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Why the application of resource accounting and budgeting did not distort the 2002 strategic review of water charges in Scotland

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Introduction

The recent paper by J and M Cuthbert continues the arguments they made earlier in the Commentary that errors in the application of Resource Accounting and Budgeting led to water customers being “overcharged”. Moreover, whilst the “implementation of the new control regime was meant to be neutral, the amount of borrowing available to the water industry under the new regime was clearly very restrictive compared to the borrowing limits applied to the industry” (Cuthbert and Cuthbert 2003; 2006).

The paper repeats their view that the miscalculation of infrastructure renewal expenditure, depreciation costs and interest cover ratio, led to a restriction on borrowing for capital expenditure within the budgetary provision set by the Executive.

In their original paper, they argued that there was a funding shortfall between the borrowing limits set by the Water Industry Commissioner (WIC) and the budgetary provision set out in his Commissioning Letter by the Minister for the Environment and Rural Development (Finnie, 2001), which arose from accounting errors over depreciation costs, as infrastructure renewals expenditure was counted twice, as part of “investment” and as part of “depreciation”. They also query the inclusion of a depreciation element within this framework, which “on the basis of the Treasury advice, should have been in AME”. These are erroneous assumptions. Firstly, infrastructure renewals expenditure was part of the Capital Programme, and a cash charge. Depreciation refers to “non-cash annual depreciation costs” and is a distinctive element of setting the RAB resource allocation in resource terms within the capital DEL, with profits scoring on the Executive’s resource DEL. Secondly, the arrangement whereby departments could score these

non-cash costs in AME under Stage 1 of the implementation of RAB, did **not** apply to public corporations who scored within the DEL (HM Treasury 2000). There was no overlap, no-double counting, and their paper contains misunderstandings of the operation of the budgetary control system in practice.

Resource accounting in practice

This can be demonstrated by setting out the system in detail. Resource Accounting and Budgeting (RAB) seeks to promote

- “a clearer view of the real costs of providing individual services, which takes account of the full costs of holding assets;
- a more accurate figure for the cost of depreciation in government;
- a more transparent split of capital and current spending with public corporations’ investment presented more clearly;
- a better measure of the total value of central government assets”.

(HM Treasury 2000, para.4)

From its introduction in Spending Review 2000, RAB has differentiated between departments and public corporations, allowing big non-cash cost items such as depreciation to be introduced in Annually Managed Expenditure (AME) for departments, whilst it scored public corporations in the Departmental Expenditure Limit (DEL) for profits and capital investment. The “current” DEL was renamed the “resource” DEL to distinguish current consumption from investment in the “capital” DEL.

In 2001-2 and 2002-3 RAB was implemented with capital charges excluded from the DEL until 2003-4. The initial resource basis was provided by departments and non-departmental public bodies (NDPBs) themselves. The exception to this was the treatment of public corporations such as Scottish Water, and the non-cash costs scored from it were correctly charged to the Executive’s Resource DEL, not AME. In 2002-3, the Scottish Water capital budget was fixed at £314m in resource terms, or £277m in cash terms, in the Executive’s DEL.

At that time, the financial controls on Scottish Water itself were set by the Minister with advice from the WIC. The water industry has two sources of finance, revenue from customer charges and borrowing from government, both of which are regulated through a revenue cap and a borrowing limit, to fund the creation of new assets in the capital programme. Therefore, the industry’s revenue income funds operational costs, maintenance costs, infrastructure renewal costs which maintain its asset base, and interest payments arising from borrowing. In 2001 it

was further required to generate a minimum 6 per cent rate of return as profits which can be used to fund the capital programme. Borrowing is used to fund the creation of new assets, but not all new assets need be funded in this way, and can be funded from revenue. At the time of the Strategic Review of Charges in 2001, the Water Industry Commissioner's recommended regulatory caps for 2002-6 reflected his view of the scope for efficiency gains, and a prudent level of borrowing which – though allocated in the Executive's capital budget – is borrowed from it and repaid in interest charges from the revenue from charges.

The capital programme over the period was costed by Scottish Water at £2.3 billion, but the WIC assumed it could be delivered for £1.8 billion, through efficiency gains, and recommended a maximum borrowing limit of £514 million. The Executive approved a budgetary provision of £714 million, to provide a "buffer" in case the efficiency gains were not delivered, and this figure was in line with the broad assumption made by the Minister that the capital programme was split two-thirds/one-third between infrastructure renewal expenditure and new investment adding to the industry's asset base.

