

Richard Leonard MSP
Convener
Public Audit Committee
Room T3.60
The Scottish Parliament
EDINBURGH
EH99 1SP

By email only

05 May 2022

Dear Richard,

The 2020/21 audit of Scottish Canals

In response to your letter of 13th April 2022 regarding the audit of Scottish Canals' Annual Report and Accounts 2020-21, and my subsequent attendance at the Public Audit Committee on 24th March please find detailed below our responses to the additional information requested to each of the points raised in your letter.

Responsibilities of the Board and Chief Executive of Scottish Canals

The Committee therefore seeks confirmation that the Board and the Chief Executive accept that the responsibility for ensuring that good governance arrangements are in place to meet the requirements placed upon Scottish Canals, ultimately lies with them.

The Board and Chief Executive accept responsibility for ensuring good governance arrangements are in place to meet the requirements placed upon Scottish Canals. Scottish Canals is a Non-Departmental Public Body (NDPB). Its Board is appointed by, and is accountable to, Scottish Ministers. The Chief Executive of Scottish Canals reports to the Board and is the designated Accountable Officer for the organisation as appointed by Scottish Ministers. As the Accountable Officer, the Chief Executive is personally answerable to the Scottish Parliament for the exercise of the functions, as set out in the Memorandum to Accountable Officers for Other Public Bodies, specifically ensuring compliance with relevant guidance issued by the Scottish Ministers, in particular the Scottish Public Finance Manual.

Good governance is integral to demonstrating the openness, transparency and accountability in the decisions and actions Scottish Canals takes to delivering its vision of being a world-class waterway network with a thriving natural environment built upon 250 years of history that benefits communities and all users who live, work, visit and play along our canals and the Board and Chief Executive oversee the corporate governance structure which underpins Scottish Canals' operations. This includes an internal committee structure which provides clear and transparent processes and documentation to support assurance and audit requirements of a NDPB operating in accordance with the Scottish Public Finance Manual.

Scottish Canals Board

The Scottish Canals' Board provides strategic leadership, direction, support and guidance to ensure that Scottish Canals delivers, and is committed to delivering its functions effectively and efficiently in accordance with its statutory obligations and the aims, policies and priorities of Scottish Ministers. It accepts its responsibility for the overall direction and performance of Scottish Canals, including its efficiency and effectiveness as a public body.

The Board comprises six members, including the Chair and the Chief Executive. Board appointments are made by Scottish Ministers in line with the Code of Practice for Ministerial Public Appointments in Scotland. Appointments are for a three-year term with the possibility of a further term, subject to evidence of effective performance and satisfying the skills, knowledge and personal qualities required on the Board at the time of re-appointment.

Exceptionally, owing to the circumstance of COVID-19, it held fifteen Board meetings during the 2020-21 financial year and monthly Board meetings during 2021-22 to ensure good governance and Board oversight of emerging strategic priorities in response to the significant challenges faced from COVID-19. It continued also to review Scottish Canals' operational and financial performance compared to plan, business strategy and risk management, as well as providing a high level review and scrutiny of health and safety issues. In 2022/23 the Board has put in place additional arrangements for monthly and by exception reporting on the progress of the actions to resolve the section 22 in addition to additional scrutiny provided at the Audit and Risk Committee.

Audit & Risk Committee

As a Board Committee, the Audit and Risk Committee (ARC) supports the Board in its responsibilities in matters of risk, control and governance and associated assurance through a process of constructive challenge. The ARC is chaired by a member of the Board and comprises at least one other Board member, up to two independent members appointed for up to three years (to be reviewed and reassessed upon completion of this term). In addition, a co-opted member may be appointed for a period not exceeding twelve months, unless the Board decides otherwise, to provide specialist skills, knowledge and experience.

A co-opted member with specific skills relating to FReM accounting was appointed to the ARC with effect from 1st October 2020 to 30th September 2021. The Scottish

Canals' Board approved an extension for up to six months to the term of this appointment in order to assist with the completion of the Annual Report & Accounts 2020-21.

In accordance with the good practice guidance of the Scottish Government's Audit Committee Handbook, the Committee reviews the Annual Report & Accounts of Scottish Canals, considers the results of the Auditor's review and opinion. It meets with management and with internal and external auditors to review the effectiveness of internal controls and business risk management. The ARC provides additional transparency over the management of Scottish Canals' operations and assets, accounting policies (including the integrity of financial statements and the Annual Report & Accounts), practices relating to risk, control and governance, and the adequacy of response to audit findings.

