

AUDIT COMMITTEE

Wednesday 10 December 2008

Session 3

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AUDIT COMMITTEE 18th Meeting 2008, Session 3

CONVENER

*Hugh Henry (Paisley South) (Lab)

DEPUTY CONVENER

*Murdo Fraser (Mid Scotland and Fife) (Con)

COMMITTEE MEMBERS

*Willie Coffey (Kilmarnock and Loudoun) (SNP)
*Cathie Craigie (Cumbernauld and Kilsyth) (Lab)
*George Foulkes (Lothians) (Lab)
*Stuart McMillan (West of Scotland) (SNP)
*Nicol Stephen (Aberdeen South) (LD)
Andrew Welsh (Angus) (SNP)

COMMITTEE SUBSTITUTES

Derek Brownlee (South of Scotland) (Con)
James Kelly (Glasgow Rutherglen) (Lab)
John Farquhar Munro (Ross, Skye and Inverness West) (LD)
*Sandra White (Glasgow) (SNP)

*attended

THE FOLLOWING ALSO ATTENDED:

Mr Robert Black (Auditor General for Scotland)
Angela Cullen (Audit Scotland)
Tanya Drury (Audit Scotland)
Nick Hex (Audit Scotland)
Barbara Hurst (Audit Scotland)

CLERK TO THE COMMITTEE

Tracey Reilly

SENIOR ASSISTANT CLERK

Joanna Hardy

ASSISTANT CLERK

Rebecca Lamb

LOCATION

Committee Room 3

Scottish Parliament

Audit Committee

Wednesday 10 December 2008

[THE CONVENER *opened the meeting at 09:30*]

Decision on Taking Business in Private

The Convener (Hugh Henry): Good morning, everyone, and welcome to the 18th meeting of the Audit Committee in 2008. I welcome members of the public and the press to the meeting, and Audit Scotland staff as well. I ask everyone to ensure that mobile phones and other electronic devices are switched off. We have apologies from Andrew Welsh. Sandra White is substituting for him—welcome, Sandra. Cathie Craigie will not join us until later because she is stuck in a traffic jam.

Agenda item 1 is to agree to take items 5, 6, 7 and 8 in private. Is that agreed?

Members *indicated agreement.*

Section 23 Reports

“The First ScotRail passenger rail franchise”

09:31

The Convener: Item 2 is a briefing from the Auditor General for Scotland on the report “The First ScotRail passenger rail franchise”.

Mr Robert Black (Auditor General for Scotland): Good morning, convener. My report on the First ScotRail passenger rail franchise was published on 28 November. It looks at Transport Scotland’s management of the franchise contract, including a review of the process for awarding the franchise extension. It also looks at First ScotRail’s performance.

The first point to make is that First ScotRail’s performance to date has been good overall and continues to improve in the items that really matter to people, which are punctuality of running, unscheduled changes to timetables, cancellations and quality of service generally. Secondly, Transport Scotland is generally managing the franchise contract effectively, and the performance measures it uses to assess First ScotRail are generally appropriate. However, there is some scope to improve. Finally, by extending the franchise, Transport Scotland has secured a guaranteed £73.1 million that will be used to reduce the Government subsidy or invested in rail services. Transport Scotland has also made some of the existing contract requirements more challenging for the operator. However, I found that some aspects of the governance arrangements for extending the franchise could have been better.

If I may, convener, I will go through some points briefly. On the background, as members will be aware, the current franchise was let in 2004 by the Strategic Rail Authority and the Strathclyde Passenger Transport Executive. That was before rail responsibilities were devolved to Scotland. Transport Scotland took over the management and monitoring of the franchise in January 2006. Because of that, my report does not cover the awarding of the original contract, which fell before the period when rail transport was devolved to the Scottish Parliament. The franchise contract was initially established as a seven-year term with an option to extend for a further three years. In April this year, the franchise was extended to November 2014. The size of the contract is considerable, with First ScotRail due to receive £2.5 billion in Government subsidy over the 10-year term.

I have divided the report into three parts. The first part looks at the management of the

franchise, the second examines the franchise extension and the third looks at the performance of First ScotRail itself. If I may, I will offer a few comments on the first part, which is about how Transport Scotland is managing the franchise contract and monitoring First ScotRail's performance. As part of the contract, Transport Scotland can financially reward or penalise First ScotRail in relation to its performance. Transport Scotland is effectively managing the core aspects of the contract. It reviews First ScotRail's performance, and the evidence is that it acts quickly to address poor performance and has clear escalation procedures to resolve issues and concerns.

However, I suggest that Transport Scotland could improve some aspects of its management of the franchise. First, passengers and the public—let us call them stakeholders—are not able to go to a single source of information on the contract and First ScotRail's performance.

Secondly, the current performance measures are generally effective, but they could be reviewed to align them more closely with the concerns of passengers and also with wider Government priorities. That could mean, for example, giving a higher priority to areas of low passenger satisfaction, such as toilet facilities on trains and how First ScotRail deals with delays when they occur, and the introduction of environmental outcome measures to reflect the Scottish Government's priority to reduce emissions.

Thirdly, although a number of transport stakeholders told Audit Scotland that Transport Scotland consults well on specific projects, they feel that it has not clarified with them its consultation arrangements.

The second part of my report deals with the arrangements for extending the contract. As I said, the option for an extension was included in the original franchise contract and Transport Scotland became concerned that key aspects of the original contract were no longer fit for purpose. Within its first year of operating, First ScotRail was performing above its punctuality and capacity targets and it had reached the point at which it was returning 80 per cent of the additional revenue that it made to the Scottish Government. Transport Scotland was concerned that low revenue returns to First ScotRail from investment might discourage it from making further service improvements. Transport Scotland therefore believed that an early review would be in the public interest.

Audit Scotland has found that Transport Scotland used a rigorous appraisal process; it modelled a range of scenarios and used expert consultants to review its work and provide advice. The extension of the franchise contract was

announced in April. As a result of the franchise extension, Transport Scotland has secured a guaranteed £73.1 million investment from First ScotRail in exchange for an estimated £57 million in potential revenue share. The £73.1 million will be used to reduce the Government subsidy or be invested in rail services.

The extension has also made the following main changes to the franchise contract. First, performance targets for reliability and capacity have been made more challenging. Secondly, revenue targets have been revised in line with more recent forecasts and the point at which First ScotRail returns a share of its revenue to the Scottish Government has been extended. Essentially, First ScotRail can now retain more revenue, but a profit cap has been introduced with half of all profits above the cap being paid to the Scottish Government. Thirdly, new service improvement options have been added, and First ScotRail is now required to provide additional information that will help Transport Scotland plan for the next franchise. First ScotRail is also more explicitly required to participate in the development of new major rail projects that will begin service after the franchise term ends, but for which planning will be required before the end of the contract.

My report also outlines that some of the governance arrangements during the review process could have been better. First, Transport Scotland's record keeping was not sufficiently detailed to provide transparency with regard to the decision-making process. Paragraph 70 of my report states that Transport Scotland's former director of finance and corporate services held shares and share options in FirstGroup and that those were appropriately declared in Transport Scotland's register of interests and annual accounts. However, it also states that the director of finance and corporate services attended key meetings at which the franchise extension was discussed and that the minutes of those meetings do not record whether he declared an interest or removed himself from the discussions. The chief executive of Transport Scotland has stated that the director of finance and corporate services did not have a vote on any decision making in relation to FirstGroup and was not involved in the review process.

Secondly, as outlined at paragraph 72 of my report, Transport Scotland did not provide the Minister for Transport, Infrastructure and Climate Change with a fully documented business case; it took the view that presentations were more appropriate.

Finally, Transport Scotland did not consult on the extension with its non-executive board members or external stakeholders. Transport

Scotland's investment decision-making board assists the chief executive with major investment decisions but it does not include the non-executive board members.

With regard to external consultation, Transport Scotland is of the view that there were commercial sensitivities and that previous consultations were sufficient.

The third part of my report looks at First ScotRail's performance. As I mentioned when I began my remarks, overall performance to date has been good and continues to improve. Delays attributable to First ScotRail have decreased. Overall passenger satisfaction with First ScotRail has increased, as have passenger numbers. There has been a slight increase in the number of cancelled services; however, those were due mostly to a period of industrial action in the greater Glasgow area. In other areas in Scotland, there was a decrease in cancellations. The quality of service both at stations and on trains is good and is improving in most areas.