The Cuthberts' mistake in this instance was in assuming that the WIC's figure was in fact a rigid limit, whereas in practice it was advice to the Minister. Within this framework, the Executive **set** the public expenditure limit on borrowing by Scottish Water, with the WIC's advice. The gap between the WIC's recommended borrowing limit of £514 million and the Executive's budget provision of £714 million, reflects this exercise of political judgement by the Minister.

It is clear, therefore, that there was no "double-counting" through the introduction of RAB to the Executive's capital DEL, as no "non-cash charges" were made on its resource budget. This was confirmed in the Treasury's letter to the Cuthberts referred to in their article (p.37), which stated that Infrastructure Renewals Expenditure is not in the Executive's Resource Budget therefore there is no need to increase revenues twice through the charges to customers. Infrastructure renewal expenditure is treated as capital, and funded through borrowing and revenues from operating activities.

The authors' response is to say they agree that this is not double-counted in the Executive's Resource DEL – but their concern is with double-counting in what they term the RAB Control Limit. This is not an official term, but clearly the source of the authors' misunderstanding of the issue. Whilst Scottish Water has adopted an accruals accounting approach, this is not within the Treasury's control regime, and therefore the Cuthberts' assertion that the non-cash basis required under RAB should have been set against AME was simply wrong. It was correctly dealt with in the Executive's resource budget, whilst infrastructure revenue expenditure in Scottish Water's capital programme was

treated as a cash cost and funded by both income from charges and borrowing, with the borrowing element funded in the Executive's resource budget in 2002-3.

The next mistake is the assumption that the Executive's financial control over Scottish Water was through a "combined limit". The Commissioning Letter of 2001 simply states that the Executive's limit is on borrowing of £314 million **plus** profits. This is **not** a combined figure, as the controls on each element are separate and can be varied, eg through supplementary borrowing consents or increased profits.

The Cuthberts have confused the application of accruals accounting within Scottish Water with resource accounting and budgeting within government. If there was any double-counting within Scottish Water's accounts, that surely would have been picked up by their auditors. The Treasury's letter states

"Scottish Water has adopted a renewals accounting approach to its infrastructure asset as a means of estimating depreciation. This means that the amount of annualised planned expenditure to maintain the operating capacity of the infrastructure (i.e. maintenance costs) is treated as the depreciation charge for the period, reflected in the income and expenditure account. It is the current charges on the income and expenditure account that should be met through current revenues, i.e. the level of charging must cover these operating costs. The actual infrastructure renewals expenditure for the year is treated as capital and funded, as is the capital programme, through borrowing from Scottish Ministers and cash generated from operating activities"

(HM Treasury, 29/4/2005)

In 2002-3, this was precisely what happened. Depreciation costs were contained in Scottish Water's revenue spending, and the infrastructure renewal expenditure in its capital programme. The authors' assumption that spending on infrastructure renewal expenditure was **part** of depreciation was mistaken, as it was a cash item of expenditure in the capital budget. The non-cash costs required under RAB were "scored" as intimated earlier in the Executive's Capital DEL. The Treasury's comments that "the Scottish Executive is controlled on the basis of two entirely separate budgets and expected to manage them within a clearly defined framework, therefore in terms of control, there is no double-counting" (Scottish Parliament Finance Committee, 2004, 2nd Report, para.108). In short, the introduction of Resource Accounting and Budgeting was implemented in accordance with Treasury rules for 2002-3. In the following year, Scottish Water was taken out of the RAB framework and accounted for only in terms of its borrowing consent.

Budgetary control since 2003

In Spending Review 2000, a Public Expenditure Limit of £940 million was set, reflecting Executive uncertainty over “the operating environment and performance of the water authorities” at that time (Scottish Parliament Finance Committee, 2004, para.93). As we have seen, the WIC’s recommendations fell well within these totals, but the Executive retained a degree of unallocated provision to ensure that any failure to meet efficiency gains could be accommodated by further lending within the public expenditure limit, and without putting up charges and revising the revenue cap. In 2003-4, the budget provision was revised to cash control, and reduced to £678 million to take account of outturn expenditure in 2002-3, when only £51 million of the £277 million borrowing provision was utilised. This gave Scottish Water borrowing consents of £610 million, with £78 million retained as unallocated provision.

