Environment and Rural Development Committee

13th Report 2004

Stage 1 Report on the Water Services etc (Scotland) Bill

Volume 1 - Report
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9 September (19th Meeting, Session 2 (2004))

Written Evidence
  Dr John Sawkins
  Ian Jones
  Chartered Institution of Water and Environmental Management (CIWEM)
  Scottish Council for Development and Industry (SCDI)
  Federation of Small Businesses in Scotland (FSB)
  Forum of Private Business, Scotland (FPB)
  Diageo
  BP Grangemouth
  Ciba Speciality Chemicals

Oral Evidence
  Dr John Sawkins, Heriot-Watt University
  Ian Jones, Quayle Munro Holdings plc
  Alan Thomson, CIWEM
  Ian Duff, SCDI
  John Downie, FSB
  Bill Anderson, FPB
  Alan Barclay, Diageo
  Dr Ray Mountford, BP Grangemouth
  David Calder, Ciba Speciality Chemicals

15 September (20th Meeting, Session 2 (2004))

Written Evidence
  STUC
  Gemserv
  Water UK
  Scottish Water

Oral Evidence
  Dave Watson, STUC
  Nigel Bromley, Gemserv
  Ceri Jones, Water UK
  Professor Alan Alexander, Scottish Water
  Dr Jon Hargreaves, Scottish Water
  Douglas Millican, Scottish Water

Supplementary Evidence
  Scottish Water (1)
22 September (21st Meeting, Session 2 (2004))

Written Evidence
- Scottish Council for Voluntary Organisations (SCVO)
- Scottish Consumer Council
- Water Customer Consultation Panels
- COSLA

Oral Evidence
- Jim Lugton, SCVO
- Trisha McAuley, Scottish Consumer Council
- Ian Smith, Water Customer Consultation Panels
- Len Scoullar, Water Customer Consultation Panels
- Councillor Alison Hay, COSLA
- Councillor Alan Kenney, COSLA
- James Thomson, COSLA

29 September (22nd Meeting, Session 2 (2004))

Written Evidence
- Water Industry Commissioner for Scotland
- Office of Water Services (Ofwat)
- Competition Commission
- The Coal Authority

Oral Evidence
- Alan Sutherland, Water Industry Commissioner for Scotland
- Dr John Simpson, Office of the Water Industry Commissioner for Scotland
- Tony Smith, Ofwat
- John Banfield, Competition Commission
- Stuart Rolley, The Coal Authority
- Stephen Hill, The Coal Authority

5 October (23rd Meeting, Session 2 (2004))

Written Evidence
- Letters from Ross Finnie MSP, Minister for Environment and Rural Development, relating to—
  - Equal Opportunities
  - Water Customer Consultation Panels

Oral Evidence
- Ross Finnie MSP, Minister for Environment and Rural Development

Supplementary Evidence
- Letter from Ross Finnie MSP, Minister for Environment and Rural Development, relating to Cost Estimates
Supplementary Evidence on the Minister’s proposals for the Water Customer Consultation Panels

Water Industry Commissioner for Scotland
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Federation of Small Businesses in Scotland
Forum of Private Business, Scotland

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Aquavitae
Citizens Advice Scotland
City of Edinburgh Council
Sarah Hendry
Highland Council
Office of Fair Trading
Phil Olson
Orkney Housing Association
Scottish Enterprise Network
Scottish Environment Protection Agency
Tillicoultry Community Council
Environment and Rural Development Committee

Remit and membership

Remit:

To consider and report on matters relating to rural development, environment and natural heritage, agriculture and fisheries and such other matters as fall within the responsibility of the Minister for Environment and Rural Development.

Membership:

Sarah Boyack (Convener)
Rob Gibson
Karen Gillon
Alex Johnstone
Richard Lochhead
Maureen Macmillan
Mr Alasdair Morrison
Nora Radcliffe
Mr Mark Ruskell (Deputy Convener)

Committee Clerking Team:

Clerk to the Committee
Mark Brough

Assistant Clerks
Chris Berry
Catherine Johnstone
INTRODUCTION

1. The Water Services etc (Scotland) Bill (SP Bill 23, Session 2) was introduced in the Parliament on 11 June 2004 by Ross Finnie MSP, the Minister for Environment and Rural Development. The Bill is accompanied by Explanatory Notes (SP Bill 23-EN), a Financial Memorandum, and a Policy Memorandum (SP Bill 23-PM) as required by Standing Orders. The Parliamentary Bureau subsequently referred the Bill to the Environment and Rural Development Committee as lead committee. Under Rule 9.6 of Standing Orders it is for the lead committee to report to the Parliament on the general principles of the Bill.

2. The provisions of the Bill that confer powers to make subordinate legislation were referred to the Subordinate Legislation Committee under Rule 9.6.2. In addition, the Finance Committee took evidence on matters relating to the Financial Memorandum accompanying the Bill. The reports of these Committees are attached as Annex A to this report.

BACKGROUND AND CONSULTATION

3. The Bill is the third piece of primary legislation on the water industry to be considered by the Parliament. The Water Industry (Scotland) Act 2002 (‘the 2002 Act’) created Scottish Water and set out the roles and functions of the Water Industry Commissioner, the Water Customer Consultation Panels and the Drinking Water Quality Regulator. The Water Environment and Water Services (Scotland) Act 2003 dealt mainly with the natural water environment and implemented the European Water Framework Directive.

4. The Bill implements policy proposals which have been developed since the Executive first consulted in June 2000 on the implications of the Competition Act 1998 for the water industry in Scotland. In February 2003 the Minister for
Environment and Rural Development announced in a written answer that the Executive intended to legislate to prohibit common carriage.

5. In October 2003 the Scottish Executive published a draft Bill, which contained draft legislative text on what is now Part 2 of the Bill – regulating competition. The draft Bill also contained a policy statement in relation to preventing environmental damage from abandoned coal mines. Proposals on this now form Part 3 of the Bill.

6. The Scottish Executive received 47 responses to its consultation on the draft Bill. The Committee had the benefit of receiving a copy of these submissions along with a summary.

7. The Parliament’s Finance Committee conducted an inquiry into the water industry subsequent to the publication of the draft Bill, and published its Report on Scottish Water on 22 April 2004. The Bill’s Policy Memorandum states that some of that Committee’s key findings are addressed by the provisions of the Bill. In particular, the Committee recommended an improved structure for the office of the Water Industry Commissioner in order to provide greater accountability and continuity in the regulation of the industry. It also recommended that consideration should be given to the regulator taking certain decisions on the basis of advice from Ministers rather than the reverse. Proposals to address these recommendations now form Part 1 of the Bill, along with the charge determination procedure set out in section 18.

8. The Committee received a private briefing from Executive officials at the time of the Bill’s introduction. Following introduction, the Committee issued an open call for written evidence, inviting respondents to concentrate their comments particularly on the changes made to the proposals between the draft Bill and the Bill as introduced.

EVIDENCE TAKEN BY THE COMMITTEE

9. The Committee took oral evidence over the course of five meetings. On 9 September the Committee took evidence from a panel of independent analysts – Ian Jones of Quayle Munro Holdings (adviser to the former Transport and the Environment Committee on its 2001 inquiry into the water industry), Dr John Sawkins, a senior lecturer in economics at Heriot-Watt University, and Alan Thomson of the Chartered Institution of Water and Environmental Management (CIWEM). On that date it also took evidence from the Scottish Council for Development and Industry, the Federation of Small Businesses in Scotland, the Forum of Private Business Scotland, Diageo, BP Grangemouth and Ciba Speciality Chemicals. On 15 September the Committee took evidence from the STUC, Gemserv, Water UK and Scottish Water. On 22 September the Committee took evidence from the Scottish Council for Voluntary Organisations, the Scottish Consumer Council, the Water Customer Consultation Panels and COSLA. On 29 September the Committee took evidence from the Water

1 S1W-33630, answered on 3 February 2003. ‘Common carriage’ refers to a system where various water and sewerage providers are permitted to use the public networks.

2 Finance Committee, 2nd Report, 2004 (Session 2), Report on Scottish Water, SP Paper 125
Industry Commissioner for Scotland, the Office for Water Services (Ofwat), the Competition Commission and the Coal Authority. On 5 October the Committee heard evidence from Ross Finnie MSP, Minister for Environment and Rural Development.

10. Many of these witnesses also provided written submissions and supplementary material. In total, evidence was received from 33 organisations or individuals. The Committee would like to record its thanks to all those who provided written or oral evidence.

PART 1 – WATER INDUSTRY COMMISSION

Introduction
11. Part 1 of the Bill provides for the dissolution of the office of the Water Industry Commissioner for Scotland (‘the WIC’), to be replaced by the formation of a Water Industry Commission (‘the Commission’). Section 1 (and the associated Schedule 1) provides for the Commission to be a body corporate, with a chief executive and 3 to 5 ordinary members (one of whom will be appointed as chairperson). In considering the provisions for the structure and general function of the Commission outlined in this Part, they should be read in conjunction with the provisions in Part 2 of the Bill. Part 2 clarifies the Commission’s function as the economic regulator of the water industry, with responsibility for regulating competition through a licensing regime and for calculating the resources that Scottish Water requires in order to achieve the objectives for the industry set by Ministers.

Structure and role of the proposed Commission
12. Most witnesses accepted the Executive’s argument that the proposal to move to a board structure for the regulator is in accordance with best practice and is likely to improve the transparency and consistency of regulatory practice. The proposal reflects the Finance Committee’s call for an improved structure and support for the WIC to ensure independent regulation and transparency across the industry. This structure is consistent with the impending replacement in England and Wales of the Director General of Water Services with the Water Services Regulation Authority.

13. The current Water Industry Commissioner for Scotland supported the move, stating that he had advocated such a structure for some time. Dr John Sawkins suggested that a board structure would help to discourage any tendency to personalise the inevitable tension that can arise between regulator and regulated industry. Ian Jones emphasised the need for members of the Commission to be expert and very robust, and suggested that a committee structure can in some ways act against regulation being strongly focused.

14. Although not specified in the Bill, the Executive has made it clear in the Policy Memorandum that the members of the Commission would be chosen to create

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3 Finance Committee, 2nd Report, 2004 (Session 2), Report on Scottish Water, SP Paper 125, paragraph 88
4 Written submission
5 Written submission
6 Written submission
a body with expert and specialist technical skills, rather than a body representative of stakeholder or customer groups. The Chartered Institution of Water and Environmental Management (CIWEM) suggested that the Commission’s numbers should be increased. Their representative, Alan Thomson, stated “It should be representative of stakeholders and having between three and five members is inadequate for that purpose.”

15. However, a substantial majority of witnesses agreed that the Commission should be focused on the core technical role of economic regulation, and should be of a relatively small and expert nature, focused on costing the implementation of Executive direction for the industry. Dr John Sawkins summarised this view when he stated that “It should be a panel of experts who conduct this narrow job.” While expressing a number of concerns about stakeholder representation (which are elaborated on below), most witnesses agreed that to make the Commission a more representative body would risk undermining its economic competence and focus.

16. The Committee is content with the proposed replacement of the WIC by a Commission. The Committee acknowledges that this is in line with best practice for regulatory authorities, and considers that it is correct for the Commission to be a specialist expert body rather than representative of various stakeholder interests. The Committee considers that it would be more appropriate for the Commission to have 5 ordinary members than 3, as 3 remains potentially too close to a ‘personalised’ relationship between regulator and regulated.

Representative of customer interests

17. While accepting that the Commission, as economic regulator of the industry, is not regarded as the correct focus for representing stakeholders, many witnesses raised concerns about how effectively this is achieved in the governance of the industry. Scottish Water summed this up clearly-

“…there is a lack of clarity because we have an economic regulator who is also by statute the customer champion, and we also have water customer consultation panels, which are intended to canvass customers' collective, rather than individual, views. If we move towards a commission rather than a commissioner—which the bill proposes and which, as our submission says, we support—the question arises of where customer issues should go in that structure. We must be absolutely sure and clear about who is responsible for what.”

18. In regulating the industry, the proposed new Commission is to have the role of promoting the interests of all customers as a whole. However, many witnesses suggested that the Bill provides an opportunity to clarify and strengthen the role of the Water Customer Consultation Panels (‘the Panels’) in providing a customer representative function. Scottish Water outlined the system in

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7 Official Report, 9 September 2004, Column 1098
8 Official Report, 9 September 2004, Column 1098
9 For example, see Official Report, 9 September 2004, Column 1123, Ciba Speciality Chemicals
10 Official Report, 15 September 2004, Column 1175
11 Section 1(1) of the Bill, inserting a new section 1(2) into the 2002 Act
England and Wales, where WaterVoice has been created as a customer representative body independent of Ofwat.12

19. The 2002 Act gives the Panels the role of representing the views and interests of customers of Scottish Water. The Bill as introduced does not address and amend the role of the Panels directly. However, the competition elements in Part 2 of the Bill provide for non-domestic customers to be served by licensed retail providers rather than by Scottish Water – effectively leaving the Panels with no role to represent the interests of that sector. The Bill makes it clear that the Panels’ functions do not extend to the services provided to licensed retailers and their customers.13

20. Very late in the Stage 1 evidence programme, the Minister wrote to the Committee outlining changes to the role of the Panels which he proposed to make at Stage 2. In oral evidence he suggested that the Panels could be made more effective and indicated his intention to “firm up” the Panels while stating that “The democratic control of Scottish Water rests with the Parliament.”14 He suggested that the Panels should have a clear route to contribute to Ministers’ consideration of objectives for the industry. They should also have the power to direct reports to Ministers, any of the regulators, and to Scottish Water itself, with a power to require a response within a reasonable period.

21. One of his proposals is that the Panels should be able to represent all end-users of the public water supply, rather than just those served by Scottish Water. The Minister suggested that non-domestic customers would still have an interest in Scottish Water’s services and its monopoly responsibility for overall distribution and supply, and he conceded that the distinction in access to the Panels which the Bill established would be unnatural.15 He therefore signalled his intention to revisit the function of the Panels at Stage 2.

22. The Committee has not had the opportunity to take oral evidence from other parties on the Minister’s late proposals. The Committee therefore wrote to a number of bodies seeking their views on the proposed changes. All those who responded welcomed an enhanced role for the Panels. The Panels themselves suggested that, “The Minister’s proposals to involve us at the policy development stage, and to give us the power to recommend across the industry thereafter, create many valuable opportunities to advocate the customer interest.”16 Others agreed that the proposals would enhance consumer representation and help to clarify the purpose both of the Panels and of the Commission. The WIC emphasised that representing customer interests in the policy development phase would not be consistent with its regulatory role.17

23. The Scottish Consumer Council (SCC) did not support the proposal that the Panels should represent non-domestic as well as domestic customers. It suggested that non-domestic customers will have a choice of supplier and the

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12 Official Report, 15 September 2004, Column 1176
13 Paragraph 7(2) of Schedule 5 amends the 2002 Act
14 Official Report, 5 October 2004, Column 1313
15 Official Report, 5 October 2004, Column 1313
16 Supplementary written submission
17 Supplementary written submission
protection of the licensing regime, as well as already having the resources to secure effective strategic representation\textsuperscript{18}. Several respondents also sounded a general caveat that the enhanced role for the Panels would need to be adequately resourced. The SCC supported the Panels’ view that it would require the ability to conduct policy research or employ specialists if it was to make informed and in-depth recommendations. In particular, it suggested that care should be taken to ensure that the Panels’ policy input is adequately resourced, so that the representation of customer interests is more than simply the sum of data from individual complaints.

24. The WIC also suggested that some customer service information would be important for both the Commission and the Panels to access. In a similar vein, the SCC proposed a statutory obligation for the two bodies to establish a formal Memorandum of Understanding to secure co-operation, exchange of information and consistent treatment of matters which affect both.

25. The Committee welcomes the Minister’s proposals to enhance the customer representation role of the Water Customer Consultation Panels. In particular, the Committee welcomes the proposal to involve the Panels at the policy development stage and the proposed enhanced powers to direct reports at various bodies. The Committee considers that the structure of the Panels must enable the full range of regional stakeholder interests to be taken into account, as well as both domestic and non-domestic customer perspectives. The Committee requests the Minister’s comments on the proposal by the Scottish Consumer Council for a statutory Memorandum of Understanding to secure appropriate co-operation between the Commission and the Panels.

Complaints process

26. At present, the WIC is responsible for dealing with individual customer complaints, once they have been pursued initially with Scottish Water. As the Bill stands, this function would therefore pass to the Commission. This function includes the power to make representations to Scottish Water on any matter relating to the complaint, but does not include a power to make a formal recommendation\textsuperscript{19}. At present each Customer Panel has the role of representing the views and interests of Scottish Water customers in its area, but the Panels do not have a role in considering individual complaints\textsuperscript{20}.

27. In considering the representation of consumer interests in the governance of the industry, several witnesses expressed concerns at the way individual complaints are handled. For example, the Convener of the Panels stated that the present system does not meet “the customer expectation of complaint resolution” and that increased customer confidence “could be achieved only by separating customer complaints from the Commission’s economic regulation function”\textsuperscript{21}. The Bill does not address this.

\textsuperscript{18} Supplementary written submission
\textsuperscript{19} Section 3 of the 2002 Act
\textsuperscript{20} Sections 2(3) and 3(2) of the 2002 Act
\textsuperscript{21} Official Report, 22 September 2004, Column 1205
28. Some saw a role for the Panels in resolving individual complaints, but the Panels indicated that they did not want their consultation role to be bogged down\textsuperscript{22}. In his letter referred to at paragraph 20 above, the Minister indicated that he proposed at Stage 2 to amend the Bill in order to transfer this function (and the small complaints team) from the WIC’s office to the office of the Convener of the Panels. The Minister suggested that this would add to clarity on the respective roles of the Panels and the new Commission. It was not immediately clear to the Committee what impact this additional responsibility would have on the operation or resources of the Panels, and no evidence was presented to indicate whether the Panels were content with this addition.

29. As noted at paragraph 22 above, the Committee therefore wrote to a number of bodies seeking their views on the suggested revisions to the complaints process. The WIC helpfully provided information on the numbers and various types of complaints which are received, and the processes involved in resolving these, including clarification of when the ‘second tier’ in the complaints process comes into play\textsuperscript{23}. The Panels categorised complaints as generally being either practical or policy-related. They suggested that policy-related complaints sit well with the Panels themselves, and would be appropriately served by the proposed enhanced power of recommendation. The practical complaints would be dealt with by the Office of the Convener.

30. All respondents agreed in principle that it was appropriate to transfer the complaints process from the WIC to the Panels, ensuring that both policy and practical issues would be dealt with by the customer representative organisation. The WIC emphasised that it would clarify the roles of both the Commission and the Panels. He suggested that it was appropriate to separate the complaints-handling process from the price-setting regulatory function, as had happened in other regulated utility markets\textsuperscript{24}.

31. Again, respondents argued that the proposal to move complaints to the Panels had to be adequately resourced. The WIC noted the increasing number of complaints and the resource-intensive nature of dealing with them. The SCC again emphasised that the balance between complaints and policy work must be maintained so that the Panels’ output was an appropriate representation of the overall customer experience. In this context, the SCC expressed concern about the Panels dealing with complaints from non-domestic customers, and suggested that this should only be done after adequate analysis of data about the complexity and level of workload involved in complaints from each sector. It suggested that dealing with non-domestic complaints could, in fact, muddy the role of the Commission in overseeing the competitive retail market for that sector\textsuperscript{25}. The Panels, however, stated that there should be no distinction in complaints from the two sectors.

\textsuperscript{22} Official Report, 22 September 2004, Column 1206
\textsuperscript{23} Section 3(3)(a) of the 2002 Act provides that the complaint need not be investigated by the WIC “if the complainer has not pursued the complaint with Scottish Water”.
\textsuperscript{24} Supplementary written submission
\textsuperscript{25} Supplementary written submission
32. The Panels suggested that an appropriate framework had to be established between themselves and Scottish Water to ensure the best possible outcome to complaints. Scottish Water described the current complaints protocol and emphasised that the transfer of the complaints function to the Panels need not impact on the established processes. However, the SCC argued that, rather than the current reliance on persuasion, formal powers of intervention were required if real customer benefits were to be achieved. In connection with the process, the SCC also suggested that the role of the Scottish Public Services Ombudsman in relation to the water industry required to be clarified.

33. The Committee acknowledges the desire to separate the second-tier complaints-handling function from the economic regulation role of the proposed Commission. However, the Committee remains concerned that handling individual complaints has the potential to swamp the representative role of the Panels. The Committee has not received sufficient evidence from the Minister to assure it that the Panels will be robust enough and resourced to a level that will minimize this risk. In this context, the Committee recommends that consideration be given to producing clear guidance for customers which will allow different types of complaints to be appropriately directed.

34. The Committee considers that the priority for the Panels should be to pick up trends arising from complaints, in order to inform its overall customer representation role. The Committee therefore requests that the Minister provides clarification on whether Scottish Water will have a duty to report data on all complaints it receives, and its decisions on them, to the Panels. The Committee also requests clarification of the potential role of the Scottish Public Services Ombudsman in relation to the water industry.

35. The Minister’s proposals were received so late in the process that it was difficult for the Committee to consider them fully in its Stage 1 evidence programme. The Committee does not currently have sufficient evidence on which to come to a conclusion. The Committee therefore agreed to take further oral evidence on this issue before considering the Minister’s proposed amendments at Stage 2.

Reporting

36. In connection with the functions of the Panels, their Convener indicated that the Panels would welcome the opportunity to report formally on their activity to the Parliament on an annual basis. This was suggested as part of a need for the Panels to be able to present a broad view of the customer experience of the Scottish water industry. Again, in his letter referred to at paragraph 20 above, the Minister indicated that he intended to introduce Stage 2 amendments to strengthen the Panels’ power to publish reports. He suggested that reports may be directed to a variety of bodies and the recipient might be required to respond within a set period. The Minister also indicated that he would lodge an amendment to provide for the Panels’ annual report to be laid before the

26 Official Report, 22 September 2004, Column 1203
Parliament. Respondents to the Committee’s request for supplementary evidence all welcomed these enhanced reporting powers.

37. The Committee welcomes the proposed enhancement of the Panels’ reporting powers. In particular, the Committee welcomes the increased transparency and potential for scrutiny which will result from the Panels’ annual report being formally laid before the Parliament.

Duty to promote sustainable development
38. The Committee noted that the Water Act 2003 has imposed an obligation on the Water Services Regulation Authority (which will replace OFWAT in England and Wales) to “carry out its duties in the manner which it considers is best calculated, amongst other things, to contribute to the achievement of sustainable development”\(^{27}\). Scottish Water currently has an obligation to “act in the way best calculated to contribute to the achievement of sustainable development”\(^{28}\).

39. The Committee heard differing views on whether the Water Industry Commission for Scotland should be given a similar statutory responsibility in the current Bill. Some witnesses felt that imposing this duty on the Commission, and asking it to use the same framework as Scottish Water, would help to produce effective pressure to ensure that these principles are followed throughout the industry. Scottish Water itself stated that “…it would be useful to us, and therefore to Scotland, for that to be mirrored by the regulator”\(^{29}\). Similarly, as an example of a sustainable development perspective, SEPA noted that in England and Wales the Environment Agency and Ofwat both have responsibilities to promote efficient water use. It suggested that the difference in Scotland “will result in an inconsistent approach to water conservation and sustainable development”\(^{30}\). Some concern was expressed that the Commission will work to a policy of simply lowering consumer costs, and that a purely economic pressure could be regarded as contradictory to a wider environmental and social justice policy framework implied by a duty to promote sustainable development.

40. Some witnesses felt that this Bill is not the right vehicle for further statutory obligations of this kind – which may dilute the focus of the Commission. The FSB argued against including this kind of obligation, as did the SCDI which stated “it is difficult for us to get a handle on how sustainability could be sensibly enshrined in the legislation”\(^{31}\). Dr John Sawkins argued that the Commission should remain tightly focused and not get into detailed operational targets and indicators, but that it should still have a duty to conduct itself in line with the principles of sustainable development\(^{32}\).

41. The Minister explained his decision not to give the new Commission this type of responsibility by distinguishing the Scottish water industry context from that in

\(^{27}\) Section 39
\(^{28}\) Section 51 of the 2002 Act
\(^{29}\) Official Report, 15 September 2004, Column1163
\(^{30}\) Written submission
\(^{31}\) Official Report, 9 September 2004, Column 1103
\(^{32}\) Official Report, 9 September 2004, Column 1094
England and Wales. The Minister suggested that, in England and Wales, imposing this duty on the regulator is a method by which a policy framework can be imposed on the industry where this cannot be done directly on the various private water providers. In Scotland, by contrast, where there is a public water provider the statutory means already exist to impose public policy priorities on the industry. It is not entirely clear, however, how such obligations could be imposed on new retail entrants in the future unless the Commission had a duty to do so in the licensing regime.

42. In that context, the Minister suggested that responsibility for contributing to the achievement of sustainable development is a matter for operational delivery by Scottish Water, not a matter for a regulator. Not imposing it on the Commission does not relieve Scottish Water of the obligation. The Commission cannot disregard Scottish Water’s obligations, and the financial parameters imposed by the Commission must allow Scottish Water to deliver all its statutory obligations and formal policy objectives. Questions about whether the operational performance was adequately delivering the sustainable development function should be a matter for Scottish Water as part of its business planning.