I make a number of recommendations throughout the report, which are brought together on pages 8 and 9. My report concludes that Transport Scotland is generally managing the franchise contract effectively; however, there are some areas where further improvement is possible. For example, Transport Scotland should develop a systematic project plan for awarding the next franchise, including the decision-making criteria, the reporting arrangements and the approval arrangements. Transport Scotland should also be encouraged to review its franchise performance measures to improve the alignment between passenger concerns and wider Government priorities and to improve its engagement with stakeholders by clarifying its consultation arrangements.

In addition, my report includes the suggestion that Transport Scotland should establish a single source from which passengers, the public and other stakeholders can easily access relevant information about First ScotRail's performance, the contract and how it is being managed.

My colleagues from Audit Scotland and I will do our best to answer any questions that you have.

The Convener: Thank you very much. I want to clarify one of your comments before I go into some of the wider issues that you have identified. Transport Scotland felt that too much money was being returned to the public purse, so it wanted to change the contract to ensure that First ScotRail retained more and the public purse retained less. Is that correct?

Mr Black: Yes.

The Convener: We will perhaps return to that at some point.

On governance, what would be your view of a Government body or agency failing to ask for a business case in such a major contract? Do you think that there are wider implications to that?

Mr Black: This is the largest contract that is let by the Scottish Government. Good practice would require a formal business case to be prepared. Transport Scotland decided that, in this case, it would be appropriate to give presentations to the minister concerned. The reason for that is perhaps best pursued with the accountable officer of Transport Scotland.

The Convener: We can certainly do that. However, from an audit perspective, whether in relation to this contract or any other contract or set of accounts that you are looking at, would you not regard such a failure as a serious lack of judgment?

Mr Black: I certainly think that for any significant contract such as this it is preferable to have a business plan in place, because that plan can be used to independently assure and audit whether best value is likely to be delivered for the taxpayer.

George Foulkes (Lothians) (Lab): You are choosing your words carefully and diplomatically. You said that it would be preferable to have a business plan in place. Can you tell us of any other major contract that you know about that has been let without a business case or a business plan?

Mr Black: Unfortunately, I cannot give you information on that, because we have not audited comprehensively across the whole public sector. However, it is certainly difficult to recall any circumstances similar to these from the work that we have done in the past.

George Foulkes: Neither you nor your colleagues can recall any instance of a major contract being let or extended without a business plan or a business case.

09:45

Mr Black: I will try to be as helpful as I can in answering that question. I remind the committee that we produced a report on major capital projects recently. There were one or two major projects included in that report in respect of which we thought that a business case could have been put together more fully. I am sure that you recall the discussion that we had about the M74 extension.

George Foulkes: It is a fairly unusual situation. As you say, the ScotRail franchise is the largest contract to be let by the Scottish Executive.

Mr Black: Yes, it is the largest contract of its type to be let.

George Foulkes: There is one more thing that I do not understand. Would it not be normal for other operators to be given some chance to bid for such a huge contract? I am thinking of big companies such as Stagecoach and National Express. That would certainly happen for a new contract; why is that not done for a contract extension?

Mr Black: When the original contract was formed, before responsibility was devolved to Scotland, there was an opportunity for all interested parties to bid for the contract, which was structured in such a way that the option for an extension was included. The view that has been taken by Transport Scotland is that the basic contract was being continued, and it was exercising the option of extending it. It is a matter for discussion with Transport Scotland as to whether or not it would have been best value to go back to the market. Having said that, the view that Transport Scotland expressed to us informally was that the continuation of the contract was far and away the most efficient way to ensure that the improvements to service that have undoubtedly taken place over the past few years could continue. It also allows the contract to reach a period beyond the planned dates for some major investments. Therefore, it provides stability and continuity.

George Foulkes: There is no way that you, or we, could tell whether or not we might have saved more money for the public purse if the franchise had gone out to a new contract, and if National Express, Stagecoach and others had been allowed to tender for it.

Mr Black: I cannot give you that opinion.

Sandra White (Glasgow) (SNP): I will start with the passenger situation before coming on to the contract. I travel back and forth between Glasgow and Edinburgh, and I agree with your assertion about cancellations.

The report mentions that Passenger Focus does a survey every six months. I am on the trains all the time, and I have never been asked to take part in such a survey; I wonder exactly who is asked. Sometimes, when you get off the train at Waverley, you are practically in Newcastle before you get your ticket collected—I think that that train comes in at platform 7. Might Passenger Focus bring more of a focus to First ScotRail's deliberations with the public? You made a point earlier about First ScotRail being more open to the public.

My second point regards the franchise and the contract. In 2006, before the extension, First ScotRail returned 80 per cent of profits—revenue

investment—to the Government. You mentioned that, following the extension of the franchise, there is a cap on profits, above which 50 per cent will be returned to Government. In your professional opinion, will less or more money go back to the public purse under the new franchise?

Mr Black: I will take the second point, and I will then turn to colleagues to amplify what I say, and to pick up the point about Passenger Focus.

Transport Scotland was concerned that the revenue-sharing arrangements might discourage First ScotRail from introducing further service improvements, as it was performing at such a high level so early in the contract. It had already reached the point at which 80 per cent of additional revenues were being returned to Government. It would be reasonable to say that First ScotRail would require quite strong persuasion to invest in further improvements, because the level of such improvements would have to be very significant before the company got additional revenue. We included an example of that in the report.

There was a sense at Transport Scotland—which would be best placed to answer the question more fully—that the programme of improvements, which everyone would agree is highly desirable, could be held back under the old arrangements, given that so much revenue was coming back to Government. So they attempted to increase the performance targets for First ScotRail quite considerably at the same time as negotiating an arrangement that would guarantee that more than £70 million would come back, which could either be used for further investments or to reduce the amount of subsidy from the taxpayer. The point is that the overall level of subsidy that will be paid by the public sector through Transport Scotland will stay the same.

Finally, there is a cap on how much the franchise holder can earn. Some might think that the cap is set at a reasonably high level. As we understand it, the Transport Scotland view is that the performance targets are now more challenging and First ScotRail is not likely to be able to reach that high a level. So Transport Scotland has made the professional judgment, along with a lot of expert advice, that the agreement will give best value and will ensure that the programme of improvement can be sustained at the same time as containing the amount of money that will be paid from the public purse.

Does anyone in the team want to expand on that, and pick up the question about Passenger Focus?

Tanya Drury (Audit Scotland): I can comment a bit more on Passenger Focus's work in Scotland and its continuing effort to work with Transport

Scotland in a specifically Scottish context. Sandra White referred to the surveys that are done twice a year. Passenger Focus is starting to use that data collection to look at regions, so that they can get a bit more detail—

Sandra White: I am sorry to interrupt you. You said that Passenger Focus will do more work in a specifically Scottish context. How many surveys have been done in Scotland?

Tanya Drury: The surveys all began at the same time across Britain, and they go back five and a half years.

Sandra White: Fine. Mr Black was saying that Transport Scotland took more of a carrot than a stick approach with the franchise extension. I am concerned that Transport Scotland seems to be doing all the work. No business plan has been produced. If a business plan had been produced, it would have been put on the table for everyone to see. Is that a concern? Will the minister have been notified of the situation?

Mr Black: It is important to distinguish the Audit Scotland comment about the rigour of the process from the absence of a business plan. The Audit Scotland team has assured me that the process undertaken by Transport Scotland in determining the formulation of the contract extension was rigorous and included the checking of analysis with independent consultants. The process was robust.

It is for Transport Scotland to explain why it did not capture all of that in a business plan that other people could see and from which they could get independent assurance about the robustness of the analysis. As I remarked in response to the convener's question, that would have been preferable.

Sandra White: Are you concerned about the contract as it was issued? You mentioned that Transport Scotland said that First ScotRail might not make enough profit above the magic cap to pay 50 per cent.

Mr Black: It is for Transport Scotland to satisfy the committee on the question whether it is satisfied or not. It has indicated to Audit Scotland that it is satisfied. I come back to my earlier points and offer the comment that First ScotRail would have to achieve a very high level of performance before it would attain the maximum revenue that it could attain.

Sandra White: Convener, I do not want to hold the committee up. I want to go on to talk about finance.

The Convener: Could you leave that for the moment because other members wish to come in?

Mr Black, it is astonishing that you say that Transport Scotland did all the work, and got all the evidence, but did not bother to produce a business case. That is not for you to answer, but it seems astonishing that information was there that could have led to the production of a business case, which might well have satisfied objective observers.

Mr Black: I understand your concerns about that matter.

Murdo Fraser (Mid Scotland and Fife) (Con): I will say at the outset that the report is very valuable. In my experience, First ScotRail provides a good service, evidence of which is in the report. You have, however, highlighted legitimate concerns about the way in which the contract extension was awarded. To pick up on Hugh Henry's point about the business case, your report says that a business case was not presented to the minister. Do we know whether Transport Scotland prepared one internally?