Therefore, the difference between the WIC’s figures and the Executive’s expenditure limits was not the result of accounting errors but different judgements by different actors with different responsibilities. Their argument that this reflected a pessimistic view of the public finance available by the WIC in their 2003 paper is misplaced. The Executive **created** the gap to deal with uncertainty in a period of organisational upheaval in the water industry.

So too, therefore, is their judgement in their 2006 paper that differences in accounting for depreciation

“- might explain the puzzling aspect of water finance over the period concerned: namely that the Scottish Executive was able to transfer significant amounts out of the funds allocated for Scottish Water in its budget”

(Cuthbert and Cuthbert 2006, page 40).

In fact, the reason for the transfers is more straightforward, in the sense of the long established pattern of underspending of capital programmes which was enhanced in the period from 2000 because of the major increases in funding available added to the problems of managing projects timeously (Midwinter, 2004). As a result, underspending of the water budget is not a post-RAB problem. It was significant in 2000-1 and 2001-2, and this allowed £148 million to be transferred to other programmes, and £205 million in 2003-4 (Scottish Executive Explanatory Note on End-Year Flexibility 2003-4). In 2003-4, this arose because Scottish Water drew down only £42 million of the £249.7 million available, because of programme slippage (£72 million), lower operating and interest costs (£45 million), and deferral of payments (£60 million) until 2004-5.

As a result, Scottish Water agreed to the transfer to allow the funding to be used for other spending which the Executive brought forward, on the understanding that

Scottish Water can have access to it under the EYF facility if needed in future. In the past two years, its underspending has fallen to £18 million and £9 million respectively, not, as the Cuthberts argue (p.36) is the amount of borrowing “very restricted compared with the borrowing limits previously applied to the industry”. In 2001-2, the budget was £256.3 million; in 2003-4 it was £249.7 million - a minor difference.

Conclusions

The argument made in two papers by J and M Cuthbert that flaws in the introduction of Resource Accounting and Budgeting led to overcharging of water customers is wrong.

In practice, Resource Accounting and Budgeting was implemented correctly through the application of non-cash costs to the Executive’s capital budget in 2002-3, as agreed with HM Treasury, and removed from the Water Budget in 2003-4, when it reverted to cash control.

Moreover, the budgetary decisions reflected Executive policy that charges should be sufficient to cover the annual costs of the industry – operational costs, depreciation and interest charges – and new borrowing used to enhance the asset value of Scottish Water.

The differences in borrowing limits between the WIC’s advice and the Executive’s expenditure provision reflected the Executive’s decision in 2002 to provide a significant level of unallocated funding in reserve to deal with uncertainty, particularly over efficiency gains.

The Executive never intended this to be used to restrain water charges as the Cuthberts infer this buffer could have been used to achieve. Indeed, this would have been inconsistent with Treasury policy of only borrowing to invest in new assets, not replace existing ones. Indeed, increasing borrowing to keep charges down **now** simply adds to the long-term costs, and passes them on to consumers in the future. Borrowing to invest is defensible where future customers receive benefits from that investment, but not to reduce the cost of current consumption.

The reallocation of provision for Scottish Water arose from a number of financial and management factors in project management, not differences in accounting practice between the WIC and the Executive.

The reality is that over the past five years, public expenditure limits have not constrained Scottish Water’s capital programme nor pushed up its charges. The WIC was required to advise the Minister on a sustainable level of borrowing and of levels of charges which would allow Scottish Water to meet its daily running costs. Scottish Water spent well below those limits in the period 2001 to 2004. In its Annual Report for 2005-6, it reports having reduced operating costs by around £150 million per

annum, and delivered around £1.5 billion of the £1.8 billion capital programme (Scottish Water 2006).

In conclusion, the Scottish Executive's implementation of Resource Accounting and Budgeting in the case of the water services budget was not "flawed", but consistent with Treasury Guidance. In the real world, budgetary decision-making requires a flexible control framework to allow Ministers to respond to emerging pressures and problems. In this case, the Executive's decisions were consistent with the policy principles set out by the Treasury, that borrowing should fund new assets, and not be used to keep down current charges at the expense of consumers in the future, whilst revenues cover the cost of current consumption. There were no accounting errors in the process.

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