43. The Committee acknowledges that it has heard contradictory evidence on whether the Commission should have a statutory duty to promote the achievement of sustainable development. The Committee considers that, ultimately, the Minister must remain accountable to the Parliament for policy objectives of this nature. Nonetheless, the Committee considers that sustainable development must be pursued consistently at all levels in the industry – operational, regulatory and political.

44. The Committee understands that the different structure of the water industry in England and Wales may lead to a different method for imposing statutory policy frameworks on the industry. However, Scottish Water’s suggestion that its obligation could usefully be reflected by a similar one on the regulator is persuasive. In particular, the Committee considers that potential new entrants to the non-domestic retail market must be required to pursue sustainable development in a manner consistent and equal to the obligation on Scottish Water. The Committee, therefore, recommends that the Minister gives further consideration to how sustainable development can be promoted throughout the industry – whether by imposing a statutory duty on the Commission, or by imposing sustainable development obligations on water and sewerage service providers through the licensing regime.

PART 2 – PROVISION OF WATER AND SEWERAGE SERVICES

Introduction – Outline of proposals

45. Part 2 of the Bill proposes to regulate the extent to which competition could be introduced to the Scottish water industry by prohibiting anyone other than Scottish Water from introducing water to, or drawing sewage from, the public networks. This prohibition on ‘common carriage’ is supplemented by the
proposal to regulate competition in the retailing of water and sewerage services. This regulation is to be achieved through a licensing regime operated by the proposed Water Industry Commission, which will authorise competition in the provision of retail services to non-domestic customers only.

46. Section 6 of the Bill provides for retailers to be licensed for the provision of water and sewerage services to ‘eligible premises’. Section 20 defines ‘eligible premises’ so that it excludes dwellings. The Executive has stated that retail competition for all customers would make the continuation of domestic billing alongside council tax impossible. It is suggested that this billing method is essential in order for charges broadly to reflect ability to pay, for discounts to be targeted appropriately, and for maintenance of the broad cross-subsidies from customers in higher Council Tax band properties to those in lower bands. Section 18 explicitly allows Ministers, as part of their policy statement on the principles of charging, to require continuation of this link between council tax banding and water and sewerage charges. It also allows Ministers to make regulations reducing charges for customers meeting specific conditions.

47. The licensing regime will be administered by the Commission. Section 10 requires the Commission to do so in a way which ensures that the market opens in a way which is orderly and not detrimental to the exercise of Scottish Water’s core functions. The Executive states that establishing a licensing regime will ensure that retailers and their customers contribute fairly and proportionately to the costs of maintaining the whole of the public networks on which they will still rely for the service. The Executive envisages that the conditions which the Commission will attach to a licence will play a central role in avoiding destabilising Scottish Water. The WIC outlined to the Committee the consultation process he expects to follow before finalising these standard conditions.

48. Sections 12 and 13 give Ministers the power to require Scottish Water to separate its retail and wholesale functions and to transfer staff to a new retail subsidiary. Only the wholesale function would remain known as Scottish Water. The retail body would be able to apply for a licence to become a provider, and to seek wholesale services from Scottish Water, on the same basis as any other retail provider.

49. Section 18 proposes changes to the process (set out in the 2002 Act) for determining Scottish Water’s charges. The new process requires Ministers to set the objectives and functions (including investment priorities) which should be funded by charges, and the broad principles which should be adopted in any charges scheme. The Commission will then be responsible for determining the charge limits within which this policy framework can be efficiently delivered. Scottish Water will then produce a detailed charges scheme within these limits. This removes Ministers from a final role in determining charges.

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34 Section 18 inserts a new section 29D(3) into the 2002 Act
35 Policy Memorandum, paragraph 41
36 Official Report, 29 September 2004, Column 1255
Section 18 also sets out the basis on which Scottish Water may be able to depart from the usual charges scheme in fairly restricted cases where a customer has taken steps to reduce the costs of supplying them. Each proposed departure must be approved by the Commission, and details published. Alongside this, Schedule 3 provides that any existing special deals between Scottish Water and individual non-domestic customers can continue until they expire, but may not be extended or renewed.

The Executive has explained that it intends to establish a right of appeal to the Competition Commission on certain matters relating to licensing and charge determination. Legislation on the Competition Commission is a reserved matter and these proposed rights are therefore not set out in the Bill. In discussion with the UK Government, it is intended to establish this right by means of an Order under the Scotland Act 1998 as soon as possible after enactment of this Bill.

The proposed model for regulation of competition

General

The Policy Memorandum sets out the Executive’s view that the Competition Act 1998 has increased the possibility of competition developing on the public networks. That Act seeks to prevent the restriction or distortion of competition and the abuse of dominant market position. The Minister stated that he had to address the fact that Scottish Water “falls broadly within the mischief of the Competition Act”[37]. He suggested that, “…the Water Industry (Scotland) Act 2002 does not indicate that we are compliant with some of the requirements of the Competition Act 1998”.

There was no real consensus among other witnesses on the implications of the Competition Act for the industry. The Convener of the Panels suggested that the Executive needed to explain the requirement for a limited competition framework much more fully to consumers[38]. Some witnesses argued that the Act presented particular threats to the maintenance of essential public services. From this perspective, it was suggested that, rather than bring forward a Bill to regulate competition, Ministers should be prepared simply to defend Scottish Water against any legal challenge to its monopoly status. For example, the STUC suggested that exclusion provisions in schedule 3 of the Competition Act would allow Ministers to argue that water is a public service and not open to competition. It suggested that the Bill ran the risk of destabilising the industry and represented ‘the thin end of the wedge’ - opening up the industry to the possibility of further privatisation[39]. The STUC did concede that its suggested position had not been tested and the outcome of any legal challenge could not be certain.

The Minister indicated that he did not consider this potential defence to be satisfactory. In the absence of statutory provision to address competition in the industry, he believed that Scottish Water’s functions and its position as monopoly controller of the public networks would potentially be vulnerable to

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[38] Official Report, 22 September 2004, Column 1208
challenge. He argued that this created the possibility of considerable instability, and the threat of uncontrolled impact on Ministers’ public policy objectives for the water industry. The Minister explained that his political preference was for no competition in the industry, and that the Bill was seeking to interpret the Competition Act in such a way as to minimise potential competition to Scottish Water. In this context, some witnesses expressed concern that the policy framework is not about developing a coherent and beneficial model of competition. Others seemed to believe that the purpose of the Bill was to increase competition rather than limit it.

55. The Minister made it clear that he wished to retain an efficiently-managed public water industry, delivering a high quality service at an efficient price. In that context, he regarded the Bill’s purpose as providing the minimum statutory regulation of competition in order to comply with the Competition Act. He preferred to set out the precise way in which competition would be allowed to develop, and not simply await any potential legal challenge to determine the development of the market. He suggested that the statutory limitations on competition, coupled with more robust independent regulation of Scottish Water, would make any potential challenge to Scottish Water’s position extremely difficult, if not impossible, and would therefore give it appropriate stability. Significant support for this position appears to be given by legal advice provided to the Finance Committee by the WIC, and by the Office of Fair Trading.

56. The Committee accepts that a statutory framework for competition is required in order to provide appropriate stability to the industry in the light of the Competition Act.

Common carriage

57. Other witnesses raised questions as to whether the Bill would be sufficient to avoid legal challenges by potential competitors. Water UK suggested that all parties share the Executive’s wish that the competition regime should be determined by Act of Parliament rather than through the courts. However, it noted that common carriage is to be allowed in England and Wales under the Water Act 2003, and questioned whether two quite different approaches could co-exist in the long term. Gemserv suggested that there is usually a move towards harmonisation as markets mature.

58. In its Policy Memorandum the Executive suggested that a prohibition on common carriage was justified on the grounds that permitting it would pose serious risks to public health and the environment. It stated that common carriage would involve third parties in the processes by which Scottish Water

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40 Official Report, 5 October 2004, Column 1316
41 Official Report, 5 October 2004, Columns 1316-17
42 For example, see written submission from the Office of Fair Trading
43 Official Report, 5 October 2004, Column 1316
44 Annex to Finance Committee report, see Annex A
45 Written submission
46 Written submission
47 Written submission
48 Policy Memorandum, paragraphs 24-5
manages the infrastructure, which would complicate these processes and introduce significant on-going additional risks of non-compliance with stringent standards. The Executive concluded that the potential risks outweigh any potential benefits which would arise from the increased opportunities for competition that common carriage would allow.

59. While a number of witnesses agreed with prohibiting common carriage on environmental and public health grounds, others questioned the evidence on which the Executive’s assessment of the risks of common carriage is based. Water UK noted that the Drinking Water Inspectorate in England and Wales concluded in 2000 that the public health and water quality risks associated with common carriage were not significant provided its guidelines were followed\textsuperscript{49}. It acknowledged that it was legitimate for a different approach to be taken in Scotland, but suggested that the inconsistency may lead potential new entrants to be more inclined to challenge the policy\textsuperscript{50}. CIWEM suggested that the risks could be managed by appropriate licensing conditions. In this context, the Convener of the Panels suggested that the Executive’s reasoning for prohibition needed to be strengthened\textsuperscript{51}.

60. The Committee\textsuperscript{52} accepts the arguments presented by the Scottish Executive for the prohibition of common carriage.

Prohibiting competition for domestic customers

61. The Executive suggested that domestic competition would prevent discounts being applied. Additionally, it argued that competition would be likely to develop in a way which picked off high value customers, and would not therefore benefit all customers. Any such ‘cherry-picking’ would risk leaving Scottish Water to serve lower-banded properties and those receiving discounts – with consequent impact on its revenue base and implication that charges would have to rise significantly for its remaining customers.

62. The Committee received little direct evidence to suggest that competition should be extended to domestic customers. The Scottish Consumer Council agreed that many domestic groups, such as those living in more remote or rural areas, may not benefit from competition. It did, however, emphasise that the way in which competition in the industry developed as a whole was likely to have significant potential effects on the domestic sector – particularly noting the potential for changes to revenues and cross-subsidies, which is discussed in more detail at paragraphs 125-8 below.

63. The Committee\textsuperscript{53} accepts that retail competition in water and sewerage services should be restricted to the non-domestic sector.

\textsuperscript{49} Written submission
\textsuperscript{50} \textit{Official Report}, 15 September 2004, Column 1151
\textsuperscript{51} Written submission
\textsuperscript{52} The Committee divided at its meeting on 3 November 2004. See Annex B, Extracts from the Minutes – Record of Divisions in Private.
\textsuperscript{53} The Committee divided at its meeting on 3 November 2004. See Annex B, Extracts from the Minutes – Record of Divisions in Private.
The effect of competition on the industry

64. A significant amount of evidence heard by the Committee related to the impact which competition could be expected to have on the water industry.

65. The prohibitions on common carriage and domestic retail competition limit the potential scope and, arguably, impact of competition. It is estimated that there are approximately 160,000 non-domestic customers in Scotland. Provision of retail services to these users was regarded by some witnesses as too small a market to attract entrants, and the potential margins too small to make any significant impact on charges

66. However, many witnesses did expect to see new entrants – even if the market was likely to develop only gradually. Development is unpredictable, but it was expected that competition (or even credible threat of competition) would cause providers to improve efficiency. The Executive suggests that providing wholesale services will require Scottish Water to improve the transparency and accuracy with which it accounts for the different costs of its business. This will make it easier for the Water Industry Commission and retailers to measure Scottish Water's progress in delivering efficiencies and for Scottish Water itself to identify the scope for greater cost effectiveness. The regulatory regime is designed to add pressure for efficiencies in the way that a competitive environment might. The Executive suggests that the development of competition in one part of the business could be expected to provide an additional spur to efficiency beyond that provided by the current regulatory arrangements. Ofwat stated that it expected competition to deliver cheaper water. Similarly, the WIC noted that “…retailers typically up their game when they are in competition with one another”. The STUC, however, highlighted research which it suggested indicated that most of the early price reductions in the energy market after introducing competition were due to factors other than competition.

67. The Panels indicated that 2010 (rather than the planned 2008) might be a more realistic period, and suggested that the pace of introducing competition would be disruptive to Scottish Water. Aquavitae, however, stated that slow progress towards liberalisation had discouraged it from investing to compete, to the detriment of customers in Scotland.

54 For example, see written submission by BP Grangemouth
55 For example, Water UK, Official Report, 15 September 2004, Column 1159
56 Policy Memorandum, paragraph 36
57 Policy Memorandum, paragraph 36
58 Official Report, 29 September 2004, Column 1262
59 Official Report, 29 September 2004, Column 1259
60 Official Report, 15 September 2004, Column 1136
61 Official Report, 22 September 2004, Column 1208
62 Written submission
The effect of competition on Scottish Water

68. A number of witnesses argued that it was appropriate for Scottish Water to be required to establish a demonstrably distinct and transparent retail subsidiary. This was regarded as an essential factor in promoting fair competition – although enforced separation of incumbent companies is not part of the competition regime in England and Wales.

69. Some concern was expressed at the pace of change at a time when Scottish Water was stabilising and facing huge challenges in investment programmes. Witnesses again argued that separation was a distraction for the company, and risked losing recent economies of scale and incurring extra costs in re-branding etc., potentially placing at risk the efficiency gains which had resulted from merging the previous water companies. The STUC opposed the diversion of essential investment resources into the management information systems that are an integral part of a regulated market. The accuracy of predicted start-up costs is discussed at paragraphs 171-3 below.

70. The implications of separation for Scottish Water staff are unclear. Evidence suggests that up to 200 staff may be involved, and section 13 of the Bill may require the transfer of all necessary staff (with protected contract conditions) to the new entity.

71. A number of witnesses emphasised the importance of the basis of the wholesale price which Scottish Water will be permitted to charge its retail subsidiary and other retail water and sewerage service providers. From a number of perspectives, this price was regarded as crucial both to the operation of competition and to the stability of the industry.

72. The STUC stated that, if the split goes ahead, the best opportunity for it not to affect staff negatively is if the split is correct in terms of costs and revenues being apportioned to each part. From a different perspective, Water UK argued that the wholesale price is the critical factor rather than the split in itself. Scottish Water similarly suggested that it would set up and run such an entity only if it could be viable.

73. Water UK stated that the Bill proposes that all retail providers will be charged an averaged wholesale price, and that the success of the approach proposed in the Bill depends crucially on the correct setting of that price. Scottish Water explained this in some detail-

“If the wholesale price does not fully cover the cost of carrying out all the wholesale activities that are being bought by new retailers, either there will be a risk that Scottish Water will be unable to fulfil all its obligations or, more probably, there will be a risk that the generality of customers, and in

63 For example, CIWEM, Official Report, 9 September 2004, Column 1096
64 Written submission
65 Official Report, 15 September 2004, Column 1145
66 Official Report, 15 September 2004, Column 1148
67 Official Report, 15 September 2004, Column 1179
68 Written submission and Official Report, 15 September 2004, Column 1148
particular domestic customers, will pick up part of the financial burden that should properly be the domain of the business customers. That risk also goes in the other direction. If the wholesale price is set too high and more than covers the costs of the wholesale activities, household customers could receive a benefit at the expense of business customers.\textsuperscript{69}

74. In evidence, the WIC indicated the basis upon which he would calculate the initial wholesale price\textsuperscript{70}. However, crucially for this debate, considerable dispute has grown up around the retail margin which is assumed to be included in tariffs. The Regulatory Impact Assessment (RIA) on the Bill says that the WIC estimates the “retail gross margin for an average business customer is in the region of 15-20\% of their total bill”\textsuperscript{71}. This estimate has been disputed by witnesses before the Committee. Water UK stated that it relied on some major erroneous assumptions. It cited work by OFWAT which put the average margin for English and Welsh water companies at 9.6\% - ranging downwards if applied only to non-domestic customers, to as low as 4\% for large industrial users.

75. The Executive’s clearly stated policy intention is that the Bill should introduce retail competition for non-domestic customers. Section 6(1)(a) sets out what a licence may authorise a retailer to do. However, it has been suggested that the Bill does not define clearly what is meant by ‘retail’. Water UK suggested that retail ‘customer facing’ functions reach deep into operational functions. It suggested that the split could not be clear\textsuperscript{72}. Scottish Water suggested that the Bill creates new risks, stating that “There will inevitably be an ambiguity around precisely what is wholesale and what is retail”\textsuperscript{73}. It suggested that the scope of the licence could be anything that is not prohibited under the Bill.

76. In order to allocate costs appropriately, a clear definition is needed of which functions rest with the wholesale part of Scottish Water’s business, and which with the retail part\textsuperscript{74}. Scottish Water indicated that, if clarity was provided on this split, it would have sufficient data to be able to make the separation by the intended date of 2008 for opening the market. The Minister defended the fact that the RIA contains only estimates. He conceded that “No one has done detailed work on that”\textsuperscript{75}. He acknowledged that considerable work was required to get it right and that getting it wrong would undermine Scottish Water. He indicated that the WIC has engaged consultants to gather the appropriate regulatory information.

77. The Minister emphasised that recourse against an incorrect price would be for Scottish Water to appeal to the Competition Commission, rather than to recoup necessary extra revenue from domestic customers. (The issue of cross-subsidy and ‘cherry-picking’ is discussed further at paragraphs 125-8 below.) The WIC stated that material new information about the retail-wholesale split could lead

\textsuperscript{69} Official Report, 15 September 2004, Column 1178
\textsuperscript{70} Official Report, 29 September 2004, Columns 1255-6
\textsuperscript{71} Regulatory Impact Assessment on the Water Services etc (Scotland) Bill, June 2004, paragraph 14
\textsuperscript{72} Written submission
\textsuperscript{73} Official Report, 15 September 2004, Column 1178
\textsuperscript{74} Official Report, 15 September 2004, Column 1149
\textsuperscript{75} Official Report, 5 October 2004, Column 1320
to a review of the wholesale price in an interim determination\textsuperscript{76}. The Committee welcomes this clarification.

78. However, given the centrality of this provision, there is considerable importance in getting it right first time. When the figures in the RIA are acknowledged to be estimates which are subject to such widely different challenges, it is extremely difficult for the Committee to be confident that it can appropriately scrutinise the potential impact of the Bill.

79. \textbf{The Committee accepts the rationale for requiring Scottish Water to separate its retail and wholesale functions. The Committee is, however, concerned at the potential for disruption to Scottish Water’s on-going delivery of challenging investment priorities and efficiency improvements.}

80. \textbf{The Committee believes that competition in the industry must be managed in such a way as to enable Scottish Water to remain a stable and efficient public provider. The Committee is, therefore, seriously concerned at evidence which indicates a high level of uncertainty about the gross retail margin and the consequent potential difficulties in setting an appropriate wholesale price. The Committee remains unconvinced that this has been addressed adequately. It therefore recommends that the Minister provides, as a matter of urgency, further explanation of how the distinction between retail and wholesale functions will be defined for the purposes of the Bill, and how the costs will be accurately apportioned.}

\textbf{Licensing}

81. No significant concerns were expressed about the procedures for licensing new entrants (including elements such as the terms of licences, the application and appeal processes, transfer and revocation of licences, and a register of licences). Similarly, no concerns were expressed about proposals to govern disconnections. However, the FSB particularly argued that the provision that Scottish Water’s retail subsidiary should no longer being required to be a ‘provider of last resort’ should be tempered to some extent. It was concerned that a legitimate start-up businesses would potentially find itself unable to secure a water and sewerage supply because of past trading problems – perhaps unintentionally preventing someone with a bad credit rating from starting up a business or someone who has been declared bankrupt from going back into business\textsuperscript{77}. Water UK implied that this might be the case when it suggested that the issue of new entrants ‘cherry-picking’ customers was more likely to apply to customer characteristics than geography\textsuperscript{78}.

82. Section 10(3) gives the Commission the power to issue directions to regulate the flow of customer information between providers. This is not specific about the process by which companies should exchange information about their customers to allow switching to take place. Some witnesses suggested to the

\textsuperscript{76} Under the proposed new section 29F of the 2002 Act, inserted by section 18(1) of the Bill. See written submission from the WIC.
\textsuperscript{77} \textbf{Official Report, 9 September 2004, Column 1109}
\textsuperscript{78} \textbf{Official Report, 15 September 2004, Columns 1149-50}
Committee that the Bill should be more explicit, and that the Commission should have a duty to ensure that companies put in place switching arrangements, and that those arrangements should mirror those being developed in England and Wales. For example, Gemserv argued that a clear structure for governing switching should be in the control of all providers (as in the energy market), to avoid undue incumbent influence.\(^{79}\)

83. The Committee accepts the procedures set out in the Bill for licensing water and sewerage service providers. However, in the light of the evidence outlined above, the Committee recommends that the Minister should consider further whether his proposals for ensuring supply to non-domestic customers are sufficiently robust. The Committee recommends that the Minister should consider further whether his proposals for switching arrangements are consistent with those operating in England and Wales. The Committee has also recommended at paragraph 44 above that the Minister consider whether the licensing regime can be used to impose consistent sustainable development obligations on water and sewerage service providers.

Charge determination process

General

84. The Minister emphasised to the Committee that the Bill marks out a distinction between his policy-making role, and the Commission’s duty to calculate the resources that those policies require.\(^{80}\) Most witnesses welcomed this approach and the change in the role of the WIC from advising the Minister to economic regulation.

85. The FSB highlighted how the proposed charge determination procedure should improve transparency:

“The clear issue over the past two years is about roles, responsibilities and accountability. We talked to Scottish Water, the Executive and the water industry commissioner, and everybody passed the buck. The bill clarifies the issue.”\(^{81}\)

86. A number of witnesses emphasised that nothing should be done to compromise this clarity. The Forum of Private Business, however, did suggest that Ministers should retain a final political ‘over-ride’ in the process of setting the charges scheme.\(^{82}\) Others suggested that this concern would be dealt with if appropriate routes were established for all stakeholder perspectives to be fully understood in the process. These ‘governance’ issues are discussed more fully at paragraphs 17-25 above.

87. In connection with this, it was suggested that some stages of the charge determination process should be open to wider consultation than allowed for in

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\(^{79}\) Official Report, 15 September 2004, Column 1152

\(^{80}\) Official Report, 5 October 2004, Column 1309

\(^{81}\) Official Report, 9 September 2004, Column 1112

\(^{82}\) Written submission and Official Report, 9 September 2004, Column 1112
the Bill. For example, before issuing their statement on principles of charging, 
the Bill requires Ministers to consult only Scottish Water and the Commission.\(^{83}\) 
The Convener of the Panels suggested that this could be extended to require 
Ministers to consult the public through the Panels.\(^{84}\) In his letter referred to at 
paragraph 20 above, the Minister indicated that he proposed to lodge an 
amendment at Stage 2 to make this change. The Scottish Consumer Council 
suggested that the Panels should also be included as statutory consultees 
when the Commission produces its draft determination of charges,\(^{85}\) and under 
section 19 of the Bill before Ministers exercise their power to confer any 
additional or supplementary powers on Scottish Water.\(^{86}\)

88. The Committee considers that the proposed charge determination 
procedure is appropriate. The Committee welcomes the Minister’s further 
proposal to include the Panels as statutory consultees before a Ministerial 
statement on the principles of charging is made (under the proposed new 
section 29D(4) of the 2002 Act). The Committee recommends, however, 
that the Panels should also be included as statutory consultees in the 
proposed new sections 29B(4)(a) and 56B of the 2002 Act, as suggested 
by the Scottish Consumer Council.

Right of appeal to the Competition Commission

89. The Committee heard evidence that the body arbitrating in disputes between 
Scottish Water and the Water Industry Commission should have detailed 
knowledge of the policy objectives for the industry, rather than simply economic 
expertise. The STUC presented a strong criticism of the proposed route of 
appeal to the Competition Commission. It suggested that it was-

“…simply not qualified to play that role in relation to a public service such as 
Scottish Water, which has clear political direction in relation to public policy. 
A political question arises as to whether it is right for the judgments in relation 
to the balance between economic efficiency and public policy considerations 
to be arbitrated by a body of economists sitting in London.”\(^{87}\)

It suggested that the right of appeal should be to Ministers, as any dispute would 
have its origin in political directions.

90. From a different perspective, Diageo suggested that a UK body may not have 
appropriate knowledge of all relevant factors in the Scottish water industry or 
the unique factors in the whisky industry.\(^{88}\) Others were clear that any appeal 
would be complex and would require an expert economic body. Scottish Water 
supported the right to appeal to a professional, independent body.\(^{89}\)

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83 For example, section 18(1), inserting section 29D(4) into the 2002 Act
84 Official Report, 22 September 2004, Column 1204
85 Section 18(1) of the Bill, inserting section 29B(4)(a) into the 2002 Act
86 Section 19 of the Bill, inserting section 56B into the 2002 Act, currently requires that Ministers 
must consult only Scottish Water and the Commission on any such proposals. See written 
submission by the Scottish Consumer Council.
87 Official Report, 15 September 2004, Columns 1139-40
88 Written submission
89 Supplementary written submission
91. The Competition Commission indicated that it would be alert to Scottish factors and that regulatory inquiries generally had common threads, on which it had the relevant expertise.\(^90\)

92. The Committee accepts, on balance, the proposed rights of appeal being to the Competition Commission. The Committee recommends, however, that the operation of this right be kept under review to assess whether it is operating in the best interests of the Scottish water industry.

**Departures from the charges scheme**

93. The Bill would end Scottish Water’s freedom to negotiate individual agreements with customers. Large users suggested that current special deals were good business for them and for Scottish Water. BP Grangemouth stated that it had pursued the option of contracting with a third party to supply it from a private source. Scottish Water’s reaction to this was, BP suggested, an appropriately competitive business response.\(^91\) BP, and other large business users, stated that they will seek alternative (off network) provision if the Bill unduly restricts them from making appropriate deals. Diageo gave examples of cases where appropriate partnerships with water authorities had led to revenue stability and cost savings on both customer and supplier sides.\(^92\) Some concern was expressed that continuing current special deals until they lapse will create uneven situations, with some being near their end and others being long-term. However, no information on the number and length of such deals was available to the Committee.

