most severely pressed.

John Swinburne: I am not talking about the ones who already receive benefit; I am talking about the 25 per cent of pensioners—that is 250,000 people—who are just keeping their chins above water. They do not want charity. They want to be able to make ends meet, but more and more burdens are being thrust upon them. Those are the people I worry about.

Allan Wilson: As do I. I do not think that it is a question of charity. What we say is that where resources are available that we want to expend, they should be targeted at the most vulnerable groups of pensioners, to lift them out of poverty, as you suggest.

The Convener: On behalf of the committee, I thank the minister and his officials for attending today's fairly lengthy session. Clearly there will be further exchanges of correspondence to clarify issues, in particular any matters that arise from Andrew Scott's opening statement, which we will consider in detail.

Scottish Executive Relocation Policy

12:21

The Convener: The second item on the agenda is consideration of an approach paper from the clerks outlining proposals for developing into an inquiry the committee reporters' investigations into the Executive's relocation policy. Members will see from the final page of the paper that we need to discuss and agree on a number of issues. I invite members' comments on the broad thrust of the paper and questions on matters of detail.

Dr Murray: The paragraph on written evidence, which is on the second page of the paper, suggests that we might be able to make use of electronic questionnaires. What controls would be in place to ensure that the evidence that came in was accurate and not, perhaps, stacked up by people who wanted to make a particular point? Obviously, the views that we hear need to be properly representative, rather than skewed. Are there checks and balances that can be used to ensure that, for example, the same person does not submit several questionnaires?

On the paragraph on oral evidence to the committee, I notice that it has been suggested that we hear from the Scottish Trades Union Congress. It would certainly be worth while to take evidence from trade unions, but would the views of the Public and Commercial Services Union and Prospect, which represent the people who are involved in relocations, be more valuable to us than the views of the STUC, which has a much wider remit and might not be particularly involved in the matter?

The Deputy Minister for Finance and Public Services recently gave evidence to the committee on the issue, so if we intend to speak to him it might be better to do so towards the conclusion of the inquiry, rather than early on.

On the case studies, I have a presumption against overseas case studies. It does not show the Parliament in a good light to have MSPs swanning around the world on various wee junkets. However, a visit to Ireland might add some value to the inquiry. I note that it was suggested that that visit might take place over a couple of days in March, but I think that it would be better to organise the trip outwith the period of the Parliament's business. It would be difficult to co-ordinate such a visit with people's other parliamentary duties in March.

The Convener: Perhaps I can respond to the issues that you raise. The clerks are in discussion with information technology staff about the checks and balances, to ensure that the questionnaires offer an effective mechanism for gathering information.

You are quite right to say that we would need to hear oral evidence from the relevant trade unions, but I think that the correct protocol would be to approach the STUC and suggest that it might be useful if its delegation included people from the trade unions that have had direct experience of relocations.

In the normal course of events in an inquiry such as this one, we would invite the minister to give evidence at the end of the process, after we had developed our interim thoughts on the matter and were ready to test them out.

I envisaged that the inquiry's agenda would be based more on policy development than on scrutiny. One of my concerns is that insufficient thought might have been given to how to implement a relocation policy in a strategic way. The committee might play a role in contributing to that discussion, rather than passively—as it were—holding the Executive to account.

We might consider the Irish visit in that context. Looking to learn from somewhere else, rather than just from what we do here, is a valuable exercise. Rather than focus narrowly on relocation, we might, on a visit to Ireland, consider some of the economic planning issues that underpin the strategy in Ireland. That might be a useful exercise for us to undertake. Although I share your concerns about people disappearing off to anywhere, I wonder whether we ought to take more than two committee members to Ireland to look into the matter with a clear idea of what we want to get out of the visit.

Dr Murray: I am not denying the fact that, in this instance, value could be added by direct discussion with ministers, civil servants and others who have been involved. My only concern is the timing of the visit. Is March the best time for it, given that a lot of other parliamentary business will be going on? A recess is coming up in April—

The Convener: The assumption is that, if we went down the route of a visit to Ireland, we would schedule it in place of a committee meeting and adjust our committee business to suit that. The clerks say that we could do that. The projected date is 15 or 16 March. We feel that we can manage the committee's business around that.

Dr Murray: Committee members have other duties in the Parliament.

The Convener: Yes, that is right.

