

AUDIT COMMITTEE

Tuesday 30 April 2002
(*Afternoon*)

Session 1

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AUDIT COMMITTEE

7th Meeting 2002, Session 1

CONVENER

*Mr Andrew Welsh (Angus) (SNP)

DEPUTY CONVENER

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

COMMITTEE MEMBERS

Scott Barrie (Dunfermline West) (Lab)

*Margaret Jamieson (Kilmarnock and Loudoun) (Lab)

*Paul Martin (Glasgow Springburn) (Lab)

*Mr Lloyd Quinan (West of Scotland) (SNP)

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

*attended

THE FOLLOWING ALSO ATTENDED:

Mr Robert Black (Auditor General for Scotland)

WITNESSES

Dr Peter Collings (Scottish Executive Finance and Central Services Department)

Mr David Reid (Scottish Executive Finance and Central Services Department)

CLERK TO THE COMMITTEE

David McGill

SENIOR ASSISTANT CLERK

Ruth Cooper

ASSISTANT CLERK

Seán Wixted

LOCATION

Committee Room 3

Scottish Parliament

Audit Committee

Tuesday 30 April 2002

(Afternoon)

[THE CONVENER opened the meeting at 14:02]

The Convener (Mr Andrew Welsh): I welcome everyone to the seventh meeting this year of the Audit Committee. I remind people to ensure that all mobile phones and pagers are switched off. We have received apologies from Scott Barrie.

Joining us today is Ruth Hargreaves from Pfizer Ltd, who is taking part in the Parliament's business exchange scheme. She is here today as an observer and to gain insight into the work of an MSP—she is closely scrutinising our colleague Keith Raffan. I welcome you to this meeting of the Audit Committee, Ruth.

Items in Private

The Convener: I would like us to decide whether to take in private agenda items 2, 4, 5 and 6. Items 2 and 4 relate to our evidence-taking session on public accounts. Item 2 is intended to allow the committee to consider lines of questioning to be put to our witnesses; item 4 allows the committee to consider the evidence that we will have taken. Item 5 is on a briefing from Audit Scotland on issues surrounding community care, which will assist the committee in any future work that it takes on in that area. Item 6 will allow the committee to consider its revised draft report on our inquiry into the Auditor General for Scotland's report "Overview of the National Health Service in Scotland 2000/01". Does the committee agree to take items 2, 4, 5 and 6 in private?

Members indicated agreement.

The Convener: The committee will shortly consider its draft report arising from today's consideration of public accounts, and the Auditor General will wish to brief the committee on his overview report on further education. It would be helpful if the committee agreed to take those future items in private. Does the committee so agree?

Members indicated agreement.

14:04

Meeting continued in private.

14:19

Meeting continued in public.

Public Accounts

The Convener: Item 3 is consideration of public accounts. I welcome our witnesses. We have with us Dr Peter Collings, the principal finance officer of the Scottish Executive, and his colleague Mr David Reid, assistant director of finance at the Scottish Executive. They are both most welcome.

We will examine issues arising from the Auditor General's reports on the 2000-01 accounts of four public bodies: the Scottish Prison Service, Scottish Natural Heritage, Scottish Homes and the Scottish Qualifications Authority. I understand that the facts that are contained in those reports have already been agreed. Is that so?

Dr Peter Collings (Scottish Executive Finance and Central Services Department): That is correct.

The Convener: We will ask questions on three main areas: issues arising from the SPS's accounting treatment for a private finance initiative contract involving HMP Kilmarnock; European state aid issues concerning the payment of grants by SNH and Scottish Homes; and the financial implications of the SQA's 2000 diet of examinations.

I will open by asking a question concerning the SPS. It seems strange that Kilmarnock prison, which was built under a PFI deal, does not appear as a property asset of either the SPS or the prison operator. Will you tell us why that situation arose and what the implications are for the SPS?

Dr Collings: I agree that it is strange. The Auditor General has brought it to the attention of the Accounting Standards Board so that it can take account of the situation as it revises its standards.

You ask why the situation arose. The Accounting Standards Board has issued guidance on how to account for PFI projects. That guidance requires considerable judgment on the part of the director of finance of the relevant body and its auditor on whether the asset is on the balance sheet of the body. The guidance does not offer the choice of having half the value on the balance sheet. It says that it is either on or it is not.

In the instance of Kilmarnock prison, the SPS took the view that, following the guidance and a technical note that was produced by the Treasury task force on private finance, which the Accounting Standards Board had agreed, the asset was not on its balance sheet. The auditor

did not disagree with that view. Separately, the contractor took the view that the asset was not on its balance sheet and its auditor did not dissent from that view, as I understand it. There is no requirement in any ASB guidance that the two parties should agree on the accounting treatment.