94. While the intention in ending special deals is clear, the implications of this change for the competitiveness of Scottish businesses are not. The Scottish Enterprise Network expressed particular concern on this point.\(^93\) Some large customers appear likely to seek off-network solutions if they lose this freedom to negotiate. This will clearly have implications for Scottish Water’s revenues, and potentially for other Scottish Water customers. Special deals can also be argued to have these implications. Evidence to the Committee did not give a clear indication of which would have the greater impact.

95. The Committee is concerned that the proposed limited departures from the charges scheme may not strike the correct balance for businesses and for the revenue base of Scottish Water. The Committee recommends that the Minister gives further consideration to this.

**EXECUTIVE CONSULTATIONS ON THE QUALITY AND STANDARDS III PROCESS – INVESTMENT PRIORITIES FOR 2006-14 AND PAYING FOR WATER SERVICES 2006-2010**

96. The Bill does not deal directly with investment priorities for Scottish Water or how Scottish Water’s core activities and objectives should be funded. However, a statement by Scottish Ministers on the objectives to be pursued by Scottish

\(^{90}\) Official Report, 29 September 2004, Column 1268  
\(^{91}\) Official Report, 9 September 2004, Column 1121  
\(^{92}\) Official Report, 9 September 2004, Column 1127 and written submission  
\(^{93}\) Written submission
Water (and the principles to be followed in a charges scheme to fund these objectives) is required by the Bill\textsuperscript{94} as the foundation for the proposed new charge determination process.

97. Two consultations are being conducted in parallel to Stage 1 of the Bill. The first is on the investment priorities for the period 2006-2014 (known as the Quality and Standards III period – 'Q&SIII'). The second is on the principles to be followed in a charges scheme. They are intricately linked.

98. Ministers’ policy statement to the WIC, which will reflect decisions on these investment priorities and charging principles, is expected in January 2005. Evidence has clearly suggested that it is difficult in practice to separate the content of a statement on what should be funded and the principles of charging entirely from the process of determining charges (and from the development of competition and arguments about how this might affect the customer and revenue base for the industry). The Committee therefore agreed to take evidence directly from the Minister on the consultations, alongside evidence on the Bill. A significant number of other witnesses also raised issues relating to investment priorities and charging with the Committee. The issues which emerged are covered briefly below.

Consultation on the Quality and Standards III process – investment priorities for 2006-14

99. Two main issues emerged in evidence: development constraints and the control of odour nuisance from waste water treatment works.

Development constraints

100. A number of witnesses focused on the development constraints created by limits on investment in new water and sewerage infrastructure. The Minister acknowledged that this issue received very low priority in the Q&SII process, and so Scottish Water has had limited funds to address it in the current 2002-2006 programme\textsuperscript{95}. Local authorities, including Highland Council, emphasised the stifling effect this had on economic development and regeneration\textsuperscript{96}.

101. The priority to be given to development constraints is intricately linked to the principle of how this work should be funded, which was the more significant element of this issue raised in evidence before the Committee. The extent to which infrastructure development is funded by current or future water charge-payers is addressed at paragraphs 133-7 below.

102. The Committee acknowledges that there will always be a need for prioritisation between possible developments. The issues are clearly different depending on whether developments are, for example, large commercial ones or small social housing projects. Similarly, there are different issues in rural areas where one or two extra housing or business units can have a significant local impact, but can also have very substantial costs to connect to the water

\textsuperscript{94} Section 18(1), inserting a new section 29D(1) into the 2002 Act
\textsuperscript{95} Official Report, 5 October 2004, Column 1291
\textsuperscript{96} Written submission
network. Flexibility to cooperate is required. Scottish Water noted the complexities of addressing this and stated:

“However, we know from our discussions with the Executive that it is acutely aware of the fact that multi-differences are involved and that development cannot be tackled with a single blunt instrument.”\(^{97}\)

103. Scottish Water argued strongly that it should not be, and was not equipped to be, in the position where its limited funding forced it effectively to act like a planning authority by determining which developments could go ahead\(^{98}\).

104. Witnesses suggested that better coordination with the local authority planning system would allow consistent prioritisation. If possible, structure planning processes should be better aligned with the water investment decisions. The Committee welcomed the Minister’s assurance that better information was coming from local authorities in this consultation process, and his assurance that he was working closely with the Minister for Communities\(^{99}\).

105. Some concerns were, however, raised that appropriate modelling to plan whether connection to the public supply was possible was not being done because no-one was willing to take funding responsibility for the modelling\(^{100}\). Without this information now it could be difficult to plan effectively in Q&SIII for future investment decisions by both the public and private sectors. The Committee welcomed the Minister’s clarification that he was encouraging Scottish Water to build the need for modelling exercises into its costings\(^{101}\).

106. The Committee welcomes the increased consideration being given to investment in new infrastructure in this consultation process. The Committee regards this as a fundamental priority for the environment and for sustainable economic development in Scotland.

107. However, the Committee recognises that this is an extremely complex issue. The scale of the issue demands very careful co-ordination. The wide range of potential development which must be addressed – including affordable and social housing, housing in rural areas, and commercial developments – involves complex decisions and potentially competing perspectives. In order to achieve the required balance between different priorities, the Committee considers that a consistent and robust system must be established for prioritising investment in new infrastructure. This must effectively integrate different perspectives within government – including housing and planning alongside the water industry.

108. The Committee considers that the prioritising of infrastructure investment must be explicitly integrated with the structure and local planning processes. Achieving equitable decisions may, however, be complicated by the different stages of development in local and structure

\(^{97}\) Official Report, 15 September 2004, Column 1169
\(^{98}\) Official Report, 15 September 2004, Column 1168
\(^{99}\) Official Report, 5 October 2004, Columns 1291 and 1299
\(^{100}\) Official Report, 5 October 2004, Column 1292
\(^{101}\) Official Report, 5 October 2004, Column 1296
plans. The Committee recommends that the Minister considers as a matter of urgency how robust prioritisation can be achieved. The Committee also requests the Minister’s comments on the position of local authorities which grant planning permission to developments when it is known that there is insufficient network water and drainage capacity.

Control of odour nuisance from waste water treatment works

109. The Committee has been referred two public petitions (PE517 and PE645) which call for action to address odour nuisance problems arising from waste water treatment works. The Committee has considered the petitions in some detail since first considering petition PE517 at its meeting on 10 September 2003, including taking evidence from Ministers. In the course of this consideration, the Committee has examined the regulatory framework for the enforcement of controls on odours and the practical steps being pursued by various authorities.

110. Evidence to the Committee indicates that major stakeholders believe in general that the regulatory framework governing odour nuisance is adequate and competent to deal with problems\(^{102}\). However, a significant (and increasing) number of complaints continue to arise. Local authorities tend to favour informal approaches to resolution of complaints, but formal powers, where used, are effective in the long term.

111. However, evidence suggests that consistency of implementation and enforcement of the regulatory regime requires to be improved as a matter of urgency. There is strong support for the Executive’s current development of a code of practice for local authority enforcement of statutory nuisance powers, as a tool to facilitate investigations and promote solutions. A statutory basis for the code is regarded as having many advantages, and the Committee has previously welcomed the Deputy Minister for Environment and Rural Development’s commitment to this.

112. The Executive has stated that it is seeking to identify a suitable legislative vehicle to make statutory provision for the proposed code. (The Executive had previously indicated that it did not consider either the proposed Water Services or Planning bills to be appropriate for legislating about odour nuisance.)

113. Difficulties remain in defining and measuring odour objectively, and monitoring can be resource intensive. Different facilities can be subject to different, or no, odour standards and different authorities have different means of measuring them. Odour problems also have a number of different causes.

114. The Committee’s welcomes the Executive’s acceptance of its request for the need for higher standards of odour control to be considered in consultations on Q&SIII. However, the consultation document gives no projected costs for addressing these issues. Scottish Water has indicated that it is unlikely that the capital costs to address all known odour issues can be accommodated within the Q&SIII exercise. Scottish Water is, however, undertaking a range of

\(^{102}\) Further background explanation and evidence was made public in the agenda papers for the Committee’s meeting on 5 October 2004, and is available on the Parliament’s web-site.
technical measures to improve odour control across a range of sites. The Committee welcomes the Minister’s indication that costings would be available to him before the final decisions on investment priorities were made\textsuperscript{103}.

115. The Committee welcomes the increased consideration being given to addressing issues of odour nuisance in this consultation process, and recommends that this issue is addressed in the Q&SIII period. The Committee is concerned that the consultation document does not contain any cost estimates for this, but welcomes the fact that these will be available to the Minister before final decisions are made.

116. The Committee remains strongly committed to seeing statutory underpinning for the proposed code of practice on odour nuisance. The Committee strongly recommends that the Minister should consider again whether the Water Services etc (Scotland) Bill could be used to give statutory basis to the code.

117. It was clear to the Committee, and acknowledged by the Minister\textsuperscript{104}, that a number of issues were not adequately raised or analysed at the time of preparation for the Q&SII investment period (2002-06). The Committee welcomes all the indications that there appears to be a significantly more comprehensive gathering of information in the Q&SIII process. It welcomes the fact that all parties appear to have grasped the importance of the process, and that issues such as development constraint are being given much fuller attention. The Minister has also acknowledged the need for cooperation with different policy areas, particularly planning and housing\textsuperscript{105}.

118. The Committee acknowledges the evidence that, once priorities and a charging scheme have been set, it is difficult to identify a basis for intervention in the middle of an investment period. Given the huge sums of money involved, and the fact that decisions are being made for an 8-year timeframe, the Committee therefore believes that it is essential that the decisions made now are as robust and accurate as possible.

119. The Committee considers that there are a number of general issues which must be addressed about the investment programme. Firstly, in the context of an 8-year plan with finite investment funds and finite civil engineering capacity, the Committee considers that the process by which investment projects are identified and implemented must be subject to continuous monitoring and periodic review. This monitoring and review must involve both Scottish Water and local authorities.

120. Secondly, the Committee considers that progress should be benchmarked and made as transparent as possible through the establishment and publication of a robust set of indicators. This will assist in enabling decisions about the priority order of projects to be clear and equitable. Alongside this, the Committee considers that any new

\textsuperscript{103} Official Report, 5 October 2004, Column 1298
\textsuperscript{104} Official Report, 5 October 2004, Column 1288
\textsuperscript{105} Official Report, 5 October 2004, Column 1299
processes should not be allowed to jeopardise the progress Scottish Water has made in its business management and the improving efficiency in its investment programme.

121. Thirdly, the Committee considers it unacceptable that Scottish Water may be unable to respond to any unforeseen need which arises during an investment period. The Committee recommends that sufficient flexibility and contingency funding should be available within the investment programme to allow Scottish Water the scope to respond appropriately to unforeseen investment needs.

Consultation on paying for water services 2006-2010

122. The Committee notes the evidence of the WIC that the current (Q&SII) level of investment is extremely challenging for Scottish Water to achieve, and that, in many respects, it is unprecedented\textsuperscript{106}. The Q&SIII consultation raises the prospect of huge further increases in this investment level, highlighting the possibility of increased charge levels. The Committee therefore also agreed to consider the ‘principles of charging’ consultation document.

123. Scottish Water aptly summarised a large amount of evidence that was received by the Committee-


d\textsuperscript{\ldots}over the past two or three years\ldots we saw huge frustration among our customers and an inability to have a debate around the issues of cross-subsidy, standing charges and all the rest of it.\textsuperscript{107}

124. The Committee recognises this frustration, and welcomes the opportunity that this consultation offers for these issues to be considered comprehensively and transparently. The discussion of the Q&SIII process above has highlighted that there is likely to be substantial pressure on charges in the coming years. In this context, it is extremely important to get the principles of charging correct. As the FSB stated to the Committee, “\textit{If we can get the principles of charging right\ldots we will take away many of the problems you are referring to [concerns about complaint processes and stakeholder representation]}\textsuperscript{108}. The Committee believes that it is important that decisions should be based on, and applied through, appropriate cross-departmental working and that they should command public confidence.

Cross-subsidies

125. A number of witnesses stated that the Executive needs to be clear about distinctions between the provision of water and sewerage as a basic social provision and the provision of services as a commercial commodity\textsuperscript{109}. This should lead to clarity about which should be funded by public spending in some form and which should be purchased through charges. A complete separation between social and commercial elements is, however, extremely difficult.

\textsuperscript{106} \textit{Official Report}, 29 September 2004, Column 1250
\textsuperscript{107} \textit{Official Report}, 15 September 2004, Column 1165
\textsuperscript{108} \textit{Official Report}, 9 September 2004, Column 1115
\textsuperscript{109} For example, Dr John Sawkins, \textit{Official Report}, 9 September 2004, Columns 1087-8
126. The Executive has explicitly stated that social policy objectives underpin the Bill, and some of these are factors which have to be included in the Ministers’ statement on charges. BP argued that, while it is legitimate to have these social objectives for the industry, social policy decisions should not be implemented via charging (which effectively uses the charging scheme as a form of redistributive taxation). Ian Jones suggested that Scottish Water is not the correct agency to be charged with practising social security, as its primary responsibility was to be efficient. Dr John Sawkins suggested that what was required was a clear decision from Ministers. From this could flow any decisions about whether cross-subsidies within the system between different groups of customers were appropriate. The Scottish Consumer Council stated that, “...help for those who cannot afford to pay must be seen as an issue of social policy, rather than service provision. It should be addressed outwith the parameters of the charging system and funded by society as a whole and not cross-subsidised by other water customers.”

127. Cross-subsidy, and the means to deal with it, was a recurring theme in evidence on the Bill. The Bill sets out to protect some elements of cross-subsidy, such as national harmonisation of charges. However, the Executive stated (see paragraph 77 above) that the Bill addresses the implications of competition for the whole revenue base of Scottish Water, so that domestic customers do not face higher charges. Despite the confidence of the Executive, some witnesses expressed some concern on this point. Both Ian Jones and the SCDI stated that competition would increase the need for cross-subsidies, particularly as large users may be ‘cherry-picked’ by providers other than Scottish Water – or may opt for ‘off network’ solutions if they can no longer negotiate appropriate special deals with Scottish Water.

128. A number of witnesses suggested that the business sector in Scotland subsidises the non-domestic sector, with consequent implications for Scottish business competitiveness. The FSB suggested that the key requirement is simply for clarity about where cross-subsidies between and within groups of customers exist, their purpose and their effects. The charge determination process allows for these to be specified by Ministers – and therefore for appropriate transparency and public debate. The Committee welcomes the Minister’s assurances that research currently being conducted by the Executive to identify cross-subsidies will be available before the Ministerial statement is made in January 2005.

129. Related to the issue of cross-subsidy is that of the affordability of water charges. A number of witnesses suggested that a definition of water poverty would have been useful in assessing this and in designing the principles of the charges scheme. The Minister indicated that he intended to re-target the approximately £75m subsidy which is currently used on single adult and second

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110 Section 18(1), inserting section 29D(2) and (3) into the 2002 Act
111 Official Report, 9 September 2004, Column 1118
112 Official Report, 9 September 2004, Column 1089
113 Official Report, 9 September 2004, Column 1089
114 Written submission
115 Official Report, 9 September 2004, Columns 1096 and 1106 respectively
116 For example, see written submission from Citizens Advice Scotland
home discounts. He proposes to use this to provide more support to fewer customers in the future\textsuperscript{117}.

130. SCVO argued that the current arrangements for charge concessions for voluntary and charity sector organisations were inflexible and over-complex\textsuperscript{118}. The Executive has indicated that this scheme will remain in place until at least 2010. However, SCVO suggested that the number of organisations benefiting was significantly lower than had been anticipated, and that it may particularly affect the decisions of organisations to move to more suitable premises. The Minister noted that any change in the scheme would simply have to be paid for by cross-subsidies from other sectors\textsuperscript{119}. However, some witnesses suggested that the funding for charities to meet these charges was one example where ‘social policy’ objectives should be funded from elsewhere in public expenditure rather than from other water charge-payers\textsuperscript{120}.

131. The Committee considers that the issue of pricing is central to the economic, social justice and environmental objectives associated with the provision of water and sewerage services. The Committee acknowledges that cross-subsidy currently has an assumed, but unquantified, role in achieving these objectives. It also notes that the trend is for cross-subsidies gradually to be removed from the pricing structure. The Committee requests that the Minister provides the Committee with the research on cross-subsidies and a comprehensive analysis of the winners and losers in the any proposed changes being considered by the Executive.

132. The Committee also requires further clarification on the eligibility for, and operation of, the charges exemption scheme for charitable organisations. The Committee requests the Minister to provide a comprehensive written briefing to the Committee, including information on the numbers of organisations qualifying, problems which may be encountered by organisations moving premises, and the options for addressing this issue which may exist through other Executive departments or through forthcoming charity reform legislation.

Development constraints

133. As noted in paragraphs 100-108 above, the Committee heard substantial evidence on the priority to be given to funds for connection of new and existing properties to the public networks. Scottish Water and other witnesses suggested that what was required was a clear mechanism for determining the apportionment of costs between public funds, Scottish Water and developers.

134. Section 3 of the Bill addresses the power of Ministers to make regulations dealing with the issue of ‘reasonable cost’ – how that part of the cost of connecting to the public water and sewerage system which Scottish Water must bear will be calculated. It also proposes that the new Commission, rather than

\textsuperscript{117}Official Report, 5 October 2004, Column 1305
\textsuperscript{118}Official Report, 22 September 2004, Column 1199
\textsuperscript{119}Official Report, 5 October 2004, Column 1304
\textsuperscript{120}For example, SCVO, Official Report, 22 September 2004, Column 1200
 Ministers, will have the right to determine any disputes which arise about reasonable costs. It is anticipated that the Executive will consult in 2005 on regulations. Scottish Water suggested that “…it is the subsequent regulations that will really bite in this sector”\textsuperscript{121}.

135. The apportionment of these connection costs is particularly relevant to the issue of development constraints. Any decision about apportioning costs will have a significant bearing on the funding required to meet investment priorities. In that context it is not clear what the impact will be of detailed regulations on this point being consulted on and produced separately from, and after, decisions about investment for 2006-14 are finalised.

136. The Committee welcomes the Minister’s suggestion that, “with infrastructure that is just for a development, we should move from a position whereby all such infrastructure is provided by Scottish Water”\textsuperscript{122}.

137. The Committee remains concerned about the issue of accountability, given that Scottish Ministers will make regulations and investment disputes will in future revert to the proposed Water Industry Commission rather than to the political level. The Committee also requests further explanation from the Minister in advance of Stage 2 on how the regulation-making power in section 3 of the Water Services etc (Scotland) Bill will interact with the decisions on investment and charging – particularly given that the regulation–making power will not be used until after the investment levels and priorities for Q&SIII have been set.

Rateable value as a basis for non-domestic charges

138. A number of witnesses suggested that changing the basis of some non-domestic charges from rateable value to a banding system was welcome. The Forum of Private Business said, “The assessment that is based on rateable value is grossly unfair.”\textsuperscript{123}, and provided a number of case studies which it regarded as particularly problematic. The FSB echoed this point and argued for a more significant usage basis for charges. Some concern was expressed that proposals to move to a banding system from 2010 would leave considerable instability in the meantime, and lead to a repeat of many of the complaints of recent years.

Resource use incentives

139. A number of witnesses discussed the possibility of changes to the proportion of charges which are based on fixed or volumetric elements. The Minister explained that the significant majority of the industry’s costs are in fixed elements rather than in volume-related elements, and so it was appropriate for the regulator to use this as the basis for charging\textsuperscript{124}. However, this decision has an inevitable impact on cross-subsidy within the system. Large business users

\textsuperscript{121} Official Report, 15 September 2004, Column 1169
\textsuperscript{122} Official Report, 5 October 2004, Column 1302
\textsuperscript{123} Official Report, 9 September 2004, Column 1102
\textsuperscript{124} Official Report, 5 October 2004, Column 1306
who have a metered element indicated that they were very volume conscious, and were strongly in favour of a higher volumetric element to charges\textsuperscript{125}.

140. One business user argued that there was a basic conflict between a high infrastructure cost and the issue of sustainability\textsuperscript{126}. Ian Jones reflected this, suggesting that there were contradictory impulses for Scottish Water. It was unlikely to benefit from a water conservation policy, given the costs it would impose\textsuperscript{127}. Ofwat noted that, in England and Wales, the Water Act 2003 gave the Secretary of State a formal role to achieve and report on water conservation\textsuperscript{128}.

141. The Committee notes evidence that both the initial capital and on-going maintenance costs of widespread water metering would be very substantial. However, the Article 9 of the European Water Framework Directive requires that water charges should provide an incentive for users to use water resources efficiently. The issue seems to have been given low priority in Scotland. The principles of charging consultation does not mention this and so it was not at all clear how this requirement will be implemented in Scotland. A number of witnesses confirmed that the Bill did not address the issue of water resource use, and Scottish Water suggested that it was not the appropriate vehicle for wider issues of this nature. Despite the considerable amount of evidence received by the Committee on this point it was, therefore, not at all clear where this debate should take place.

142. The Committee remains concerned that there does not appear to be any current consideration of issues of efficient water resource use and measures for water conservation – particularly given the requirements of the Water Framework Directive. The Committee acknowledges that this is an extremely complex issue, overlapping considerably with other issues of infrastructure, pricing system and cross-subsidy.

143. The Committee recommends that the Minister gives serious consideration to measures and incentives for efficient use of water resources. In particular, the Committee recommends that the Minister should commission research to investigate this issue and identify potential strategies. The Committee also considers that there is a strong argument for non-domestic customers to move towards metering as a long-term goal.

PART 3 - COAL MINE WATER POLLUTION

Introduction
144. Part 3 of the Bill proposes powers to enable the Coal Authority (‘the Authority’) to tackle and prevent coal mine water pollution in Scotland. The Authority currently works closely with SEPA through a formal Memorandum of Understanding to take action in preventing damage to the environment caused

\textsuperscript{125} For example, BP Grangemouth and Diageo, see \textit{Official Report}, 9 September 2004, Columns 1124-6
\textsuperscript{126} Ciba Speciality Chemicals, see \textit{Official Report}, 9 September 2004, Column 1126
\textsuperscript{127} \textit{Official Report}, 9 September 2004, Column 1091
\textsuperscript{128} \textit{Official Report}, 29 September 2004, Column 1267
by discharges from abandoned coal mines. Evidence to the Committee was
generally supportive of the provisions in the Bill, which were seen as
strengthening the Authority’s powers, and reflecting provisions that have
already been made for England and Wales in the Water Act 2003. However, a
number of issues were raised in evidence.

Compulsory purchase

145. As part of its role in preventing the polluting effect of discharges, the
Authority monitors disused shafts and boreholes to assess the extent of rising
mine waters. While it owns abandoned mine-workings, it may have to negotiate
with other landowners to gain access and secure land for monitoring boreholes
and pursuing other remedial works. SEPA has powers of access and
compulsory purchase for environmental purposes, but the Authority does not
have similar statutory powers. The Authority indicated that there have been
occasions in Scotland when its work has been compromised or could not be
carried out because it was unable to gain access to the affected land, or to
acquire land by agreement. The Authority cited examples where it has been
delayed in dealing with two of the most polluting discharges on SEPA’s priority
list. The Bill seeks to address this issue. The Committee noted that both
SEPA and the Authority welcome the compulsory purchase provisions in the Bill
as a means of resolving such problems in the last resort.

146. No evidence was presented to the Committee to suggest that the compulsory
purchase powers are not appropriate or necessary. The powers were described
as adequate and a useful last resort in a range of options. In oral evidence the
Authority confirmed that it has never had to resort to using the compulsory
purchase option established for use in England or Wales, but that its existence
was a very powerful tool. SEPA welcomed the proposals.

Relationship between SEPA and the Authority

147. A significant number of pollution incidents need to be dealt with under a
priority list which is drawn up by SEPA and reviewed annually. The Committee
notes that the Authority has a rolling programme to deal with these incidents
within a timeframe which will comply with the Water Framework Directive.

148. Witnesses suggested that the Bill provides sufficient clarity to reinforce the
existing good practice which has developed between the Authority and SEPA.
However, given that the Authority does not have a base in Scotland and in view
of the need for urgent action to be taken when incidents are reported, COSLA
questioned whether the Bill should contain further guidance on the allocation of
responsibility for cleaning up discharges.

Pollution from other types of mining

149. Some concerns were raised about pollution from other types of mineral
extraction works. The Committee heard that the processes and technical
knowledge required are similar to that for dealing with coal mine water pollution.

129 Official Report, 29 September 2004, Column 1270
130 SEPA and The Coal Authority, written evidence
131 Official Report, 29 September 2004, Column 1271
132 Written submission
133 Official Report, 22 September 2004, Column 1215
Although the Authority has neither the responsibility nor resources to deal with discharges from other types of mining, it indicated that it would be willing to use its expertise in other mining industries if required\textsuperscript{134}. In oral evidence the Minister confirmed that SEPA has powers under the Water Environment and Water Services (Scotland) Act 2003 to deal with water pollution from disused mines\textsuperscript{135}, but it is not clear to the Committee how this might operate in practice.