The ARC met quarterly in the 2020-21 financial year and six times in the 2021-22 financial year. The ARC meetings in 2021-22 were held on 11 March 2021; 10 June 2021; 30 September 2021; 18 November 2021; 7 December 2021; and 22 December 2021. The ARC members accommodated adjustments to the planned ARC meeting, usually held in August to scrutinise and recommend approval of the Annual Report & Accounts, in response to the revised external audit timetable to include sufficient time to audit the valuation of assets agreed with Grant Thornton. For oversight the ARC Chair provides a written summary report to the Board following each meeting of the ARC as well as providing a verbal update and the ARC minutes. The ARC provided its opinion in its annual report to the Board confirming the ARC's reasonable assurance that there is an adequate level of control and governance in place across Scottish Canals and that matters arising during the year have been, or are being, addressed by management.

Chief Executive

The Chief Executive is a member of the Board and is accountable to the Board. The Chief Executive provides operational leadership to Scottish Canals and ensures that the Board's aims and objectives are met, and that Scottish Canals' functions are delivered and targets met through effective and properly controlled executive action. The Chief Executive is also the designated Accountable Officer for the organisation as appointed by Scottish Ministers and is personally answerable to the Scottish Parliament for the exercise of the functions, as set out in the Memorandum to Accountable Officers for Other Public Bodies, ensuring compliance with relevant guidance issued by the Scottish Ministers with particular adherence to the Scottish Public Finance Manual.

Executive Management Team

The Executive Management Team (EMT) supports the Chief Executive/Accountable Officer in the day-to-day management and operation of Scottish Canals. The EMT is responsible to the Board for all aspects of operational management and delivery within Scottish Canals. It is responsible for devising and keeping under review annual business plans (including resource budgets) to deliver the priorities identified in the Corporate Plan, monitoring Scottish Canals' Annual Report & Accounts, performance against operational priorities identified in the business plan as well as reputation

management, corporate communications and initiating timely and appropriate action when circumstances require adjustments to be made. Integral to all of this is a responsibility to keep the Board informed of progress and risks, in particular where unforeseen novel and contentious issues arise. In addition, the EMT has the responsibility to agree Scottish Canals' overall portfolio of investment and inform the Board of investment decisions. The Financial & Business Services Directorate managed by the Director of Finance & Business Services oversees finance planning, overall capital and revenue budgets and departmental allocations.

Action plan

The Committee ask that you provide information on your contingency plan, in the event that Scottish Canals is unable to meet the deadline of December 2022.

As I mentioned in my opening statements to the Public Audit Committee on 24 March, the anticipated delivery date of December 2022 to meet the statutory reporting timetable for the Annual Report & Accounts for the year ended 31 March 2022 is ambitious. There remains a risk that this deadline is not achieved, although as Sarah Jane Hannah assured the Committee, Scottish Canals has committed to reporting progress to the Board regularly, and any issues arising around the delivery will be identified promptly.

If there is an anticipated short delay of Grant Thornton providing an unqualified opinion on the Annual Report & Accounts for the year ended 31 March 2022, Scottish Canals will agree the Annual Report & Accounts to be laid before Parliament in the new year at an appropriate time with this delay.

However, if an extensive delay due to, for example, issues with the progress of the valuations, unanticipated additional work again required by Grant Thornton, or Grant Thornton are again unable to conclude on their opinion, Scottish Canals will seek guidance from Audit Scotland, the Board, Transport Scotland and Scottish Government to sign off the Annual Report & Accounts for the year ended 31 March 2022.

With the year ended 31 March 2022 being Grant Thornton's final year of providing external audit services to Scottish Canals, Audit Scotland is expected to provide those audit services for Scottish Canals for the year ended 31 March 2023 onwards. Therefore, it is imperative that the team at Audit Scotland are fully sighted on the work, the methodologies used, and are also able to provide assurance that they are content with the proposed judgements and estimates on the valuation of the canal infrastructure.

The Committee seeks reassurance that Scottish Canals now has the appropriate skills and capacity in place to undertake the work that is required.

