AUDIT COMMITTEE

Tuesday 10 January 2006

Session 2

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AUDIT COMMITTEE

1st Meeting 2006, Session 2

CONVENER

*Mr Brian Monteith (Mid Scotland and Fife) (Ind)

DEPUTY CONVENER

*Mr Andrew Welsh (Angus) (SNP)

COMMITTEE MEMBERS

*Susan Deacon (Edinburgh East and Musselburgh) (Lab)
*Margaret Jamieson (Kilmarnock and Loudoun) (Lab)
*Mrs Mary Mulligan (Linlithgow) (Lab)
*Eleanor Scott (Highlands and Islands) (Green)
*Margaret Smith (Edinburgh West) (LD)

COMMITTEE SUBSTITUTES

Chris Ballance (South of Scotland) (Green)
Mr David Davidson (North East Scotland) (Con)
Marlyn Glen (North East Scotland) (Lab)
Mr John Swinney (North Tayside) (SNP)

*attended

THE FOLLOWING ALSO ATTENDED:

Mr Robert Black (Auditor General for Scotland)
Caroline Gardner (Audit Scotland)
Arwel Roberts (Audit Scotland)

THE FOLLOWING GAVE EVIDENCE:

Professor Alan Alexander (Scottish Water)
Sir Ian Byatt (Water Industry Commission for Scotland)
Dr Jon Hargreaves (Scottish Water)
Douglas Millican (Scottish Water)
Katherine Russell (Water Industry Commission for Scotland)
Alan Sutherland (Water Industry Commission for Scotland)

CLERK TO THE COMMITTEE

Shelagh McKinlay

SENIOR ASSISTANT CLERK

Joanna Hardy

ASSISTANT CLERK

Clare O'Neill

LOCATION

Committee Room 2

Scottish Parliament

Audit Committee

Tuesday 10 January 2006

[THE CONVENER *opened the meeting at 10:19*]

Items in Private

The Convener (Mr Brian Monteith): I commence the Audit Committee's first meeting of 2006, to which I welcome the Auditor General for Scotland and his team from Audit Scotland, the public, the media, committee members and clerking staff. I wish everyone a good new year. I ask everyone present to ensure that all pagers and mobile phones are switched off, so that they do not interfere with the public address system.

We have no apologies and everyone is present, so we will move on to agenda item 1, which is to seek the committee's agreement to take in private items 5 and 6. Item 5 is consideration of the evidence under item 4 on the "Overview of the water industry in Scotland" and item 6 is consideration of our approach to the report "Scottish Executive: The NorthLink ferry services contract", which is item 2. Does the committee agree to take items 5 and 6 in private?

Members *indicated agreement*.

"Scottish Executive: The NorthLink ferry services contract"

10:20

The Convener: Item 2 is a briefing from the Auditor General on his report entitled "Scottish Executive: The NorthLink ferry services contract".

Mr Robert Black (Auditor General for Scotland): In December 2000, the Scottish Executive awarded a five-year contract to a service operator called NorthLink Orkney and Shetland Ferries to run the lifeline ferry service to the Orkney and Shetland Islands. NorthLink is a joint venture between Caledonian MacBrayne and the Royal Bank of Scotland that started to operate in October 2002. Under the contract, the Scottish Executive was to pay NorthLink a basic subsidy of £45.7 million over five years, adjusted for inflation and supplemented, if necessary, by additional payments under material change provisions in the contract.

NorthLink encountered financial difficulties and, in April 2004, the Minister for Transport announced that the contract was to be retendered early. Last August, media reports said that the subsidy that the Executive paid to NorthLink had risen substantially to £63 million and a member of the Scottish Parliament wrote to me about the matter. Therefore, I asked Audit Scotland to examine the management of the contract and the claims for additional financial support.

The Scottish Executive's main objective in providing lifeline transport services was to ensure that the cost of transporting passengers and their cars was not excessive and that good accessibility between the islands and the mainland was maintained. The Executive decided that offering a subsidy to a shipping operator would be the best way of ensuring an adequate ferry service. New vessels were required—partly to comply with new maritime safety regulations that were due to be implemented soon—and it was decided that private sector funding would be arranged for the acquisition of those vessels.

The European Community guidelines on state aid to maritime transport that were in force at the time required member states to conduct an open tender exercise and to limit financial assistance to a contract lasting no more than five years. That was of concern to the Executive, as the new vessels were expected to last about 25 years. As the successful bidder was not guaranteed to win a subsequent tender, potential bidders might seek extra subsidy by depreciating the 25-year life of the ferries over the shorter contract period. After lengthy negotiations, the European Commission agreed that the Scottish Executive should set a maximum affordability price for a five-year contract. If bids for a five-year contract were less than that limit, no other contract duration options would be considered.

Overall, I conclude that the Scottish Executive undertook a robust tendering exercise. However, the complex negotiations with the Commission over the contract duration took longer than expected and the contract was not signed until December 2000, which was a year behind schedule. The Executive met the key objective of having new vessels in place before the new maritime safety regulations came into force in October 2002, but to ensure service provision up to the start of the new contract, it had to negotiate a six-month extension of the former contract with P&O, at a cost of £8 million.

The Executive provided a clear specification of its requirements that was based on service levels and outputs, and bidders were left to design and cost a service that met those standards. It was made clear that the successful bidder was expected to bear the operational risks of higher costs or lower demand.

Much of the information that the Executive made available to bidders was provided by the existing operator. NorthLink was concerned about two aspects of the information. NorthLink guaranteed the terms and conditions of maritime staff who transferred from P&O, but it considered that the information that was made available did not allow it to form an accurate view of what those costs might be. Subsequently, additional costs arising under that heading were covered by material change provisions in the contract. NorthLink also found it difficult to form an accurate view of the total volume of freight that P&O previously carried.

Six ferry operators were shortlisted and three of those submitted bids. NorthLink's bid for the basic subsidy of £45.7 million was within the affordability price that was set for the five-year contract and was cheaper than the only other remaining bidder at the final stage. NorthLink's costs were higher than those of the other bidder, but NorthLink anticipated generating more passenger income and more freight surpluses because its traffic growth assumptions were higher. Financial difficulties evolved largely as a result of competition from Pentland Ferries, which commenced operations in the spring of 2001, and from North Isles Ferries, which was created in 2002 by a group of hauliers who were concerned about the prospect of higher freight prices. Some of NorthLink's costs were also higher than expected.