Report to the Parliament

150. The Committee acknowledged that the work of the Authority has not been well known to it in the past. It has been suggested that a duty might be imposed on SEPA to report formally to the Parliament at regular intervals on progress being made on mine water pollution. The Authority indicated that it would welcome any suggestions on enhancing reporting of this activity\textsuperscript{136}.

151. The Committee is broadly content with the provisions contained in Part 3 of the Bill. In particular, the Committee accepts that the proposed compulsory purchase powers are appropriate. The Committee recommends, however, that the Minister gives further consideration to how the work of the Authority in addressing mine water pollution is reported. The Committee also requests the Minister to consider further whether additional powers are required to address water pollution from other types of mineral workings and landfill sites in Scotland.

SUBORDINATE LEGISLATION

152. The Bill contains a number of powers to make subordinate legislation. Section 27 outlines the Parliamentary procedure to which instruments under the Bill will be subject. The Subordinate Legislation Committee examined these provisions in detail at its meetings on 29 September and 5 October and discussed a number of issues with the Scottish Executive. That Committee’s report is reproduced in full at Annex A. A number of significant points arise.

Sections 4(7) and 5(7) – Exceptions to the prohibitions

153. Sections 4(7) and 5(7) of the Bill specify exceptions to the offences relating to the prohibition of common carriage. The Subordinate Legislation Committee has raised concerns that these powers are extremely wide. In that Committee’s view (and as the Executive recognises) these powers could have a fundamental effect on the way in which the prohibitions operate and thereby on the core provisions of the Bill. That Committee expressed very serious concerns about the Executive’s position on this. In order to protect the policy intention, it would appear that it may be better to draw the powers more narrowly, or that such powers might more properly appear on the face of the Bill rather than in delegated powers.

154. The Subordinate Legislation Committee has reported its very serious concern that the proposed affirmative procedure does not provide sufficient safeguards

\textsuperscript{134} Official Report, 29 September 2004, Column 1274
\textsuperscript{135} Official Report, 5 October 2004, Column 1327
\textsuperscript{136} Official Report, 29 September 2004, Columns 1272-3
given the width of the powers. It recommends that these powers should be subject at the very least to affirmative procedure combined with a requirement of prior public consultation. Given the use to which they might be put, they may in fact be more suited to a super-affirmative procedure. This procedure can be handled within Standing Orders and has previously been used by the Executive.

155. The Committee shares the concerns of the Subordinate Legislation Committee, and recommends that the exercise of these powers should be subject to a degree of scrutiny beyond that provided by the usual affirmative procedure.

Section 19 – Directions regarding Scottish Water’s functions
156. Section 19 of the Bill gives Ministers powers to include in directions to Scottish Water objectives regarding the standards and timescales to which services should be delivered. It also inserts a new section 56B into the 2002 Act to give Ministers a broad power to confer additional or supplementary functions on Scottish Water – a power which would be subject to affirmative procedure. It is not immediately clear what these powers might be used for, or what their limits may be.

157. The Minister sought to clarify their purpose. He indicated that section 19 would be used to direct Scottish Water to adopt and meet objectives agreed for investment priorities and the principles of charging. Section 19 is therefore intricately linked with section 18 (which sets out the charge determination procedure). This ensures that all the objectives that are set for the industry through the quality and standards process are functions that will have to be taken account of by the Water Industry Commission in determining the amounts to be funded through charges.

158. While it noted that the powers in the proposed new section 56B remain very broad, the Subordinate Legislation Committee approved the affirmative procedure chosen. However, the Committee remains unclear on what the powers might be used for. As noted in paragraph 87 above, the Scottish Consumer Council suggested that the Panels should be included as statutory consultees before Ministers exercise this power.

159. The Committee requests that the Minister provides further detailed explanation on how he intends to use the powers set out in section 19.
Section 20(3) - Meaning of ‘dwelling’ in relation to eligible premises

160. The Subordinate Legislation Committee also expressed concern about the Parliamentary procedure to be used in respect of this delegated power to vary the meaning of ‘dwelling’. The Executive states that the power would be used in only a limited fashion for the purposes outlined in the Explanatory Notes. However, the Subordinate Legislation Committee observed that the power in the Bill is drafted very widely and could be used to amend the definition of ‘dwelling’ in almost any way - for example, by breaking the link with the council tax regime entirely. That Committee also noted that the power allows Ministers to modify primary legislation. It concluded, therefore, that exercise of this power should be subject to affirmative procedure rather than the negative proposed. The Committee endorses this recommendation.

Paragraph 1(7) of schedule 2 - Consideration of licence applications

161. This paragraph gives Ministers the power to specify circumstances in which the normal licence procedures should not apply. The Subordinate Legislation Committee noted that it was not entirely clear how this power would operate or in what circumstances it is proposed that it be used. It observed that it is not unknown to confer order-making powers that authorise exemptions from certain statutory provisions. However, the proposed power seems to go wider than this and in particular seems to allow the provisions of the Bill to be modified. That Committee is unsure whether, in so far as the power would allow the substantive obligations imposed by sub-paragraphs (4) to (6) to be disapplied, negative procedure would provide sufficient Parliamentary control. It welcomed the Executive’s commitment to look at that again following its comments.

162. The Committee is also unconvinced that negative procedure provides the appropriate level of Parliamentary scrutiny for the exercise of this power, and recommends that the Minister should consider subjecting it to affirmative procedure.

POLICY MEMORANDUM

163. Under Rule 9.6.3 the Committee is required at Stage 1 to consider and report to the Parliament on the Policy Memorandum.

164. While there has been a draft Bill consultation stage prior to introduction, some of the provisions of this Bill have been included since the draft. In particular, Part 1 of the Bill and section 18 (on the charge determination process) were not included in the draft. However, these provisions have been generally welcomed by all witnesses, and it should be acknowledged that they respond in part to recommendations by the Parliament’s Finance Committee.

165. However, as already noted (for example, at paragraph 53 above) there are a number of areas where witnesses have suggested that the Executive’s justification and explanation for its decisions on regulating competition need to be strengthened. In particular, the Executive’s proposals on regulating competition have changed since first outlined in 2000. Further explanation of the reasons for this, and the implications of the proposed model, would have
been welcomed by many witnesses. The Panels, in particular, suggested that the necessary level of information and assessment of the proposed changes had not been given\textsuperscript{141}.

166. Nonetheless, the Policy Memorandum does provide information which effectively supplements the information on the face of the Bill. In particular, information about the rights of appeal to the Competition Commission (which, as explained in paragraph 51 above, is not in the Bill) was helpful.

167. The Policy Memorandum is also required to set out an assessment of the effects of the Bill on (among other things) equal opportunities. The Memorandum notes general statutory duties to provide services in a non-discriminatory way, and focuses on the need for consultation processes to be widely accessible. The Committee wrote to the Minister seeking a detailed assessment of how the policy of the Bill relates to six questions (recommended by the Parliament’s Equal Opportunities Committee). The Minister’s reply emphasises that the Bill’s provisions on setting charge limits and licensing ensure geographical harmonisation and protection against discrimination. The Executive does not generally consider that the Bill will affect people differentially on the basis of any of the personal attributes identified by the Equal Opportunities Committee.

168. The Policy Memorandum is also required to set out an assessment of the effects of the Bill on sustainable development. Whether the Commission should have a statutory duty to promote sustainable development, and whether the principles of charging should include firmer incentives for water resource conservation, have been discussed in detail at paragraphs 38-44 and 139-143 respectively above.

169. Overall, the Committee considers that the information provided in the Policy Memorandum is adequate.

**FINANCIAL MEMORANDUM**

170. Under Rule 9.6.3 the Committee is also required at Stage 1 to consider and report to the Parliament on the Financial Memorandum. The Finance Committee sought written evidence from interested parties and then took oral evidence from Scottish Water, the Water Industry Commissioner and Executive officials and produced a report on the Financial Memorandum. This report is reproduced in full at Annex A. Two points of particular significance arise from that report.

*Establishing a licensing regime*

171. In evidence to both the Finance Committee and the Environment and Rural Development Committee, Scottish Water challenged the assumptions set out in the Financial Memorandum for the one-off costs of establishing the licensing regime. Independent research commissioned by Scottish Water indicates that the cost estimates in the Financial Memorandum (which are based on advice from the WIC) are in many cases too low, and some potential costs are not

\textsuperscript{141} Written submission
included. The research concludes that one-off costs are likely to be £10-18m above the £12.6m estimated in the Memorandum, and that on-going operational costs are likely to be £4.7-6.9m per annum above the £1.9m estimate in the Memorandum.

172. While expressing concern at the gap between the estimates, the Minister stated that he felt that these costs in the water industry should not be comparable to those in other utility markets. However, in oral evidence he stated that he had not yet seen the detail of the research report, and therefore felt unable to comment. The Minister subsequently wrote to the Committee, indicating that he had now considered the research. He suggested that some of the assumptions underlying it were at odds with the structure of the market which would be established under the Bill, and stood by his estimates.

173. This issue remains a matter of some concern, as these disputed costs are the majority of the direct costs expected to arise from the Bill. In the context of the public water provider disputing these estimates, it is difficult for the Committee to be confident that the information given in the Memorandum is accurate. The Committee notes the Minister’s commitment to continue to examine the issue with a view to narrowing the range associated with the possible costs of the licensing regime. In particular, it notes that the Executive has funded a detailed scoping study on the activity required to establish the regime and the costs of this, and that this is due to be published shortly.

**Competition and efficiency**

174. The Finance Committee also expressed concerns at disagreement between the WIC and Scottish Water on the calculation and assumptions underlying Scottish Water’s level of efficiency compared to other providers. While this is not specifically referred to in the Financial Memorandum, the Finance Committee recommended that its concerns should be pursued with the Minister by the lead committee.

175. This is related directly to the debate about the correct apportioning of costs between retail and wholesale functions (which is discussed in detail at paragraphs 71-80 above). Paragraph 14 of the Regulatory Impact Assessment highlights the WIC’s estimate of the efficiency gap, which informs the cost savings that a relatively efficient competitor could potentially pass on to customers. Both Scottish Water and Water UK dispute these estimates, arguing that they are out of date at present and that the efficiency gap will have been largely eliminated by the time the competition regime is expected to be established.

176. The Minister did not appear to consider this difference to be a fundamental problem, regarding it as part of the inevitable tension between regulator and regulated. However, Water UK suggested that continued differences on this point could lead to too low a wholesale price being set. Given the fundamental importance of this issue to the stability and impact of competition, it is a matter
of some concern that the Committee cannot have full confidence that it has accurate information on which to judge the potential impacts of the Bill.

177. The Committee remains seriously concerned about the lack of clarity on both of these issues raised by the Finance Committee. The Committee cannot have full confidence that the core costs associated with the Bill have been accurately presented, or that it has been provided with sufficient information to enable it to assess the likely impact of the Bill on the industry. The Committee recommends that the Executive’s further work on establishing the costs of the licensing regime should be concluded as a matter of urgency. If possible, this should be presented to the Parliament before it considers the Financial Resolution for the Bill.

178. The Committee further recommends that an updated Financial Memorandum should be provided to the Parliament prior to Stage 3. The Committee notes that the Parliament’s Standing Orders do not currently require a Financial Memorandum which is considered to provide insufficient information to be updated. The Committee recommends that the Procedures Committee consider whether the Standing Orders should be amended to establish such a requirement.

CONCLUSION

179. The Committee shares the desire of the Minister to strengthen the Scottish water industry, to improve its regulation and the representation of customer interests. In the preceding sections the Committee has drawn attention to some of the main areas in which the Bill could be improved in the interests of the water industry as a whole. Additionally, a number of issues have been identified on which the Committee requests further information from the Minister. The Committee urges the Minister to respond to it in writing on all these requests for further information or recommendations for further consideration. The Committee urges him to do so as soon as possible, and in good time before the start of Stage 2 proceedings.

180. Taking account of these issues requiring further consideration, the Committee recommends that the general principles of the Bill should be agreed to.

144 The Committee divided at its meeting on 3 November 2004. See Annex B, Extracts from the Minutes – Record of Divisions in Private.
ANNEX A - REPORTS FROM OTHER COMMITTEES

Finance Committee

Report on the Financial Memorandum of the Water Services (Scotland) Bill

The Committee reports to the Environment and Rural Development Committee as follows—

Introduction

1. Under Standing Orders, Rule 9.6, the lead committee in relation to a Bill must consider and report on the Bill’s Financial Memorandum at Stage 1. In doing so, it is obliged to take account of any views submitted to it by the Finance Committee.

2. This report sets out the views of the Finance Committee in relation to the Financial Memorandum of the Water Services etc. (Scotland) Bill, for which the Environment and Rural Development Committee has been designated by the Parliamentary Bureau as the lead committee at Stage 1.

Background

3. At its meeting on 9 September 2004, the Committee took evidence from Alan Sutherland, the Water Industry Commissioner (WIC) and from Dr John Simpson the Commissioner’s Director of Cost and Performance. The Committee also took evidence from Scottish Water which was represented by: Dr Jon Hargreaves, Chief Executive, Douglas Millican, Finance Director and Ian McMillan, Non-executive Board Member.

4. The Committee the took evidence at its meeting on 14 September 2004 from Scottish Executive officials; Andrew Scott, Head of the Water Services Division, Clare Morley, the Bill team leader and Tom Harvie-Clark, Economist with the Analytical Services Division.

5. In addition, the Committee received written evidence from Scottish Water, Water UK, the Water Customer Consultation Panels and Scottish Enterprise. These submissions are reproduced at Appendix A. The Committee would like to thank all those organisations who took the time to send their views on the Financial Memorandum to the Committee.

Financial Memorandum

6. The main provisions of the Bill are:

- to replace the Water Industry Commissioner with a body corporate, the Scottish Water Commission;

- to prohibit common carriage in the water or sewerage systems. This means that only Scottish Water can use the public water and sewerage pipe network in Scotland.
to establish a licensing regime for retail competition for non-household premises only ie, the new entrant to the market will offer billing and other customer services in competition with the incumbent. This regime will be managed by the Water Industry Commission;

- to require Scottish Water to set up a separate retail subsidiary for the purpose of applying for a license under the Bill;

- to provide new arrangements for determining Scottish Water’s charges;

- to provide further statutory powers for the Coal Authority in Scotland

7. The costs of the Bill, as set out in the Financial Memorandum are summarised in the following paragraphs.

8. It will cost £25,000 to recruit and appoint members of the Water Industry Commission. There will be similar ongoing costs where re-appointments are required. This cost will be met by the Scottish Executive.

9. Board members will receive remuneration in line with Scottish Executive policy on NDPB members’ pay – which will be up to £260 per day for board members and £370 per day for the chair). It is estimated there will only be “modest” additional administration costs from supporting a Board and therefore, the total additional operating costs associated with restructuring into a body corporate will not exceed £150,000 per annum. These costs will be met by increasing the levy on Scottish Water.

10. It is estimated that preparatory work for establishing a licensing regime will cost the Water Industry Commissioner £5m. This will cover general administrative work, legal advice, accounting projects, other advisory work and market research. These costs will be met by the Scottish Executive through grant in aid from the budget for the water industry.

11. It is estimated that it will cost £100,000 for Scottish Water to set up a separate retail function – due to legal and accounting costs. However, the main bulk of the costs will be in preparing for and responding to the new regime. The WIC has estimated that this could amount to £5m. The Financial Memorandum states that some of these costs could be offset by potential savings arising for the separation of the businesses.

12. It is likely to cost £50,000 for a licence applications and this will be charged to licence holders.

13. Switching costs (ie, costs involved in transferring customer data) are estimated to be: £2.5m for the initial cost of a switch engine with an average ongoing annual cost of £500,000. Additionally it is estimated to that around £500,000 per annum will be required to maintain the data used by the switch engine. These costs will be borne by licence holders.
14. It is anticipated that it will cost £1m for each charge determination (this is likely to happen once every four years). This will be funded through increases to the levy on Scottish Water.

**Coal authority**
15. The Financial Memorandum does not anticipate any additional costs to the Coal Authority as a result of the Bill.

**Summary of Evidence**

**General issues**
16. The Committee questioned whether the need for the Bill, and the financial implications of not introducing it, outweighed the costs of the provisions in the Bill. The WIC, Scottish Water and the Executive all stated that legal advice to them had indicated that the Water industry in Scotland could be open to challenge under the Competition Act 1998 and the Bill was seen a necessary, precautionary step. The WIC subsequently provided the Committee with a copy of his legal advice and this is attached at Appendix A.

17. This was further amplified by Executive officials who stated that the financial risks of not introducing this Bill could arise from an imposition of common carriage which the Executive assessed could have a detrimental impact on public health and could lead to an inability to maintain discounts for less affluent customers. In addition, the Executive stated that if the market were to become entirely contested, then terms on which loan funds are granted to Scottish Water might be challenged. The Executive estimated that the difference between the interest rates which are currently charged on such loans and interest rates on the open market could be £40m over Scottish Water’s entire loan stock.¹

18. It was noted that the Bill will set a national harmonised water charge which “will be segmented according to the circumstances of different users, such as large and small users”². The principle behind this is to have a controlled market which could militate against larger users opting out of using Scottish Water which could lead to other, smaller users having to pay more to make up for the loss of income from larger users.

19. The Committee questioned the Executive further on this to find out whether there will be careful consideration of the issue of cross-subsidy to take into account the needs of different parts of Scotland and of different users of the system. The Executive confirmed that subsidies will be examined and decisions will be taken in December 2004 or January 2005 as to what any future subsidies should be. The Committee recognises that these issues and those such as environmental compliance and development constraints are not directly associated with this Bill but are issues which will need to be looked at carefully in the context of the next Strategic Review of Charges.

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¹ Scott, Official Report, 14 September 2004, Cols 1655 and 1656
² Scott, Official Report, 14 September 2004, Col 1656
Setting up a Water Industry Commission

20. Both the WIC and Scottish Water indicated that they were satisfied that the stated costs of setting up the Commission were adequate. **The Committee has no reason to believe that this is not the case.**

Establishing a Licensing Regime

21. The Committee noted, and was concerned, that there was a difference of opinion between the WIC and Scottish Water as to the costs of establishing a licensing regime.

22. The costs as set out in the Financial Memorandum were based on advice from the WIC whose estimates had been informed by previous research. However, Scottish Water commissioned its own, independent research from IBM Consulting. This research concluded that the one-off costs of setting up the new regime would be in the range of £22.7m - £30.3 million (as opposed to £12.6m) and that ongoing operational costs would be in the range of £6.6m - £8.8m per annum (as opposed to £1.9m per annum). A breakdown of this analysis is provided in Scottish Water’s written submission at Appendix A.

23. When questioned over the figures, the WIC responded that he had not seen the research carried out for Scottish Water and that:

   “among the critical issues is to hear what the regulated company says its costs will be, to challenge those costs, and to understand what scope for efficiency the company believes will arise that would offset the costs in some way.”

24. When Executive officials were questioned over this, they responded by saying that they felt the figures in the Financial Memorandum were “reasonably robust” and that the proposed competition market would be much simpler than the electricity and gas markets.

25. However, the Committee remains concerned that the figures produced for Scottish Water show one-off costs £10-£18m higher than in the Financial Memorandum and ongoing costs which are approximately £5-£8m higher. As the setting up of this regime accounts for the majority of the costs arising from the Bill, the Committee believes it is imperative that agreement is reached about the accuracy of the figures. It is noted that the WIC is continuing to work on costs and the Executive stated that he will publish a scoping study in the next couple of months. However, this means that the Committee is not able to assess the accuracy of this part of the Financial Memorandum and finds the situation highly unsatisfactory. **The Committee believes it is imperative that a reconciliation is reached so that there can be more certainty over costs and recommends that Environment and Rural Development Committee raises this issue with the Minister as a matter of urgency.**

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3 Sutherland, Official Report, 9 September 2004, Col 1615
4 Scott, Official Report, 14 September 2004, Col 1657
5 Morley, Official Report, 14 September 2004, Col 1655
26. Additionally when the Committee took evidence from the Minister on broader water issues, it questioned whether the setting up of the new subsidiary company would create upheaval and uncertainty for staff and whether staff and their union representatives had been consulted regarding the new regime. The Committee commented that such uncertainty had been a major problem during the setting up of Scottish Water. In addition, the Committee asked questions regarding the number of staff who will be transferred and whether their existing terms and conditions will be transferred. The Minister responded that while there may be some disruption it would not be on the scale of that which happened when Scottish Water was set up. He agreed to write to Scottish Water about the specific issues as regards staffing and then to respond in writing to the Committee.

27. A question was also raised about the financial implications for Scottish Water if billing arrangements were changed. The Bill leaves the billing of domestic households with Scottish Water as it prohibits competition for those households. The Committee recognises this is therefore not an issue for Scottish Water at the moment but noted the Executive’s estimate that it costs Scottish Water between £4 and £6 to issue a domestic bill. However, in England and Wales where companies do not issue bills through local authorities, it can cost around £15 to £20.⁶

**Competition and Efficiency**

28. In setting up the licensing regime, Scottish Water will charge its retail subsidiary an averaged wholesale price. The Regulatory Impact Assessment (RIA) sets out the WIC’s estimate of the financial benefits for business customers as a result of this. This assessment is that the retail gross margin for an average business customer is in the region of 15% to 20% of their total bill. The WIC also estimates that there is an efficiency gap of 42% between Scottish Water and “the most comparable water companies in England and Wales. If it is assumed that Scottish Water’s billing and collection activities are broadly of the same level of relative efficiency to their other activities, it is reasonable to assume that an efficient new entrant would be prepared to reduce the bill for a standard connection by at least £30.”⁷

29. Both Scottish Water and Water UK have questioned these estimates. In its written submission to the Committee, Water UK set out a detailed argument against the assumptions used by the WIC and concluded that “By the time the market opens in 2008 it appears likely that Scottish Water will have largely eliminated the efficiency gap. In this case, an overstatement of the retail gross margin – namely a wholesale price that is too low – will have a negative impact on domestic customers.”⁸

30. When the WIC was questioned on this, his Director of Cost and Performance gave the following explanation:

“On the basis of the gap that we published, it would cost Scottish Water £1.86 to deliver a service equivalent to that which the leading company can

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⁶ Scott, Official Report, 14 September 2004, Col 1664
⁷ Regulatory Impact Assessment on the Water Services etc. (Scotland) Bill 2004
⁸ Submission from Water UK
deliver for 87p….The latest comparisons that we have are for 2002-03; Ofwat has not yet published any information for 2003-04. I would regard the efficiency gap, as stated in the impact assessment, as of the right order….Scottish Water has made substantial and welcome improvements over the past financial year and that is continuing today. On the basis of the figures that Scottish Water has provided to us, my £1.86 figure becomes £1.76…Scottish Water says that it expects to improve by a further 10 per cent in this financial year; that takes us to £1.51. Another 10 per cent improvement in the following year would take us to £1.36….If we ask where the leading company will be by 2008, we can only speculate but, if we assume that the leading company improves by 2 per cent per year..then the figure of 87p becomes 77p”

31. Scottish Water countered this by saying that “there is a wide range between the most efficient company and the least efficient company.” The WIC responded that “the average company in 2002-03 would have delivered the equivalent service for £1”. However, Scottish Water went on to say that “the relevant aspect is not what the gap might be against the leading company, because that leading company might have no interest in competing in the Scottish market. The relevant issue is the cost base of Scottish Water’s retail activities compared to the cost base of new retail companies that want to come in to the market.”

32. Again, the Committee is concerned at the disagreement between Scottish Water and the WIC and would recommend that the Environment and Rural Development Committee explore this issue with the Minister.

Charge Determination

33. The Bill gives new powers for Scottish Ministers to direct Scottish Water in regard to its functions and the costs of complying with any direction would be taken into account by the new Water Industry Commission in making its charge determination. The Financial Memorandum states it is not possible to predict what costs might arise in this way.

34. When questioned about this, Executive officials explained that this will occur as part of the Strategic Review process at which time, the services Ministers believe Scottish Water should deliver will need to be balanced with the investment required, and consequently the size of water bills. The position was summed up as:

“There is no point in raising water charges to such a point that people cannot afford them and there is no point in specifying a capital programme that cannot be delivered — or that cannot be delivered efficiently.”

9 Simpson, Official Report, 9 September 2004, Cols 1621 and 1622
10 Millican, Official Report, 14 September 2004, Col 1622
11 Simpson, Official Report, 14 September 2004, Col 1624
12 Millican, Official Report, 14 September 2004, Col 1624
13 Scott, Official Report, 14 September 2004, Col 1659
Conclusions

35. As stated in paragraph 21, the Committee is content with the estimated cost of setting up the Water Industry Commissioner for Scotland. However, it is not entirely convinced by the stated costs of establishing a licensing regime, given the disagreement between Scottish Water and the WIC. As stated in paragraph 25, the Committee recommends that this issue be pursued with the Minister.

36. The Committee also notes the disagreement between the WIC and Scottish Water on the calculation and assumptions underlying Scottish Water’s comparative level of efficiency. Given the importance of this issue, the Committee recommends that this be pursued with the Minister.