Since May 2021, and for the first time, Scottish Canals has had in place both a Director of Finance and a Head of Finance who are both qualified and have experience of

working in other NDPBs operating under the technical requirements of the Scottish Public Finance Manual and the Government Financial Reporting Manual (FreM).

The finance team has already procured the services of a technical financial accountancy firm with extensive public sector and NDPB experience. An analysis of the requirements of the FreM, the required capital policies, analysis of other NDPB valuations, and the proposed methodologies is now underway to support the Scottish Canals team and to provide additional professional assurance to Grant Thornton.

An extensive procurement exercise is underway to secure an appropriate team of valuation experts, which is the main area of risk in concluding this work and it is anticipated that this will be secured in June following the procurement process in order to achieve the deadline of December 2022.

There is a detailed specific timetable for this multifaceted work running alongside Scottish Canals' normal business as usual and year-end procedures. This will include input from across the organisation including finance and engineering colleagues. This remains a high priority for the entire organisation in accordance with our Business Plan for 2022/23. The teams have appropriate knowledge to inform the work of the experts, however, there remains not only a risk around both the internal and external resources and coordination required for the project, but also a risk that this complex set of valuations will not meet Grant Thornton's requirements, and that their own resources and associated schedule is in place to in order to sign off the Annual Report & Accounts. The detailed timetable has been shared with Grant Thornton, and both Scottish Canals and Grant Thornton are committing to working together if there are any pieces of work which require realignment in order to mitigate any risk of delay for December.

Reclassification by the Office of National Statistics

Given reclassification was flagged as a possibility by Audit Scotland in 2012, and that the ONS had also undertaken two assessments of Scottish Canals since then, the Committee seeks confirmation as to what discussion the Board had, if any, to consider and prepare for the prospect of becoming a NDPB?

In October 2013, Audit Scotland reported to Scottish Canals that from 2015/16 onwards and in order to retain status as a public corporation, the organisation would require to demonstrate that the majority of income is from commercial activities.

Their recommended and agreed action was to provide a Corporate Plan in order to generate sufficient commercial activities and related income to maintain the status.

Although the Board oversaw the discharging of the corporate plan, no additional recommendations, subsequent monitoring, nor actions were reported to Board after the 2015/16 audit and ONS review. Although there were communications between ONS and HM Treasury, it wasn't until 2nd September 2019, Scottish Canals was contacted by Transport Scotland to advise that ONS has contacted them and had some queries regarding the 2017/18 Annual Report & Accounts.

On 4th September 2019, Scottish Canals received a letter from ONS advising that they had reviewed the accounts and were recommending that as “SC has not covered 50% of its cost by its sales over a sustained-multi-year period, it is recommended that it is considered to be a non-market body”.

The Board were notified of this decision, and the then CEO entered into discussion with ONS and SG to discuss the finding as it had excluded elements that had been previously included in the previous assessments.

Between 2nd and 10th September 2019, several meetings were held with ONS and other parties to discuss the criteria used for ‘market testing’. This resulted in detailed meetings with ONS, Transport Scotland and SG colleagues to challenge the findings on the 18th September and 3rd October. The SC Board were updated of all progress throughout the way, and the Chair attended various meetings in person alongside the CEO.

Following the meeting in October 2019, the SC Chair wrote to Transport Scotland sponsors, and advised that we accept the finding and that in his view the only conceivable way forward in the short term was as an Executive NDPB. The Chair had been with SC throughout the journey since 2012, and therefore had previous knowledge of the situations. As it was a new Board and CEO, we were not sighted in the same detailed history.

At the Board meeting on 28 November 2019 <https://www.scottishcanals.co.uk/wp-content/uploads/sites/2/2020/01/Minutes-of-Board-meeting-on-28.11.19-website.pdf>, the Board was further updated following the review of Scottish Canals’ ONS classification whereby Scottish Canals had been classed as a non-market body given that the majority of its funding was Grant in Aid. Following the ONS review the Scottish Government sponsor team had recommended to the Cabinet Secretary that Scottish Canals operate as a NDPB with a closer financial relationship with SG.

Accordingly, Scottish Canals required to change its budgeting approach in line with HM Treasury central government requirements with effect from 1st April 2020, and adopt a new Government Financial Reporting Manual (FReM) accounts direction for the financial year ending 31st March 2021. The Board noted that there would be no extension to the timing of these public sector accounts reporting changes. Further, the change to accounting under FReM was in line with an external audit recommendation.