Each party has followed the guidance that has been issued on the subject to the best of its abilities and has produced the result that we have. I agree that that result is not sensible. That reflects on the guidance and the need to revise it. The ASB has a major programme of reviewing guidance on assets that are under various sorts of contract or lease. At some point, one hopes, it will produce guidance that produces sensible results in all cases. However, there is no sign of that appearing early.

The Convener: So we are using something that is not sensible. When will the ASB guidelines be decided on? When will the situation be sorted out? What is the time scale?

Dr Collings: The ASB has been considering the matter actively for several years and has produced various suggestions. Given that the process is also tied up with the United Kingdom's moving to follow fully international accounting standards, which at the moment do not cover such circumstances, we are probably talking about years rather than months before we have revised guidance that covers the situation adequately. I do not know whether Audit Scotland has a different view on that. My view is that revised guidance is unlikely to be early.

Mr Robert Black (Auditor General for Scotland): I agree with that.

The Convener: That means that we will have an anomalous situation and could be in limbo for several years. What is the normal practice in PFI contracts? Is it normal practice for assets not to appear on balance sheets?

Dr Collings: In most PFI contracts, we expect the asset to appear on the balance sheet not of the public sector body, but of the private sector company. However, examples will arise where the situation is the other way round. In those cases, the public sector views the deal as good value for money and, under the guidance that has been produced, makes the assessment that the asset should be on the balance sheet. In those instances, one would hope that the asset was not on the balance sheet of the private sector body. The difficulty is that, under the guidance, such anomalous circumstances can arise.

The Convener: Who owns the property?

Dr Collings: The Prison Service is the legal owner of Kilmarnock prison. However, the contractor has a 25-year concession on it. At the

end of that 25-year period, the prison reverts back to the Prison Service.

The Convener: We will come later to the risks that are involved. I want to clarify that it is the Prison Service that owns the prison, but, under a contract that is anomalous, the private company has taken it over.

Dr Collings: It is not the contract that is anomalous; it is the accounting treatment.

The Convener: That will not be sorted out.

Dr Collings: Full disclosure of the value of the asset and of the payments that are due under the contract are to be found in the Prison Service accounts. In that sense, therefore, there is full public disclosure of the financial implications of the contract.

Mr Keith Raffan (Mid Scotland and Fife) (LD): I do not want to ask you questions that we should direct towards the SPS board, but is the ASB waiting for international standards to be set in the field?

Dr Collings: The ASB is not waiting; it is pressing for international standards that would adequately cover the field. It is not sitting back, doing nothing and waiting for it to happen. The ASB is one of the most active participants in the process of setting international standards.

Mr Raffan: Why cannot the ASB act unilaterally?

Dr Collings: If the ASB wished to do so, it could act ahead of an international standard being set. The question for the ASB is whether it should revise its guidance if an international standard is not going to be set for a long time. I understand that there is no move to do that at the moment.

Mr Raffan: Are the consequences of that anomalous situation significant?

Dr Collings: No. It is entirely a matter of the presentation of the accounts. It does not affect any of the goings-on in the real world.

The Convener: Given that the anomaly has lasted two years and that it could last another two years or more, would it not be sensible to sort it out? When the international guidelines appear, the chances are that the ASB guidelines will be pretty close to them. Why allow an anomaly that everybody accepts is strange to continue?

Dr Collings: The Auditor General has drawn the ASB's attention to the matter. We will have to see how the board reacts.

The Convener: Will the Executive help to press the case to sort out the anomaly?

Dr Collings: I am entirely happy to do so, if that seems helpful. Our assumption was that, as the

Auditor General had done so, there was no need for us to do so. I am happy to say that we concur entirely with his views. I am also happy to raise the matter with the Financial Reporting Advisory Board, the body that advises the Treasury and us. Members may recollect that we agreed to sign up to FRAB. I am happy to raise the issue with that body.

The Convener: That would be helpful.

Mr David Davidson (North-East Scotland) (Con): The Executive's finance department has to liaise with the Westminster Treasury on all sorts of accounting procedures. We are in a situation in which no international standard applies and nothing in the rulebooks applies. What is the fallback position? All accountability must rest with the Executive, which must be the longstop, regardless of whether there are international standards. What is the procedure for accounting for the asset within the Executive? What position have you advised the Executive to adopt—if you have given such advice—in relation to the contract, given that you do not follow the international accounting standards that the Auditor General must apply to his remit?