37. The Committee recognises that there are other issues such as investment and cross-subsidy which are associated with Bill, although not directly related to it. As was stated in the Committee’s report on Scottish Water (SP Paper 125) the Committee believes it is imperative that there is widespread consultation on investment needs and the principles of charging and that there must be much greater transparency in this and the decision-making process. The Committee took further evidence from the Minister for Environment and Rural Development on broader water issues, following its earlier inquiry into Scottish Water and raised such issues with the Minister.
Appendix A

SUBMISSION FROM SCOTTISH ENTERPRISE

Thank you for your letter of 28 June 2004, inviting Scottish Enterprise (SE) to present its views on financial aspects of the Water Services Etc (Scotland) Bill with reference to the cost implications associated with the new regulatory framework, new licensing regime and the new charge determination. Since SE has no specific involvement in this area we have limited our comments to SE as an economic development agency and as a user of water as follows:

- the proposed Water Industry Commission for Scotland should also take into account the importance of economic development and work towards the achievement of ‘A Smart Successful Scotland’, by addressing issues as continued affordability and overcoming development constraints;

- in international comparisons, Scotland is uncompetitive in terms of water charges, being the fifth most expensive in a recent NUS Consulting survey and with countries such as Belgium, Italy and Spain having a comparative advantage in terms of pricing. Key sectors such as paper processing, pharmaceuticals as well as the chemical industry are especially price sensitive, given their large water usage. SE would welcome and approach by Scottish Water to invest and structure prices to ensure a sufficiently competitive environment in which all businesses in Scotland can succeed and

- the harmonisation of prices across Scotland, although to be welcomed in terms of increased price transparency, will have negative effects on certain industries which have located in specific regions of Scotland. For example under West of Scotland Water, companies had the ability to negotiate individual deals, but this facility is being withdrawn and so companies which were specifically enticed to the west coast on the proviso of competitively priced water are going to face increased water charges. SE welcomes harmonisation of charges and the interim pricing measure, but believes that there should be a mechanism in place for favourable pricing interventions which are deemed to be strategically important to the economy.

In conclusion, SE welcomes this opportunity to highlight certain concerns over the proposed Water Services Etc. (Scotland) Bill to the Finance Committee and the information contained herein is expanded upon in the submission to the Environment and Rural Affairs Committee and is attached for reference.

1.0 Introduction

Scottish Enterprise (SE), alongside HIE, is the main economic development agency for Scotland covering 93% of the population from Grampian to the Borders. The Scottish Enterprise Network consists of SE and 12 Local Enterprise Companies. Working in partnership with the private and public sectors (including Scottish Water), the Network aims to build more and better businesses, to develop
the skills and knowledge of Scottish people, and to encourage innovation to make Scottish business internationally competitive. SE’s activities focus on the three priority areas laid out in ‘A Smart, Successful Scotland’: Growing Businesses; Global Connections and Skills and Learning.

SE recognises the aspirations behind the proposed changes to the Water Services (Scotland) Bill and has consequently made the following comments to the consultation process. The first two points, (paragraphs 2 and 3) are general comments on the Water Industry, the latter reflect changes proposed by the Bill.

2.0 International Competitiveness

It is important that Scotland can compete effectively with its international competitors. However, Scotland is presently internationally uncompetitive in terms of water charges, ranking fifth most expensive in a recent survey conducted by NUS consulting\(^\text{14}\). Key sectors such as paper processing, pharmaceuticals as well as the chemical industry are especially price sensitive, given their large water usage. It is our opinion that the principal responsibility should remain with Scottish Water to invest and structure prices to ensure a sufficiently competitive environment in which all businesses in Scotland can succeed.

3.0 Development Constraints

The Committee should note the significant constraints to development which SE and its client companies are facing in their achievement of the ambitions of ‘A Smart, Successful Scotland’ and would call upon the new Water Commission to recognise that the principle responsibility for overcoming these problems should not be left to the development agencies but resolved by an adequately resourced Scottish Water. SE is currently working with Scottish Water to evaluate the impact of development constraints on the achievement of SE’s Five Year Investment Plan.

4.0 Restructure of the office of the Water Industry Commissioner

SE welcomes the development of the Water Industry Commission for Scotland, but is concerned that there is no mention of its role in supporting economic development, one of the principal aspirations of the Scottish Executive.

SE recommends that the Water Commission is required to consider the impact of any action on the Scottish economy and that its own actions and those of the water industry as a whole, should contribute to the achievement of the ambitions highlighted in ‘A Smart, Successful Scotland’. This should be central to the future objectives of both the Water Commission and Scottish Water.

However, the proposed stance for the Water Commission is more concerned with ensuring that qualitative standards are met and that issues of continued serviceability are maintained. In short, it highlights the preservation of the status

\(^\text{14}\) Countries more expensive than Scotland are Germany, Denmark, Netherlands and France. However water standards in Germany, Netherlands and Denmark exceed the maximum requested in the UK and may contribute to the higher costs
 quo and does not promote a development agenda, which is again contrary to the ambitions highlighted by ‘A Smart, Successful Scotland’. SE believes that the Commission should be made responsible for ensuring that Scottish Water has built into its plans sufficient funding to permit further sanctioned growth.

5.0 Transparency of Costs

SE believes that costs should be transparent, appropriate and any existing cross subsidies be removed to ensure that Scottish business is only paying for what it receives. It therefore welcomes the transference of price setting to the Commission with its intention to set up an accountable system of price adjudication.

6.0 Charge determination

SE agrees in principle that charges should be set on an harmonised basis, so that customers in the same group and using the same services should pay for these services at the same rate irrespective of where they are in the country. At present, certain key SE customers receive varying rates from Scottish Water and the system of discounts and special agreements is ill-defined with a consequent lack of transparency. Despite this, the previous practice of discounting tariffs offered by Scottish Water has proved useful in attracting and retaining large water using, inward investment projects to Scotland. Potentially the removal of such discounts could make Scotland a less attractive location in the future.

SE is concerned that Scottish Water will no longer have discretion to make agreements with specific customers about the charges levied on them. Instead, it is proposed that all charges must be made by reference to a charges scheme which will require to be specifically authorised by the Commission on the basis that the charge-payer has taken action which reduces the cost to Scottish Water of serving them.

SE would prefer that a system of discounts for significant customers is continued at least in the interim and that there should be the option of approaching the Minister or the Commission to petition for interventions which are viewed as being strategically important to the Scottish economy.

7.0 Resolving Constraints to Development

SE, in its daily activities and in consultation with many of its key customers, has noticed increased instances of development constraints resulting from lack of investment/provision of water services in areas such as Robroyston\(^{15}\) in the East End of Glasgow and recent difficulties around Perth\(^{16}\). The concern is that the Commission will not address this issue due to its focus on new environmental

\(^{15}\) At Robroyston the main constraint is insufficient capacity in the water and sewerage system resulting in spilling and flooding.

\(^{16}\) Scottish Water has recently indicated embargoes on accepting additional waste water to its system and treatment plants in certain areas of Tayside, this is mainly due to possible court action arising from SEPA against Scottish Water for unacceptable treated waste water being discharged into controlled waters.
/ qualitative standards and the recently established serviceability criteria. As previously outlined, the Commission should consider the development agenda and as an option, permit Scottish Water to increase its debt provision in order to cover the costs involved. This increase in investment would be covered by the subsequent increase in revenue.

8.0 Separation of Scottish Water

SE supports the separation of responsibilities between the wholesaler and retail side. Scottish Water should continue to be the sole supplier of water and sewerage services on the public network (wholesale), but with the possibility of new entrants to the market providing non-household customers with services such as meter reading and billing and collection of charges (retail).

Providing wholesale services would require Scottish Water to improve the transparency and accuracy with which it accounts for the different costs of its business. This would make it easier for the Commission and customers to check Scottish Water’s progress in delivering efficiency and for Scottish Water itself to identify the scope for greater cost effectiveness.

9.0 Protection of Developer Rights

At present, if there is a development constraint, then Scottish Water passes the costs of provision to the relevant developer. However any subsequent activity, which may arise in an adjacent location and not controlled by the same developer, has the right of access to the system. In theory, the original developer could have paid for provision, but due to other market factors may not be able to utilise the access paid for. Other developers would have benefited at his expense. SE suggests that there is an ability to reserve a percentage of potential capacity for the original developer for at least a restricted time period. The failure to control access, could lead to greater market failure, with developers refusing to pay for connection charges unless they can guarantee timely utilisation.

10.0 Conclusion

The significance of water provision as a component of economic development cannot be understated. SE welcomes this opportunity to comment on this Bill and hopes that the observations contained within this document as well as the forthcoming responses to the two Scottish Executive consultations, (‘Investing in Water Services 2006-14 –The Quality and Standards 3 Project’ and ‘Paying for Water Services 2006-10’), will give an accurate and true reflection of how the Network sees the Water Industry developing.
SUBMISSION FROM SCOTTISH WATER

Summary

Scottish Water welcomes the opportunity to present evidence on the Water Services etc. (Scotland) Bill. This Bill proposes a range of reforms to the structure and regulation of the Scottish water industry, and Scottish Water supports Ministers’ policy aims in this Bill.

Scottish Water welcomes the overall approach to strengthening the economic regulation regime and the process for conducting Strategic Reviews of Charges. We note that the Water Industry Commissioner is in the process of consulting on his methodology on the 2006-10 Strategic Review of Charges, and we will provide detailed comments to his office on his proposals.

In respect of the proposals to introduce a retail market for business customers, we support the Scottish Executive’s proposal to establish a regulated response to the requirements of the Competition Act. The necessary changes should be introduced with the minimum possible disruption and additional costs to the business and its customers.

Scottish Water has reviewed the information set out in the Financial Memorandum (FM) and the associated Regulatory Impact Assessment (RIA). It appears that:

- The cost of implementing the regime set out in the FM may be understated, while
- The potential financial benefits of the regime set out in the RIA may be overstated. In particular, the overall level of inefficiency in the RIA may refer to a historical assessment and the level of costs allocated to the retail business may include wholesale customer service costs.

Structure of this paper

1. Since the Finance Committee is concerned with the financial impacts of the Bill, this evidence focuses on the retail proposals, which have the major impacts on costs and benefits.

2. Scottish Water will provide evidence to the Environment and Rural Development Committee in respect of the wider regulatory issues raised by the Bill.

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17 The data may be drawn from the Water Industry Commissioner’s publication “Strategic Review of Charges 2002-2006”, page 186, Table 18.4, which refer to 2000/01 analysis in respect of the predecessor water authorities.

18 Evidence drawn from the Water Industry Commissioner’s publication “Our work in regulating the Scottish Water Industry: Background to and framework for the Strategic Review of Charges 2006-10”, pages 54, 75 and page 129, table 11.1.
Policy aims in respect of competition

3. Scottish Water supports Ministers’ aims of responding to the requirements of the Competition Act 1998 by providing a regulated arrangement for the licensing of water and sewerage retailers.

4. The proposed retail regime may require the establishment of a retail subsidiary by Scottish Water. This should be undertaken so as to minimise the disruption to Scottish Water’s operations and to minimise the additional costs to the business and its customers.

5. It is proposed that the retail business will be subject to price regulation through its licence until there is sufficient competition in the retail market. Clearly, such a price control would need to provide the retail business with sufficient revenue to enable it to carry out its functions at the lowest reasonable overall cost. To this end, the Bill should include provisions to enable the retail business to be funded to cover its reasonable costs, for at least the period when it is subject to a price control.

Cost assessment in Financial Memorandum (FM)

6. Independent research\textsuperscript{19} commissioned by Scottish Water suggests that the costs of establishing and operating the market mechanisms are likely to be higher than those set out in the FM.

7. There is a range of on-going costs to Scottish Water not included in the FM. These include new functions to manage the relationships and contracts with new retailers, the duty to act as retailer of last resort, and new increased costs of managing certain wholesale customer service functions due to additional frictional costs from the proposed business separation. In addition, Scottish Water Retail will incur additional costs due its new functional responsibilities. The table below sets out Scottish Water’s current assessment of the likely costs of implementing the new retail competition regime.

\footnote{\textsuperscript{19} Research has been commissioned from IBM Consulting, who have developed market mechanisms for the deregulation of a range of European energy markets}
Table 1: Implementation costs

<table>
<thead>
<tr>
<th>Topic</th>
<th>Cost assessment in FM</th>
<th>Scottish Water’s current assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs of establishing competitive regime and market mechanisms</td>
<td>£2.5 million plus £0.5 million per year</td>
<td>£10.8-18.4 million plus £3.1-5.1 million per year³</td>
</tr>
<tr>
<td>Establishment costs to Scottish Water Wholesale</td>
<td>£5 million</td>
<td>£5.8 million</td>
</tr>
<tr>
<td>Establishing Scottish Water Retail as a legal entity</td>
<td>£100K</td>
<td>As per FM</td>
</tr>
<tr>
<td>On-going costs of Scottish Water Retail in respect of new functions and costs of separation</td>
<td>Not included</td>
<td>£1 million plus £1.5 million per year</td>
</tr>
<tr>
<td>New wholesale functions incl. support of market and on-going costs of separation</td>
<td>Not included</td>
<td>£0.75 million per year</td>
</tr>
<tr>
<td>Commissioner’s costs</td>
<td>£5 million plus £1 million per year</td>
<td>As per FM</td>
</tr>
<tr>
<td>Switching costs</td>
<td>£30-50 per switch i.e. £300-500K per year</td>
<td>As per FM</td>
</tr>
<tr>
<td>Total – “One-off” costs of establishment plus “On-going” operational costs</td>
<td>£12.6 million plus £1.9 million per year</td>
<td>£22.7-30.3 million plus £6.6-8.8 million per year</td>
</tr>
</tbody>
</table>

Benefit assessment in Regulatory Impact Assessment (RIA)

8. The RIA assumes that Scottish Water is 42% less efficient than competitors, a position that may refer to a historic assessment of the former water authorities’ position in 2000/01²⁰. Scottish Water has already reduced its inherited operating costs by 20% since 2002, and expects to reduce them by around 40% over the period to 2006. We expect that Scottish Water’s level of efficiency relative to the water companies in England and Wales will have improved significantly by 2006, and even further by 2008.

9. The RIA assumes that the level of retail gross margin in Scottish Water is between 15-20%. Scottish Water has undertaken a comprehensive cost assessment project to examine the allocation of its own costs between retail and wholesale activities. This indicates that the retail element of costs for non-domestic customers is between 6-9%.

²⁰ The data may be drawn from the Water Industry Commissioner’s publication “Strategic Review of Charges 2002-2006”, page 186, Table 18.4, which refer to 2000/01 analysis in respect of the predecessor water authorities.
10. The data given in the RIA implies that the possible efficiency savings (42% inefficiency and 15-20% retail margin) that might be available to customers could amount to £22-29 million. Scottish Water estimates that such benefits will be substantially lower than those suggested in the RIA because of our lower assessment of retail margin and residual inefficiency when the market opens in 2008.

Impact on the Wholesale Business

11. The correct setting of the retail margin and wholesale price will be critical because of the risk of creating an unintended cross-subsidy either to or from business customers in the new competitive market – at the expense, or to the benefit, of Scottish Water’s household customers.

Transitional effects

12. The proposals to establish a retail market are helpful in avoiding the potential disruption if water competition was allowed to develop without a formal regulatory structure. Even with this regulated response, there will be inevitable disruption to Scottish Water with the creation of new market arrangements and the likely creation of a separate retail subsidiary. Establishing a fully separated retail subsidiary could involve the transfer of around 200 staff from Scottish Water.

SUBMISSION FROM WATER CUSTOMER PANELS

The Water Customer Consultation Panels were established by the Water Industry (Scotland) Act 2002, to represent the views and interests of customers of Scottish Water.

The Panels welcome the opportunity to comment on the financial implications of the Water Services Bill, however, find it difficult to form a clear view due to the lack of detailed analysis provided. The Panels would have liked to have seen further breakdown of the estimates of costs within the Financial Memorandum to allow for easier consideration and understanding. It has been suggested that the final costs may be substantially higher than the current estimates.

The Panels would be extremely concerned if uncertainty over cost estimates resulted in a severe impact on pricing policy for all customers. A visible and detailed analysis on all aspects of the Bill would assist alleviate this concern. In particular, the requirement on Scottish Water to separate its wholesale and retail operations, the development of strategies to respond to competition and the licensing regime, and the ongoing costs of serving such a regime, require careful assessment and clarity of financial impact.

The Panels are also concerned regarding the financial implications of possible disparities between Ministers principles and policy decisions on paying for water
services, and their place within a wholesale charging scheme. Were it to transpire that the framework for competition led to shortfalls, this burden would then fall to remaining Scottish Water customers, or to the Executive. (For example, if Ministerial decisions on cross-subsidies could not be sustained, or potential loss of large users resulted in significant revenue deficiency.) The Panels would encourage clear and transparent measures to safeguard Ministerial policy objectives and the benefits to customers of those policies.

The Panels final comment at this stage would be in considering the much broader implications that may result from the Bill, especially the potential distraction for Scottish Water and the Water Industry Commissioner from the efficient and effective delivery of the next investment programme, which will be as large in scale and scope as the current programme. The potential financial ramifications of this are understandably difficult to forecast, but must be given due care and attention.

**SUBMISSION FROM WATER UK**

**Introduction**

Water UK is very pleased to have the opportunity to comment on the Water Services etc. (Scotland) Bill. Water UK represents the water and sewerage service operators in England, Wales, Scotland and Northern Ireland, in both the private and public sectors. It is as a UK organisation that we comment here, as we commented in response to the 2000 “Managing Change in the Water Industry” and the 2001 “The Water Services Bill – the Executive’s Proposals” consultations.

We support the prime objective of the Bill, as stated in the Policy Memorandum, ‘to ensure that there is a robust transparent regime that operates in the interests of all customers.’ In particular, we agree that the competition regime proposed for Scotland should benefit all customers, not just those who are able to change service supplier. Our comments focus on the way in which the Bill proposes to achieve this objective and we have grouped them under three broad headings:

- Links with the Competition Act 1998 (CA98)
- Pricing regime
- Wholesale price charged by Scottish Water

**Link with the Competition Act 1998**

In many respects, the Scottish Parliament has to face the same competition issues in formulating the Bill as the UK Parliament did in passing Water Act 2003 (WA03). We note with interest that the Bill will create a different competition regime in Scotland from that now being introduced in England and Wales. The crucial difference appears to be that the Drinking Water Inspectorate (DWI) in England and Wales concluded in 2000 that the public health and water quality risks attached to common carriage were not significant provided its guidelines were followed. In contrast, the public health risks of common carriage are considered unacceptable in Scotland.
We wonder whether this judgement could be legally challenged. We also wonder how the argument that the public health risks are unacceptable could be sustained if the applicant for common carriage were a company using common carriage in England or Wales. There is also the question of whether the Bill goes further than is necessary to protect public health when it rules out sewerage common carriage. Generally, we wonder whether two quite different solutions, north and south of the border, to, essentially, the same problem can co-exist for long.

The relationship between CA98, European law and the Bill is, of course, for the Scottish Parliament to determine. We are raising questions here because we share the Scottish Executive and Parliament’s wish that the competition regime in Scotland should be primarily determined by Acts of Parliament and not through the courts.

The proposal in the Bill for a licensing regime is a solution which is common to both competition regimes north and south of the border and we very much support its principle. From the start, we lobbied hard for a licensing regime to supplement CA98 and there is now a general consensus that only licensed competitors should be allowed.21

**Pricing Regime**

We are concerned about the provisions, as we understand them, that the Bill makes for the pricing regime which will apply in the competitive area. One concern is that, if too much of the pricing regime is left to regulator’s discretion, it may be open to legal challenge. Our other concern is that the pricing regime should be fully supportive of the social and environmental objectives assigned to Scottish Water. Essentially, the issue is that competition without a proper pricing methodology prescribed by legislation could lead to cherry-picking by new entrants seeking to supply only the highest return/lowest cost customers. The likely effect of this would be twofold:

- Regional tariffs might become ‘de-averaged’, either because the undertaker chooses to de-average in order to protect its customer base, or because the regulator or courts find that this is necessary for tariffs to be cost-reflective, and therefore non-discriminatory under CA98. Since there are several cross-subsidies – which the Scottish Parliament is likely to consider socially desirable – implicit in regionally averaged water tariffs22, some mechanism is needed to preserve them in the face of competition.

- Competition risks reducing Scottish Water’s ability to finance its national functions, particularly those regarding the protection of the environment. Scottish Water customers pay for these activities through water charges. An unbridled competition regime could encourage business customers to

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21 Licensing has been brought into law in England and Wales with WA03.

22 For example, cross-subsidies are likely to exist between urban and rural customers, and between high and low rateable value domestic customers. In England and Wales the cross-subsidy from large industrial users to domestic customers has now been unwound, primarily due to the threat of “inset” competition.
become free-riders by opting to be supplied by a competitor who does not have the same obligations as Scottish Water and can undercut it.

The Bill proposes to avoid these problems by setting up a retail subsidiary of Scottish Water which Scottish Water will charge on the basis of an averaged wholesale tariff. We understand that this wholesale tariff will be the same for all customers, whether they are customers of the Scottish Water retail subsidiary or of its competitors. This approach, to set an averaged price on Scottish Water activities – none of which will be open to competition – has similarities to the solution chosen in WA03, where the problem of protecting social and environmental objectives is addressed through strict pricing rules. That Act states in formal legal terms the access pricing principle that economists will recognise as the efficient component pricing rule (ECPR), also referred to as “retail minus”.23 The success of the approach proposed in the Bill depends crucially on the correct setting of the wholesale price between Scottish Water and its subsidiary (discussed in the next section) and on the pricing regime applied to the retail subsidiary.

Subject to the wholesale price being set correctly, the proposed wholesale pricing regime, as we understand it, could protect Scottish Water’s objectives and its remaining customers. However, its retail subsidiary will be open to cherry-picking and free-riding if its charges are based on average accounting principles. Customers for whom retail services are relatively cheap to provide will be attractive to competitors, leaving the relatively expensive ones to the Scottish Water retail subsidiary. Moreover, if the retail subsidiary has obligations that its competitors do not, such as to provide some support services to all customers, whether domestic or business (services which are not related to billing such as operations-related calls, water conservation information, etc.), it will be unable to compete and its prices will increase for its remaining customers. Competition will be distorted, will not provide appropriate incentives to the retail subsidiary, and will provide benefits to some customers only at the expense of others.

Wholesale price charged by Scottish Water

The separation of Scottish Water from its retail subsidiary can, in principle, produce some real benefits – clarity, accountability, control - that make it worth supporting. Indeed, some of our members in England have chosen this organisational structure. However, it is not clear that the Bill recognizes the conditions that need to be put in place for the benefits of separation to arise in Scotland. More important, there is a risk that the wholesale price will be set too low, which will not protect Scottish Water’s objectives nor protect domestic customers from increases in charges as a direct consequence of competition for business customers.

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23 ECPR is the only access pricing approach that both promotes efficient market entry and prevents cherry-picking
Our experience of helping develop a framework for competition in England and Wales is that customer-facing activities reach deep inside operational functions. Customers are instrumental in helping to identify network or supply failures; they also need to be informed of operational events. In addition, particularly in emergencies, some domestic customers, including those located on a business customer site, need special services that can only be provided by a water operator, not by a customer care function. We do not know the extent to which customer-facing activities will be retained within Scottish Water or transferred to its retail subsidiary, especially as it is not always feasible or desirable to separate facilities for domestic customers from those for business customers. It will be crucial to separate these functions between Scottish Water and its subsidiary most carefully, to determine how those transferred to the retail subsidiary will be financed and how the two entities will inter-act and exchange information. These questions have implications for the retail subsidiary’s ability to compete, as we said earlier, and also for the cost estimates in the Financial Memorandum. However, we are unable to quantify them and would refer to Scottish Water’s evidence to Parliament.

Crucial to the regime is the averaged wholesale price which Scottish Water will charge its retail subsidiary and, thus, the retail margin assumed to be included in end-user tariffs. We have evidence that leads us to doubt the estimates for the turnover of the Scottish Water retail subsidiary in paragraph 14 of the RIA. It gives the Water Industry Commissioner’s estimate of the retail gross margin as being in the order of 15% to 20% of business customers’ bills. Experience in the gas and electricity industries is cited in support of this estimate, which was first published in the document “Strategic Review of Charges 2002/6”. However:

- This estimate is based partly on assumed data for three English water companies; we understand from them that some of the estimates are grossly inaccurate.\(^{24}\) If this was corrected, the estimate above would be reduced by about half, to less than 10% of customers’ bills.

- The comparison with energy industries is likely to be misleading; there have been several publications highlighting the fact that network costs represent a much greater proportion of total costs in the water industry than is the case in gas and electricity. It is not reasonable to assume that retail costs in water are in similar proportions to those in gas and electricity.

- A recent survey by the Office of Water Services (Ofwat, the economic regulator in England and Wales) of the retail margin in England and Wales showed that water retail operating costs, expressed as a percentage of water turnover, average only 9.6%.\(^{25}\) We have no reason to believe the position in Scotland is significantly different.

It is also worth noting that the retail costs considered above (quoted for English water companies by the Water Industry Commissioner, in gas and electricity and

\(^{24}\) A significant element of the cost assumptions appear wrong by a factor of 7
\(^{25}\) This covers all water customers (household and non-household). The figure for non-household customers only is much smaller, as indicated in the next paragraph.
in Ofwat survey) are for the costs of serving the entire customer base, both domestic and non-domestic. The retail cost of serving domestic customers in England and Wales, expressed as a percentage of the average household bill, is much greater than that for non-domestic customers, reflecting the much lower average domestic bill. Therefore the relevant retail percentage for non-domestic customers is lower. Using Ofwat survey quoted above it can be shown that retail costs for large business customers may be as low as 4% of their total charge.