The Executive agreed to restructure the timing of subsidy payments and to make additional payments of £600,000, covered by the material change clauses in the contract, which I mentioned earlier. However, those payments did little to alleviate NorthLink's financial difficulties. By the summer of 2003, the company was indicating that it was unlikely to be able to deliver the remainder of the contract. The Executive provided additional emergency funding of £500,000, but NorthLink stated that it needed £3 million to avoid legal action by creditors. In the event, NorthLink defaulted on both its July and August 2003 vessel leasing payments.

In August 2003, the Executive decided that it would need to retender the northern isles ferry services contract. The Executive's priority was to ensure continuity of the lifeline services. An interim contract was negotiated so that NorthLink would continue to operate while a new tender exercise was carried out. The revised contract, which was agreed in September 2004, is based on monthly subsidies that are paid to NorthLink on the basis of forecast cash projections. NorthLink's regular performance reports to the Executive show that the ferry services have operated reliably and punctually and have been largely well received by passengers and businesses.

In the first three years of NorthLink's operation, from October 2002 to the end of September 2005, the Executive has paid the company about £71 million. That is a basic subsidy of £33.6 million; other payments of £16.7 million that were allowed for under the terms of the original contract; a further £2.5 million to pay off in one instalment leases related to some of the assets used by NorthLink; and additional funding of £18.2 million to maintain the delivery of services.

Retendering of the northern islands ferry contract began in April 2004. I am not in a position to say much about that, as the new contract will not be in place until April 2006; however, the form of the new contract reflects the need to ensure the continuity of lifeline services if the service provider gets into financial difficulties and, at the same time, to comply with EC guidelines on state aid to maritime transport. I understand that the proposed new contract does not seek to transfer all operational risk to the service provider and recognises that costs can be higher and income lower than expected for reasons beyond the operator's control. Therefore, it will provide some protection to the new operator by allowing the Executive to consider paying additional subsidy if the operator's losses exceed £750,000 in any one year. However, the contract has not yet been formed and I am unable to say any more about it. The Executive has worked with NorthLink to provide more detailed information to bidders, which was a problem the first time around. More information should be available than was the case in the previous tender exercise.

I offer one or two general conclusions. First, the Scottish Executive transport group had limited options once NorthLink got into difficulty, given the requirement to maintain lifeline services. We must recognise that.

Secondly, it is clearly challenging to balance social objectives with economic considerations. Although I cannot comment on the new contract, it seeks to balance those two factors—the social considerations and the need to achieve best value through the service.

Thirdly, such complex contracts are clearly a one-off and—apart from one or two other ferry services—are unlike anything elsewhere in Scotland. Therefore, it is absolutely essential that adequate time should be provided for proper planning, not least for resolving any legal issues relating to EC procurement rules.

Finally, everyone now recognises the importance of providing bidders with high-quality information. That issue matters because if operational risk is transferred to a provider without good information, bidders might price the consequent uncertainty into the contract.

Those are my main findings. As ever, I am happy to answer any questions. My colleagues from Audit Scotland will help me to do that.

10:30

The Convener: I thank the Auditor General for an interesting report. We will discuss our reaction to the report under agenda item 6, but we now have the opportunity to ask any questions or request further information about it.

Eleanor Scott (Highlands and Islands) (Green): Where do I start? I could go through the report line by line and ask nit-picking questions at every level, but I will try not to do that.

Under the title "Risks borne by the winning bidder", exhibit 3 refers, among other things, to

"the risk that demand for services does not match the levels planned".

Clearly, that was a problem. The bidder should have borne that risk, but it was unable to do so. It seems to me that, in the case of lifeline services, the risks that can be transferred to an operator are limited in scope. The report refers to

"the twin priorities of securing service continuity and the transfer of operational risks."

If those are twins, they cannot be identical twins, because securing service continuity will always need to come first. Realistically, how much risk can we insist that an operator should bear? At the end of the day, do not the operators have us over a barrel, given that they can just say that they cannot continue to provide the service?

Mr Black: That is a fundamental question, to which no one has an easy answer. As I remarked in my conclusion, balancing the social objective of service continuity with the objective of achieving best value—which implies a transfer of risk to the operator—is extremely difficult to achieve. That is why the Executive is attempting to ensure that, although the new contract will require the operator to bear some losses if it fails to crystallise the assumptions in its business plan, the contract will also provide the opportunity for additional subsidy to be brought in if it is needed. As I said, I am not in a position to comment on the new contract, but that arrangement is clearly driven by the need to attempt to achieve a balance between those two factors.

Eleanor Scott: There was a risk that the demand for services might not match what was predicted, but the successful bidder won the tender because it offered a bid that was predicated on an increased demand. I do not know much about the tendering process, but I would like to know the extent to which the rules allow for such things to be questioned. You said that the tendering process was robust. Must we simply accept the projections of the lowest tender or can we question them?

Mr Black: As I said at the outset, I have concluded that the contract procedure that the Scottish Executive followed was robust. That is partly because the Executive carried out sensitivity testing of some of the projections. However, at the end of the day, it is not possible to second-guess a service provider and the business risks that the provider is willing to undertake.

When the tender was being prepared and accepted, there was no competition from Pentland Ferries or from the other ferry operator—that was a new factor. With the benefit of hindsight, we might say that more might have been done to factor in that possibility, but sensitivity analysis was undertaken so, to a large extent, the Scottish Executive had exercised what auditors tend to call due diligence in putting together the tender arrangements within the framework of ministerial policy.

Mrs Mary Mulligan (Linlithgow) (Lab): You mentioned in your briefing that it was always understood that the Scottish Executive transport group would cover material change. I am not sure how we decide that there was material change as opposed to commercial risk, as in the opposition taking up more of your business than it would otherwise. Perhaps you could explain how that was categorised.

Mr Black: A section of the report describes material change. I wonder whether colleagues could help me to find it.