Additional information

During the meeting you undertook to provide the Committee with information in relation to allocations made towards the maintenance backlog along with information on the additional opportunities that are available to you to generate income ([Cols 23 and 24 of the Official Report](#)). The Committee looks forward to receiving this information in due course.

Scottish Canals receives revenue Grant-In-Aid (GIA) and capital GIA annually from the Scottish Government for the management of 140 miles of inland waterway and more than 4,000 individual assets, ranging from the 200- 250-year-old engineering structures of the Avon Aqueduct and Ness Weir to modern tourism icons like The Falkirk Wheel and The Kelpies. The infrastructure assets not only support tourism, but provide a corridor for leisure activities, active travel, community connection, and provide a catalyst for investment and regeneration across Scotland.

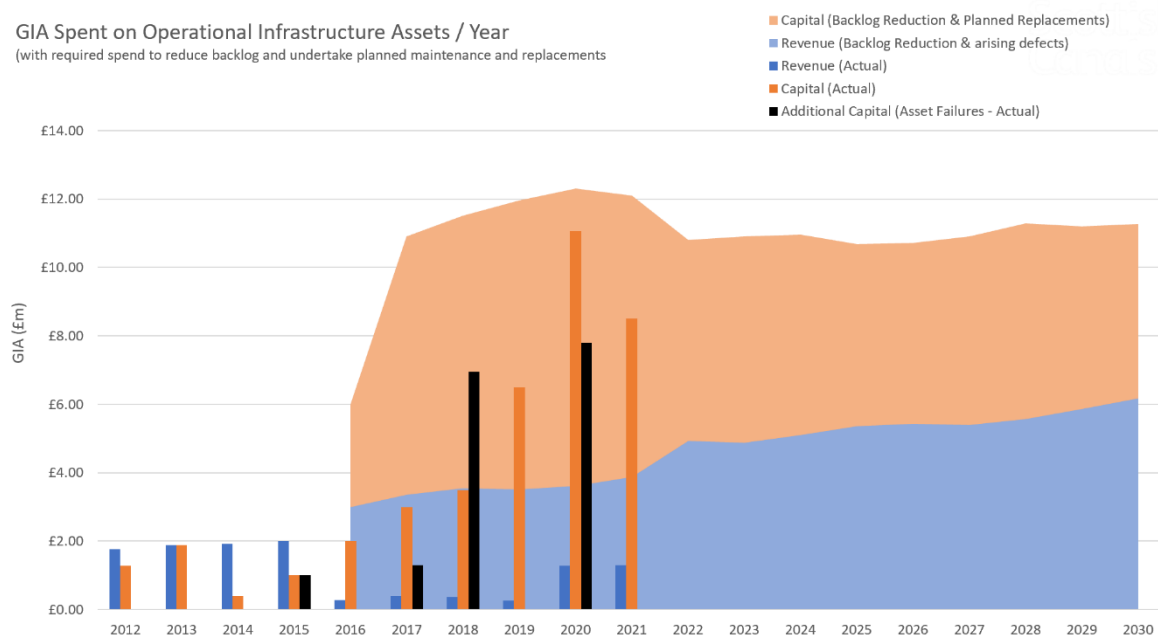
The aging canal infrastructure assets, including reservoirs, canals, lock gates and bridges, including rail bridges, require considerable investment to maintain. Despite the organisation working to generate its own income to reinvest in caring for the assets, the growing impact of climate change, and the fact that these waterways have seen significant under investment throughout their operational life has meant that Scottish Canals calculated a £70m backlog in 2016.

To manage the risks that have arisen through underinvestment, Scottish Canals established an Asset Management Strategy (AMS) in 2018. The blueprint sets out how the organisation will manage, care for, and prioritise maintenance activities on the nation's 250-year-old waterways network to ensure the safety of the public and bring the widest possible benefits for all the people of Scotland.