The true scale of water retail costs is obviously of interest to prospective licensees, but there is a danger from a public policy perspective of over-stating them. If the wholesale price is set too low in order to encourage the retail market to develop, domestic customers will suffer increased charges in order to maintain Scottish Water overall revenue; licensees, initially, will benefit at their expense. Later, as retail margins are competed away, the benefits will transfer to business customers, still at the expense of domestic customers. The size of the retail gross margin is therefore a very important issue and we urge Parliament to research it most carefully.

There is some recognition of the potential cost to domestic customers of not setting the wholesale price correctly in the RIA and Policy Statement, but the assumption that Scottish Water is 42% less efficient than English water companies is used to justify the financial pressure on Scottish Water’s wholesale operation. By the time the market opens in 2008 it appears likely that Scottish Water will have largely eliminated the efficiency gap. In this case, an overstatement of the retail gross margin – namely a wholesale price that is too low – will have a negative impact on domestic customers.

Conclusions

The issues of how the separation is achieved between Scottish Water and its retail subsidiary and of the wholesale pricing regime are crucial to the success of the competition regime proposed in the Bill. The Bill’s proposal to create a separate retail arm for Scottish Water does not in itself ensure that the effects of competition are confined to retail activities serving business customers. The allocation of costs to both wholesale and retail will affect the financing of the wholesale business and may ultimately affect charges to domestic customers. If these issues are not addressed, through legislation and regulation, competition in Scotland could encourage cherry-picking and leave domestic customers alone to pay for the environmental and social objectives given to Scottish Water.
Appendix B

SUPPLEMENTARY SUBMISSION FROM SCOTTISH EXECUTIVE RURAL AFFAIRS DEPARTMENT, WATER SERVICES DIVISION

When I appeared before your Committee on 14 September, I undertook to provide detail in writing of the costs of the Water Industry Commissioner establishing the licensing regime proposed in the Bill.

The Financial Memorandum estimates that the cost of the Water Industry Commission establishing the licensing regime should be around £5 million. This is based on analysis by the Water Industry Commissioner to scope the work which will be involved. As the Financial Memorandum states, there will remain some uncertainty with these costs until the initial work gets underway. Each component of the cost will be subject to careful scrutiny as part of the Commissioner’s and, in due course, the Commission’s budget.

The information below covers each of the categories of expenditure listed in Table 1 of the Financial Memorandum (page 40). The expenditure would be incurred over the period from 2005 to 2009 when the licensing regime is expected to be developed.

General administrative work is estimated to cost £2.5 million. This includes staff, based on current estimates that around 5.5 full time equivalent staff are required, their recruitment, salaries and other employment costs. It also covers the costs of the considerable consultation that will be carried out on the licensing regime and licence conditions with Scottish Water, prospective new entrants and with customers.

£1.5 million is allowed for legal advice, which will be essential to drawing up the licence conditions and considering licence applications. This is consistent with the initial findings of an independent analysis of the resources required to implement the licensing regime. The Water Industry Commissioner will publish this analysis by the end of October. Although some of this work will be done in-house by the Commission, their size and the type of assistance required means that the Commissioner has advised that their requirement for senior legal advice should be contracted out.

£0.5 million is allowed for accounting projects, which will include: designing reporting requirements for new entrants to ensure they are fit and proper; setting up databases to examine the probity of prospective new entrants, both initially and on an ongoing basis; ensuring that market participation can develop in an orderly way; and ensuring that new entrants can meet licence requirements.

The majority of the ‘other advisory work’ for which £0.4 million is allowed relates to the use of Reporters to check information provided by new entrants, verifying that new entrants can do what they suggest and the impact of precise proposals on Scottish Water. The other part of this item is an allowance for economic or financial consultancy advice required to defend a licensing decision.
And finally, £0.1 million is allowed for market research which will be required to support consultation on the licensing regime, with Scottish Water, prospective new entrants and customers, to understand their views, and, once the first phase has been completed, understand its impacts.
1. Introduction

1.1 Shepherd+ Wedderburn have been asked by the Office of the Water Industry Commissioner for Scotland (the WIC) to prepare this advice note in relation to the application of competition law to Scottish Water.

1.2 This note summarizes certain legal advice given previously by us to the WIC and updates our earlier advice by reference to the proposals currently before the Scottish Parliament in the shape of the Water Services etc. (Scotland) Bill (the Bill).

1.3 The WIC has asked us to comment, in relatively high-level terms, on (a) the competition law risks faced by Scottish Water in refusing to provide competitors with access to its public network and (b) the impact of the Bill on those risks.

1.4 This advice note addresses these two issues in the following way. We begin (section 3) by describing the general competition law context in which Scottish Water finds itself. We then (section 4) highlight the key areas of competition law risk faced by Scottish Water in relation to third party network access. Finally, we consider, in section 5, how the Bill may mitigate those risks.

1.5 The advice contained in this note is confidential to the WIC and should not be disclosed to or relied upon by any other person without our prior written consent.

1.6 We have agreed that a copy of this note may be supplied to the Finance Committee of the Scottish Parliament for the purposes of its current examination of the financial memorandum to the Bill.

2. Executive summary

2.1 By refusing to grant third party access to its network, Scottish Water presently faces the risk of competition law challenge.

2.2 A successful challenge could result in adverse consequences for Scottish Water’s economic viability and for its customers.

2.3 The proposal to prohibit third party use of Scottish Water’s networks under the Bill will (in conjunction with the proposals mentioned in para. 2.4) assist in tackling this risk.

2.4 By proposing to subject Scottish Water (and its revenues) to more robust, independent regulation, the Bill also contributes to competition law risk mitigation.

2.5 Taken together, these proposals would, in our view, substantially eliminate the competition law risks facing Scottish Water in this context.
3. **The competition law context**

3.1 The principal UK competition law rule which applies in this context is section 18(1) of the Competition Act 1998 (the **Chapter II Prohibition**). This outlaws abuse of a dominant position.

3.2 Also relevant are paragraphs 4 and 5(2) of schedule 3 to the 1998 Act. Paragraph 4 (the **SGEI Exclusion**) excludes the Chapter II Prohibition from conduct related to performance of a service of general economic interest (an **SGEI**). Paragraph 5(2) (the **Legal Requirements Exclusion**) provides that the Chapter II Prohibition does not apply to conduct to the extent to which it is engaged in in order to comply with a legal requirement.

3.3 In addition, we believe that it is important to bear in mind the relevance of EC competition law in this context. First, section 60 of the 1998 Act requires the UK rules to be interpreted (in the absence of relevant differences) so as to be consistent with the corresponding EC rules. Second, we consider that the EC rules themselves (principally, Article 82 EC on which the Chapter II Prohibition is modelled) could apply to certain aspects of Scottish Water's activities.

4. **Key competition law risks**

4.1 In considering the risks arising from the Chapter II Prohibition in relation to third party access to Scottish Water's network, one needs to consider (a) how a refusal by Scottish Water to provide network access might fall within the scope of the prohibition and (b) the likelihood of such a refusal being found to amount to abuse.

**Scope of the prohibition**

4.2 We have little doubt that Scottish Water would qualify as a dominant undertaking for the purposes of the Chapter II Prohibition (at least in respect of its core activities). However, the prohibition is only engaged if a dominant undertaking acts abusively.

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1 Certainly, the Chapter II Prohibition has (with some justification) attracted the greatest attention. However, it is also worth recalling the wide-ranging powers of investigation, inquiry and remedy conferred on the OFT and Competition Commission under the market investigation provisions in Part 4 of the Enterprise Act 2002.

2 Section 18(1) provides as follows: *Subject to section 19 [excluded cases – not reproduced], any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market is prohibited if it may affect trade within the United Kingdom; (2) Conduct may, in particular, constitute such an abuse if it consists in- (a) directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions; (b) limiting production, markets or technical development to the prejudice of consumers; (c) applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage; (d) making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of the contracts.*

3 Paragraph 4 provides as follows: *Neither the Chapter I prohibition nor the Chapter II prohibition applies to an undertaking entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly in so far as the prohibition would obstruct the performance, in law or in fact, of the particular tasks assigned to that undertaking.*

4 Paragraph 5(3) defines "legal requirement" as "a requirement — (a) imposed by or under any enactment in force in the United Kingdom; (b) imposed by or under the Treaty or the EEA Agreement and having legal effect in the United Kingdom without further enactment; or (c) imposed by or under the law in force in another Member State and having legal effect in the United Kingdom."
In very general terms, abuse takes one of two forms: exploitative conduct (directed at customers) or exclusionary conduct (directed at competitors).

In terms of exclusionary conduct, the 1998 Act lists some classic examples of abusive conduct directed at competitors, viz: "directly or indirectly imposing [...] unfair trading conditions" (e.g. refusal to supply), "applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage" (in other words, discrimination); and "making the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts" (e.g. "tying" or "bundling" behaviour).

In the context of a network utility business, such as the water and sewerage industry, the operator of the network is typically (and for obvious reasons) regarded as occupying a dominant position in relation to the 'downstream' markets (such as water supply and sewage disposal) which depend on access to the network. In that position (often referred to in terms of controlling an 'essential facility'), the network operator abuses its dominant position if it refuses to provide access to the network on reasonable terms and conditions.

Accordingly, a refusal by Scottish Water to provide a competitor with access to its network on reasonable terms would, in the absence of some compelling justification, amount to abuse of a dominant position contrary to the Chapter II Prohibition.

Likelihood of abuse

We are familiar with the various arguments that have been made in order to justify a refusal to provide access in the case of Scottish Water's network, in particular those related to public health. However, we would query whether (for instance, in light of common carriage proposals in England & Wales) there are sufficiently clear public health grounds to deny third party access, as opposed to permitting it on tightly regulated terms.

There would appear to be more convincing justifications for refusing access under the SGEI Exclusion, i.e., that Scottish Water requires to maintain exclusive rights over the public networks in order to be able to carry on its public service tasks in economically acceptable conditions.

Arguments seeking to justify exclusive rights on the basis of the SGEI Exclusion have been advanced in a variety of cases at EC level.

In the Almelo case a local electricity distributor in the Netherlands sought to challenge, under Article 82, the requirement under Dutch law that it purchased all of its wholesale requirements for electricity from IJM, a regional distributor. IJM had, for its part, been given the task, through the grant of a non-exclusive concession, of ensuring the supply of electricity in the relevant part of the Netherlands. In particular, it had an obligation to ensure that throughout the concession territory, all consumers, whether local distributors or end-users, received uninterrupted supplies of electricity in sufficient quantities to meet demand at any given time, at uniform tariff rates and on terms which may not vary save in accordance with objective criteria applicable to all customers.

Whilst leaving it for the national courts to decide on the facts, the Court stated that exclusive rights such as those conferred on IJM, "must be allowed in so far as they are necessary in order to enable the undertaking entrusted with such a task of general interest to perform it. In that regard, it is necessary to take into consideration the economic conditions in which the undertaking operates, in particular the costs..."
which it has to bear and the legislation, particularly concerning the environment, to which it is subject.\(^6\)

4.12 In the Corbeau case, an undertaking looking to enter the postal services market in Belgium sought to challenge under Article 82 the exclusive rights conferred on the Belgian Post Office for delivery of all mail. In this case, the BPO had an obligation to collect, carry and distribute mail on behalf of all users throughout Belgian territory, at uniform tariffs and on similar quality conditions, irrespective of the specific situations or the degree of economic profitability of each individual operation.

4.13 The Court then set out the following legal analysis:\(^8\):

The question which falls to be considered is therefore the extent to which a restriction on competition or even the exclusion of all competition from other economic operators is necessary in order to allow the holder of the exclusive right to perform its task of general interest and in particular to have the benefit of economically acceptable conditions.

The starting point of such an examination must be the premise that the obligation on the part of the undertaking entrusted with that task to perform its services in conditions of economic equilibrium presupposes that it will be possible to offset less profitable sectors against the profitable sectors and hence justifies a restriction of competition from individual undertakings where the economically profitable sectors are concerned.

Indeed, to authorize individual undertakings to compete with the holder of the exclusive rights in the sectors of their choice corresponding to those rights would make it possible for them to concentrate on the economically profitable operations and to offer more advantageous tariffs than those adopted by the holders of the exclusive rights since, unlike the latter, they are not bound for economic reasons to offset losses in the unprofitable sectors against profits in the more profitable sectors.

4.14 In other words, as the OFT has put it, the Court's judgment is, "based on the 'cherry picking' or 'cream skimming' argument, i.e. that the introduction of competition in these markets would have resulted in the new entrants targeting the profitable customers/sector and leaving the higher cost customers/sector to be supplied by the incumbent at a prohibitively high price, against the interest of these customers, or would result in the incumbent being made reliant upon state subsidies.\(^9\)

4.15 The Court in Corbeau made clear, however, that the grant of exclusivity had to be closely tailored to those services that comprised the universal postal service, stating that, "the exclusion of competition is not justified as regards specific services dissociable from the service of general interest which meet special needs of economic operators and which call for certain additional services not offered by the traditional postal service, such as collection from the senders' address, greater speed or reliability of distribution or the possibility of changing the destination in the course of transit, in so far as such specific services, by their nature and the conditions in which they are offered, such as the geographical area in which they are provided, do not compromise the economic equilibrium of the service of general economic interest performed by the holder of the exclusive right.\(^10\)

4.16 In the Air Inter case,\(^11\) allegations of abuse were made in respect of a refusal to allow a private airline to operate flights on certain routes in France (Orly-Marseille and

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\(^6\) Almelo, paragraph 49 of judgment.

\(^7\) Case C-320/91, Criminal proceedings against Paul Corbeau.

\(^8\) Corbeau, paragraphs 16 – 18 of judgment.

\(^9\) OFT 421, op. cit., paragraph 3.6.

\(^10\) Corbeau, paragraph 19 of judgment.

Orly-Toulouse) which were reserved exclusively to AI. For its part, AI had an obligation to operate 20 unprofitable domestic air routes regularly and at tariffs that were not prohibitive, in order to contribute to regional development. AI used revenues from the two (profitable) reserved routes to subsidise costs on the unprofitable routes.

4.17 AI claimed that, since it had to finance its air transport entirely by itself without public aid, it needed to cross-subsidise tariffs within the 22 routes. In the context of that cross-subsidy, income from the two 'money-spinner' routes were intended to finance the loss-making routes. Such a system of subsidies, according to AI, could not function without a grant of exclusivity on the 'money-spinner' routes.

4.18 The Court of First Instance was not, however, impressed by these assertions. First, AI had not put a figure on the probable loss of revenue if other air carriers were allowed to compete with it on the two routes in question. Second, it had not shown that that loss of income would be so great that it would be forced to abandon certain of the (subsidised) routes forming part of its network.

4.19 In addition, the CFI pointed out that, "the domestic air network system combined with the internal cross-subsidy system to which the applicant [i.e. AI] refers in support of its case did not constitute an aim in themselves, but were the means chosen by the French public authorities for developing the French regions. The applicant has not argued and still less established that, following the entry into force of [EC rules liberalising air transport], there was no appropriate alternative system capable of ensuring regional development and in particular of ensuring that loss-making routes continue to be financed".\(^\text{12}\)

4.20 It can be seen that the SGEI Exclusion cannot be used to justify the unilateral assertion of exclusive rights unless it can be shown that exclusivity is objectively justified, in all the circumstances, as a proportionate and cost effective response to a need in the general economic interest.

4.21 Looking at Scottish Water, there are two key tests which it must satisfy, in our view, in seeking to rely on the SGEI Exclusion to deny third party network access. First, the Scottish Parliament should take the step of formally conferring on it exclusive rights over the network. The present absence of legislative endorsement may undermine Scottish Water's ability to claim that exclusivity is objectively justifiable. Second, the current regulatory status of Scottish Water under the 2002 Act, in terms of which its revenue levels are fixed by its owners (i.e. Scottish Ministers) rather than an independent regulator, should be bolstered in order to support the arguments that exclusivity is being used to protect an efficiently run SGEI.\(^\text{13}\)

4.22 Accordingly, as things stand at the moment in relation to Scottish Water and its regulatory status, there is a substantial risk that a court would not be prepared to support use of the SGEI Exclusion to justify a denial of network access.

**Impact of enforced third party access**

4.23 If Scottish Water is unable to rely on the SGEI Exclusion and third parties are able to enforce their rights to access the network using the Chapter II Prohibition, the

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\(^{12}\) *Air Inter*, paragraph 140 of judgment.

\(^{13}\) According to the European Court, a potentially abusive situation is created by a Member State, "when the undertaking to which it grants an exclusive right extending to [relevant] [...] activities is manifestly not in a position to satisfy the demand prevailing on the market for activities of that kind and when the effective pursuit of such activities by private companies is rendered impossible by the maintenance in force of a statutory provision" (Case C-41/90 *Höfner* [1991] ECR I-1979, para. 31).
adverse consequences for Scottish Water's economic viability – and the position of its remaining customers – could be severe.

5. Potential impact of the Bill

5.1 The proposal to prohibit third party use of Scottish Water's networks under the Bill would represent an important advance in tackling the competition law risks outlined in the previous section.

5.2 It would certainly provide Scottish Water with the ability to rely for the first time on the Legal Requirements Exclusion (as opposed to the SGEI Exclusion) as a defence to any Chapter II claim arising from refusal to grant access.

5.3 However, if that were as far as the Bill was to go, we doubt whether this ability would provide a complete defence to future competition law challenges.

5.4 This is because, whilst the Chapter II Prohibition can be 'disapplied' in this manner\(^{14}\), its EC counterpart (Article 82 EC) cannot\(^{15}\). And, as we have pointed out earlier, there are good grounds to regard Article 82 as applying in this context. It would therefore remain open to an aggrieved third party to invoke (EC) competition law to challenge a refusal to grant network access, with all of the same adverse consequences identified above.

5.5 This means that, in addition to the ban on third party access, it is important that any ban is accompanied by the necessary conditions to allow Scottish Water to rely on the SGEI Exclusion (at both UK and EC level). These would include measures to ensure that the interests of Scottish Water's customers are adequately safeguarded in relation to the raising and spending of its monopoly revenues.

5.6 In our view, the Bill makes several important contributions in this respect by strengthening independent regulatory oversight of Scottish Water and its revenues. In particular, it grants determinative (as opposed to advisory) powers over Scottish Water's charges to the Water Industry Commission, subject to appeal to the Competition Commission.

5.7 Indeed, we take the view that the proposals contained in the Bill, taken as a whole, would substantially eliminate the competition law risks facing Scottish Water in relation to third party network access.

\(^{14}\) Leaving aside the argument that the grant of exclusive rights to Scottish Water would exceed the legislative competence of the Scottish Parliament because it impinges on a reserved matter (i.e. head C3 in Schedule 5 to the Scotland Act 1998).

\(^{15}\) Article 86(1) EC, which provides that, "In the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary to the rules contained in this Treaty, in particular to those rules provided for in Article 12 and Articles 81 to 89", would override the Scottish Parliament's decision to insulate Scottish Water from an EC competition law challenge.
Appendix D

ADVICE NOTE FROM DUNDAS & WILSON CS TO SCOTTISH WATER ON APPLICATION OF COMPETITION LAW TO SCOTTISH WATER

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Dear Tom

Competent law treatment of Scottish Water

Following a number of discussions over recent months, I thought it might be useful to set out in writing our view of the potential application of competition law to Scottish Water ("SW") against a background of the regulatory framework envisaged by the Water Services etc. (Scotland) Bill (the "Bill"), introduced to the Scottish Parliament on 11 June 2004.

1. Executive Summary

In short, the Bill clarifies a number of uncertainties in the current regime, vesting key decision-making powers in the hands of the Water Industry Commission (the "Commission") and the Scottish Ministers (the "Ministers") with the result that certain potential competition law challenges, in particular as regards pricing, are likely to be directed at those bodies and not at SW. In addition, the current legislative provisions under the Water (Scotland) Act 1980 do not address issues of common carriage and as a policy decision the Scottish Executive on public health grounds will include provisions within the Bill to prevent third parties placing water into SW’s system. Whilst this is a decision for the Ministers, and differs from the approach in England and Wales, the impact on SW is to clarify its statutory role and responsibilities in relation to this area. In relation to retail competition the Bill improves the position of SW by ensuring not only will SW have no ultimate discretion as regards its pricing, (with further valuable protection afforded SW through its right to appeal charge determination decisions of the Commission to the Competition Commission ("CC"); but the principal trading terms which govern its relationship with retail entities ("Licensees") will also be pre-determined. The risk of competition law exposure will moreover be minimised through the setting up of a separate subsidiary company to carry out the performance and functions of SW’s retail entity ("SWR"). However, since SW will not be immune from competition law challenge as a wholesale operator, it will need to implement certain internal compliance procedures to ensure that when dealing with both Licensees and other third parties, it does so without the risk of infringement.

2. Introduction

As you know, the two fundamental prohibitions (on anti-competitive agreements and abuses by dominant undertakings) set out in the UK Competition Act are applied and enforced by the...
Office of Fair Trading ("OFT"). It is only the OFT which can apply these provisions in relation to water and sewerage services in Scotland and unlike the Office of Water Services ("OFWAT"), the Commission will not have concurrent jurisdiction. Nonetheless, the new legislative regime will in a number of respects effectively ringfence SW from successful competition law challenge. As set out in more detail below, SW should now be protected from allegations of infringement in matters of pricing, the terms and conditions governing its relationship with Licensees and by virtue of the incorporation of a separate subsidiary to carry out SWR's functions.

3. **Pricing - Charge Determination**

As summarised below, section 18 of the Bill sets out the procedure for making, approving and publishing schemes of charges.

1. Following the Ministers' policy statement, the Commission issues a draft determination which will contain maximum charge limits (and can contain different maximum charges for different types of customers). The draft is published and a public consultation exercise will take place.

2. SW drafts its charges scheme, setting out the proposed charges for each of its services. In doing so, it cannot exceed the maximum charge limits set down by the Commission.

3. SW submits its proposed charges scheme to the Commission for approval.

By virtue of the fact that the Commission has final sign-off of the charges scheme, the provisions of section 18 appear to leave little, if any, discretion on the part of SW in this regard and therefore any challenges by Licensees on pricing issues should lie with the Commission and not with SW. It is likely that dispute resolution procedures will be included in the licences to be drafted by the Commission, referred to below. In practice, one would in any event expect Licensees to take an active part in the consultation stage referred to in point 1 above.

Although no reference is made to it in the present draft of the Bill, the policy memorandum expressly provides for an order to be made under the Scotland Act 1998 giving SW the right to appeal decisions of the Commission in relation to the charge determination process to the CC. This right of appeal represents a key protection for SW. There is no indication that Licensees will have the power to avail themselves of such an appeal process.

4. **Terms and conditions - the Licence**

The primary interface that SW will have with the Licensees, including SWR, is through the licence ("Licence"). It is expected that the Commission will issue the standard conditions of the Licence (the "Standard Conditions") within nine months of the Act coming into force. The Licence should include terms which:

- define the service to be provided;
- set out expectations for behaviour by market participants;
govern relationships between:
- wholesaler and retailer;
- retailer and customer;
- regulator and retailer;

- allow for regulatory intervention; and

- provide a vehicle for enforcement, sanction or ultimately removal of the Licence and expulsion from the market.

Therefore, not only will SW have very little or no discretion in relation to pricing (i.e. charge determination), but its principal trading terms will be pre-determined and any dispute over the terms of the Licence (whether on competition grounds or otherwise) will be between the Commission and the Licensee, not directly with SW. However, it is worth saying that the Licence is unlikely to cover every eventuality and where a certain aspect of a trading relationship is not covered by the Licence, SW will be subject to the terms of the Competition Act. We can obviously advise you further in this regard once the Commission issues the Standard Conditions.

Moreover, the Licence will not protect SW from potential challenge from other third parties with whom it deals. By way of example, OFWAT recently investigated a complaint by the manufacturer of a particular brand of wall mounted meter box ("WMMB") about difficulties it was facing in trying to sell its product in a particular undertaker’s area. It was alleged that the undertaker was refusing to connect the manufacturer’s brand of WMMB to its network whilst allowing the connection of other types. Any such third party complaints will be dealt with by the OFT, not the Commission. In light of the remaining potential for challenge in this way (i.e. from non-Licensee third parties), it is worth reiterating the importance of internal compliance procedures which can be put in place to ensure that any such complaints are resolved swiftly and in SW’s favour.

5. SWR

As you are aware section 12 of the Bill confers on the Ministers the power to require SW to create a separate subsidiary to perform the functions and obligations set out in the Licence as well as imposing a general duty on SW that it must not treat SWR any more or less favourably than it treats other Licensees.

As previously advised, whether the Ministers exercise this power or not, the creation of a separate subsidiary (operating as regards SW on an arms-length basis with effective firewalls to ensure that information about the retail activities of competitors or potential competitors cannot be filtered down to SWR) is likely significantly to minimise the risk of competition law challenge.
I hope the confirmation of this advice is helpful, though please do not hesitate to contact me should you require any further clarification or wish to discuss these matters further. I should reiterate that the advice contained in this letter has been prepared for the benefit of Scottish Water and is intended solely for its use.

Kind regards

Yours sincerely

Tom Usher
Subordinate Legislation Committee

Water Services etc. (Scotland) Bill

Delegated Powers Scrutiny

Stage 1 Report

The Committee reports to the Environment and Rural Development Committee as follows—

1. At its meetings on 28th September and 5th October 2004 the Subordinate Legislation Committee considered the delegated powers provisions in the Water Services etc. (Scotland) Bill. The Committee submits this report to the Environment and Rural Development Committee, as the lead committee for the Bill, under Rule 9.6.2 of Standing Orders.