Arwel Roberts (Audit Scotland): There are two stages to this practice. First is the tendering process, which defines a specification for the service that is to be provided. In this case, that was determined by the Scottish Executive. Then it is down to the potential bidder to determine how it will provide the service. There is a process of determining whether that bidder is technically competent to deliver the specified service, but it is recognised that there are areas in which there is uncertainty, for example the cost of fuel and certain operating costs that are outside the control of an operator, which will vary and to a certain extent can be taken into account only when the tender is submitted. Such areas, which are beyond the direct control of the potential bidder, are regarded as areas of material change. Other areas, such as possible competition, are down to the potential bidder's judgment, and different bidders will take a different view. In looking at how different bidders determine that, the Scottish Executive is concerned about whether the bidders are taking a reasonable—though not necessarily identical—view of whether competition is likely.

Mrs Mulligan: In the context of the report, are you content that the Scottish Executive's transport group was paying additional funding for actual material changes rather than for a misjudgment by the bidder?

Mr Black: There was a combination of factors. As Arwel Roberts has just commented, the contractor should have borne the risks associated with emerging competition. That competition significantly affected the contractor's cash flow, so in part the extra payments that went to NorthLink were to cover elements for which it should have borne the risk. However, it was clearly unable to finance that pressure from its own resources. Undoubtedly, elements of the extra money that was paid were to do with keeping the service going rather than meeting material change clauses.

Arwel Roberts: Paragraph 3.7 of the report lists the items for which the contractor sought additional payment. Information was not available to them when they made their bid.

Mr Andrew Welsh (Angus) (SNP): There is almost a feeling of inevitability about this. Even though the operator carries the risk, in practice there will be subsidies because this is a lifeline service. Paragraph 10 of the summary, on page 4, sets out the situation, which boiled down to a straight choice between NorthLink and P&O: three bids were reduced to two. That situation has now repeated itself in the new contract. NorthLink's costs were higher and its bid succeeded on the basis of assumptions about increased income that, in the event, did not materialise. It bothers me that the assumptions in SETG's sensitivity analysis strengthened the NorthLink case. That leads to the thought that SETG's analysis was wrong and that not enough attention was paid to the overoptimistic income figures rather than to the more inevitable costs. Has SETG improved its analysis procedures?

Arwel Roberts: The strict answer to that is that we will not know until it has awarded the new contract. From placing this contract, it has certainly learned that one cannot make assumptions about levels of use and costs. In so far as the contract has thrown up areas in which the SETG needs to be more careful, the group has acknowledged that it needs to learn lessons, but none of us can guarantee that it has covered all the angles on the contract.

Mr Black: On the Scottish Executive transport group's performance, I refer you to paragraphs 2.28 and 2.29, on page 21 of the report, where we record the fact that NorthLink expected to generate more demand because it was operating new ships and improving the services, was going to reduce fares and was going to market through special offers—one would expect an operator to think about those possibilities—and the fact that its projections were informed by analysis that was carried out by the Scottish Office in the 1980s, which demonstrated traffic growth when new ferries came on to the Clyde and Hebrides routes. We are told that transport economists had validated the projections as reasonable and that the Scottish Executive transport group carried out its own sensitivity analysis on the bids. The key point to mention to the committee is:

> "The results of this analysis suggested that even if no passenger growth were achieved, losses could be contained within NorthLink's available working capital".

Of course, it transpired that the situation was much worse than that.

In the work that we do, there is always a risk of operating with perfect hindsight but, looking back at what was being managed at the time, I do not think that the Scottish Executive's actions were unreasonable.

Mr Welsh: However, the assumptions were wrong and NorthLink picked that up quite quickly in the contract. The fundamental starting point was one of overoptimism, and the situation was exacerbated by competition from smaller operators. That was known to NorthLink before it took over. What was the SETG's reaction to NorthLink's concern about its ability to deliver at an agreed price, which came quite early in the process? In other words, how quickly are such matters picked up when the practice shows that the assumptions are wrong?

Mr Black: I am sorry, but we cannot answer that question. It would have to be put to the Scottish Executive.

Margaret Jamieson (Kilmarnock and Loudoun) (Lab): We are aware of the complexity of the tendering process and of the difficulties that the Scottish Executive transport group had in that it relied solely on the information that was provided by P&O, which was providing the service at the time. However, that leads me to challenge whether the Scottish Executive officials had sufficient knowledge to deal with the contract. It also leads me to challenge the robustness of the financial checks on NorthLink and the other bidders and whether the Scottish Executive officials had the financial competence to make recommendations. We note the excess payments that have been made; those payments certainly call into question the Executive officials' financial competence.

It would also be interesting to find out whether the P&O bid would have been cheaper to the public purse in the longer term. Has that been examined?

Mr Black: We comment in the report on the skill mix of the people who worked on the procurement process. The transport group established a tender working group for the project, the membership of which included members of the transport group itself and

"staff from the Scottish Executive's economic and advisory services, solicitors, accountancy services, finance and procurement divisions."

It also included a maritime consultant who gave the group professional advice. In my opinion, the group had the appropriate mix of professional skills to oversee the project.

10:45

Margaret Jamieson: Was any information gleaned from P&O's bid to determine whether the NorthLink bid represented the best value for money?

Mr Black: The NorthLink bid was significantly cheaper than the P&O bid. The—

Margaret Jamieson: It was initially cheaper, but was it cheaper over the term of the contract? Given what we now know, has there been any analysis—

Mr Black: It had a significantly lower cost over the term of the contract. One of the interesting features of the EC rules that apply to such contracts is that there is an obligation to accept the lowest tender if the quality is acceptable.

The Convener: I have a question about the P&O bid. The fact that two operators came in at a later date and competed against NorthLink raises questions about the bidding process. It is clear that operators believe that they can come in without subsidy and compete against the subsidised operator. Is there any reason to believe that operators would not have come in and competed against P&O if it had been the successful bidder, given that its services would have been more expensive? Do we know whether the fact that the competitors operated separate services rather than services to both sets of islands allowed them to be cheaper—that is, to pick off one route, to have lower costs and therefore to compete?

I ask those questions simply because, if we went through the process again, we might be concerned that, having awarded a contract, new companies would come in and do the same again. In the short term, that would benefit the public to some extent, but it might not be a benefit in the long term.