14:30

Dr Collings: There is guidance—I referred to the ASB guidance, which was supplemented by guidance from the Treasury task force. The difficulty is that the parties, having followed the guidance in good faith, have found themselves in this anomalous situation. It is not that there is no guidance and that therefore we might be expected to make a judgment because we are signed up to guidance. Unfortunately, this is the result that following the guidance has produced.

Mr Davidson: In that case, if guidance exists and if the Executive is following that guidance, where does the Executive place the asset?

Dr Collings: We place it off our balance sheet. It is a matter for the company whether it places the asset on its balance sheet—that is not a matter for us.

Mr Davidson: May I clarify that point? Are you saying that the Executive's position is, "This has nothing to do with us and we do not have a view on where it belongs at this point in time"? I asked where you placed the asset, not where you did not place it. Have you labelled it within the Executive's system as something that does not belong to the Scottish Executive and that therefore must belong to the contractor, or is it simply in limbo?

Dr Collings: We labelled the asset as not belonging to the Executive. However, it will revert to the Executive after 25 years and the value of that reversion is reflected in the accounts.

The Convener: How can you label something as not belonging to the Executive when you say that the SPS owns it?

Dr Collings: In accounting, there is a difference between the substance of transactions and their legal form. In general, there is a presupposition that accounts will be dealt with according to a transaction's substance rather than its legal form. The legal form is that the Executive owns the prison. The substance of the transaction is that, for that 25-year period, the prison is under the control of the contractor. The accounting treatment reflects the substance of the relationship, in order to avoid the creative accounting problems that might exist if we were to follow its legal form.

Mr Raffan: I am trying to get the situation straight in my mind. Could one say that it is similar to freehold and leasehold?

Dr Collings: In some respects, yes. Let us ignore PFI and go back to the period before PFI existed. We have had leases that lasted for longer than PFI leases. There are two main types of lease: operating leases and finance leases. Under both, the contractor has had ownership of the asset, but under accounting standards—and finance leases—the asset is shown on the balance sheet of the organisation that leases the asset. The assessment is of where—practically rather than legally—the balance of the risks and rewards of ownership lies.

The Convener: Is there disagreement over where that balance lies?

Dr Collings: The contractor and the SPS arrived at different views.

The Convener: Who sorts out that difference? We seem to be in limbo again. Who decides which position is correct?

Dr Collings: Nobody has the job of making that decision. We are responsible for our accounts and have no responsibility for the contractor's accounts. The two sets of auditors will talk to each other. When they consider the evidence together, they may—or may not—reach a view as to where the asset should sit.

Paul Martin (Glasgow Springburn) (Lab): Does the asset have any tax or Inland Revenue implications for Premier Prison Services? As far as the Inland Revenue is concerned, is it beneficial that the asset is not noted in the contractor's accounts?

Dr Collings: As far as I am aware, there are no tax implications. Implications would be more likely to arise if, for example, Premier Prison Services attempted to borrow more money. That would affect its balance sheet, which might influence people who would be lending to it. However, as far as I am aware, there are no tax implications.

Paul Martin: So the Inland Revenue would not want to clarify the ownership of assets.

Dr Collings: No, I do not think that it would.

Paul Martin: Why would that be? Do assets not have tax implications? That is a technical question that may require further clarification, but can you say unequivocally that there are no tax implications?

Dr Collings: I cannot say that unequivocally. I am happy to write to the committee on the matter. As far as I know, there are no tax implications—the Inland Revenue's rules on capital allowances do not quite square with the accounting rules, so the treatment of assets for tax does not quite square with the accounting rules. The Inland Revenue operates under its own set of rules on assets.

Paul Martin: Can you explore that issue further and get back to the committee?

Dr Collings: Yes.

Paul Martin: That would be appreciated.

The Convener: If the SPS and the prison operator have different views on who bears the majority of risks and rewards, do similar doubts exist about other obligations on either party under the PFI contract? If so, what are they?

Dr Collings: I do not think that there are any such doubts. The issue is the relative importance of the different risks that are carried by each party. It is not about who carries which risk; it is about the balance of risks, once they are added up.

The Convener: But contracts normally set out clearly the rights of and obligations on each party.

Dr Collings: They do.

The Convener: Why is that not the case with this contract?

Dr Collings: The contract sets out those rights and obligations, but where the balance of the risks and rewards of ownership lies is a matter of judgment. That is why it is possible to come up with different results. It is not a matter of plugging the provisions of the contract into a formula and arriving at a set result.