Scottish Canals, as with many other public sector organisations, is 'Operating with Risk'. However, through our engineering knowledge and strategic decisions Scottish Canals is managing these risks appropriately by applying varying strategies across the network. These strategies, as set out in the [AMS 2018-2030](#), sets out a range of investment opportunities and clear indication of the consequences of underinvestment. Within the document our clear ambition is to reach 'Steady State' whereby the condition of the entire canal network enables safe use for a full range of activities, we are not at this position therefore with limited funds available we 'Operate at Risk' and require to move to localised 'Restricted Services', where significant issues arise, should significant funding issues arise we have defined a route to strategically moving areas of waterways towards a 'Conserving status' being minimum care and maintenance to keep the canal safe, or eventually a 'Preserving status' whereby the use of assets is withdrawn. The strategy sets out a clear methodology enabling prioritisation of works where the performance of assets needs to be, in order to deliver corporate and statutory objectives.

As can be seen from the table below investment in the canal infrastructure assets has varied since 2012, with a more notable steady stream of capital GIA since 2019. GIA capital allocations to the infrastructure assets have increased significantly from 2019 (percentage uplift c.250%) as a result of asset failures. These failures served to highlight the impact that canal closures have on the local and social economies. Revenue for infrastructure maintenance has largely remained static, and well below the required levels to achieve best value from our assets, or to reduce the maintenance backlog.

GIA Spent on Operational Infrastructure Assets / Year
(with required spend to reduce backlog and undertake planned maintenance and replacements)



In real terms the backlog has increased due to more accurate cost estimates used in the calculations, and more recently the cost inflation and availability of materials and services in part due to Brexit and COVID-19 pandemic.

Research has shown that a vibrant canal corridor boosts the health and wellbeing of those who use the canal and those who live nearby. It attracts third party and private sector investment, unlocking areas for regeneration and housing. Since 2012, Scotland’s Canals have contributed to the creation of 8500 jobs along the canal through regeneration, 9000 homes, and well over £1.53 billion of economic growth, all of which are directly attributable to the regeneration and maintenance of the canals. A safe and functional canal network supports Scottish Government targets for NetZero by facilitating active travel and providing a biodiverse blue/green space for communities and in tackling inequality by providing high quality spaces and places through some of the poorest urban areas in Scotland.

While Scottish Canals is effectively managing the risks of its operational infrastructure assets, annualised funding reduces our ability to plan and invest in a long-term strategic way. Extended budget horizons would improve our ability to deliver multi-year capital investment programmes, driving significant efficiencies through enhanced planning and deployment.

Income Generation

Scottish Canals generates a significant level of revenue income from its assets to supplement the grant in aid it receives, generating in between £5m per annum (during COVID-19) to £9.4m (19/20) over the last five years net contribution has been averaging c£1.9m

Scottish Canals have increased our income generation between 2016/17 to 2019/20 by £2.4m to £9.4m on average this income represent c.45% of our total expenditure

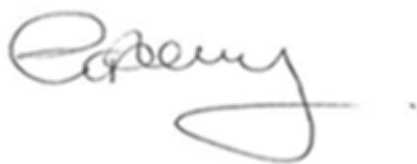
and is critical to delivering safe and accessible waterways necessary to unlock the considerable wider public value.

These returns have been achieved via professional management of a mixed portfolio of property and estates, joint ventures, destinations, transit and commercial boating licences, moorings fees, utilities and freight charges. We have a significant opportunity to grow this portfolio over the coming years with investment of external funds to support the long-term maintenance of the Smart Canal and Sustrans funded projects such as Stockingfield Bridge/ Bowling Harbour. We also have clear plans to deliver reinvestment from our existing portfolio, together these income streams could see on average c.£1.5m a year invested in income producing opportunities. This strategy is planned over the next 10 years and the first phase of this could see our revenue income increase by c.£750k over the next five years

As a result of the change in status to an NDPB, we can no longer hold funds over the year end. This change has required us to revise our investment approach, with all new investment funds requiring to be fully expended within the financial year. The only alternative to this is to work long term with joint venture partners. This change has restricted our capability to undertake larger commercial development and regeneration work and presents significant challenges around the management of planned capital receipts and subsequent reinvestment. However, these restrictions are no different from other NDPBs. We have clear plans to manage the change however we anticipate this may reduce our ability to deliver larger, more complex projects and may restrict the investment opportunities available to us in the coming years.

I hope this additional information and assurances adequately addresses your points.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Catherine Topley', with a small dot at the end of the signature.

Catherine Topley
Chief Executive