Mr Black: I am sorry, convener. I cannot help much with your reflections and your implied question. One indubitable fact, however, is that competitors who came in went out again. The market is clearly a difficult one in which to operate successfully. It is not as though the new contract was formed in an environment in which there was a lot of competition. At present, there is little competition apart from a specialised container service that is limited in scope. The fact that operators have not succeeded in the longer term illustrates the challenges that the Scottish Executive faces in achieving a balance between a lifeline service and best value in the contract.

The Convener: Thank you for that answer. I understood from the start that the question might be an insoluble one.

Arwel Roberts: May I add to what has just been said? It is important to recognise the distinction between passenger services and freight services. Passenger services are subsidised, but freight services are not. It is passenger services that attract the requirement to satisfy the maritime safety regulations. Freight services do not have the same exacting requirements. If, after a joint passenger and freight service has been established, someone can identify a niche in the market, it might be possible to operate a service at a much cheaper level than can be predicted ahead for a joint service.

Mr Welsh: You mentioned that these were complex, one-off contracts that were a first for Scotland. Was any attempt made to compare the services with those in other countries, such as Norway?

Arwel Roberts: As part of the exercise we tried to establish where comparable services might exist. The Norwegian ones are different in that they do not go to and fro, but travel for long distances up and down the coast. I believe that there are similar services in parts of New Zealand and there are certainly such services in British Columbia but, as far as we are aware, they face the same difficulties. They need subsidy.

Eleanor Scott: I wish to ask about the renegotiation of the contract, referring in particular to page 29 of the report. It says:

> "the company was unwilling to continue … without some assurances of basic recompense to its shareholders to accept the risks of so doing."

It goes on to say:

> "The revised contract … involves a monthly subsidy to be paid to NorthLink … It also provides some incentive to NorthLink by allowing additional payments to be made, dependent on NorthLink's financial performance".

It will seem to Mr and Mrs Taxpayer that, far from bearing any risk, the operator is continuing to be rewarded. There has been no penalisation at all. The operator is now receiving performance-related payments, which seems a bit bizarre.

Arwel Roberts: I agree with the bit about the operator being incentivised. That is true—it is part of the revised arrangements.

Susan Deacon (Edinburgh East and Musselburgh) (Lab): I want to go back to an issue that is highlighted at an early point in the report, on the negotiations with the European Commission and the extent of the early delays. Indeed, there was quite a costly extension to the P&O contract. Based on the investigations that Audit Scotland has conducted with respect to this particular contract, do you have any observations about why such delays have occurred, how they might have been avoided, how the negotiation process with the Commission, which is a continuing and critical part of the backdrop to this area of service provision, might be expedited more effectively, and how greater clarity and transparency could be achieved?

Mr Black: One of the key lessons that can certainly be learned through this experience is to recognise the need to allow adequate time to undertake the necessary clearance with the European Commission on such matters. I am not sure whether Audit Scotland can help you with an answer about the nature of the negotiations that were talking place with the Commission at the time.

Arwel Roberts: One of the issues was that new vessels were clearly needed, not just for maritime law reasons, but because of the age of the ships that P&O was operating. From memory, I think that the investment was in the region of £100 million—but I am not absolutely sure about that.

Mr Black: That is right.

Arwel Roberts: Part of the issue was about how to construct a contract that would comply with the five-year time limit while enabling an operator to recover the costs of that level of investment. In the end, the solution was to remove the investment outside the immediate contract process. Effectively, another party invested in the ships, and the vessels were leased back to NorthLink, the idea being that the Executive could still comply with the five-year limit in accordance with the EC regulations without risking vessels being taken away by a contractor when the retendering exercise was rerun in five years' time.

Mr Black: For completeness, the report records that the Executive was successful in getting the new vessels operating by autumn 2002, so that there was no breach of the maritime safety rules.

Susan Deacon: Leaving aside the details of the substance, can any lessons be drawn about how the actual negotiation process might be improved, particularly with regard to what might be done at the hand of the Scottish Executive? Is the process as you have described it inevitable, given how things operate?

Arwel Roberts: Part of the answer is that, for the immediate future, the vessels exist. There is a company that owns them, which is prepared to lease them to whoever operates the service next. There is not an exact duplicate here of the situation with which the Executive was faced when the contract was initiated. The same problem could arise when those vessels need to be replaced in 25 years, or whatever their lifetime is.

Margaret Smith (Edinburgh West) (LD): I want to pick up on the point that you made about the obligation under EC regulations to accept the lowest tender. That is a continuing issue that is giving quite a lot of concern elsewhere in Scotland. Presumably there is a get-out clause on that obligation—if the Scottish Executive transport group had believed that the bid was not robust, for example.

Arwel Roberts: Under EC regulations, the process has two stages. At the first stage, a given number of bidders will submit proposals and a judgment is made regardless of cost, because at that stage there is no indication of what the tender cost is. At that first stage, judgments are made about the competence of the bidders to meet the specifications of a contract. That reduces the number of bidders. Those that are taken on to the second stage are regarded as equally competent to deliver the contract and the second decision is made purely on cost. However, the overall decision is not made on cost alone: it is made as a result of having already decided that all those who submit cost tenders are technically competent. Therefore, in theory, from the EC point of view, it makes no technical difference which contractor is appointed, because that decision is made purely on cost.

Margaret Smith: If I understand you correctly, all the bidders who get through to the second stage are assumed to be equally competent. Once they have got through the first stage, they start on a level playing field in every respect except cost.

Arwel Roberts: Yes.

Margaret Smith: Therefore, the Scottish Executive cannot weigh any one part of a bid more lightly or more heavily than any other part. At the second stage, the Executive is driven simply by cost.

Arwel Roberts: According to the EC rules, yes.

The Convener: We seem to have covered all the questions that we had on that subject. I thank Audit Scotland for answering them.

Further Education Colleges

10:57

The Convener: We move to consider the response from the Executive to the committee's seventh report on further education colleges. Members have a paper before them from the accountable officer, Eddie Frizzell. I invite comments from members on the Executive's response. Afterwards, I will invite Audit Scotland to make its comments and observations so that we can consider where we go.