Mr Black: It would be, strictly speaking, more accurate to say that a business case was presented, but a documented business plan was not. Audit Scotland has seen the papers that were used to put the case together and considers that it was a robust process.

Murdo Fraser: So Transport Scotland held the information internally, but did not choose—for whatever reason—to present it in that form to the minister?

Mr Black: In the form of a documented business plan—that is correct.

Murdo Fraser: The committee can pursue that with Transport Scotland. I have a question about a slightly different aspect of the contract renewal—consultation. You said earlier that Transport Scotland did not consult stakeholders on the extension; it took the view that there were commercial sensitivities, and that previous consultations were sufficient. In approaching the issue as auditor, do you find that explanation to be satisfactory?

Mr Black: I am afraid that I have to repeat my earlier remark that that question would be best answered by Transport Scotland, which took the judgment that there were commercial considerations involved in the process that required a high degree of confidentiality. It is a matter of judgment to balance those commercial interests against the interests of the taxpayer, the Parliament and the public, in relation to who has knowledge of the intentions with regard to such a major contract.

Murdo Fraser: If the convener allows, I will approach the question from a different direction. Given what we have heard about the size and the

scale of the contract, would it be unusual for a contract of that size to be extended without proper and full public consultation?

Mr Black: The problem that I have in answering that is that it is difficult to think of a parallel—this is the largest contract involving current revenue expenditure from Government in Scotland. The contract was made before responsibility was devolved to the Scottish Parliament and the Scottish Government, and it was structured on the basis that there would be an extension. The circumstances are therefore unique, which brings us back to the judgment about whether it was appropriate to share more widely information—and if so, how much—that Transport Scotland was considering an extension.

The Convener: Do you believe that it would have been good practice to follow the route that Murdo Fraser suggested?

Mr Black: I find it difficult to comment on that, because I am not in a position to second-guess Transport Scotland's judgment on commercial issues. I hope that it took advice on that, and that it is able to explain its reasoning to the committee.

10:00

Nicol Stephen (Aberdeen South) (LD): Murdo Fraser has covered quite a bit of the ground that I was intending to discuss—his questions got to the heart of the matter. The statements from the Auditor General in paragraphs 72 and 73 on page 22 of the report raise quite serious issues. I understand from his responses that it is difficult for him to go much further, but those serious issues still need to be addressed.

The obvious sources of further information are Transport Scotland and ministers. In relation to the correct statement that Robert Black made at the beginning of his presentation about paragraph 2 of the report, on page 3, I point out that the Scottish Executive was not technically the body that issued the original contract in 2004, although it was heavily involved. A significant high-level team of officials worked full time on the letting of this major contract, which was recognised at the time as being the largest and most significant contract of its kind that the Scottish Executive was involved in letting.

The relationship with the Strategic Rail Authority is interesting because it had considerable experience of letting contracts of this scale and nature. It would be interesting to know whether Audit Scotland investigated the SRA's role in issuing extensions of contracts and whether Transport Scotland followed the same procedures that were previously followed by the SRA when there were such extensions, as I am sure there must have been.

I have some other questions, but I will pause to allow the Auditor General to answer that one.

Mr Black: The question is an entirely reasonable one. The audit considered only the First ScotRail contract, but I believe that the team has some information about the extent to which the First ScotRail contract is similar to the contracts that have been let elsewhere in the United Kingdom.

Angela Cullen (Audit Scotland): It is worth reiterating that we did not consider the awarding of the original contract or the role that the Strategic Rail Authority played in that. However, we considered some of the other franchises, and Tanya Drury can give you some high-level information on those.

Tanya Drury: I emphasise Angela Cullen's point that this is high-level information. The other franchises are now managed by the Department for Transport. The key difference is that most of the other franchises have 10-year contracts with reviews after, say, seven years to determine whether they will continue for the additional three years. The contract for the First ScotRail franchise was essentially for seven years with the possibility of an extension for three years. That is a different approach, which limits the amount of comparison that we can do.

Nicol Stephen: If we are to consider the matter further—and there is a serious case for doing so—we should consider the past practice of the Strategic Rail Authority. The fact that it handled matters in a particular way does not mean that it was the correct way or an acceptable way. It would be interesting to discover how it handled major contracts and extensions.

I want to push the Auditor General a little further on the point about the business case. We need to be as clear as possible about paragraph 72, on how Transport Scotland handled the issue. From the responses that we have heard this morning, I have the impression that Transport Scotland did have a high-level team with a significant number of staff working full time on the proposed contract extension, and that senior consultants were employed, no doubt at significant cost, to provide professional support and advice. It has been suggested that, as a result, a business case was available within Transport Scotland, but not one that amounted to a full business plan.

I am still struggling to understand whether, in your view, a fully documented business case exists or existed within Transport Scotland that could have been presented to the minister, or whether the body of advice fell short of being a business case or a business plan.

Mr Black: As I believe I may have said in answer to earlier questions, Audit Scotland

considered that the analysis was robust and that there were lots of papers to support the decision that was made. Transport Scotland's chief executive decided that it should make representations to the minister that contained, in effect, a business case; however, it did not pool together a fully documented business plan that others could read, either at the time or after the event, to satisfy themselves about the overall case that was being made to the minister. The short answer is that, to the best of our knowledge, a fully documented business plan does not exist.

Nicol Stephen: Okay. Thanks very much. I have two final points to raise.

The decision was made in the contract extension to return a greater proportion of the profits to the company operating the franchise. Are you suggesting that you have seen documented evidence that that was an appropriate and professional thing to do and that there was independent support for that move?

Mr Black: The Audit Scotland team has seen that documentation and has advised me that the analysis was appropriate and that the process was robust.

Nicol Stephen: My final question relates to paragraph 73, on the failure to consult interested organisations and bodies. Is there documented evidence to suggest that Transport Scotland sought independent advice on the issue and received the advice that it should not consult or involve outside bodies and interests? As I understand it, organisations were not even aware that the extension of the contract was being considered. Is there back-up and support for the approach that Transport Scotland took?

Mr Black: At the heart of that matter is confidentiality for commercial reasons. As I say in my report, Transport Scotland did not secure separate advice on the point but made its own judgment that it was balancing commercial sensitivities in the public interest.

Nicol Stephen: The argument about commercial sensitivities can be used in almost every public sector contract because, especially when a quoted company is involved, there will always be an impact if it is suggested that a contract might be continued, terminated or issued. It would be unfortunate if such sensitivities became the catch-all excuse that the public sector used in all situations relating to commercial issues.

Mr Black: I agree with that view.

Nicol Stephen: Thanks very much.

George Foulkes: I have one small question that follows on from that. Is it correct that you were not consulted either, Mr Black? Were you unaware

that the announcement of the contract extension would be made on 2 April?

Mr Black: That is correct. I was not advised in advance.

George Foulkes: I understand why the chief executive of Transport Scotland did not want to talk about the matter to outside people, but why would he feel that it would create problems for commercial decisions if he discussed the matter with you and your staff?

Mr Black: With the support of the committee, we had committed early last year to undertake a review of the performance of the First ScotRail contract, in view of its size and its significance in Scotland. However, when we planned the study, neither the team nor I was aware that there was an intention to consider extending the contract. Frankly, it would have been helpful if we had been advised of that—or if I had been advised of that in confidence—because we could then have adjusted the performance audit more readily to accommodate any concerns that Transport Scotland had. Having said that, I guess that confidential matters are discussed regularly across Government. I would not expect accountable officers and senior civil servants to feel the need to advise me of everything.

George Foulkes: But Transport Scotland knew that, with the support of this committee, you and your colleagues had done work on a study on the ScotRail franchise. However, without consulting you, Transport Scotland went ahead and made an announcement on 2 April, which took you and all of us by surprise.

Mr Black: That is correct.

Stuart McMillan (West of Scotland) (SNP): I have a quick, wee question about the financial regulations, but before that I want to say something about the report.

The report is excellent and, in the main, paints a positive picture of a body that provides a public service in Scotland. Reports come to the committee—for example, the one on NHS Western Isles—about something that is fundamentally broken and requires a review to try to fix it, but the report that we are discussing gives a positive picture of a public service in Scotland, which must be welcomed.

Some positives came out of the franchise extension, such as the guaranteed extra investment, the profit capping, the continued high performance indicators and the continuity going forward to the Commonwealth games. Certainly, colleagues have raised concerns this morning about the mechanism for the extension, but I just wanted to get all that off my chest.