The Convener: Was there something about the risks that are involved that made them difficult to state clearly in the contract and that made the situation particularly complex or difficult to resolve?

Dr Collings: I do not think so. The problem is that PFI contracts lie close to the boundary between the balance of risks and rewards lying on the public sector side and the balance of risks and rewards lying on the private sector side. Typically, each side carries some risks. Which side carries the majority of risks is a matter of judgment. Such

a situation is particularly prone to happen with PFI contracts, because there is a difficult judgment to exercise.

Mr Raffan: Can you give us examples of the risks and rewards? I am not asking you to list them all, because that might take a whole day.

Dr Collings: Risks that lie with the operator relate to, for example, operational cost overruns, maintenance cost overruns, the operation of the prison and performance failing to meet contractual standards. Risks that lie with the SPS are, for example, demand risk—for example, if there are insufficient prisoners, places will not be needed. If there were a policy change that meant that the SPS decided to terminate the contract, the risk of the cost would lie with the SPS. Those are the sorts of risks that we are talking about.

The Convener: We will now examine whether the Scottish Executive is satisfied with guidance that enables a property asset to appear in either party's balance sheet.

Mr Davidson: We take the Auditor General's position as a given, and move forward from there. What factors are taken into account in assessing the degree of risk transference in the operating contract? Given the situation that we are in, how can both sides seem to conclude that the other side bears the bulk of the risks? Were those factors not discussed before the contract was signed? How can two people take different views on who has the risk? There must be some Scottish Executive guidelines that indicate what the factors are and how you define them. Can you give us some guidance on that?

Dr Collings: I am hesitant to do that, as I am not sure where to start. Essentially, the guidance is contained in "Treasury Taskforce Private Finance Technical note No 1 (Revised)". Any risks that relate purely to service provision, and are not tied in any way to the property, are excluded. For example, if security staff in a prison were not trained adequately and did not meet some of the standards that the SPS set, the resulting risk would be borne by the contractor, but would be

"irrelevant to determining which party has an asset of the property."

In other cases, one must reach a judgment about who has most access to the benefits of the property and most exposure to the associated risks. That involves writing down all the risks and trying to quantify their potential financial effects. By examining historical data for the operation of prisons, for example, we can decide how likely each risk is to materialise. After adding up the risks, bodies can decide whether something should sit on their balance sheet. Each body does so based on its own view of its position and the risks that it faces.

Mr Davidson: The Executive acts as a clearing house for PFI projects and must give permission for them to go ahead. The objective of most PFI projects is to transfer risks, on the basis that the private sector is better at handling them. Before the Executive approves a contract, there must be an agreed set of factors. Does a manual or list exist to help the Executive to make that decision? You have described how you objectively consider and quantify risk. Presumably contractors and executive agencies do that in-house. However, when a project is referred back to the Executive for final permission to proceed, under what agreed set of factors does the Executive operate? If those factors are clear, the people involved with a contract further down will have a better idea of the Executive's position. We must then ask why they do not agree with what the Executive set out in the first place.

Dr Collings: Prior to committing to contract, we require the body concerned—in this case, the SPS executive agency—to reach a view on whether the asset should appear on its balance sheet. In coming to a decision, the body is required to follow guidance issued by the ASB and the Treasury. Once it has done so, we ask it to provide a preliminary opinion from its auditor. Auditors will not commit themselves to a firm opinion to which they promise to adhere once the accounts have been produced. However, they will give an indication of whether they are happy with the analysis that a body has produced.

To sum up, we require bodies to provide us with their view, together with detailed explanations of whether the asset will appear on their balance sheet and an indication of whether, at least for the moment, their auditor agrees with the view that they have taken.

Whether an asset is on or off balance sheet would not necessarily affect whether a contract goes ahead. It is perfectly possible, although I have never come across it, to know ahead of signing a contract that an asset will be on balance sheet, but to decide to go ahead with the contract because it is good value for money. As the accounting and budgeting treatment will be different if that is the case, we need some indication ahead of signing the contract.

Mr Davidson: I accept that. However, why do you think that the other side of the contract took the view that the risk was with the Prison Service? Do you take a view on that?

14:45

Dr Collings: No, that is a matter for the contractors. Our concern is what the Prison Service does.

Mr Raffan: What lessons has the Executive learned from Kilmarnock prison in relation to future

PFI or public-private partnership deals involving prisons?

Dr Collings: You would have to ask the Prison Service for an answer on the broad point—I am not an expert on prisons. In terms of the accounting treatment, it is clear that it would be sensible for us to check out with contractors whether they had a different view of the accounting treatment ahead of contract. If they had a different view, that would not necessarily prevent us from taking up the contract or change our view. However, it might be sensible to find out their view at that point.