Margaret Jamieson: Can I start at the end of the response? When the committee was taking evidence on further education colleges, my concern was about funding for colleges that cover rural and remote areas. I am decidedly unhappy about the response from the Enterprise, Transport and Lifelong Learning Department, which says that there is at present no evidence to suggest that higher education institutions generally are being affected by the cost of taking students from remote areas. That does not fit with the evidence that we heard. We heard evidence about colleges having to provide an establishment at a distance. That is not dealt with in the response. We also talked about linking the funding to similar models, such as the Arbuthnott formula, yet there is no mention of that in the response. There is merely a statement in paragraph 47 that

"This review is scheduled to commence in May 2006."

Some colleges are still having difficulties because of the areas that they serve. I would have expected work to help them to be already under way. I know that we will get further information on FE colleges from Audit Scotland later this month. It may well be that that is an area to which we can return, instead of keeping the correspondence going.

11:00

The Convener: Okay. The committee would be interested in keeping a watching brief on remoteness, but it is fair to say that, given that some colleges are more remote than others, we were surprised at some of the colleges that met the remoteness criteria.

Margaret Jamieson: Exactly.

The Convener: It is clear that the definition of remoteness will be germane to Margaret Jamieson's point and what the Executive decides to announce.

Are there any more questions?

Mr Welsh: I want to deal with the situation at West Lothian College. Paragraph 11 on page 2 of the Executive's response mentions "concerns about the College's ability to eliminate the 'operating' element of the accumulated deficit"

within the agreed timescale, so it looks as if that timescale will not be met.

The Convener: Excuse me—that part of the response is about Inverness College.

Mr Welsh: I beg your pardon; I apologise to West Lothian College. Is the timescale for eliminating Inverness College's deficit being revised and, if so, do we have a new date? Did the meeting that took place on 20 December produce any result? Finding the finance to deal with the accumulated deficit is a major problem, especially as it involves pension payments. Can Audit Scotland give us an update on the position?

The Convener: I am not sure that Audit Scotland will be able to deal with that point. What struck me about paragraph 13 is that although it mentions that a meeting was to be held on 20 December 2005, it does not say that the information from that meeting would be forwarded to the committee. It is natural to assume that, having been told that there would be a meeting on 20 December, we would be interested in its outcome. It would have been logical to add to the information that there would be a meeting an assurance that we would be informed of its outcome. I rather suspect that members will want to know that outcome. At the very least, we will now have to write to the college or to the accountable officer in the Executive department to establish what has happened.

Rather than go backwards and forwards to Audit Scotland, it might be best to go through our observations first and then invite comments from Audit Scotland.

Mrs Mulligan: I want to comment on West Lothian College rather than Inverness College, although I agree with the points that have been made. We asked to be kept up to date on the negotiations on the private finance initiative contract at West Lothian College. As we have not heard anything, I can only assume that matters have not been resolved. I am conscious of the timing and am concerned that there could still be uncertainty as we go into the next financial year, which could prevent the college from getting on with its business. We should not be unaware of that. It would be useful to get any update information as soon as possible.

The Convener: Paragraph 13 makes it clear that the

"underlying deficit of £516,000 represents a significant deterioration against a forecast outturn of £244,000 deficit".

That is quite a significant variation in the projections, which was obviously going to be discussed at the meeting on 20 December. [*Interruption.*] I should clarify that I am talking about the projections for Inverness College.

As there are no further comments, I invite Caroline Gardner to give Audit Scotland's observations on the response that we have received from Eddie Frizzell.

Caroline Gardner (Audit Scotland): Rather than comment in detail on the response itself, I want to put it in context by saying where we are in the cycle of audit work on further education.

Two things are happening as we speak. The annual deadline for the receipt of audited accounts for FE colleges is 31 December, so we have just got in the audited accounts for all the colleges. It is likely that the committee will receive section 22 reports on at least one college in the next three or four weeks as we consider the accounts and examine the issues that they throw up. Inverness College is obviously a strong candidate for a section 22 report, given what the committee has been told by the Executive, although I must stress that that is based on unaudited information, as we have only just received the audited accounts.

You asked us for an update on the Scottish Further and Higher Education Funding Council's progress on the committee's earlier recommendations relating to the sector. That update is being finalised as we speak and is due to go to the printer this week. We expect it to be published before the end of January. It might be worth seeing both sets of information before members decide how they want to follow up the issues that they have identified today from the department's response.

The Convener: That is helpful. From the unaudited information that you have received from West Lothian College, is there any indication that it is a candidate for a section 22 report?

Caroline Gardner: I cannot comment on that at the moment. All that I can say is that that college's position in respect of the PFI contract has not yet been resolved, as far as we are aware.

The Convener: Thank you.

From what members have said, it is clear that there is still a great deal of interest in a number of issues relating to a number of colleges, which we want to follow up. However, further evidence that is pertinent to our deliberations is still to be made available and it would therefore make sense to hold off further consideration until that information is before us. We should not have to hold off much more than a month at most; indeed, perhaps we can consider the information during the meeting on 7 February. Do members agree that such an approach is appropriate?

Members *indicated agreement*.

The Convener: We will defer further discussion until 7 February.

I thank Caroline Gardner and suspend the meeting for a couple of minutes while our next witnesses take their seats.

11:06

Meeting suspended.

11:08

On resuming—

"Overview of the water industry in Scotland"

The Convener: I welcome our witnesses for item 4 and invite Sir Ian Byatt to introduce his team.

Sir Ian Byatt (Water Industry Commission for Scotland): Thank you very much. It is nice to be here.

On my right is Mr Alan Sutherland, who was the water industry commissioner for Scotland until last June. He advised Scottish ministers on Scottish Water price limits. On my left is Katherine Russell, who is the secretary to the new Water Industry Commission for Scotland, which I have the honour and pleasure of chairing. The commission has recently announced price limits for Scottish Water for the next four years.

The Convener: Do you want to make an opening statement?

Sir Ian Byatt: No. We are delighted to be here and will be happy to answer your questions.

The Convener: I invite Professor Alan Alexander to introduce his team.

Professor Alan Alexander (Scottish Water): Good morning. We are grateful to the committee for accommodating us with respect to the timing of the session. For reasons that may emerge, deferring the session to January from December has been helpful.