On the financial regulations, Nicol Stephen said a moment ago that commercial confidentiality is a catch-all. I am maybe a bit confused, but I do not fully understand the situation. When a public body allocates funds to a private organisation, it is easy for it to say, "We can't discuss X because of the financial regulations," but I find that a bit strange, given that public money is going into a private organisation to run a public service. Is there any way that such financial information can be made public? I am a bit confused by the whole situation.

Mr Black: If a public body desires to award a contract involving competition, it is good practice to ensure that commercial confidentiality is observed. Sometimes that would relate to elements of the specification, but invariably it would relate to the content of the tenders that people provided. Once a contract is let, how much information about the nature of the contract to make available in the public domain is a matter of judgment. Generally, the contract specification and the cost to the public purse should be in the public domain, but commercial matters such as how the successful supplier will deliver the contract are not released into the public domain. In addition, there may be commercial sensitivities around whether the detailed content of rival tenders may be made public.

As I think I said in response to earlier questions, the situation in question is an unusual one in which a large contract was extended. It is important to distinguish between whether it would have been possible to intimate that Transport Scotland was considering extending the contract and information about the content of the extension. I imagine that everyone would agree that there are commercially sensitive issues in respect of the latter aspect.

10:15

Stuart McMillan: I fully accept that, but I would understand the commercial confidentiality argument more if we were dealing with the beginning of a contract. I feel that the rules may be too strict to have applied to the extension of a contract, rather than the establishment of a brand-new contract.

Mr Black: It is fair to say that there are no rules—this has been a matter of judgment throughout.

Willie Coffey (Kilmarnock and Loudoun) (SNP): My question relates to the terms and conditions for extending the contract. Paragraph 68 states clearly that there were no conditions under which an extension should be considered. That is a governance issue that has been raised regularly in the committee in relation to other subjects. It appears that because of that, and

because of how matters turned out, there was something wrong with the manner in which Transport Scotland presented the business case—the impression has been given that Transport Scotland missed something or failed to observe some guidelines or requirements. It would be helpful if you could clarify whether that is the case.

You mentioned the rigorous analysis that was carried out over 18 months. I would be interested to know why that was not sufficient to give comfort to us and others that a reasonable case for extending the franchise had been made. What is the essential difference between that analysis and a formal business plan? How much added value would such a plan have provided? At some stage, it might be useful for us to hear from Transport Scotland why it thought that its chosen approach was correct. Do you think that the approach taken was acceptable?

Mr Black: In paragraph 68 of the report, I say that the original contract, which was drawn up not by Transport Scotland but by the bodies that were responsible at the time,

"did not specify the conditions under which an extension should be considered".

Transport Scotland had to work on those. The procedures and analysis that it undertook were fit for purpose and robust. However, it is good practice for a formal business plan to be put together for a contract of this size and complexity. That plan should be available to be read and considered by the people who are taking the decisions and by other parties who wish to satisfy themselves of the robustness and quality of the analysis that has been carried out.

Willie Coffey: Was there any breach of the guidelines relating to how Transport Scotland should have presented its case?

Mr Black: The essential point at issue is that it is good practice to prepare a business plan.

Willie Coffey: But Transport Scotland did not breach any guidelines or requirements.

Mr Black: It depends on which guidelines and requirements you are talking about. As members will recall, when we presented the review of major capital projects, we drew the committee's attention to the Treasury guidance, which requires a business plan to be prepared for such projects. It is fair to see that guidance as relevant to a contract such as the extension of the First ScotRail franchise.

Willie Coffey: In what ways—other than the fact that other parties would have been able to have sight of it—would a business plan have differed from a business case? Would its content have been different?

Mr Black: It depends on the circumstances. A business plan would have brought everything together in one place and could have been read and, hopefully, understood by people who were not party to the detailed process at its different stages.

The Convener: I note your point that it would have been good practice for Transport Scotland to have produced a business plan. Sometimes there can be serious errors of judgment, even though no specific rules are broken. I return to the issue that Willie Coffey identified in paragraph 68 of the report. Rightly, Transport Scotland tried to establish criteria to determine whether the extension should be awarded. Is there a record of that? The report says:

“no formal record was made of the criteria being approved.”

We cannot establish when the criteria were approved. Do we even know what the criteria were?

Mr Black: As you will be aware, one of the general findings of the study is that the process could have been better recorded and documented throughout. The handling of the criteria may well be an example of that issue. Can anyone assist in answering the question?

Angela Cullen: We have nothing to add to the Auditor General's comments. The team has reviewed a collection of documents, which has allowed us to do our analysis, but there is nothing pulling it together. No clear criteria were formally documented.

The Convener: So Transport Scotland has told you that criteria were established, but it cannot tell you what the criteria were, nor can it identify when the decision to establish those criteria was made or who made it.

Angela Cullen: That is right. Criteria are set out in a collection of documents, but they are not pulled together in a single document. It is not clear who made the decision on the criteria or when it was made.

The Convener: It is clear that enough was done to satisfy Transport Scotland that there were some criteria, but we do not know who made the decision on those criteria or who would have applied them.

Angela Cullen: Yes, we do not know that.

The Convener: The other serious issue that you identify in your report is the potential conflict of interest. I am sure that other members will want to come in on that. Mr Houston was a major shareholder in the company to which the franchise extension was awarded. Is that correct?

Mr Black: He held shares and share options in the company, the value of which is unknown to us.

The Convener: Okay. Do you know what type of shares he held? Is that a matter of public record?

Mr Black: We know only what was in the declaration of interest and the note in the accounts, which referred to the fact that the director of finance held shares and share options in FirstGroup.

The Convener: The level of the shareholding is one issue, and whether that is material to the appropriateness of his being allowed to participate in the process at all is a matter for Mr Houston and his then employer. The other issue is that of allowing a senior executive who has share options in a company to sit in on meetings at which discussions are taking place about whether to award that company an extension to its franchise. Am I correct to say that someone who has share options has an even bigger material interest in the share price outcome than a normal shareholder?

Mr Black: It is correct to say that the holder of such options might stand to benefit or lose to a more significant extent than someone who simply holds shares, because they can exercise those options at the point that they deem to be most advantageous to themselves.

The Convener: So regardless of whether Mr Houston participated in the decision making, the fact that he was party to discussions of an extremely sensitive nature, which it is clear could influence the share price, is a matter of serious concern.

Mr Black: At this point, I must simply refer you to what we found in the records and what the chief executive of Transport Scotland told us. The fact that Transport Scotland's director of finance and corporate services had shares and share options in FirstGroup has been recorded. Good practice would dictate that, at the very least, that interest should be declared at meetings, at the start of a relevant agenda item, and that the person concerned should take no further part in that agenda item. The minutes of the meetings in March indicate that the director of finance and corporate services remained at the meetings, but there is no reference to or documented record of whether he explicitly declared his interest and what part, if any, he took in the meetings.

The Convener: It is clearly a concern that we do not know whether the person participated in the meetings. From an audit perspective, do you have concerns about someone in such circumstances being involved in the decision-making process? Would it be good practice to suggest that they step aside?

Mr Black: I will answer that in two parts. First, in the normal course of events, the auditor could reasonably be expected to check whether there

were documents, such as a register of interests or a note on the accounts, that recorded properly the interests that any employees had. We could not expect the auditors to be present at every meeting and on every occasion. Therefore, the second point is that it is a matter for the individual in the meeting or decision-making forum to decide whether they need explicitly to declare an interest and either remove themselves from the meeting or at least take no further part in it. I would hesitate to go beyond that in this case.

The Convener: I understand that, and we may want to pursue the point with Transport Scotland.

Sandra White: I want to go back to the beginning, bearing in mind that the original contracts started in 2004 and Transport Scotland did not come on stream until 2006. I take it that Mr Houston joined the board of Transport Scotland in 2006, so he was there from the beginning.

Mr Black: The director of finance was appointed as an executive of the new Transport Scotland agency around the time of its inception. He was not really a member of the board because Transport Scotland does not have a formal board in the statutory sense.

Sandra White: Sorry for raising that point—you are right.

Mr Black: I apologise for being so precise, but the matters are so important that I must ensure that I am accurate in my replies.

Sandra White: Absolutely.

My point is that it was known from the start that there was the option to extend the contract. The contract was awarded up to 2011 with a potential three-year extension. Anyone in any capacity in Transport Scotland—including Mr Houston—would have known that there was the option of extension. The person we are talking about registered his interest. Should someone who had such an interest and knew what could happen have been taking part in meetings at all?

Mr Black: I find that question difficult to answer. There may be an issue about whether, when the person was being considered for employment, the interests that he may have held were fully known and explored, although that is well outwith the ambit of the audit process. However, that is the background against which all subsequent events and concerns have to be considered.