Mr Raffan: On the narrow accounting issue.

Dr Collings: Yes.

Paul Martin: To what extent is the Scottish Executive content with guidance that enables the property asset to appear on neither party's balance sheet subsequent to a PFI contract?

Dr Collings: It is right that we sign up to the ASB and follow guidance, because that means that our accounts are produced on the same basis as others in the United Kingdom. Departing from that would be dangerous. As I said earlier, in this case, the guidance has not produced a sensible result overall and I am happy to raise that issue with FRAB. However, as a matter of principle we should continue to follow the guidance and work with the Treasury to make it better.

Paul Martin: What are the implications of not relying on the guidance? Is it within the Executive's powers not to follow the guidance and to circulate its own instructions on accounting treatment in PFI contracts?

Dr Collings: That is entirely possible. However, it would raise several problems, such as a lack of comparability between accounts produced here and elsewhere. Furthermore, we would need to bring the Auditor General and Audit Scotland with us; if we did not, those bodies might feel that the accounts failed to take a true and fair view, as they did not follow UK guidance.

Mr Raffan: Are you aware of a comparable situation down south?

Dr Collings: I have not heard of any comparable cases.

The Convener: We will now consider whether the public sector is at risk if there is a loss of service or additional cost because Kilmarnock prison becomes unavailable for an extended period—through fire, for example.

Margaret Jamieson (Kilmarnock and Loudoun) (Lab): Perhaps I should declare an interest, because Kilmarnock prison is in my constituency. If Kilmarnock prison were unavailable for an extended period, who would be

responsible for rehousing the prisoners and who would bear the cost of the transfer?

Dr Collings: I begin by saying that my knowledge of prisons is limited—I do not work in the SPS. However, I will endeavour to answer as best as I can; if I get anything wrong, I will write to the committee and say so.

The Convener: That would be appreciated.

Dr Collings: Essentially, the financial risk lies with the contractor, but the risk in terms of finding alternative accommodation would lie with the Prison Service. It is clear that the considerable financial penalties on the contractor would make available funds, which could be used to help finance the provision of alternative accommodation.

The Convener: Who insures the prison?

Dr Collings: The contractor.

Margaret Jamieson: Is the Scottish Executive satisfied that Premier Prison Services has adequate insurance cover to meet its liabilities?

Dr Collings: Yes. That matter is covered in detail in the contract. If the prison became permanently unavailable—for example, because of fire—that would be covered and Premier Prison Services would, through its insurance, bear the costs to the Prison Service of making alternative arrangements.

Margaret Jamieson: Are you saying that if—in the worst-case scenario—Kilmarnock prison was destroyed totally by fire, the SPS would be relied on to house prisoners elsewhere in the estate and that the private contractor would be liable through its insurers for the total rebuilding of the prison?

Dr Collings: The Prison Service would have the option of rebuilding the prison or imposing a financial penalty on the contractor to provide the Prison Service with funds for alternative provision. Either avenue would, in principle, be open to the Prison Service.

Margaret Jamieson: The difficulty is that Kilmarnock prison houses 500 category B prisoners, the vast majority of whom have been tried and are at various stages of their sentences. Obviously, they could not simply go walkabout; they would have to go somewhere else. Given the problems with capacity in the prison estate, what provisions exist in the contract to ensure that prisoners would remain in the SPS?

Dr Collings: The contract gives considerable cover to the Prison Service for a financial risk that is associated with things going wrong. Difficult operational issues would arise from the destruction of any prison—whether private or public—and the Prison Service would have to deal with them. The Prison Service is covered comprehensively for financial risks.

Margaret Jamieson: That is the point that most members of the committee and of the Parliament have great difficulty in understanding. It appears to be only the financial risks that are high up on the agenda. There are 500 inmates in Kilmarnock at any given time, the vast majority of whom have been tried. They would have to be rehoused. The SPS could not simply phone up a hotel chain to ask for 500 beds. The accommodation must be secure. What provisions exist in the contract for that eventuality?

Dr Collings: The Prison Service is required to have in place plans for managing operational risk for the whole prison estate in Scotland. The operational issues are no different for public or private prisons. The SPS has in place operational plans in case any of its prisons become unavailable, but I am not privy to the details of those plans.

Margaret Jamieson: Convener, it might be unfair to ask Dr Collings such detailed questions about the SPS. Perhaps we should ask them of the SPS.

Mr Raffan: Hear, hear.

The Convener: Indeed; we should consider so doing.