Committee remit

1. Under the terms of its remit, the Committee considers and reports on proposed powers to make subordinate legislation in particular Bills or other proposed legislation and on whether any proposed delegated powers in particular Bills or other legislation should be expressed as a power to make subordinate legislation.

2. The term “subordinate legislation” carries the same definition in the Standing Orders as in the Interpretation Act 1978. Section 21(1) of that Act defines subordinate legislation as meaning “Orders in Council, orders, rules, regulations, schemes, warrants, bye-laws and other instruments made or to be made under any Act”. “Act” for this purpose includes an Act of the Scottish Parliament. The Committee therefore considers not only powers to make statutory instruments as such contained in a Bill but also all other proposed provisions conferring delegated powers of a legislative nature.

Report

Introduction

3. This Bill, introduced on 11 June 2004, aims to strengthen the regulatory framework for the water industry and to provide certainty for the industry. It secures the Scottish Ministers’ public health, environmental protection and social policy objectives by prohibiting common carriage on the public water and sewerage networks and prohibiting retail competition for household customers. In addition, the Bill contains provisions relating to the Coal Authority.

4. The Bill is in four parts-

- Part 1 replaces the office of the Water Industry Commissioner (“the Commissioner”) established under the Water Industry (Scotland) Act
2002, with a body corporate, the Water Industry Commission (“the Commission”).

- Part 2 makes a series of provisions regarding the provision of water and sewerage services, including a prohibition of common carriage on the water and sewerage networks; the establishment of a licensing regime for retail competition for non-household premises; and enabling Scottish Water to establish a subsidiary for the purposes of applying for licences under the Bill.

- Part 3 makes provision regarding coal mine water pollution, providing a statutory basis for the remediation programme carried out by the Coal Authority to tackle and prevent pollution.

- Part 4 makes miscellaneous and general provision, including the procedure for exercising the order and regulation making powers provided under the Bill.

5. Inevitably, the Bill contains a large number of delegated powers and has therefore been referred to the Committee for consideration of these powers under Rule 9.6.2 of the Parliament’s Standing Orders.

6. In addition to the delegated powers which are examined below, the Bill contains a number of powers to make determinations or give directions (see for example new section 1(3) on page 1 and Schedule A1 paragraph 3(1)(c) on page 25) but these powers appear to be of an executive or operational nature and therefore not of interest to the Committee.

7. The Executive provided the Committee with the usual memorandum on the delegated powers provisions in the Bill, which is reproduced at Appendix 1. Having considered the following provisions with the assistance of the memorandum, the Committee approves them without further comment: Sections 2, 7(2), 9(5), 16(3), 26, 27(2), 30; schedule 2 paragraphs 1(1) and (4), 11(1) and (2)(g).

### Individual delegated powers

#### Part 2

**Section 4(7)** Exceptions to offences regarding the public water supply system

**Section 5(7)** Exceptions to offences regarding the public sewerage system

**Background**

8. Section 4 prohibits common carriage on the public water supply system and retail competition in water services in relation to domestic customers. It does so by making it an offence for anyone other than Scottish Water or someone acting on its behalf to introduce water into the public water supply system; use the public water supply system to supply water to the premises of another person; or make arrangements for the supply of water to the premises of another person through the public water supply system.
9. Section 4(7) enables the Scottish Ministers to make regulations specifying circumstances where these prohibitions do not apply, or persons or categories of person to which they do not apply, or only apply to a certain extent.

10. The Executive envisages using these powers if it emerged in practice that the prohibitions were catching activities that it had not been the Scottish Ministers' intention to prohibit. If this turned out to be the case, it would be necessary to amend the provisions establishing the prohibitions in order for them to have the original intended effect.

11. Since this power could have an effect on the fundamental provisions of the Bill, provision is made for any regulations made under this section to be subject to affirmative parliamentary procedure. In addition, the Scottish Ministers are required to consult on any regulations made under this section.

12. Section 5 makes provision to prohibit common carriage and limit retail competition in relation to the public sewerage system equivalent to that provided for in section 4 in relation to the public water supply. Among other things, it makes it an offence for anyone other than Scottish Water or someone acting on its behalf to draw sewage from that system; use that system to dispose of sewage from the premises of another person; or make arrangements for the provision of sewerage to or the disposal of sewage from the premises of another person through that system.

13. The reasons for taking this power are similar to those for taking the power in section 4(7) of the Bill. Once again, given the significance of the power, such regulations are subject to affirmative parliamentary procedure and prior consultation.

Report
14. The Committee considered the justification for these powers very carefully as the Committee considered that the powers could, as recognised by the Executive, have a fundamental effect on the way in which the prohibitions operate by allowing the Scottish Ministers to extend by regulations the exemptions set out in the Bill from offences prescribed in the Bill. In particular, the Committee was concerned that the power might be capable of being used in such a way as to privatise water services.

15. The Committee appreciated that the powers were subject to affirmative procedure and that there was a limited requirement for prior consultation. However, given the use to which they might be put, the Committee indicated to the Executive that it was considering whether the provisions might be more suited to super-affirmative procedure or, indeed, whether it was appropriate to delegate the powers at all. The Committee asked for the Executive’s views.

16. In its response, the Executive reiterated the information provided in its memorandum to the Committee on the delegated powers in the Bill. It intends that these powers be exercised only where it emerges that the offences, which are broad in scope, catch activities that it had not been the Scottish Ministers’ intention to prohibit.

17. It is not the Bill’s intention to restrict inadvertently Scottish Water’s continuing ability, in accordance with existing statutory powers, to make arrangements with third
parties in connection with the provision of water and sewerage services. Sections 4 and 5 of the Bill contain provisions which address one specific circumstance that might otherwise be caught by the offences contained in these sections. Sections 4(5) and 5(5), exempt third parties supplying water or providing sewerage services to others with the help of services provided by Scottish Water under section 30 of the Water Industry (Scotland) Act 2002 from the offences.

18. However, given the width of Scottish Water’s existing powers, it is difficult to predict at this stage all of the circumstances in which legitimate arrangements with third parties might be caught by the broad offence provisions in a way which was not intended. Some of these may only emerge later, once the provisions have come into force. Accordingly, the Executive remains of the view that the reserve powers in sections 4(7) and 5(7) of the Bill are necessary to reflect Scottish Water’s continuing flexibility to enter into arrangements with third parties in connection with the provisions of water and sewerage services.

19. The Executive considers that affirmative procedure and the consultation requirements set out in subsection (8) of each section provide for an appropriate degree of public consultation and Parliamentary scrutiny. The Executive’s reply is reproduced at Appendix 2.

Report

20. The Committee considered this response but concluded that it does not appear to add anything to the Executive’s position as set out in the Memorandum. In particular, the Committee disappointed that the Executive did not address the Committee’s principal concern that the power might be used to privatise water “by the back door”.

21. The Committee fully understands the Executive’s stated intention in proposing these delegated powers but has been given no explanation as to why the powers have been drafted much more widely than that intention may warrant. The Executive itself acknowledges the fundamental effect that these powers could have on the purposes of the Bill and has not denied that they are capable of being used as widely as the Committee has pointed out.

22. The Committee therefore reports to the lead committee that it has very serious concerns about the very wide extent of the powers the Bill proposes to delegate and the possible consequences that such delegations of power could have. It seems to this Committee that it is at least strongly questionable whether affirmative procedure provides sufficient safeguard given the width of these powers. This Committee therefore recommends that the Environment and Rural Development Committee consider these powers and the procedure chosen from its own perspective.

23. The Committee noted that subsection (8) of sections 4 and 5 binds Ministers to consult only Scottish Water, the Commission and “such other persons as they consider appropriate”. It seems to the Committee, however, that the proposed powers are so extensive as to require public consultation and it so recommends.
Section 17  
Disconnections Code

Background
24. Section 17 contains substantive policy on disconnections. Section 16(6)(a) provides that compliance with the Disconnections Code is one of the conditions that must be satisfied if a request by a service provider to discontinue services is to be granted. The Committee considered that there might be a case for this Code to be subject to some degree of more formal Parliamentary supervision such as laying the Code in draft before the Parliament for approval by affirmative resolution or requiring that the Code be confirmed by order made by the Ministers subject to negative procedure. In this regard, the Committee noted the example of the framework document under the Fire Bill also before it at Stage 1. The Committee asked the Executive for comment.

25. In its response, the Executive notes the Committee’s suggestion that the Disconnections Code, which is to be made by the Water Industry Commission for Scotland, be subject to a degree of more formal parliamentary supervision. However, it does not agree that this is necessary and explains the current position regarding disconnections which are essentially an operational matter for Scottish Water, taking into account the circumstances of each case.

26. Section 16(1) of the Bill makes specific provision for the discontinuance of non-domestic water supplies, at the request of licensed water service providers. It is not intended that the Code rewrite or extend the provisions of section 16 which place in statute the key provisions which must be observed in considering a disconnection. In particular, section 16(6) ensure that any disconnection must not adversely affect any supply of water to premises for domestic purposes or any supply to any other premises.

27. The Bill takes provisions which are at present left to the discretion of the industry and instead requires the regulator, with its responsibility to promote the customer interest, to set out a binding Code. Section 17(4) requires the regulator, in drawing up a Code, to consult on it, including the Convener of the Water Customer Consultation Panels who have a further responsibility to represent the customer interest.

28. In those circumstances, the Executive considers that it is unnecessary for provision to be brought into effect by the Scottish Ministers by order.

Report
29. The Committee accepts this further explanation from the Executive and approves the power as drafted.

Section 19  
Powers of the Scottish Ministers

Background
30. Section 19 inserts a new section 56B into the 2002 Act. Section 56 of the 2002 Act already gives Scottish Ministers wide powers of direction over Scottish Water in relation to the exercise of its powers and functions. Section 56B enables the Scottish Ministers to make an order conferring on Scottish Water additional or
supplementary functions relating to the provision of water and sewerage services. In effect these will become part of Scottish Water’s core functions (as defined in section 70(2) of the 2002 Act) and will require to be taken into account by the Commission, when assessing Scottish Water’s revenue requirements under the new regime for charging as set out in the amendments to the 2002 Act made by section 19 of the Bill.

31. The power will be subject to affirmative procedure and to prior consultation with Scottish Water and the Commission.

Report
32. This is, as the Executive recognises, a very wide power but there does not appear to the Committee to be anything inherently objectionable in it. The Committee noted that an order under the power can only add to the functions of Scottish Water. It cannot take any away.

33. The Committee therefore approves the power and the affirmative procedure chosen.

Section 20(3) Meaning of “dwelling” in relation to eligible premises

Background
34. Section 20 defines “eligible premises” for the purposes of the licensing regime provided for at Part 2 of, and schedule 2, to the Bill. A licensed provider can make arrangements to provide services to customers in respect of such premises without contravening the general prohibitions in sections 4(3) and 5(3). By linking the definition to premises other than a “dwelling” for council tax purposes (within the meaning of Part 2 of the Local Government Finance Act 1992 (“the 1992 Act”)), the main purpose is to ensure that licensed providers cannot make arrangements to provide services to households. Section 20(3) enables the Scottish Ministers to vary, by order, the meaning of “dwelling”.

35. The Executive points, by way of example, to section 20(2) itself which already recognises that the regime under the 1992 Act to define a dwelling for council tax purposes might operate to exclude premises which, as a matter of policy, there would be no good reason to exclude from the scope of application of the new licensing regime under this Bill, such as “the residential part of part residential subjects”. This means that premises which are technically residential but which form part of a building whose main purpose is to function as a business, for example a care home, are not excluded from the scope of application of the new licensing regime for that reason alone.

36. The Executive envisages that the power under section 20(3) might be exercised should the definition of “dwelling” in the 1992 Act be further amended in a way which cuts across the policy objectives for this Bill. In the same way that the power to amend the definition of “dwelling” in section 72(4) of the 1992 Act itself can be varied under negative resolution procedure (see section 113 of the 1992 Act), subordinate legislation is considered appropriate here as the power is intended to be exercised only to ensure the policy intentions provided for in the Bill continue to be maintained.
Report
37. The Executive has explained the purpose behind this provision which it suggests would be used in only a limited fashion for the purposes outlined in the Memorandum.

38. The Committee observes, however, that the power in the Bill is very wide and could be used to amend the definition of “dwelling” in almost any way, for example by breaking the link with the council tax regime entirely.

39. The Committee therefore asked the Executive to explain further why it considers that a delegated power is appropriate in this case and whether its exercise should be subject to affirmative procedure rather than the negative proposed.

40. The Executive repeated that the power is intended to be used in very narrow circumstances and refers by way of example to section 72(4) of the Local Government Finance Act 1992 which enables the Scottish Ministers to make an order, which is subject to negative parliamentary procedure (section 112 of the 1992 Act), to vary the definition of dwelling for council tax purposes.

41. The meaning of dwelling under the 1992 Act (subject to the modification in section 20(2) of the Bill in respect of part residential subjects) is presently defined in a manner which meets with the policy objectives of the Bill, namely, to reflect the fact that domestic premises should not be subject to the new water and sewerage services licence regime.

42. If, however, the definition of dwelling under the 1992 Act was further amended, the Executive would require to consider whether this would, to any extent, cut across the policy objectives for the Bill. If it would do so, the Executive needs to have the flexibility to be able to respond to that by further modification of the definition of dwelling for the purposes of the Bill.

43. Given this, the Executive considers that the power is necessary and, given the equivalent powers in the 1992 Act, negative resolution procedure is appropriate.

Report
44. The Committee appreciates that there may be a need to amend the definition and that any amendment to the definition in the 1992 Act, if made by subordinate legislation under that Act, could not necessarily (for technical reasons) be reflected in relation to the Bill without specific powers in the Bill.

45. The Committee notes that the 1992 Act is cited as a precedent but observes that delegated powers in Bills were not subject to specialist Parliamentary scrutiny until 1992 and the establishment in that year of the relevant Committee in the House of Lords.

46. The Committee normally recommends that where a power is taken to amend primary legislation it should be subject to affirmative procedure unless good cause is shown to the contrary. The Committee is not convinced that the Executive has made a sufficient case for negative procedure and therefore, whilst approving
the delegation of power, recommends that it should be subject to affirmative procedure rather than the negative procedure proposed in the Bill.

**Paragraph 1(7) of schedule 2  Consideration of licence applications**

**Background**

47. This power enables the Scottish Ministers to prescribe by order the circumstances in which the detailed provisions relating to the consideration of licence applications by the Commission would not apply. It was not entirely clear to the Committee how this power would operate or in what circumstances it was proposed that it be used. It asked whether, for example, it would be possible to exercise the power only in respect of sub-paragraph (5) so that, if the Commission were minded to refuse an application, it would not have to give the applicant notice of this fact and whether it would be open to disapply sub-paragraph (6) and ignore representations.

**Report**

48. The Committee observed that whilst it is not unknown for order-making powers to be conferred that authorise exemptions from certain provisions, the proposed power seems to go wider than this and, in particular, to allow the provisions of the Bill to be modified. The Committee was unsure whether, in so far as the power would allow the substantive obligations imposed by sub-paragraphs (4) to (6) to be disapplied (as opposed to the detailed requirements to be specified in orders), negative procedure would provide sufficient Parliamentary control. The Committee therefore asked for further explanation and justification of the power.

49. The Executive explains in its response the reasoning behind the provision but, in view of the Committee’s concerns, is considering further whether there are other ways to address these matters. **The Committee therefore draws the Executive’s response to the attention of the lead Committee which it may wish to pursue at Stage 2.**

50. The Committee has no further comment to make on the Bill at Stage 1.
Appendix 1

SCOTTISH EXECUTIVE MEMORANDUM
TO THE SUBORDINATE LEGISLATION COMMITTEE
ON
SUBORDINATE LEGISLATION PROVISIONS

WATER SERVICES ETC. (SCOTLAND) BILL

Provisions Conferring Power to Make Subordinate Legislation

Purpose

This memorandum has been prepared by the Scottish Executive to assist the Subordinate Legislation Committee in its consideration, in accordance with Rule 9.6.2 of the Parliament’s Standing Orders, of the provisions in the Water Services etc. (Scotland) Bill which confer power to make subordinate legislation. It describes the purpose of each such provision and explains the reasons why these matters have been left to subordinate legislation, rather than included in the Bill.

Outline and scope of the Bill

The objective of this Bill, as provided for in the Policy Memorandum accompanying the Bill, is to strengthen the regulatory framework for the water industry, ensuring that there is a robust, transparent regime that operates in the interests of all customers. The Bill also provides certainty for the water industry, and secures the Scottish Ministers’ public health, environmental protection and social policy objectives by prohibiting common carriage on the public water and sewerage networks, and prohibiting retail competition for household customers. In addition the Bill contains provisions relating to the Coal Authority.

The Bill is in 4 parts:

Part 1, The Water Industry Commission for Scotland
Part 1 replaces the office of the Water Industry Commissioner (“the Commissioner”) established under the Water Industry (Scotland) Act 2002, with a body corporate, the Water Industry Commission (“the Commission”), to improve the transparency, accountability and consistency of regulation in the water industry.

Part 2, Provision of Water and Sewerage Services
Part 2 of the Bill makes a series of provisions regarding the provision of water and sewerage services, including a prohibition of common carriage on the water and sewerage networks; the establishment of a licensing regime for retail competition for non-household premises; and enabling Scottish Water to establish a subsidiary for the purposes of applying for licences under the Bill.
Part 3, Coal Mine Water Pollution
Part 3 of the Bill makes provision regarding coal mine water pollution, providing a statutory basis for the remediation programme carried out by the Coal Authority to tackle and prevent pollution.

Part 4, Miscellaneous and General
Part 4 of the Bill makes miscellaneous and general provision, including the procedure for exercising the order and regulation making powers provided under the Bill. As identified in section 27 of the Bill, the following subordinate legislation powers are contained in the Bill:

Delegated Powers

Part 1

Section 2 Water Industry Commissioner for Scotland

Power conferred on: The Scottish Ministers
Power exercisable by: Order made by Statutory Instrument
Parliamentary procedure: Negative resolution procedure

Section 1 of the Bill, by amendment of section 1 of the Water Industry (Scotland) Act 2002 (“the 2002 Act”), establishes the Water Industry Commission for Scotland, to replace the office of the Water Industry Commissioner. Section 2 enables the Scottish Ministers to dissolve the office of the current Commissioner, on such date as is appointed by order. This section will allow Ministers to dissolve the office of the Commissioner once the new Commission is established.

Reason for taking this power

It is considered that negative resolution procedure is the most appropriate procedure for exercising this power. Full Parliamentary scrutiny is not considered to be required as the dissolution of the office of the Commissioner is as a consequence of the establishment of the Commission. The establishment of the Commission is the substantive policy objective, and as such is subject to full Parliamentary scrutiny in relation to the provisions of the Bill as a whole.

Part 2

Section 4(7) Exceptions to offences regarding the public water supply system

Powers conferred on: The Scottish Ministers
Power exercisable by: Regulations made by Statutory Instrument
Parliamentary procedure: Affirmative resolution procedure

Section 4 prohibits common carriage on the public water supply system and retail competition in water services in relation to domestic customers. It does so by making it an offence for anyone other than Scottish Water or someone acting on its behalf to introduce water into the public water supply system; use the public water supply system to supply water to the premises of another person; or make
arrangements for the supply of water to the premises of another person through the public water supply system.

Reason for taking this power

Section 4(7) enables the Scottish Ministers to make regulations specifying circumstances where these prohibitions do not apply, or persons or categories of person to which they do not apply, or only apply to a certain extent. It is envisaged that these powers would be used if it emerged in practice that the prohibitions were catching activities that it had not been the Scottish Ministers’ intention to prohibit. If this turned out to be the case, it would be necessary to amend the provisions establishing the prohibitions in order for them to have the original intended effect. Since this power could have an effect on the fundamental provisions of the Bill, provision is made for any regulations made under this section to be subject to affirmative parliamentary procedure. In addition, the Scottish Ministers are required to consult on any regulations made under this section.

Section 5(7) Exceptions to offences regarding the public sewerage system

Powers conferred on: The Scottish Ministers
Power exercisable by: Regulations made by Statutory Instrument
Parliamentary procedure: Affirmative resolution procedure

As with section 4 of the Bill which deals with the public water supply system, section 5 makes equivalent provision to prohibit common carriage and limit retail competition in relation to the public sewerage system and, among other things, makes it an offence for anyone other than Scottish Water or someone acting on its behalf to draw sewage from that system; use that system to dispose of sewage from the premises of another person; or make arrangements for the provision of sewerage to or the disposal of sewage from the premises of another person through that system.

Reason for taking this power

As with section 4(7) of the Bill, section 5(7) enables the Scottish Ministers to make regulations specifying circumstances where these prohibitions do not apply, to also be used if it emerged in practice that the prohibitions were catching activities that it had not been the Scottish Ministers’ intention to prohibit. Once again, given the significance of the power, such regulations would be subject to affirmative parliamentary procedure and prior consultation.

Section 7(2) Granting of a licence

Powers conferred on: The Scottish Ministers
Power exercisable by: Order made by Statutory Instrument
Parliamentary procedure: Negative resolution procedure

Section 6 affords the Water Industry Commission powers to grant licences to persons authorising them to provide retail services in relation to water and sewerage services, in respect of premises connected to the public networks which are not dwellings.
Section 7 provides that the Commission may only grant such a licence if it is satisfied that the applicant can adequately perform the activities authorised by the licence. In assessing the ability of the applicant to do this, the Commission must have regard to the knowledge, experience, expertise, financial acumen and business viability of the applicant. Section 7(2) enables the Scottish Ministers to specify additional matters which might be relevant to the Commission’s consideration as to whether to grant a licence, which the Commission would be obliged to take into account when considering licence applications.

**Reason for taking this power**

The power is necessary to allow the Scottish Ministers to ensure as far as possible that licence holders from the outset are to be judged by reference to meaningful criteria on their ability to provide a consistent and reliable service to their customers, and provides for flexibility to respond to any unforeseen circumstances in relation to assessing the qualities of prospective licence holders. It is not anticipated that the power will be applied in anything other than exceptional circumstances, since the list of considerations provided for at section 7(2) of the Bill is considered to provide the Commission with sufficient scope to determine an applicant’s suitability.

**Section 9(5) Commission’s power to charge fees**

- **Power conferred on:** The Scottish Ministers
- **Power exercisable by:** Order made by Statutory Instrument
- **Parliamentary procedure:** Negative resolution procedure

Section 9 provides for the Commission to obtain information from water and sewerage services providers as well as giving it powers, in subsection (5), to charge them fees for certain matters in relation to the exercise of its licensing functions. The licensing functions are set out in sections 6 to 11 of, and schedule 2 to, the Bill. The matters in respect of which the Commission may charge fees are to be specified by the Scottish Ministers by order.

**Reason for taking this power**

The subject matter of this power is a detailed operational matter and subordinate legislation is therefore more appropriate to ensure that the Commission has powers to charge fees for the range of activities it will have to carry out in connection with its licensing functions, such as, for example, processing licensing applications and taking associated enforcement action whilst affording flexibility to respond to changing circumstances resulting from the operation of the new regime. As indicated in the Financial Memorandum, this power will be used to ensure that licence holders will meet the ongoing costs of the Commission for operating the new licensing regime.

**Section 16(3) Notices of Discontinuation of supply of water**

- **Power conferred on:** The Scottish Ministers
Section 16 enables the holder of a water services licence to request Scottish Water to discontinue a supply of water to premises which that licence holder has arranged to provide with water services. Scottish Water must carry out this request provided that the conditions of the disconnection code (to be made under section 17) are met, and provided that the disconnection does not affect any supply of water for domestic purposes, or any supply of water to premises other than the premises in question.

Section 16(2) provides that a water services licence holder, at least 14 days before making such a request to Scottish Water, must serve a notice on the occupier of the premises in question, and on Scottish Water and the Commission, informing them of the intention to make the request to disconnect. Section 16(3) enables the Scottish Ministers to make an order prescribing the form and content of such notices.

Reason for taking this power

It is not considered necessary to define in detail the form and content of the notice on the face of the Bill and that this is more appropriate for secondary legislation. This also affords sufficient flexibility to make amendments to these details if required in light of the operation of the new regime. In any event, the substantive policy on disconnection is contained in the Bill (sections 16 and 17), and accordingly will be subject to Parliamentary scrutiny.

Section 19  Powers of the Scottish Ministers

Power conferred on:  The Scottish Ministers
Power exercisable by:  Order made by Statutory Instrument
Parliamentary procedure:  Affirmative resolution procedure

Section 19 inserts a new section 56B into the 2002 Act. Section 56 of the 2002 Act already gives Scottish Ministers wide powers of direction over Scottish Water in relation to the exercise of its powers and functions. Section 56B enables the Scottish Ministers to make an order conferring on Scottish Water additional or supplementary functions relating to the provision of water and sewerage services. In effect these will become part of Scottish Water’s core functions (as defined in section 70(2) of the 2002 Act) and will require to be taken into account by the Commission, when assessing Scottish Water’s revenue requirements under the new regime for charging as set out in the amendments to the 2002 Act made by section 19 of the Bill.