Sandra White: You are right, which is why I wanted to elaborate on the point. From the beginning, my great concern about the conflict of interest issue that the convener raised is that no minutes were taken. You mentioned in your opening statement that it was said that the director of finance and corporate services did not have a vote, but did the minutes record that he did not

vote? We do not seem to have anything in black and white that says that he did not take part in discussions or votes.

Mr Black: There is no written record of whether the person declared an interest and whether he actively did not take part in the decision-making process. I received an assurance from the chief executive of Transport Scotland that the interest that the director of finance had was known to him and that the person did not take part in voting at the meeting.

Sandra White: I think that I will leave it at that, convener.

10:30

Nicol Stephen: Is it fair to summarise paragraphs 68 to 71 in the report as saying that the arrangements were at best loose, that they caused real concerns and that they could indeed be unacceptable?

Mr Black: It is fair to say that had the proceedings and meetings been better recorded I would have been able to give the committee a more explicit assurance on this matter. At the heart of the problem lies the fact that the minutes of the meetings were imperfect and that matters were not addressed explicitly one way or the other.

Nicol Stephen: Paragraph 68 says:

“Transport Scotland reports that criteria were established to determine whether the extension should be awarded, however, no formal record was made of the criteria being approved.”

You have mentioned on a number of occasions the reassurances that you have been given by the chief executive of Transport Scotland. However, the content of each of the paragraphs to which I have referred raises real concerns. Indeed, that is how one might characterise the deliberate decision to exclude the two non-executive directors from the membership of the investment decision making sub-group. Do you feel that you have a continuing responsibility to investigate these concerns further or is it a matter for the committee?

Mr Black: I can be quite clear and say that the audit examination has reached the limits of what is possible. With regard to the status of the Transport Scotland board, members will appreciate that it is an executive agency and not a non-departmental public body that is separately constituted in law: the board is a construct of an administrative act rather than of regulation. The fact is that Transport Scotland has decided that the non-executives should not be party to decision making on policy advice that goes to the minister.

Perhaps by way of context I should also point out that Audit Scotland has proposed in its forward programme to carry out work on the operation and procedures of boards across the whole of Government, from which some lessons might emerge.

Nicol Stephen: Is it therefore fair to say that, at the moment, you take no view on the arrangements and that, with regard to areas where criticism might be implied—such as there being no formal record of the criteria that were being approved—you are simply presenting the information to the committee and leaving it up to us to decide what to do with it?

Mr Black: That is a very fair summary.

George Foulkes: I remain rather perplexed about all this. Who was in the chair at these meetings?

Mr Black: Meetings of the investment decision-making board would have been chaired by the chief executive, who is accountable for policy advice to ministers. Around the table would have been his five senior executives.

George Foulkes: Does the chief executive chair the board and the IDM?

Mr Black: Yes. Two non-executive board members are present at meetings, but the IDM is an advisory body that is chaired by the chief executive.

George Foulkes: Am I right in thinking that, nowadays, it is not good practice for a chief executive to be the chairman of a board?

Mr Black: It is important to distinguish between statutory bodies, such as NDPBs, and other forms of organisation—although, as George Foulkes says, it is not good practice for the chair and the chief executive to be combined in them, either. As I remarked earlier, Transport Scotland has been established as an executive agency and the board is purely advisory. The board has no statutory role whatever and exists simply to provide advice to the accountable officer on matters such as internal audit, remuneration and governance arrangements.

George Foulkes: The finance director, however, would be one of the five executive directors.

Mr Black: It is important to distinguish between the Transport Scotland board and the investment decision-making board.

George Foulkes: Is the finance director one of the five executive directors?

Mr Black: Yes.

George Foulkes: So, if he did not vote, who did?

Mr Black: As I understand it, the decision would have been taken by the chief executive of Transport Scotland, because it is his responsibility to advise the minister. However, he would have taken the views of the others around the table, who would be in his executive directors team.

George Foulkes: So, there would be no vote: the chief executive is the man who makes the decision.

Mr Black: I recall wondering at the time about the use of the word “vote”. However, that is the terminology that was used by the chief executive of Transport Scotland when he explained to us the role of the director of finance.

George Foulkes: If the chief executive is in the chair and makes the ultimate decisions, is not voting irrelevant?

Mr Black: As I said, the language is the language that was used by the chief executive.

George Foulkes: Why were the two non-executive directors excluded?

Mr Black: Transport Scotland—including, of course, its chief executive—had decided that the non-executive members should not be part of the investment decision-making board.

George Foulkes: Why?

Mr Black: That is in line with the arrangements that exist in Government; for example, the Scottish Government has an advisory body—its audit committee—that advises the accountable officer on matters relating to good governance and proper management of the office. However, it is clearly for civil servants to provide policy advice to the minister. The arrangement that George Foulkes is asking about is very much four-square with the arrangement that prevails across Government.

George Foulkes: When members first attend this committee, we are required to declare any interests. There is no such procedure in relation to the board of Transport Scotland, I assume.

Mr Black: Apparently not.

George Foulkes: Would the finance director, who had an interest but has now resigned, have been responsible for producing a business plan, had one been produced?

Mr Black: Our understanding is that that is not accurate. We understand that the expert advice was prepared separately by professionals in Transport Scotland and was validated by appointed consultants, and that the director of finance was not central to that process. As I say,

that is not documented anywhere; it is the advice that I have received from the chief executive of the agency.

The Convener: You suggest that the board is an advisory board, and that the chief executive would take advice from members who attend the boards meetings, including the director of finance. In a matter such as the extension of a contract that has major financial implications, would you normally expect the chief executive to take the advice of the director of finance?

Mr Black: I would expect the chief executive to listen carefully to the advice of the relevant experts in the room. It is possible to envisage a public body—I am not thinking of Transport Scotland in this regard, as I have no knowledge of the detail of the operation of its business—in which the director of finance was in charge of the corporate services and the financial housekeeping of the body but was not involved in the major policy decisions of the body.

The Convener: Do we know whether that pertained in this case?

Mr Black: We have the assurance of the chief executive that the director of finance did not take part in consideration of this particular contract extension.

The Convener: In some organisations, the director of finance may well deal only with housekeeping. However, in an organisation in which the director of finance deals with policy, one would expect the chief executive—particularly if he or she did not have a financial background—to take advice from the senior person with responsibility for financial policy.

Mr Black: It is not documented in the report, but our understanding is that a key person in this case was someone who is called the director of strategy and investment, rather than the director of finance and corporate services. As I think I have said, the financial and economic analysis was undertaken by internal staff—predominantly by an internal economic adviser from within the strategy and investment directorate—and was supported and validated by external consultants. The economic advisers are under the management of the director of strategy and investment, not of the director of finance and corporate services. As I have remarked, we did not look explicitly at the roles of individuals. Therefore, we cannot say more than I have said about the role of the director of finance and corporate services, or whether he contributed to the analysis of the rail franchise in any way.

The Convener: Leaving aside whether that individual contributed to that discussion or influenced, at whatever level, the eventual decision, the fact is that he was not only a shareholder but had options. The fact that he

attended a meeting at which the considerations were discussed potentially gave him access to information that could be construed by others as being advantageous to him.

Mr Black: I would prefer not to comment on that, convener.

The Convener: Okay. That is fine.

Nicol Stephen: As the Auditor General has correctly pointed out, Transport Scotland is an executive agency; therefore, these matters of concern are ultimately the responsibility of the permanent secretary and ministers. Is that correct?

Mr Black: That is correct.

Nicol Stephen: Have you received any reaction from the permanent secretary or from ministers to these issues of concern?

Mr Black: No.

Nicol Stephen: Who is the accountable officer in relation to these issues?

Mr Black: The accountable officer in relation to the work of Transport Scotland is the chief executive.

Nicol Stephen: Of Transport Scotland?

Mr Black: Yes.

Nicol Stephen: Is there an individual within Government to whom the chief executive has—

Mr Black: The chief executive of Transport Scotland holds that accountability under the principal accountable officer, who is the permanent secretary.

Nicol Stephen: So, the line of responsibility is directly from the chief executive to the permanent secretary.

Mr Black: That is my understanding.

Nicol Stephen: Often, individuals are appointed within the Government who have a particular responsibility for executive agencies and NDPBs. Do you know who that individual is in this instance?

Barbara Hurst (Audit Scotland): No, but the director general economy has the transport directorates within his brief. Transport Scotland would feed into those directorates. That director general is Andrew Goudie, who also has an interest here.

Mr Black: I would hesitate to imply that there is a direct personal accountability relationship between the chief executive of Transport Scotland and Mr Goudie. In terms of the sponsor relationship, there will be accountability for what they are delivering. However, it may well be the

case that the principal line of personal accountability runs to the principal accountable officer. That is something of which we do not have robust knowledge.