Who is liable for personal injury in a private prison? If a prisoner was housed in a SPS prison, I assume that the SPS would be liable.

Dr Collings: I am fairly sure that the contractor would be liable.

The Convener: I assume that the contractor would cover the liability with insurance. If the prison burned down completely, would the contractor be responsible for insuring the building?

Dr Collings: Yes.

The Convener: Are you assured that the cover is adequate?

Dr Collings: The contract goes into considerable detail about the level of insurance cover that the contractor is required to take.

Margaret Jamieson: A number of fatal accident inquiries have related to deaths at Kilmarnock prison. The SPS was legally represented at those inquiries, as was Premier Prison Services. That seems to represent a public demonstration of shared risk. If Premier Prison Services was found to be at fault, why must the SPS have legal representation at FAIs?

Dr Collings: I assume that the Scottish Prison Service continues to consider that it has responsibility for people who are in that prison. The SPS exercises that responsibility through Premier Prison Services, but it continues to have a degree of responsibility to the public for operation of the prison service at Kilmarnock.

Mr Raffan: In a reply to Margaret Jamieson, you used the phrase "considerable cover" rather than the phrase "total cover" or "complete cover". Will you define "considerable cover"?

Dr Collings: Premier Prison Services is contracted to take out adequate insurance in case of problems that prevent it from carrying out its contractual duties. The insurance ensures that sufficient money would be available to meet the financial consequences of any problems that arose.

Mr Raffan: I wish to be absolutely clear about the consequences, which I view as being twofold. One is to cover the situation of rebuilding the prison or of giving money to the SPS to rebuild the prison. The other is to cover rehousing prisoners while the prison is rebuilt or alternative accommodation is found. Is that correct?

Dr Collings: The insurance covers whatever solution SPS decides to take to rehouse prisoners.

Mr Raffan: Does that include the transition period?

Dr Collings: Yes.

The Convener: We turn now to questions that relate to Scottish Natural Heritage and what was then Scottish Homes. Keith Raffan has a question about whether the European Commission has decided whether the nature conservation management agreements entered into by SNH before 1 January 2000 constitute state aid.

Mr Raffan: What is the current position? Do those grants constitute state aid?

Mr David Reid (Scottish Executive Finance and Central Services Department): The European Commission has not yet come to a view or taken a decision on the notification that the UK Government gave at the end of 1999. In February, our representatives raised the matter again with the Commission, which said that it is not yet in a position to say when it will come to a view on the matter.

Mr Raffan: Why is the Commission taking so long?

Mr Reid: The Commission feels that it dealt with the most pressing requirement, which was to agree the new scheme operating under the new European regulations from 1 January 2000. The Commission does not give the same priority to examining schemes that have operated in the past as it does to new schemes that member states wish to initiate. The committee must appreciate that the issue was raised because it affects all the conservation agencies throughout the United Kingdom. The Commission's approach to our notification was that the position should be regularised. I believe that the Commission might

take the view that, having approved the new scheme, it is content to let matters rest for the time being in relation to what happened prior to January 2000.

15:00

Mr Raffan: Does that put you in a potentially difficult position in that you might at some time have to try to recover grants that have been paid?

Mr Reid: There is no formal statement from the Commission on those matters, either. The Commission has indicated that it has no intention of asking the UK Government to pursue past payments. The emphasis was on regularisation of a situation that resulted inadvertently from failure to identify or notify management agreements before the matter came to the Commission's attention.

Mr Raffan: So you are off the hook.

Mr Reid: That is the advice that the UK Government has given us—it applies in England.

The Convener: The Commission has the power to recoup the moneys. How much is at stake?

Mr Reid: The power would be to require the member state to recover the money from the recipients. It would be for us, rather than for the Commission, to recoup any funds. No European funds, as such, are involved.

The Convener: Will you give us an idea of the amount of money that would be involved?

Mr Reid: I cannot give a precise figure but, as the Auditor General's report indicates, the amount that is paid on management agreements is between £2 million and £3 million a year. I reiterate that the Commission has not indicated that it is likely to pursue requiring any part of the UK to recover money.

Mr Raffan: Are you confident that no other grant scheme breaches European state aid regulations?

Mr Reid: We have to consider the circumstances in which the issue came to light and the circumstances that are reported on in connection with Scottish Homes. Schemes were operating that were not considered to be caught by the state aid requirements, because they were not considered to involve classic state aid to business.