On my right is Dr Jon Hargreaves, who is the chief executive of Scottish Water, and on my left is Douglas Millican, who is Scottish Water's finance director.

The Convener: Do you require to make an opening statement?

Professor Alexander: No. We are happy to answer questions on the report and our written submission.

The Convener: For the benefit of those who are watching or listening in, let me explain that the purpose of today's evidence session is not so much to hold an inquiry as to gather information for the committee. After today's session, we may request further information once we have deliberated on the answers that we have received, but we are not engaged in a typical committee inquiry that would lead to a report that makes a number of recommendations. The purpose of today's session is simply to explore the issues and to find out more information.

In following up the Auditor General for Scotland's "Overview of the water industry in Scotland", we will focus on Scottish Water's improvements in its performance capacity, its achievement of efficiency savings and the capacity of its investment programme to deliver and meet the demands of new developments. We will also look at the relationships between Scottish Water, the Water Industry Commission, the Competition Commission and the Scottish Executive.

I will start with the first question. Why was there such a wide gap between the £2.3 billion original estimated cost of Scottish Water's capital programme and the £1.8 billion cost target that was set by the water industry commissioner?

Professor Alexander: We need to consider the historical situation, which is that the £2.3 billion was a composite figure that was arrived at by summing the costs of the capital programmes that the former water authorities had set out in 2001-02 before Scottish Water was created. It is fair to say that, at that point, the regulatory process under which we work was in its infancy—it was certainly less mature than it is now. When the water industry commissioner applied to those numbers the methodologies that are in the public domain, he came to the view that the outputs that were required—this is an important point to emphasise—could be delivered much more efficiently than was implied by those costings. That is why the cost target moved from £2.3 billion to £1.8 billion. The key point is that Scottish Water has been operating to that lower number for the delivery of those outputs.

It might be useful if Douglas Millican commented on that in a little more detail.

Douglas Millican (Scottish Water): Essentially, our perspective is that the £2.3 billion figure became history when Scottish Water was created in April 2002. The £1.8 billion target was assumed in the price limits that were set back at the end of 2001, so we have operated to the £1.8 billion target right from the beginning of Scottish Water. We have set up our contracts to ensure that we deliver within that target.

Clearly, some things have changed over time. We have had to meet additional obligations, which have required additional funding. There have also been changes to inflation relative to the assumptions that underpinned the original £1.8 billion target. However, the £1.8 billion—as modified by agreement through the regulatory process—has been the target to which we have worked over the past three and a half years. We will continue to work to that target over the balance of the current regulatory period.

The Convener: Does Sir Ian Byatt wish to add any comments or observations on behalf of the Water Industry Commission?

Sir Ian Byatt: As all those things took place during the period of the water industry commissioner, perhaps the former water industry commissioner can comment.

Alan Sutherland (Water Industry Commission for Scotland): I have nothing to add to what has been said. Professor Alexander has outlined exactly the process that was used at the time. There were large differences between the three authorities and there were differences in the quality of the information available. In addition, the regulatory process at the time was relatively new. The £1.8 billion figure was the best estimate at the time, just as we gave our best estimate for inflation. We underestimated capital inflation and we overestimated inflation as measured by the retail prices index, but we were predicting the future rather than looking back at the past.

Dr Jon Hargreaves (Scottish Water): Given that the sub-context of the question was where the disagreements have been between us, I should point out that neither side has ever disagreed with the £1.8 billion figure. We have all worked towards delivering the outputs for £1.8 billion. We in Scottish Water believe that we will be able to achieve that. It is important to recognise that that continuum started before Scottish Water and has continued right through the process until today.

11:15

Professor Alexander: There has perhaps been a misapprehension that £500 million was somehow cut. It was not. We were told that the commissioner believed that the outputs could be delivered more efficiently. There was no reduction in the outputs; there was simply a reduction in the amount of money that was available to deliver them. That is what efficiency is about.

The Convener: That leads me neatly to my next question, which will test that answer. Is there a risk that, in order to make cost savings and to gain efficiencies, Scottish Water has had to compromise on the technical specifications of capital projects or its performance might fall short of required standards? You suggest that you are meeting the performance targets, but is there concern about technical specifications?

Professor Alexander: I will make a general comment on that and then ask Jon Hargreaves to go into the specifics. It is important that the committee and everyone else realise that the regulatory process makes it impossible for us to make a trade-off between standards and expenditure. Therefore, our programme is directed at improving standards. We have been improving standards throughout the past three and a half years for the price that is specified by the regulatory process.

Dr Hargreaves: In principle, you are absolutely right, convener. If we cut costs without bearing in mind what we are trying to achieve—the realignment of our processes, putting in better information technology systems and managing our data and people better—there is a risk that we end up just chopping costs. Anyone can reduce the costs of a business; there is nothing clever about that. However, reducing costs while demonstrating a continuous improvement in service is the key to improved efficiency. The regulator rightly makes that point on many occasions.

To date, Scottish Water has been very successful in doing that. We have reduced operating costs by £100 million and we will have saved £500 million in efficiencies. We have improved matters on every count. Whether we have improved them as fast as England and Wales have or as fast as people would like is an interesting debate. However, our standards and efficiencies have improved, which tells me, the boss of this business, that we are getting the balance right in how we take costs out.

The accusation that is often thrown at us is that we have made efficiencies by ripping a load of people out of the business. In fact, the highest percentage reduction in costs—as opposed to the highest number of pound notes taken out of the process—has not been in manpower. We have made higher percentage reductions in chemicals and procurement than in the number of people who work for us, although it is true that we have removed many people from the business as we have streamlined our processes, added automation and put in more efficient, less manually intensive plant.

However, there are balances involved. What we are really managing is risk. We are managing the day-to-day risk of thousands of assets, some of which are 150 years old. I see that members are drinking water from a bottle, but the water that they drink from the tap comes from a plant that was built 150 years ago. One could argue that it is probably well past its sell-by date and that we need to replace it. It is still fit for purpose and is still hanging in there, but it is getting tired, as many old assets do.

A balance has to be struck between the risk of non-compliance with all the regulatory policies and keeping charges at an acceptable level for customers. That is where regulation has played a major part in driving the Scottish water industry from being well behind England and Wales—from where I came—to being in the pack. We are not the best, but we are in the pack; we are no longer the lame dog of the industry. That is a huge achievement for those who have been involved in the process.