Nicol Stephen: Clearly, if we have concerns about the operation of Transport Scotland, it would be appropriate to have some communication and discussion with the most senior appropriate Government civil servant. From what Mr Black is saying, it seems that that person is the permanent secretary. We could take further advice on that.

10:45

Mr Black: I would strongly encourage you to take further advice on that interest.

Nicol Stephen: It is only fair that we ask on the record about the circumstances of the resignation of Transport Scotland's director of finance. Have you been given information on the circumstances and the reasons for the resignation?

Mr Black: No.

Nicol Stephen: We would have to pursue that with Transport Scotland or the Scottish Government.

Mr Black: Yes.

The Convener: Unless there is a particular line of inquiry that we have not explored, I intend to draw this part of the meeting to a conclusion.

George Foulkes: With your permission, convener, I will ask a small question. I am not clear who made the decision to extend the franchise. Transport Scotland is an advisory body, and it agreed to seek the minister's views. So the minister did not actually make the decision. Is that right?

Mr Black: The chief executive of Transport Scotland would be best able to help you with that. What is clear is that the chief executive is personally accountable for the advice that is given to ministers.

George Foulkes: Ultimately, it is the minister's responsibility, though, is it not?

Mr Black: Yes. We say in the report that the minister approved the extension on 27 March.

The Convener: The final contribution will be from Cathie Craigie, who has not participated so far.

Cathie Craigie (Cumbernauld and Kilsyth) (Lab): Thank you, convener. I apologise to you for being late. I would not normally come in on an issue when I have not been present for the whole discussion, but I want to pick up on a point that Mr Black made in response to either Nicol Stephen or George Foulkes. Transport Scotland is an

executive agency that has senior management-level meetings to make decisions about tens of millions of pounds of expenditure. However, that practice seems to be badly managed in terms of the records that are kept. Is that normal for an executive agency? Are guidelines given to executive agencies? Should we be worried that what has happened at Transport Scotland could be happening elsewhere?

Mr Black: I would not want to give the impression that I think that the process was badly managed. As I said in answer to previous questions and in my opening remarks, the process was robust in most respects, with good analysis. However, the record keeping was inadequate. Because of that, I cannot give an absolute assurance on the areas of concern that have been addressed during this meeting.

It is part of an executive agency's responsibility to give advice to ministers. To that extent, Transport Scotland is no different from any other executive agency of Government. We have not looked in detail at the governance arrangements of such bodies, so I find it difficult to generalise—from the circumstance in question—on the rest of Scottish Government. However, it is reasonable to say that the standards of financial management and governance in the Scottish public sector, not least in agencies such as Transport Scotland, are generally high. It is important to bear that in mind when one is considering an issue such as this.

The Convener: Thank you for that. I also thank Mr Black and his team for a full session. We will consider what we want to do about the issue in a later agenda item.

"Financial overview of the NHS in Scotland 2007/08"

The Convener: We move on to item 3, and ask for a briefing from the Auditor General on the report "Financial overview of the NHS in Scotland 2007/08".

Mr Black: Thank you, convener. If I may, I will just introduce the report. As the committee knows well, I bring a report each year to Parliament on the financial performance of the national health service in Scotland. In addition, every second year we prepare a report that looks at NHS performance in the round as well as at its finances. Last year, a wider performance audit overview looked at the finances and the performance.

This year's report is more restricted and considers only financial performance, so I emphasise that it does not have the same level of detailed information as the one that we produced last year. I have suggested on several occasions in my reports and to the committee that the NHS in

Scotland should consider preparing its own annual report on its performance. I am therefore delighted to report that, last month, the chief executive of NHS Scotland published for the first time an annual report on the NHS.

The commentary on financial performance in my report is drawn mainly from the final reports of the auditors that we have in each of the 14 NHS boards, the nine special boards and the Scottish Government health directorates. It is also drawn from various other sources of information, such as our public performance reports.

I will quickly run through the four parts of the report. Part 1 describes the financial performance of the NHS in 2007-08. I am pleased to tell the committee that the overall financial position was good. The NHS in Scotland spent £10.1 billion and ended the financial year with a £26 million underspend against its budget, of which £24 million was revenue and £2 million was capital. The boards and special boards generated a £76 million underspend, but that was offset by a planned overspend of about £50 million by the Scottish Government health directorates at the centre. All NHS bodies met their targets for the financial year, except Western Isles NHS Board, which failed to meet its revenue resource limit target—although for the first time in five years, the board generated an in-year surplus. As the committee is aware, I prepared a section 22 report on the board's financial position, which the committee discussed at its meeting on 29 October.

As I have highlighted in previous years, a sign of good financial health for any NHS body is that it can meet its recurring expenditure—what we might call its day-to-day expenditure—from its recurring income in the year. I am pleased to report that this year, NHS bodies were generally less reliant on non-recurring funding, which is sometimes called one-off funding, to meet financial targets or to support their financial positions. In total, the underlying recurring deficit for NHS bodies reduced from more than £90 million last year to about £16 million this year.

In recent years, there has been substantial capital investment in the health service in Scotland. Capital expenditure more than trebled in cash terms between 2003-04 and 2007-08, increasing from £132.5 million to £438.8 million last year. By 2010-11, the figure will reach not far short of £600 million, which is a substantial capital investment. The health service clearly must ensure that those capital projects deliver the intended benefits. We plan to produce a report early next year on how well the NHS manages its assets: that report will come to the committee.

I made several other comments in the report about financial issues relating to the health service. I will draw the committee's attention to

three in particular. First—as, I suspect, committee members are well aware—spending per head on the NHS has been higher in Scotland than it is in other parts of the United Kingdom. That trend continued in 2007-08.

Secondly, the committee is well aware that, in recent years, the NHS has been working with partners such as local authorities to shift the balance of care from acute hospitals to more community-based provision. However, from the high-level numbers, the health service cannot yet demonstrate that resources are following the shift in the balance of care. It is important that the Scottish Government health directorates develop ways of estimating the costs that will allow them to provide that information in reports.

Thirdly, on the important question of efficiency, the health directorates have reported that the NHS in Scotland met its overall efficient government initiative targets between 2005-06 and 2007-08. The service is reported to have achieved £610 million of savings against a combined target of £534 million.

Part 2 of the report describes the cost pressures on the NHS. I guess that many of those pressures will be well known to the committee from my previous reports and your previous considerations, but it is important that I highlight them briefly.

Pay modernisation continues to be a significant cost to the NHS. The agenda for change project is still not fully implemented, and the costs will not be fully known until the process has been completed.

Equal pay claims, which I mentioned in my report last year and which are an important issue for the NHS, represent another cost pressure that has not yet been quantified. Again, I must report that the NHS is still not in a position to estimate the cost of those claims, which could represent a substantial commitment in the future.

Other cost pressures that the NHS faced in 2007-08 are well known to the committee. They include the increasing costs of drugs, fuel and energy, the costs of service redesign initiatives and the costs of reducing waiting lists. Members will see from exhibit 9 in my report that the rate of increase of the costs of drugs has recently reduced.

Part 3 of my report comments on health bodies' governance and management arrangements. For the most part, NHS bodies have sound governance arrangements, but the auditors at Orkney NHS Board and Western Isles NHS Board again raised governance and financial management arrangement issues, which I feel obliged to highlight.

Auditors at five boards, including NHS Orkney and NHS Western Isles, also identified particular

issues to do with the appointment and associated governance of senior staff. We attempted to summarise those issues in exhibit 12, which is on page 18 of the report.

All NHS boards except NHS Orkney have community health partnerships in place. Some boards are reviewing or restructuring those partnerships. The Scottish Government recently announced that it plans to carry out a study of CHPs, starting in January 2009, which I welcome. Audit Scotland plans to undertake a review of CHPs, which will be critical to delivering the new balance of care in the future, but we will defer starting that study until the Scottish Government is well through its work.

Finally, we as auditors took a tentative look at the NHS's financial outlook for 2008-09 and beyond. On the basis of the latest information that auditors in the individual boards supplied to us, all boards except NHS Western Isles predict that they will break even in 2008-09, despite an expectation of smaller funding increases than they have enjoyed in recent years and the demanding efficiency targets that have been set for the NHS. The boards expect to face cost pressures that are similar to those that I reported for 2007-08, but new pressures on budgets are also emerging, including the cost of fully complying with the European working time directive for junior doctors. It is encouraging to report that boards are forecasting that they will be even less reliant on non-recurring funding than they have been this year.

A picture of further improvement in the financial position of the health service has been presented, but NHS bodies have set themselves challenging savings targets to achieve that. To illustrate what I mean, for 2008-09 six boards have savings targets that are much higher than the savings they delivered in 2007-08.