In the case of the management agreements, the funding was to help with the conservation of the environment. In the case of the Scottish Homes grants, the funding was to assist with the provision of social housing. Such cases tend to come up in unusual areas, not in typical business development schemes, so we cannot say that we are 100 per cent confident that no other scheme

breaches European regulations. Given the coincidence of those schemes coming to our attention, awareness of the state aid issue is much higher within the Executive than it has ever been.

We have put measures in place. A state aid unit has been established in the Executive and, as part of our financial guidance, we have issued a note that advises people about the processes that are to be followed if they are setting up a financial assistance scheme, in case it is caught by rules on state aid. Nothing else has come to light that would cause concern. Although I cannot give Keith Raffan the absolute assurance that he seeks, we feel that if other schemes offended state aid rules, we ought to have known about them by now.

Mr Raffan: Does the state aid unit work much more closely with the Commission than did the Executive hitherto?

Mr Reid: The unit provides a centre of expertise within the Executive. It works closely, rather than directly, with the Commission through the United Kingdom permanent representation to the European Union in Brussels and the Executive's office in Brussels. The existence of that office has provided another helpful focus on Europe as an issue. It also provides a means of conducting a dialogue with relevant Commission officials.

Mr Raffan: I do not want to get bogged down in detail, but I would have thought that when we are trying to sort out something like this—which is quite complex and detailed, and touches on unusual areas—why must we go through UKREP? Why can officials not talk to officials?

Mr Reid: When there is an issue to discuss, the substantive dialogue takes place between Executive officials and Commission officials, but those matters are not devolved. The UK's dealings with the Commission are reserved, as is state aid.

Mr Raffan: I am well aware of all that. That is not the point. I was in Brussels four weeks ago, where I talked to officials. I suppose I was causing a diplomatic incident, but I do not care. The point is that I was getting information from them. Nobody from UKREP was present. I understand the political point that you made, but the point is that we want to talk in order to get the issues straightened out so that there are no more pitfalls. That is what we are trying to sort out. If talks are conducted through intermediaries, there are invariably problems.

Dr Collings: There is a big difference between the sort of informal contact that Keith Raffan is talking about—and which goes on to a considerable extent—and what David Reid is talking about, which is the formal process when we are aware that a specific scheme might be causing a problem. When a specific scheme is involved, we must go through that formal process.

The Convener: Why is there such an element of doubt? The EU is usually precise in what it issues. How do such situations arise? How clear are the rules? If a scheme is devised in Scotland or the UK, surely there must be some way in which to check it before we hand out money.

Mr Reid: The approach to dealing with nature conservation in the UK since the late 1940s has been to use management agreements of the type that we are talking about. Management agreements are part of the fabric of the way in which nature conservation operates. It is not as if there was a narrowly defined and clearly identifiable new scheme that we could examine and say, "This is state aid; it has to be notified." Management agreements reflect a long-term way in which to address environmental issues. It is because of the way that that trespassed into the area of potential financial assistance to the agriculture sector that it came to light that it is a matter that cuts across to state aids rules, when it was realised that action had to be taken. That came to light in England and the other UK countries were brought into the exercise.

In light of the experience of the past two to three years and the creation of our state aid unit, any new scheme of financial assistance, of whatever kind, will be proofed against whether it constitutes a state aid.

The Convener: So, although the situation is purely historical, it hangs over as a potential problem.

Mr Reid: That is my interpretation of events. It is only an interpretation, but it is a reasonable one.

Mr Raffan: You have answered my next question on proofing—I will use the word as you did—new grant schemes for compliance with European state aid rules. Is that also the responsibility of the state aid unit in the Executive?

Mr Reid: That is one of the tasks that the state aid unit carries out.

Mr Raffan: I presume that the Treasury also does that.

Mr Reid: It does not do so for the Scottish Executive. I am not familiar with the processes that operate in Whitehall.

Mr Raffan: You are not familiar with them?

Mr Reid: I am not familiar with how Whitehall would apply the same sort of proofing arrangement.

Mr Raffan: Some grant schemes apply to the United Kingdom. I take it that we are talking about reserved issues in that regard.

Mr Reid: Yes.

Mr Raffan: So why are you not aware of what

the Treasury does?

Mr Reid: Schemes that operate throughout the UK are not the Executive's responsibility.

Mr Raffan: Right. Does the Treasury proof such schemes?

Mr Reid: I am quite confident that it does some form of proofing.

Mr Raffan: Would not it be nice to know how they do that in case it would help you? The Treasury is doing UK proofing and you are doing proofing; they do not know how you are doing it and you do not know how they are doing it. It might be quite nice for you to talk to each other—you might learn something. Best practice, and all that.