Professor Alexander: It is worth adding that although, for obvious reasons, the emphasis today is on economic regulation, we have two other regulators—the drinking water quality regulator and the Scottish Environment Protection Agency—who would, frankly, jump all over us if our quality outputs declined because of how we were managing the business economically.

The Convener: Are you saying that the regulators have not jumped all over you?

Professor Alexander: No, although they do when they need to. On all the measures, things are getting better. We are often accused of being the organisation with the most SEPA intervention. We are, because we have the most consents.

Susan Deacon: Following on from the convener's question, I would like to know about how you "take costs out", to use Jon Hargreaves's term. What impact has the pressure to reduce those costs had on design solutions? To what extent are those solutions being standardised to meet your cost pressures? To what extent are bespoke solutions that meet local needs being developed?

Dr Hargreaves: You are right. Taking £500 million out of a capital programme requires us to do things fundamentally differently—we cannot carry on as we did in the past. Historically, in the water industry and, I suspect, in other similar industries, there have been a lot of non-productive building costs. Many people spend their time watching other people do their jobs in case they do not do them properly. That ends up with a bunch of people rushing round with lawyers making claims. The way in which the industry has historically managed its capital investment programme has not been based on trust but has been based on making claims. We design something and ask somebody to build it; he then runs out of money and puts in a claim; we get a lawyer, end up in arbitration and add 10, 15, 20 or 30 per cent to the cost of the concrete that was poured. Our challenge is to avoid that.

I have been in this industry for 30 years, and I know that it is very good at reinventing the wheel. By definition, engineers love doing things differently even though there may have been a perfectly good way of doing it for many years. It gets boring building the same thing again and again. We have standardised where sensible; for example, why change things such as the control panels that manage the processes? They are doing the same thing—managing electricity, air and flow movement through concrete—so why have different ones? Standardising means that we get the best price because we are buying 1,000 of them.

We have built 80 new package plants for drinking water in north Scotland. Those plants are membranes that are built in a factory and are connected to the supply in the click of a finger. If they are to be used on remote islands, they are dropped in by helicopter. They are built in a factory and are standardised to meet regulations, which are driven by European legislation that has passed into law in this country, sometimes through Westminster but increasingly through the Scottish Parliament. The technologies that we apply have to meet those standards.

I believe that, in saving money in that way, we are also building better assets for the future. They will be easier to maintain and will be more cost effective. If there are 50 plants and each one is different, spare parts have to be carried for each. If there are 50 identical plants, we need carry only a quarter of the spare parts. It is similar to car manufacturers using the same basis for their operations. We have had many debates about specific issues such as odour at sewage works, but the technology for that is not standardised. As yet, nobody in the industry has a standard solution for managing odour. As every sewage works smells, solutions end up being more bespoke. In that case, we need to apply clever engineering and technologies, such as process engineering.

We have to do our studies carefully because we can waste huge amounts of money building inappropriate technologies. We are always looking at standardising, and we will do it where we can: where it needs to be different, it will be. In the past, we would have said, “We will just build it differently because that makes it really interesting.” That is a pessimistic view, but that is what we have inherited. I could take you to plants in Scotland that are 4 miles down the road from another plant doing the same job with the same water using completely different technology. Historically, that is how it was done. I am not criticising the people of the past, but that was not efficient.

Susan Deacon: When it is considered that a bespoke solution may be required in a given area, how is that factored into the financial discussion and what priority is it given?

Dr Hargreaves: The gentlemen from the Water Industry Commission could probably explain that better than I can. I know from when I managed a company down south that a widely used phrase is that we tend to deal with such matters “in the round.” The programme that we have been discussing with the regulators involves thousands of projects. We are not dealing with one huge project—dare I say it, we are not building a Holyrood—rather, we are dealing with thousands of projects, the costs of which range from £10,000 to £120 million. The projects are being done to legal deadlines that are determined by the regulations with which we must comply. Therefore, our processes and systems must be aligned to deal with the bigger, the large and the small.

In an ideal world, before we have a discussion about financial matters with the gentlemen from the WIC, we should have a pretty good idea about what technical solution we need for each particular issue. One point that we are learning in Scotland is that we need to get ahead of that game. Earlier in quality and standards II—the period that we are in at the moment—because Scotland was not used to the regulatory process, people drifted into it. We were not specific about the technologies and we assumed certain things and priced them up.

We have replaced 3,000km of water mains in Scotland. We needed to give only three different prices for that—for mains that go through a highway in the middle of big cities such as Edinburgh, for those in small towns and for those in rural areas. By and large, we can standardise the prices, after which it is up to us to deliver the improvements with those standard prices. The regulatory process recognises that we use averages. However, with projects such as the one that we are considering to replace the 150-year-old plant in Edinburgh, to persuade the guys from the WIC to allow us to spend money on that, we must first demonstrate need and secondly that the technical solution will be cost effective over the life of the plant. Given that the plant is to last say 60 years, we compare one technology with another by calculating the net present value of their capital and operating costs. We need a bespoke solution, because we are not building other big plants like that in Scotland.

We are going to build another 120 little membrane plants in the north of Scotland. In that case, I just put in a standard cost, because I have an idea that it will be between £0.5 million and £2 million and I know enough about the ground that we operate in to be able to take a view on the costs, so I can give an average. The regulator will then rightly challenge us and say, “You guys can do this a bit cheaper. You can standardise the process even more and put more pressure on your suppliers, so we will give you only £400,000 instead of £0.5 million.” That is how the regulatory tension benefits customers. If it was left to the engineers in the business, they would always build the £0.5 million plant—that is life. Regulation constantly challenges that and pushes back the frontiers.

If the regulator pushes us too hard in one direction and we do not think that we can build the assets for a certain sum, in today’s world—although it was not like this before—we can go to the Competition Commission to say that we do not agree with the regulator’s challenge. Earlier in the Q and S II period, because Mr Sutherland was advising ministers, we went to the minister to say that we thought that Mr Sutherland had got some matters wrong. The minister had the role that the Competition Commission now has.