Boards will also need to consider carefully the implications of the introduction of single outcome agreements between the Scottish Government and local authorities and the abolition of the ring-fenced budget arrangements for local government. There might be a risk with delayed-discharge funding, for example, because it is being allocated directly to councils and will no longer be ring-fenced. Therefore, there are areas of pressure that we must bear in mind.

As ever, I am happy to answer questions, with support from the Audit Scotland team.

Murdo Fraser: Another excellent report has been produced. It contains a huge amount of useful information.

I want to ask about the revenue underspend of £24 million and the capital underspend of £2

million in 2007-08 that you mentioned. What happens to that money?

Mr Black: It is taken back to the centre in the NHS. If there is an underspend, the money is made available for other purposes.

Murdo Fraser: We do not, though, have information about how that money is reallocated.

Mr Black: No—not explicitly.

11:00

The Convener: I will ask a general question. Is the pressure on boards to operate efficiently lessened if they do not feel that they can use the benefits of that efficiency in the future—if the money just returns to the centre?

Mr Black: It is difficult to give a simple answer to that question. Through the financial accountability arrangements and the annual reviews that are conducted between the health directorates and boards, accountability is strong on financial and service performance. The NHS still operates an arrangement whereby significant sums of money are allocated for particular purposes, such as initiatives to tackle waiting times. Not all that money is allocated at the beginning of the year. In fact, the pattern is that the money is released during the year for boards to take up.

It is difficult to be exact about the overall level of incentives to perform that that system implies. To the extent that money that was not notified in advance is released during the year, robust financial planning on a sustainable basis is that bit more challenging for boards. However, I do not wish to give the impression that that has been raised with us as a major problem in managing board finances.

Do members of the team have anything to add?

Barbara Hurst: If an underspend relates to planned expenditure on a project, boards can agree with the centre to carry forward that money. That is built into the system for planned project work.

Willie Coffey: Mr Black said that the NHS budget is £10 billion. The annual underspend to which Murdo Fraser referred totals £26 million, which is 0.26 per cent of the budget. That is interesting, but the saving is quite small. Perhaps the clinical negligence provision offers more opportunity to make funds available—I have mentioned that several times before. Page 16 of the report shows that the NHS sets aside £125 million for cases of clinical negligence. Pay-outs in the past 10 years have peaked at only £8 million, apart from last year, when the figure rose to £20 million, but that was anomalous. Why is so much—£125 million—held in the coffers, when the

evidence is that we have paid out only about £8 million in each of the past 10 years? Perhaps the opportunity exists to reinvest some of that money in front-line care.

Mr Black: It is important to bear in mind the distinction between the amount that is paid out and the amount that is provided for claims that will be required to be paid and for contingent liabilities, which are potential claims. It is fundamental to good financial management to provide for expenditure that will definitely occur and to recognise liabilities for other spending. That lies at the heart of the difference between the amount that is paid and the amount that is provided for.

Historically, claims for clinical medical negligence in Scotland have been low in comparison with those south of the border. However, the trend has been for an increase. It is not entirely clear whether that is due simply to the one-off settlement of a small number of cases, as the report says, or to a longer-running trend. We need to keep the issue under review.

The issue is not a problem for individual boards, because they pay into a central pot as a form of insurance scheme. The cost of clinical negligence is shared among all the boards, so it does not hit the finances of any board more than another.

Willie Coffey: I absolutely appreciate everything that you said. I am just interested in the scale of the difference between the cost and the provision. As I said, pay-outs have peaked at about £8 million per year, but the NHS sets aside £125 million for claims. Although I appreciate that there is a need to do that, the difference is so huge that some attention needs to be paid to it.

Mr Black: I am not sure that we can comment on the appropriateness of the provision. Can Nick Hex help?

Nick Hex (Audit Scotland): The provision is meant to cover not just the coming year but future years. It is not just £8 million or £20 million for a particular year; the money will cover all cases in the pipeline, quite a lot of which might take more than a year. We are aware of the number of cases, but as the Auditor General says, we cannot say whether the provision is adequate.

Willie Coffey: I will leave it at that.

Sandra White: The report is excellent; it looks like good news for the health service and patients.

Agenda for change and equal pay come up all the time—Robert Black mentioned them earlier. I note that all health boards should have gone through the agenda for change process by 31 December 2008. Agenda for change is constantly being raised with me, and I am sure that other members hear about it, too.

Murdo Fraser asked about health boards' savings going into the central financial pot. Can health boards use savings to pay for agenda for change or equal pay, or are there certain criteria for the use of extra money?

Mr Black: As I said in my opening remarks, the NHS has some pretty challenging targets for future efficiency savings of more than £600 million for the next few years. That money is available for reinvestment, but it is not possible to earmark future savings for any particular activity.

As we said in our report, the Scottish Government's latest estimate is that agenda for change will cost about £634 million to the end of 2007-08. You are therefore right to say that it is a significant issue for the NHS.

Sandra White: I know that you might not be able to answer my questions but I am looking for some comfort for nurses and others about agenda for change. Your report notes that only four health boards are fully committed to agenda for change. It seems sensible that the staff should be the first to receive any efficiency savings, rather than that money being put into a capital project.

Barbara Hurst: All boards have made provision for agenda for change. Even if they have not settled in the current financial year, they will carry money forward to do so.

The uncertainty is around the level of appeals and the equal pay claim. We know of a case—a discrimination challenge—involving agenda for change in England. That is where the uncertainty lies, not in the accruals for paying existing staff.

Sandra White: Thank you for that clarification.

George Foulkes: It is not all good news. Paragraph 86 says

"it is not yet clear how the SFT will work or how the NHS will be able to access capital funding from this source",

and paragraph 87 says

"It is not yet clear how the SFT intends to secure the private investment for these and future capital projects."

Do you or your colleagues have any indication about how the Scottish Futures Trust will work?

Mr Black: No. Unfortunately, I cannot supply you with any more information than what is in the report.

George Foulkes: Is there nothing on the horizon?

Mr Black: I do not have any information on that at all.

The Convener: On the lead-in for project development, are any concerns emerging about the lack of clarity on how funding will be provided?

Mr Black: We have not looked at the issue in any detail. I am sorry, but I find it difficult to answer that question.

Cathie Craigie: Pages 23 and 24 of Audit Scotland's report, from paragraphs 71 through to 74, refer to savings. Paragraph 71 states that

"In order to achieve their financial positions for 2008/09"

boards have identified £170 million of savings, split between recurring and non-recurring savings. Did your team do any work to identify where boards are making those savings? There is a case study from Glasgow, but can you draw information together in a chart to indicate which services are being affected?

Mr Black: We are unable to comment on that because, as I said, the report is a high-level review of finances in the past year, with no more than a general indication of some of the future challenges that are out there. We plan to undertake further work in the area in the coming year. I ask Barbara Hurst to give an indication of our intentions.

Barbara Hurst: We plan to kick off a study early in the new year that will examine efficiencies across the public sector. We will consider not only the 2 per cent efficiency targets but how public bodies are gearing up to make efficiency savings and whether those are recurring or one-off savings. We hope to publish the report in late summer, so it is a case of jam tomorrow for the committee. We will examine how not only health bodies but local government and central Government bodies make efficiencies.

Cathie Craigie: Paragraph 73 states that boards have highlighted the risk that they may fail to achieve the planned savings for 2008-09. What is the fallback position? I understand that, if an organisation is asked to make a saving of 1 or 2 per cent, that money does not go to the organisation, as it is expected to make the saving within its budget. When do alarm bells ring? When are decisions made to alter the budget allocations to deal with any problems?

Mr Black: It is very difficult for us to comment in-year, because the position within individual boards can change markedly as the year progresses. Any comments that we offer on such matters are always tentative and we are reluctant to give figures. We decided that, on the basis of the information that we acquired from NHS Greater Glasgow and Clyde, we could put in an example of the challenge that boards face. I said in my opening remarks that the savings that a number of boards are expected to find in future are greater than the savings that they managed to deliver in the past. That is one high-level indication of the pressure that will be on board finances against the overall position of their managing their finances

rather well. Can the team help on the efficiency savings question?

Nick Hex: One of the issues that we looked at in the Western Isles was Government monitoring. Cathie Craigie asked about alarm bells ringing. The Government has a robust system in place to monitor how boards are doing in meeting their budgets. She is right to point out that the savings are built into the budget at the start of the year, so this is all tied in with boards not exceeding their revenue resource limit, through which they manage their financial position throughout the year. A system is in place, and the auditors keep an eye on the situation. We do not necessarily look at the financial position in the round until the year end, but we are aware that the Government keeps an eye on it.