Mr Reid: I do not deal directly with our state aid unit. I would be very surprised if they did not have contact with Whitehall.

The Convener: We move on to consideration of the additional costs that the SQA incurred in 2001-02 in rectifying the diet 2000 problems.

Margaret Jamieson: The Auditor General advises in his report that an extra £3.1 million was provided to the SQA to rectify the problems of diet 2000. Did the SQA receive any additional funding in 2001-02? If so, was it directly related to the diet 2000 problems?

Dr Collings: The SQA received a grant of just under £11 million in 2001-02. That was not related to the 2000 exam diet. It related to what was required to deliver the following exam diet. The issues surrounding the 2000 exam diet were sorted out during the financial year 2000-01.

Margaret Jamieson: Are you saying that the difficulties that were rectified by the injection of £3.1 million did not recur?

Dr Collings: No. I am saying that, for example, spending on the SQA systems continued in 2001-02 and that there was a grant that enabled that work to continue. To that extent, work continued, but not to sort out the problems with the 2000 diet. Rather, it was to sort out the SQA's underlying problems.

Margaret Jamieson: Did those underlying problems relate back to diet 2000?

Dr Collings: Yes.

Margaret Jamieson: Do you have a figure for that work?

Dr Collings: As I said, the grant to the SQA was just under £11 million, which related to the difference between the income that the SQA got from fees and how much it required in 2001-02 to deliver the diet for 2001 and to prepare for the diet for 2002. In other words, the SQA has historically

funded itself from fees, but it was not funding itself by £11 million.

The Convener: Let us be clear. The solutions to the problems that occurred in 2000 are still being paid for in subsequent years.

Dr Collings: The solutions to those problems are being paid for, rather than any sort of rectification of diet 2000. The cost of providing an exam system is higher than was expected.

The Convener: Are the problems of 2000 solved?

Dr Collings: They are solved to the extent that the 2001 diet was generally thought to have been delivered successfully. However, it was delivered at a greater cost than previous diets.

15:15

Paul Martin: The information that was available when the Auditor General's report was prepared indicated that the problems of the 2000 diet did not recur during 2001. Is that the case?

Dr Collings: Yes.

Paul Martin: The Auditor General's report on the SQA's accounts refers to several reviews on the problems of diet 2000. Are you satisfied that those problems will not be repeated?

Dr Collings: My responsibilities relate to finance. Education colleagues are responsible for delivery of the exam service. I am confident that the financial issues that cropped up, regarding billing and collection of exam fees, have been sorted out. As I said, the general conclusion was that the exam system that was delivered in 2001 worked. Colleagues advise me that there is every expectation that it will continue to work in 2002.

Paul Martin: Let us relate that to the joined-up government approach. Surely, you would not be happy to release funding unless you were satisfied with delivery of the service.

Dr Collings: Indeed. I have sought reassurances from education colleagues, who have considered the system in detail and given me such reassurances. However, I have not personally gone through the details of the system by which they produce and mark papers.

Paul Martin: Both at your level and at a senior level in education, is it clear that best value will be achieved from the additional funds? Are you and your senior counterpart in education satisfied that there will be no repeat of the problems?

Dr Collings: The funds were necessary to provide a successful diet—that is what happened and the expectation is that that will continue. On best value, we are all working toward long-term improvement of the system. It is a long haul.

Paul Martin: Are you satisfied that no further

large financial input will be required to address fundamental management problems?

Dr Collings: Further financial input will be required, because the cost of delivering the diet will continue to exceed the amount that is expected to be recouped through fees. However, that is not the same as the management measures that were required in 2000.

The Convener: The final word goes to Margaret Jamieson. We are considering whether the financial consequences that are referred to in the Auditor General's report have been fully addressed.

Margaret Jamieson: Does the current cash flow and invoicing in the SQA meet with your approval? At one stage during the difficulties of diet 2000, the SQA had an overdraft of £900,000 and credit notes to the value of £750,000. Are you satisfied that the SQA now has an appropriate level of outstanding credit?

Dr Collings: The SQA's credit has now returned to its level prior to the difficulties in 2000. As the report states, the specific difficulties related to billing people accurately and the reluctance of exam centres to pay bills that they were not sure were correct. Those difficulties have been resolved and we are back to normal.

The Convener: So, the large overdraft has been resolved.

Dr Collings: Yes.

The Convener: Do you want to make any final comments?

Dr Collings: I do not have any further comments, thank you.

The Convener: I thank our witnesses, Dr Collings and Mr Reid, for their attendance and evidence. We now move into private session.

15:20

Meeting continued in private until 16:31.

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