Ms Alexander: In keeping with our role as the Finance Committee, we should encourage people to undertake cost-benefit analyses of any area that they are looking at. In that respect, the Treasury has, in the recent pre-budget report, highlighted a commitment to using economic rationale for relocation in a United Kingdom context. It would be slightly unbalanced if our only evidence session were used to listen just to the interests of those who are affected—I do not think that the committee paper intends us to do that. Clearly, there is a bigger rationale behind why a certain policy might be pursued.

The Treasury has obviously done all the legwork on that. We could seek its advice about who has done the best work outwith the Treasury and invite that person or body not to be an independent adviser to the committee, but to come and testify. A piece of the testimony should be on the economic rationale for relocation decisions and how they are thought through. That is probably obtainable from the Treasury, which has been investigating the matter recently.

John Swinburne: We have to look at the whole principle of relocation. In theory, it looks perfect, but an organisation can try to relocate and find that 93 per cent of its employees in Edinburgh do not, for various reasons, want to go to Inverness. In Edinburgh, they might have two family incomes, whereas if they move up to Inverness they might have only one family income. The relocation is not just for the one person; the whole family may have to relocate and find new jobs. The issue has not been looked into deeply enough. I fear that natural wastage could creep in, because of the ham-fisted way in which the issue is being handled at present.

Fergus Ewing: I broadly welcome the paper. I am sorry that I missed the first part of the discussion. I wonder whether some of the information that is referred to in the section entitled "Scottish Case Studies" will be obtained by means of correspondence rather than oral evidence sessions. I thought that correspondence might be the way to go, as it would enable us to spread the net a bit wider.

I support Wendy Alexander's suggestion that we should consider the economic rationale. Perhaps we could invite a Treasury minister to come and explain that to us so that we will have the chance for an obstructive—

The Convener: Obstructive?

Fergus Ewing: That must have been a Freudian slip. I was testing whether everybody is awake. I meant to say that we could have a constructive session with our friends in the Treasury.

My final point is on rather a different matter. I support the reasoning behind the trip to Ireland. I hope to go on that trip and be constructive over there as well. In the light of Tavish Scott's remarks about the differing views of relocation there—I think that Fine Gael might be against it—we might, as a matter of courtesy, see whether we could get together with politicians from all the parties, including the main Opposition parties. We should not be seen to talk only to the Government party.

12:30

The Convener: I think that members were told about the expected visit to the Scottish Parliament by members of the Irish Parliament. Following that visit, members of the Finance Committee could make an exchange visit to the Irish Parliament. The visit of the Irish members might mean that we can do part of our work in Edinburgh. We should see the visits as a double opportunity to exchange views.

On Fergus Ewing's point about case studies, I think that what was envisaged was not an evidence session for each of the case studies but a visit from MSPs to each of the settings. The intention behind the visits is that they would allow members to see for themselves what had been happening.

Jeremy Purvis: I endorse that useful proposal. Instead of just calling for written evidence from staff who have been relocated—to Galashiels, for example—we should ask the agencies involved about any work has been done in that respect. I do not want to add an additional burden to staff in those agencies by asking them to fill in yet more forms if they have already undergone an exercise about their views on relocation.

I agree that it would be useful to hear from the Treasury. The minister also talked about the work that the Scottish Executive is undertaking to attract UK Government and European Union jobs into Scotland. Given that we want to look at policy formation, those would be useful elements of the call for written evidence.

The Convener: We can write to the Treasury to get preliminary information. After that, we can see how we take forward that element.

The Scottish Natural Heritage case involves the relocation of a non-departmental public body. Specific issues arise in that context. It might be useful to explore the issues with the trade unions when they give oral evidence. We need to look into the impact on people who do not have the rights that civil servants would have in the context of a relocation decision.

Jim Mather: I support what Jeremy Purvis said about UK job transfers. I suggest that a sensible connection could be made with Gordon Brown's announcement—I think that it was around last November—about the transfer of 20,000 civil service jobs out of London.

The Convener: Okay. I will go through the questions that are set out in paragraph 7 of the paper. I think that there is a general acceptance of the methodology and schedule that is outlined in the paper for the implementation of the inquiry. I also think that we have given the clerks adequate guidance about witnesses and the direction that we want to the inquiry to take.