11:15

Stuart McMillan: Paragraphs 33 and 34 of the report are on sickness rates and efficiency savings. There is quite a contrast between the average sickness rate for NHS boards and the rate at NHS 24, which is 9.06 per cent. Is there a reason why the sickness rate at NHS 24 is so high compared with the rates at other bodies?

In addition, I note that the sickness absence savings target has been extended to March 2009. Is any progress being made towards achieving the target and reducing sickness rates?

Barbara Hurst: NHS 24 has always struggled with sickness absence. We can understand some of the reasons for that, because the staff work in a stressful environment. There has also been a conscious policy for NHS 24 to recruit staff, particularly nurses, who are subject to health constraints such as bad backs or whatever. The rate appears to be high, but there are some underlying reasons for that.

The 4 per cent target across the piece is a challenging target for the health service, because it is a public service in which there is a risk of occupational health issues. The health service certainly does not want staff who are sick to go in to work. All that we would say is that the 4 per cent target is challenging, and I think that the health service knows that.

Cathie Craigie: The rate for NHS 24 sticks out like a sore thumb compared with the others. It would be interesting to find out whether NHS 24 is examining the matter. I understand that a good percentage of its staff are employed on a part-time basis, and those people might have other jobs. I accept your point that people who are physically unable to do jobs on wards might work at NHS 24, but NHS 24 also employs people from other backgrounds such as the civil service and call centres. Do you know whether NHS 24 has

analysed how many of its employees work there as a second job rather than as their main job?

Barbara Hurst: Correct me if I am wrong, but I think that, when we considered the matter in more detail, we found that NHS 24's sickness rate was not that different from call centre sickness rates. Although it looks odd compared with the others, it might not be odd compared with the rates for comparable services.

I would be surprised if NHS 24 were not examining its rate of sickness absence, but I cannot give you an absolute assurance because I do not know whether it is doing so.

Sometime next year we will start a study of emergency care services, and of course NHS 24 is key to that, so we will pick up the matter as part of that study.

Nicol Stephen: Exhibit 3 on page 8 shows that, at the end of 2007-08, the NHS boards, as opposed to the special boards, were still carrying a deficit of about £35 million. That is projected to decrease to about £16.5 million by the end of 2008-09. How are those figures agreed with the health directorates? You mention an underspend of £24 million by the NHS in Scotland, and I think that the NHS boards had an underspend of £50 million in 2007-08. How should we interpret that in the context of the continuing deficits? Would the deficit be £85 million if NHS boards had not underspent by £50 million, or is that a simplistic way to look at it?

Mr Black: Perhaps Nick Hex can take us through the figures.

Nick Hex: I can, if you would like me to disentangle them. Exhibit 3 shows the underlying financial position for the board—it is not the year-end position, which is highlighted in appendix 1 and which shows where the board finishes in terms of its financial accounts. As you can see, all the boards apart from NHS Western Isles achieved their revenue resource limit.

Exhibit 3 essentially strips out any one-off funding that the board receives and any one-off payments that it makes during the year. We are simply trying to match up the recurring funding that the board receives with the recurring expenditure that it makes, to show how the board lives within its means. As you rightly point out, we have shown that the NHS boards—the territorial boards, as it were—have a total underlying deficit of £35 million, but that is offset slightly by the special boards, which have an underlying surplus of £18 million. That deficit has reduced significantly for the NHS boards from about £103 million last year.

Things are moving in the right direction. Increasingly, the boards are more financially sustainable, in that they do not have to rely on

one-off funding to bridge that £35 million gap and break even, as they would have had to do in the past. I do not know whether that helps.

Nicol Stephen: I could carry on for some time, but I will stop there. It points me in the right direction, which is helpful.

The Convener: With regard to the issue of the underlying deficits as a percentage of recurring income, the figures for NHS Orkney and—to some extent—NHS Shetland are worrying. You state at the top of exhibit 3:

“The three island boards and NHS Highland have the biggest underlying recurring deficits as a percentage of their recurring income.”

The committee has identified that issue before. We have pondered whether there are issues with regard to the size and the relative expense of maintaining an infrastructure for those small boards, as well as attracting the expertise. The committee can deliberate on that later, so I will leave it aside, but is there a particular worry about NHS Orkney, and perhaps NHS Shetland, that needs to be considered?

Mr Black: It is difficult to say at this stage. The auditors are keeping an eye on it, and we are aware that NHS Orkney in particular has some issues that it needs to address. I do not want to say anything about the future position of those boards, but they will need to be carefully monitored. I am not sure whether Nick Hex would like to comment on the detailed analysis, bearing in mind that all this will be in the *Official Report*, as I keep reminding my staff.

Nick Hex: I do not think there is anything to add.

Nicol Stephen: The figure for the underlying deficit in NHS Western Isles in 2007-08 is £2.5 million, and it is £1.1 million for 2008-09. Does that mean that NHS Western Isles is expected to make a surplus of £1.4 million in 2008-09, or is that too simplistic?

Nick Hex: Again, it is about trying to convert some of the one-off funding on which the board has relied in the past into recurring funding—or rather, about the board trying to live within its means. Part of that relates to efficiency: if the board can achieve recurring efficiency savings, that helps to ensure that it can live within its recurring budget.

Sandra White: You mentioned that you were going to consider the finances of public bodies. In paragraph 88, you talk about the new international financial reporting standards, which you say

“will have significant implications for NHS bodies as it is more likely that they will be required to show PFI assets on their balance sheets.”

Will you elaborate on that? What will NHS bodies have to do? Will the new set-up have financial implications for them?

Mr Black: The introduction of the international financial reporting standards—and bringing assets on balance sheet—will be an issue not only for the Scottish Government but for the UK as a whole. Discussions are on-going about how the new reporting standards will be treated. My understanding is that provisions will be made at the level of health boards to cover that. Unfortunately, I am not fully sighted on the latest UK-level policy decisions on the issue.

Nick Hex: All we can really say is what is in that paragraph, which is that we are aware that the new reporting standards may have an impact. It will be down to the individual bodies and the auditors to decide whether some of the new capital schemes will be included on their balance sheets. That may imply some additional costs, depending on how those schemes are shown. Various accounting issues are tied up in that, which are probably too complex to explain here. However, I am not aware of any significant developments since that paragraph was published.

The Convener: Thank you for your contribution. The discussion has been useful. We will come to our deliberations on the issue later in the agenda.

Section 22 Report: Response

“The 2007/08 audit of Western Isles Health Board”

11:26

The Convener: We have received a response from the accountable officer on the Auditor General for Scotland’s report on the 2007-08 audit of NHS Western Isles. We have deliberated long and hard about NHS Western Isles and considered the health board in some detail. I am not sure that there is much more that the committee can do. Unless members have something specific that they want to pursue, I suggest that we note the report.

Nicol Stephen: I agree, but it is worth pointing out that Nicola Sturgeon mentions—in paragraph 9 of her letter to John Angus Mackay—that the board’s financial plan

“projects a return to recurring balance by 2010-11”—

I asked about exhibit 3 earlier partly because it showed a recurring balance table—

“and you assured me that you remained sighted on this.”

I do not know what that means, but those are the words in the letter. It suggests that the health board is expected to make either surpluses next year and in 2010-11, or a very big surplus in one of those two years.

According to the table in exhibit 3 that I asked about earlier, the current recurring deficit is £2.5 million. In order to achieve a surplus, there would need to be quite a significant turnaround from the current position, which, as I understand it, is effectively to achieve a break-even point. We need to keep a careful eye on that. It will be very challenging for such a small health authority to achieve a recurring neutral position by 2010-11 without there being an impact on clinical services. At least we now have an answer to that question—the last time that we discussed it, there was no target. We do not know whether that target is the result of pressure from the Scottish Government or is entirely voluntary on the part of the health board, but it suggests that the target is to achieve that break-even point within two years.

11:30

The Convener: We can continue to ask for updates on the issue. It is worth recording yet again our gratitude for the progress that has been and is being made by those who are currently involved with Western Isles NHS Board—there has been a remarkable turnaround.

Stuart McMillan: In his letter, on page 4 of paper AU/S3/08/18/5, under the heading "Staffing", Kevin Woods states:

"More generally, the Scottish Government is facilitating a significant level of additional staffing support to strengthen the capability of NHS Western Isles."

That is a positive step, but I am keen to get more information on the support that is being provided. Given that we asked about senior staffing, I would like to know exactly what is being done.

The Convener: We have no information to date, but we can find that out. Do members agree to note the report?

Members *indicated agreement.*

11:31

Meeting continued in private until 12:31.

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