Reason for taking this power

The making of an order under new section 56B is subject to affirmative procedure (as ensured by schedule 5, paragraph 7(7) of the Bill, which amends section 68 of the 2002 Act), ensuring that any amendment of Scottish Water’s core functions (as defined by section 70(2) of the 2002 Act) will be subject to appropriate Parliamentary scrutiny, given its significance, and is subject to prior consultation with Scottish Water and the Commission.
Section 20(3)  Meanings of “dwelling” in relation to eligible premises

Power conferred on:  The Scottish Ministers
Power exercisable by:  Order made by Statutory Instrument
Parliamentary procedure:  Negative resolution procedure

Section 20 defines “eligible premises” for the purposes of the licensing regime provided for at Part 2 of, and schedule 2, to the Bill. A licensed provider can make arrangements to provide services to customers in respect of such premises without contravening the general prohibitions in sections 4(3) and 5(3). By linking the definition to premises other than a “dwelling” for council tax purposes (within the meaning of Part 2 of the Local Government Finance Act 1992 (“the 1992 Act”)), the main purpose is to ensure that licensed providers cannot make arrangements to provide services to households. Section 20(3) enables the Scottish Ministers to vary, by order, the meaning of “dwelling”.

Reason for taking this power

Section 20(2), however, already recognises that the regime under the 1992 Act to define a dwelling for council tax purposes might operate to exclude premises which, as a matter of policy, there would be no good reason to exclude from the scope of application of the new licensing regime under this Bill, such as “the residential part of part residential subjects”. This means that premises which are technically residential but which form part of a building whose main purpose is to function as a business, for example, a care home, are not excluded from the scope of application of the new licensing regime for that reason alone. It is envisaged that the power under section 20(3) might be exercised should the definition of “dwelling” in the 1992 Act be further amended in a way which cuts across the policy objectives for this Bill. In the same way that the power to amend the definition of “dwelling” in section 72(4) of the 1992 Act itself can be varied under negative resolution procedure (see section 113 of the 1992 Act), subordinate legislation is considered appropriate here as the power is intended to be exercised only to ensure the policy intentions provided for in the Bill continue to be maintained.

Section 26  Ancillary provision

Power conferred on:  The Scottish Ministers
Power exercisable by:  Order made by Statutory Instrument
Parliamentary procedure:  Negative resolution procedure, unless the Order amends primary legislation, in which case affirmative resolution procedure.

Section 26 enables the Scottish Ministers to make such incidental, supplemental, consequential, transitional, transitory or saving provision as they consider necessary or expedient for the purposes or in consequence of the Bill.

Reason for taking this power

Schedule 5 of the Bill already contains amendments of enactments in light of the substantive provisions of the Bill. This power is required in the event that it becomes apparent, after enactment, that further legislative provision is required to fully
implement the policy of the Bill. It is considered appropriate for such provision to be
made by subordinate legislation. Section 27 provides that where an order is to be
made under section 26 and the order does not amend primary legislation, negative
resolution procedure will be used. Where it is intended that primary legislation is
amended, the Bill provides for the closer Parliamentary scrutiny afforded by the
affirmative resolution procedure.

**Section 30**

**Short title and commencement**

Power conferred on: The Scottish Ministers

Power exercisable by: Order made by Statutory Instrument

Parliamentary procedure: No parliamentary procedure

Section 30 provides for the short title and commencement arrangements for the Bill.

Section 30(2) provides for the Scottish Ministers, by order, to appoint a day when the
provisions of the Bill are to come into force, and section 30(3) provides that different
days may be appointed for different purposes.

*Reason for taking this power*

This is a standard order making power to ensure effective commencement of the Bill.

**Paragraph 1(1) of Schedule 2**

**Licence applications**

Power conferred on: The Scottish Ministers

Power exercisable by: Order made by Statutory Instrument

Parliamentary procedure: Negative resolution procedure

Further to Part 2 of the Bill, schedule 2 provides more detail on the operation of the
licensing regime. Paragraph 1 concerns applications for licences. Paragraph 1(1)
provides that the Scottish Ministers may specify in an order the exact form and
information to be contained in an application for a water or sewerage services
licence.

*Reason for taking this power*

As with the power in section 16(3) of the Bill (above), the detailed content of licence
applications is appropriate to be set out in subordinate legislation for flexibility and
given that these relate to technical matters arising from the operation of the new
licensing regime.

**Paragraph 1(4) of Schedule 2**

**Notices of licence applications**

Power conferred on: The Scottish Ministers

Power exercisable by: Order made by Statutory Instrument

Parliamentary procedure: Negative resolution procedure

Paragraph 1(4) requires applicants for licences to publish a notice of their
application, explaining the procedure whereby anyone can make a representation to
the Commission about the application. The time within which the notice must be
published, and the additional information it must contain, is to be specified by the Scottish Ministers by order.

*Reason for taking this power*

As with the power in section 16(3) of the Bill (described above), the subject matter of the power is a detailed operational matter and subordinate legislation is therefore more appropriate, and affords the Scottish Ministers flexibility to respond to changing circumstances resulting from the operation of the licensing regime.

**Paragraph 1(7) of Schedule 2**  Consideration of licence applications

Power conferred on:  The Scottish Ministers  
Power exercisable by:  Order made by Statutory Instrument  
Parliamentary procedure:  Negative resolution procedure

Sub-paragraphs (4) to (6) of paragraph 1 of Schedule 2 provide that an applicant for a licence must publish a notice of their application; where the Commission plans to refuse an application, it must give the applicant notice of this, and specify a timescale within which the applicant may make representations to the Commission about the planned refusal; the Commission must take into account any representations made by the applicant, or any other person, in determining the application. Paragraph 1(7) enables the Scottish Ministers to make an order specifying circumstances in which these provisions do not apply.

*Reason for taking this power*

It is anticipated that this power will be exercised should the operation of the licensing regime highlight that certain classes of application ought not to be subject to the general procedures provided for at subparagraphs (4) to (6). Subordinate legislation is considered to be the most appropriate for this detailed operational matter and negative resolution procedure affords Parliament a sufficient degree of scrutiny.

**Paragraphs 11(1) and 11(2)(g) of Schedule 2**  Register of licences

Power conferred on:  The Scottish Ministers  
Power exercisable by:  Order made by Statutory Instrument  
Parliamentary procedure:  Negative resolution procedure

Paragraph 11 provides that the Commission must keep a register of all water and sewerage services licences. Paragraph 11(2) prescribes the information which is to included in the register. In this way policy intention behind this provision is currently contained on the face of the Bill. Paragraph 11(1) enables the Scottish Ministers, by order, to prescribe the manner in which the register is to be kept, and paragraph 11(2)(g) enables the Scottish Ministers to specify additional information to be included in the register.
Reason for taking this power

Once again, it is considered unnecessary to set out the detail of this on the face of the Bill. The subject matter of the power is a detailed operational matter and subordinate legislation is therefore more appropriate, and affords the Scottish Ministers flexibility to amend these details in the light of the operation of the new licensing regime. Negative resolution procedure affords the Parliament a sufficient degree of scrutiny.
Appendix 2

Water Services etc. (Scotland) Bill at Stage 1

Thank you for your letter of 28 September 2004 in which you requested an explanation of a number of matters in respect of the above. We set out our response in relation to each matter below, with apologies for not being able to meet your original deadline and with thanks for the slight extension given.

PART 2

Section 4(7) Exceptions to offences regarding the public water supply system

Section 5(7) Exceptions to offences regarding the public sewerage system

In the Committee’s view and, as the Executive recognises, these powers could have a fundamental effect on the way in which the prohibitions operate and thereby on the fundamental provisions of the Bill.

In the Committee’s view these powers should be subject at the very least to affirmative procedure and a requirement of prior consultation. However, given the use to which they might be put, the Committee is considering whether the provisions are more suited to super-affirmative procedure or suited to delegated powers at all. The Committee asks for the Executive’s view and whether it would consider that such powers might more properly appear on the face of the Bill.

The Executive responds as follows:

Sections 4(7) and 5(7) of the Bill enable the Scottish Ministers to make Regulations to provide for exceptions to the offence provisions provided for at sections 4(1) to (3) and 5(1) to (3). As the Executive advised in its Memorandum to the Committee, it is intended that these powers be exercised only where it emerges that the offences, which are broad in scope, catch activities that it had not been the Scottish Ministers’ intention to prohibit.

It is not the Bill’s intention to inadvertantly restrict Scottish Water’s continuing ability, in accordance with existing statutory powers, to make arrangements with third parties in connection with the provision of water and sewerage services. Sections 4 and 5 of the Bill contain provisions which address one specific circumstance that might otherwise be caught by the offences contained in these sections. Sections 4(5) and 5(5), exempt third parties supplying water or providing sewerage services to others with the help of services provided by Scottish Water under section 30 of the Water Industry (Scotland) Act 2002 from the offences.

However, given the width of Scottish Water’s existing powers, it is difficult to predict at this stage all of the circumstances in which legitimate arrangements with third parties might be caught by the broad offence provisions in a way which was not intended. Some of these may only emerge later, once the provisions have come into force. Accordingly, the Executive remains of the view that the reserve
powers in sections 4(7) and 5(7) of the Bill are necessary, to reflect Scottish Water’s continuing flexibility to enter into arrangements with third parties in connection with the provisions of water and sewerage services.

In recognition of the fact that the making of such Regulations could have an effect on the fundamental provisions of the Bill, sections 4(8) and 5(8) provide that the Scottish Ministers must consult on any Regulations to be made under sections 4(7) or 5(7), and section 27(4) of the Bill provides that such Regulations are to be subject to affirmative parliamentary procedure. The Executive considers this provides for an appropriate degree of public consultation and Parliamentary scrutiny.

Section 17 Disconnections Code

Section 17 contains substantive policy on disconnections. Section 16(6)(a) provides that compliance with the code is one of the conditions that must be satisfied if a request by a service provider to discontinue services is to be granted. The Committee considers that there may be a case for the code to be subject to some degree of more formal Parliamentary supervision such as laying the code in draft before the Parliament for approval by affirmative resolution or requiring that the code be confirmed by order made by the Ministers subject to negative procedure. In this regard, the Committee notes the example of the framework document under the Fire Services Bill also before it at Stage 1. The Committee asks the Executive for comment.

The Executive responds as follows:

The Executive notes the Committee’s suggestion that the Disconnections Code, which is to be made by the Water Industry Commission for Scotland, be subject to a degree of more formal parliamentary supervision.

However, at present, disconnection of all water supplies is essentially an operational matter for Scottish Water, taking into account the circumstances of each case. As indicated, section 16(1) of the Bill makes specific provision for the discontinuance of non-domestic water supplies, at the request of licensed water service providers. The Executive considered that, given the new procedure, the regulator should be required to set out, having consulted with the industry (as required by section 17(4)), essentially, a code of best practice as regards disconnections in accordance with these provisions. It is not, however, intended that the code rewrite or extend the provisions of section 16 which place in statute the key provisions which must be observed in considering a disconnection. In particular, section 16(6) ensure that any disconnection must not adversely affect any supply of water to premises for domestic purposes or any supply to any other premises.

The Bill therefore takes provisions which are at present left to the discretion of the industry and instead requires the regulator, with its responsibility to promote the customer interest, to set out a binding Code. Section 17(4) requires the regulator, in drawing up a Code, to consult on it, including the Convener of the Water
Customer Consultation Panels who have a further responsibility to represent the customer interest.

In those circumstances, the Executive considers that it is unnecessary for provision to be brought into effect by the Scottish Ministers by order.

Section 20(3) Meaning of “dwelling” in relation to eligible premises

The Executive states that the power would be used in only a limited fashion for the purposes outlined in the Memorandum. The Committee observes that the power in the Bill is nevertheless drafted very widely and could be used to amend the definition of “dwelling” in almost any way, for example by breaking the link with the council tax regime entirely.

The Committee asks the Executive to explain further why it considers that delegated powers are appropriate in this case and whether their exercise should be subject to affirmative procedure rather than the negative proposed.

The Executive responds as follows:

The Executive notes the Committee’s observation that the power provided for under section 20(3) of the Bill is widely drafted.

However, the power is intended to be used in very narrow circumstances. For example, section 72(4) of the Local Government Finance Act 1992 enables the Scottish Ministers to make an order, which is subject to negative parliamentary procedure (section 112 of the 1992 Act), to vary the definition of dwelling for council tax purposes.

The meaning of dwelling under the 1992 Act (subject to the modification in section 20(2) of the Bill in respect of part residential subjects) is presently defined in a manner which meets with the policy objectives of the Bill, namely, to reflect the fact that domestic premises should not be subject to the new water and sewerage services licence regime.

If, however, the definition of dwelling under the 1992 Act was further amended, the Executive would require to consider whether this would, to any extent, cut across the policy objectives for the Bill. If it would do so, the Executive needs to have the flexibility to be able to respond to that by further modification of the definition of dwelling for the purposes of the Bill.

Given this, the Executive considers that the powers is necessary and, given the equivalent powers in the 1992 Act, negative resolution procedure is appropriate.

Paragraph 1(7) of schedule 2 Consideration of licence applications

It is also not entirely clear to the Committee how this power would operate or in what circumstances it is proposed that it be used. For example, would it be possible to exercise the power only in respect of sub-paragraph (5) so that, if the Commission were minded to refuse an application, it would not have to give the
applicant notice of this fact? Would it be open to disapply sub-paragraph (6) and ignore representations?

The Committee observes that whilst it is not unknown for order-making powers to be conferred that authorise exemptions from certain provisions, the proposed power seems to go wider than this and in particular to allow the provisions of the Bill to be modified. The Committee is unsure whether, in so far as the power would allow the substantive obligations imposed by sub-paragraphs (4) to (6) to be disapplied (as opposed to the detailed requirements to be specified in orders), negative procedure would provide sufficient Parliamentary control. The Committee therefore asks for further explanation and justification of the power.

The Executive responds as follows:

In originally framing this provision, we had in mind the fact that, before the provisions are commenced more generally, the entity to be established by Scottish Water by virtue of a requirement in accordance with section 12 of the Bill, would require in the first instance to apply for a licence under Part 2 of the Bill to provide water and sewerage services. During that period, it was considered that there may be a case for a simplified applications procedure to be in place. It was also considered that there may be circumstances in which non-substantive amendments of existing licences e.g. to correct factual errors in the original licence, might be facilitated by means of a simplified procedure.

However, in light of the Committee’s concerns, we are considering further whether there are other ways to address these matters.

We hope that this is of assistance to the Committee in its further deliberations concerning the Bill. We would of course be happy to provide further clarification if that would be helpful.

Scottish Executive

3rd October 2004
ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE

EXTRACT FROM THE MINUTES

16th Meeting, 2004 (Session 2)

Wednesday 16 June 2004

Present:

Sarah Boyack (Convener)                      Roseanna Cunningham
Rob Gibson                                   Karen Gillon
Alex Johnstone                               Maureen Macmillan
Nora Radcliffe                               Eleanor Scott (Deputy Convener)

Apologies: Mr Alasdair Morrison

The meeting opened at 11.32 am.

Water Services etc. (Scotland) Bill: The Committee considered arrangements for its consideration of the Bill at Stage 1 and agreed—

- the terms of a call for written evidence on the Bill;
- a timetable and programme of evidence, including proposed witnesses, for its Stage 1 consideration of the Bill;
- to delegate to the Convener authority to approve any claims under the witness expenses scheme arising from this programme of evidence.

The meeting closed at 12.25 pm.

Tracey Hawe
Clerk to the Committee
ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE

EXTRACT FROM THE MINUTES

18th Meeting, 2004 (Session 2)

Wednesday 30 June 2004

Present:

Sarah Boyack (Convener)    Rob Gibson
Karen Gillon                Maureen Macmillan
Mr Alasdair Morrison       Nora Radcliffe
Eleanor Scott (Deputy Convener)

Apologies: Roseanna Cunningham and Alex Johnstone

Also present: Dr Sylvia Jackson and David Mundell

The meeting opened at 11.42 am.

Work programme: The Committee considered its forward work programme and—

• noted the likely timeframes for undertaking work in relation to the Water Services etc (Scotland) Bill and other forthcoming Executive legislation;

• agreed that it wished to receive informal briefings from Executive officials on consultations on Quality & Standards III and the Principles of Charging, and formal evidence from the Minister on these issues during its consideration of the Water Services etc (Scotland) Bill at Stage 1;

The meeting closed at 12.02 pm.

Tracey Hawe
Clerk to the Committee
ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE

EXTRACT FROM THE MINUTES

19th Meeting, 2004 (Session 2)

Thursday 9 September 2004

Present:

Sarah Boyack (Convener)  Roseanna Cunningham
Karen Gillon  Rob Gibson
Alex Johnston  Mr Alasdair Morrison
Maureen Macmillan  Nora Radcliffe
Mr Mark Ruskell (Deputy Convener)

The meeting opened at 10.01 am.

Water Services etc. (Scotland) Bill: The Committee took evidence at Stage 1 from—

Panel 1

Dr John Sawkins, Senior Lecturer in Economics, Heriot-Watt University;
Ian Jones, Chairman, Quayle Munro Holdings plc;
Alan Thomson, Chartered Institution of Water and Environmental Management;

Panel 2

Ian Duff, Chief Economist, Scottish Council for Development and Industry;
John Downie, Parliamentary Officer, Federation of Small Businesses in Scotland;
Bill Anderson, Campaigns Manager, Forum of Private Business, Scotland;
and

Panel 3

Alan Barclay, General Manager – Port Dundas Whisky, Diageo;
Dr Ray Mountford, Commercial Development Manager, BP Grangemouth;
David Calder, Head of Manufacturing, Ciba Speciality Chemicals.

The meeting closed at 12.48 pm.

Tracey Hawe
Clerk to the Committee
ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE

EXTRACT FROM THE MINUTES

20th Meeting, 2004 (Session 2)

Wednesday 15 September 2004

Present:

Sarah Boyack (Convener) Roseanna Cunningham
Karen Gillon Rob Gibson
Alex Johnstone Mr Alasdair Morrison
Maureen Macmillan Nora Radcliffe
Mr Mark Ruskell (Deputy Convener)

The meeting opened at 9.53 am.

Water Services etc. (Scotland) Bill: The Committee took evidence at Stage 1 from—

Panel 1
Stephen Boyd, Assistant Secretary, STUC;
David Watson, Scottish Organiser - Unison, STUC;
Bobby Buirds, Regional Officer – Amicus, STUC;

Panel 2
Nigel Bromley, Chief Executive, Gemserv;
Ceri Jones, Regulation and Competition Director – Northumbrian Water, Water UK; and

Panel 3
Professor Alan Alexander, Chair, Scottish Water
Dr Jon Hargreaves, Chief Executive, Scottish Water
Douglas Millican, Finance Director, Scottish Water.

The meeting closed at 1.15 pm.

Tracey Hawe
Clerk to the Committee
ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE

EXTRACT FROM THE MINUTES

21st Meeting, 2004 (Session 2)

Wednesday 22 September 2004

Present:

Sarah Boyack (Convener)  Karen Gillon
Rob Gibson               Alex Johnstone
Maureen Macmillan        Mr Alasdair Morrison
Mr Mark Ruskell (Deputy Convener)  Nora Radcliffe

Apologies: Roseanna Cunningham.

The meeting opened at 10.34 am.

Water Services etc. (Scotland) Bill: The Committee took evidence at Stage 1 from—

Panel 1
Jim Lugton, Policy Officer, Scottish Council for Voluntary Organisations;
Trisha McAuley, Head of Corporate Resources, Scottish Consumer Council;

Panel 2
Ian Smith, Convener, Water Customer Consultation Panels;
Len Scoullar, Member – North West Water Customer Consultation Panel; and

Panel 3
Councillor Alison Hay, Argyll and Bute Council, COSLA;
Councillor Alan Kenney, Fife Council, COSLA;
James Thomson, Finance Policy Manager, COSLA.

The meeting closed at 12.23 pm.

Tracey Hawe
Clerk to the Committee
EXTRACT FROM THE MINUTES

22nd Meeting, 2004 (Session 2)

Wednesday 29 September 2004

Present:

Sarah Boyack (Convener)          Karen Gillon
Rob Gibson                        Alex Johnstone
Maureen Macmillan                 Mr Alasdair Morrison
Mr Mark Ruskell (Deputy Convener) Nora Radcliffe

Also present: Fergus Ewing and John Farquhar Munro.

The meeting opened at 9.38 am.

**Water Services etc. (Scotland) Bill:** The Committee took evidence at Stage 1 from—

**Panel 1**

Alan Sutherland, Water Industry Commissioner for Scotland;

Dr John Simpson, Director of Cost and Performance, Office of the Water Industry Commissioner for Scotland;

**Panel 2**

Tony Smith, Director of Competition and Consumer Affairs, Office of Water Services (Ofwat);

John Banfield, Senior Inquiry Director, Competition Commission; and

**Panel 3**

Stuart Rolley, Senior Development Manager, Environment Team, The Coal Authority;

Stephen Hill, Development Manager, Environment Team, The Coal Authority.

The meeting closed at 12.34 pm.

Tracey Hawe
Clerk to the Committee
Present:

Sarah Boyack (Convener)       Rob Gibson
Karen Gilron                 Alex Johnstone
Richard Lochhead             Maureen Macmillan
Mr Alasdair Morrison         Mr Mark Ruskell (Deputy Convener)

Apologies: Nora Radcliffe.

The meeting opened at 9.39 am.

3. **Petitions**: The Committee considered the following petitions—

   **PE517** and **PE645** on control of odours from waste water treatment works.

The Committee agreed to take forward issues arising from the petitions when taking oral evidence from Ross Finnie MSP, Minister for Environment and Rural Development, under items 4 and 5. The Committee further agreed to incorporate consideration of these issues into its Stage 1 report on the Water Services etc. (Scotland) Bill.

4. **Executive consultations on water services**: The Committee took evidence from Ross Finnie MSP, Minister for Environment and Rural Development, on the following Executive consultations—

   - Investing in Water Services 2006-2014: the Quality and Standards III Project;
   - Paying for Water Services 2006-2010: a consultation on the principles of charging for water services.

5. **Water Services etc. (Scotland) Bill**: The Committee took evidence at Stage 1 from Ross Finnie MSP, Minister for Environment and Rural Development.

The meeting closed at 12.36 pm.

Tracey Hawe
Clerk to the Committee
ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE

EXTRACT FROM THE MINUTES

24th Meeting, 2004 (Session 2)

Wednesday 27 October 2004

Present:

Sarah Boyack (Convener)  Rob Gibson
Karen Gillon              Alex Johnstone
Richard Lochhead         Mr Alasdair Morrison
Nora Radcliffe           Mr Mark Ruskell (Deputy Convener)

Apologies: Maureen Macmillan

The meeting opened at 10.34 am.

Item in private: The Committee agreed to consider item 4 (the draft Stage 1 report on the Water Services etc. (Scotland) Bill) in private, and to consider any subsequent drafts in private at future meetings.

Water Services etc. (Scotland) Bill (in private): The Committee considered a draft Stage 1 report, and agreed a number of changes. The Committee agreed to consider a further draft report at its next meeting.

The meeting closed at 12.36 pm.

Mark Brough
Acting Clerk to the Committee
ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE

EXTRACT FROM THE MINUTES

25th Meeting, 2004 (Session 2)
Wednesday 3 November 2004

Present:

Sarah Boyack (Convener)            Rob Gibson
Karen Gillon                      Alex Johnstone
Maureen Macmillan                 Mr Alasdair Morrison
Nora Radcliffe                    Mr Mark Ruskell (Deputy Convener)

Apologies: Richard Lochhead

The meeting opened at 10.02 am.

Water Services etc. (Scotland) Bill (in private): The Committee considered a draft Stage 1 report. A number of changes were proposed and agreed to, some by division. The Committee agreed to schedule an extra meeting on 4 November 2004 to consider a further draft. The Committee also agreed arrangements for the publication of the report.

The Committee further agreed to take, in advance of Stage 2, additional oral evidence on proposed amendments suggested by the Minister for Environment and Rural Development, and agreed proposed witnesses.

The meeting closed at 11.58 am.

Mark Brough
Acting Clerk to the Committee
1. The Committee divided on a proposal by the Convener:

That the Committee accepts the arguments presented by the Scottish Executive for the prohibition of common carriage.

The proposal was agreed to by division: For 6, Against 1, Abstentions 0
For: Sarah Boyack, Rob Gibson, Karen Gillon, Maureen Macmillan, Nora Radcliffe, Mark Ruskell
Against: Alex Johnstone

2. The Committee divided on a proposal by the Convener:

That the Committee accepts that retail competition in water and sewerage services should be restricted to the non-domestic sector.

The proposal was agreed to by division: For 6, Against 1, Abstentions 0
For: Sarah Boyack, Rob Gibson, Karen Gillon, Maureen Macmillan, Nora Radcliffe, Mark Ruskell
Against: Alex Johnstone

3. The Committee divided on a proposal by the Convener:

That the Committee recommends that the general principles of the Bill should be agreed to.

The proposal was agreed to by division: For 7, Against 1, Abstentions 0
For: Sarah Boyack, Rob Gibson, Karen Gillon, Maureen Macmillan, Mr Alasdair Morrison, Nora Radcliffe, Mark Ruskell
Against: Alex Johnstone
ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE

EXTRACT FROM THE MINUTES

26th Meeting, 2004 (Session 2)
Thursday 4 November 2004

Present:
Sarah Boyack (Convener) Rob Gibson
Maureen Macmillan Mr Mark Ruskell (Deputy Convener)
Nora Radcliffe

Apologies: Karen Gillon, Alex Johnstone, Richard Lochhead, Mr Alasdair Morrison

The meeting opened at 12.45 pm.

Water Services etc. (Scotland) Bill (in private): The Committee considered and agreed a draft Stage 1 report.

The meeting closed at 12.50 pm.

Mark Brough
Acting Clerk to the Committee
Members who would like a printed copy of this *Numbered Report* to be forwarded to them should give notice at the Document Supply Centre.