We need to agree that, once we have completed the report, it will be given full publicity via press briefings in the normal way. We also need to agree that the three Scottish case studies will be undertaken as visits and that we will carry out one overseas case study. We need to decide how big an element the overseas case study should be.

Jeremy Purvis: If we are going to visit Falkirk and Galashiels, I do not think that we should shy away from visiting somewhere else just because it happens to be in another country. We should visit all the places on the same basis.

The Convener: If we go to Ireland, we will do more than we do when we go to Falkirk, to be honest. We shall try to make that a visit with a number of meetings over a two-day period, whereas I suspect that the visits to Galashiels and Falkirk might take two or three hours of members' time. Once we have decided on the scope of the Irish visit, we will need to seek agreement through the Conveners Group for that to go ahead. I would need to get a bid in, through the clerks, relatively quickly, so we should perhaps deal with those issues by correspondence. Those members who want to express an interest in being part of that delegation should do so at that point.

Finally, I suggest that we agree to conclude our consideration of petition PE670 by drawing the petitioners' attention to the committee's on-going work on relocation. I have written to Tavish Scott asking for more information, following receipt of a letter from PCS. I hope that, when we have that further information, we can complete the process.

Does the committee agree to allow up to two members to go on three separate Scottish case studies in March and two or more members to go on an additional Irish case study, also in March?

Members *indicated agreement.*

Budget Process 2004-05

12:37

The Convener: Agenda item 3 is consideration of the Executive's response to our report on stage 2 of the budget process 2004-05. Members will see that Arthur Midwinter is looking tanned on his return from Tenerife.

Members should have a copy of the Executive's response, together with a paper from the clerks and the Scottish Parliament information centre. Arthur Midwinter has supplied us with a supplementary briefing paper, which was e-mailed yesterday. Members will see that various issues have been picked up from the response, which we may want to discuss. In addition, as agreed at our meeting on 16 December, we need to decide on the format for our budget seminar, for which 27 April is the suggested date.

I offer Arthur Midwinter the opportunity to say a few words on his additional briefing paper or on anything else that he would like to highlight.

Professor Arthur Midwinter (Adviser): I should say a few words about the paper, because most members will have received it late on—I did not get home until the early hours of Saturday morning. I wish you all a belated happy new year and I thank the convener for mentioning Tenerife. I hasten to add that we had problems with the water, which may or may not have been due to slippage in Tenerife's capital programme.

I was heartened by the way in which the Executive responded to the committee's report. There are three groups of issues that we ought to consider. The first is fairly straightforward and concerns the issues on which the Executive accepts the committee's recommendations. I add the caveat—and on this I agree with Ross Burnside's paper—that we should continue to monitor whether the issues on which the Executive has accepted the committee's recommendations are delivered in a way that is acceptable to the committee.

The second set of issues relates to areas where the Executive says that it notes the committee's comments and wishes to improve its performance. I think that those are all issues where the Executive can improve performance, but we have to deal with them very quickly. If the committee is willing, those matters should be grouped together and tabled for discussion between officials on both sides to ensure that we are progressing them and having an input into deliberations on how information might be improved. We should not simply leave those matters to the Executive and come back to them later. I would like to have an early meeting with the Executive officials.

The third group of issues is more problematic, as I do not think that the Executive's responses are adequate. There has been a long-term difficulty with the block allocations, going back to the previous session. The Executive suggests that it may not necessarily produce those figures in the draft budget. That is fine, as long as it does not produce them after the draft budget, which has happened. The two relevant committees—the Health Committee and the Local Government and Transport Committee—should be able to discuss the block allocations while having the financial assumptions before them. A committee complained previously that it was being asked to approve the budget in a vacuum. Therefore, I would go back to the Executive on that point.

On the assessment of financial prospects, I read what the Executive says as being slightly less of a commitment to provide such information than we have had in the past. I think that the convener ought to reaffirm that the Executive committed itself to providing as full a financial assessment as it can, although it is clear from statements coming from the Chancellor of the Exchequer's residence that we can get useful ballpark figures for a preliminary discussion. Again, we should remind the Executive that it committed itself to providing a financial assessment around the beginning of the spending review process.

On the stage 1 spending recommendations, the committee asked for a corporate response so that it could be sure that all parties on the Executive side were signed up to the recommendations. We wanted a corporate record of what the outcomes would be so that committees could monitor what was happening. I am happy for the spending recommendations to be in a separate document. I also think that specific recommendations should be before subject committees separately, so that the committees can deal with them more easily.

Probably the most problematic area is the assessment of costs and service outputs. The Executive used the phrase "practical and helpful" in its response, which I do not think is practical and helpful because it is kind of meaningless. What is meant by "practical and helpful"? I would be astonished to find that there were programmes for which it was impossible to quantify the costs or the expected outputs. I cannot see why ministers should be approving expenditure programmes if they do not know the cost or what is expected for the money. I fully accept that measuring outcomes is much more problematic, but I think that we must have further discussion with the Executive on costs and outputs and clarify what the difficulties are.

On the budget seminar, I hope that there will be discussions next month between officials about where we moving to on the revisions to the budgetary process. If there are, some of the budget discussions will happen well before the committee's seminar.

I noted that, in the budget debate in December, the convener of the Equal Opportunities Committee, I think, rather kindly asked us to give guidance on how to equality proof the budget. I certainly do not feel competent to do that, so it might be helpful if we had a session on equality proofing, which is in danger of becoming a running sore in our negotiations with the Executive. People are unhappy about the progress that has been made. It might be useful to have a session in which people considered the practicalities.

The Convener: Are there any questions or comments from members?

Fergus Ewing: A comment and a suggestion about end-year flexibility arise from paragraph 3. The minister's response is:

"we think that the announcement on September 11 provided a clear explanation of the level of EYF".

Our briefing paper reminds us that the committee took the view that greater clarity in future EYF announcements was required. We have heard during the meeting, particularly from Wendy Alexander's probing questioning, about EYF in relation to the water industry and how difficult it is to obtain clarity. It struck me that the budget debate that took place this year immediately followed the EYF statement. However, in previous years, the EYF statement was made on the previous day, which meant that there was a proper opportunity for us to go away and consider the implications of what is, by definition, a complicated matter.

I wonder whether the committee might suggest to the Executive that—other crises permitting and provided that the Parliamentary Bureau can schedule it—discussions of EYF should, in future, be decoupled from the budget debate. Preparing to ask the minister questions about EYF and then having all the budget documents landing on your desk just as you are about to get to your feet to make a speech is not satisfactory. The previous arrangement at least gave us 24 hours and the opportunity to make a more considered and constructive contribution to what is undoubtedly a difficult topic. I have meant to make that suggestion before, but now seems to be a good occasion. I hope that other members feel that the suggestion is sensible and could be discussed with the Executive.

12:45

The Convener: The particular circumstances this year meant that the budget was produced much later than normal. We hope that those circumstances will not be repeated. The suggestion that the statement be taken in advance of the debate is perfectly reasonable. That arrangement would assist all members of the committee to contribute to discussions. I am happy to see whether we can get the Executive to adopt that practice, which is better than what happened this year.

Are members content that Ross Burnside's paper and Arthur Midwinter's suggestion of separating the issues into three broad areas represent a reasonable way in which to proceed? I will try to find ways of dealing with the points that Arthur Midwinter highlights in paragraph 5, with the aim of producing a draft committee response to the Executive.

Just before we leave this agenda item, we should discuss the seminar. Susan Duffy may want to say something about that.

Susan Duffy (Clerk): It would help with the organisation of the seminar if we could find out today what members feel would be the most suitable format and if we could get a feel for the number of attendees to expect.

Ms Alexander: We are midway through discussions with the Executive, so we should wait to see whether we can reach agreement before we try to give structure to a seminar whose feel will depend on the result of the discussions, which started last September. Big issues are outstanding on historic data and on performance data, as well as on the restructuring of the process. We should wait until the discussions are complete, which will, I hope, happen in the next month or so.

The Convener: That is a reasonable suggestion. I suggest that we have a kind of seminar sub-committee—perhaps including Wendy Alexander, Jim Mather and me—to thrash out the issues. Arthur Midwinter could join us, too. We should determine which issues we want to bring out and then come back to the committee with a firmer proposal. Are members content with that suggestion?

Members *indicated agreement*.

The Convener: Agenda items 4 and 5 are the consideration of draft reports on the Antisocial Behaviour etc (Scotland) Bill and the Local Governance (Scotland) Bill. We have already agreed that those two items will be taken in private.

12:49

Meeting continued in private until 12:58.

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