Susan Deacon: I have a final question on that issue. I would be happy if Sir Ian wanted to comment on the matter, too. I am awfully glad that Dr Hargreaves mentioned the issue of odour from waste water treatment plants.

Professor Alexander: We thought that we would get our retaliation in first.

Susan Deacon: No one was happier than I was when the minister stood up in February last year and confirmed that action was to be taken on odour from 35 waste water treatment plants throughout Scotland. Let us take that as a specific example. I presume that the figure of 35 could have been higher or lower. It might have been 10, but with greater investment in more bespoke solutions for specific plants. How was the figure of 35 reached? How is the balancing act achieved between a standard approach and more bespoke and, almost by definition, more costly local solutions?

11:30

Dr Hargreaves: How did we arrive at the figure of 35? The answer is that it is a balance. Given what goes to sewage works, one does not have to be a genius to work out that they smell. Every sewage works smells and we have 2,000 of them. Some of them, like Seafield, are big and are located near a lot of people. They are a terrible inconvenience to the people who live nearby. Historically, the industry said, “Well, you shouldn’t have built your houses so close. You’ll get used to it.” That was the attitude for many years. To be fair to the industry, a lot of sewage works were built away from houses but subsequent planning decisions allowed people to build houses next to them. We deal with that problem on a daily basis and it is equally wrong, in my opinion.

As far as the decision to take action on 35 waste water treatment works is concerned, it was a question of getting the right balance and considering those works about which we receive a lot of serious complaints. The Scottish Executive held a consultation and the Deputy Minister for Environment and Rural Development stated the objectives. The figure could have been 100 or 200, but the decision to take action on 35 works represents a balance and it takes into account the amount of money that can be afforded to deal with the very difficult ones. That is where we are at the moment.

As you know, the new code will come into practice in the not-too-distant future and we are responding to that. When the code is in place, we will need significantly more money to deal with odour at sewage works. We will need to have a discussion with the regulator about that.

Sir Ian Byatt: I have little to add. Jon Hargreaves and the others from Scottish Water described the situation well. The matter started with the minister deciding how many objectives were needed and what they should be. In the case of odour, the question whether action should be taken on 35, 36 or 236 waste water treatment works is a matter for the Scottish Executive. It will make a decision based on advice from Scottish Water on the possible costs. It may well ask the Water Industry Commission for advice as well.

On the point about how much these things cost and how efficient companies can be, Jon Hargreaves is correct to point out that it is right to deal in averages and that there will be some dispersion around the average. He explained how he arrived at his averages and he distinguished between the replacement of pipes in rural areas and the replacement of pipes in the middle of Edinburgh. Our job is to examine the different averages and consider whether they are sensible. We do that primarily by benchmarking against what is going on in England and Wales. In England and Wales there is a combination of bespoke solutions and standard solutions and a combination of pipe replacement in rural areas and pipe replacement in urban areas.

We are not saying that Scottish Water could do things particularly differently. We are saying that we observe that other water companies are doing the same job but doing it perhaps more efficiently and more cheaply. We challenge Scottish Water to do that and we will set the price limits on the basis of what we think an efficient firm could do. That is our statutory duty. We are here to set the price limits on the basis of the lowest reasonable cost of achieving ministerial objectives and, of course, of providing good service to customers.

Douglas Millican: I have a minor point of clarification. It is clear that the ministerial objectives state that action will be taken on a minimum of 35 works. It is recognised that, when the code of practice is implemented, more extensive work might be required, so the figure of 35 was set very much as the minimum.

Sir Ian Byatt: Should the ministerial objectives change for one reason or another, the Water Industry Commission can put into operation the system of interim adjustments to the price limits. If Scotland wants better water in one way or another—even to provide proper water to the Scottish Parliament—there is a process by which the commission can consider the costs of that and adjust the price limits. The system is quite flexible.

The Convener: We will now move our questions away from the capital spend.

Mrs Mulligan: Dr Hargreaves indicated that savings on staff costs are not the biggest element of total savings, although obviously they represent a sizeable proportion. What is the impact on customers from the significant reduction in staff numbers?

Professor Alexander: The general answer is the one that I gave earlier, which is that our customer service standards across the board have increased at the same time as staffing numbers have been reduced. It is important to say that the effect of economic regulation was to make it essential for us to look at everything we did and at the way in which we did it to see whether things could be done more efficiently. Where we found that we could do things more efficiently while also improving standards, we went ahead. It is also important to say that the regulatory settlement for 2002-06 included the substantial sum of £200 million for spend-to-save projects. That money allowed us to invest in a voluntary severance scheme under which people could exit the business at a time that was suitable to them and the business. I reiterate a point that I made earlier, which is that we cannot make a trade-off between standards and expenditure. We need to ensure that we have the people in place to deliver customer standards to the level that the regulators specify.

Dr Hargreaves: Two issues are involved: perception and reality. I have just about completed my second round of all the councils. It takes about a year to do that, given that there are 32 of them and each one wants a big chunk of my time. Part of my job is to go around the country and talk to them.

The perception in some parts of Scotland is that, because we closed 50 depots, people cannot do what they used to do, which was to nip into the depot, have a chat with the bloke there and get him to fix something. People cannot do that any more; they have to go through a proper process in which they ring up and get the job costed, after which we manage and do it properly. Some people see that as a deterioration in service.

The reality is different. We know that that is the case because our service standard is measured every second of the day. The committee would not believe the amount of data that we provide. I am told by my staff that we provide the regulators in Scotland with something like 80 million pieces of data each year. With well over 100 people being involved in regulating the water industry on a daily basis, there is an argument that if we did our job properly, all of them would be out of a job. However, people should not hold their breath on that one; nobody is perfect.

As I said, the perception is that the local service has deteriorated, but you only have to look at the quality of drinking water, at the amount of sewage that we remove and treat to a higher standard and at the speed of our telephone answering to see that that is not the case. Far from cutting back, in some areas we have invested huge sums. One of the reasons why the number of customer complaints has risen is that we now have more telephones with people on the end of them. Our customers can ring us up and have their query answered. Previously, we did not receive a lot of complaints from people in some parts of the country because it was difficult for them to make a complaint. Now it is very easy for them to do so.

I am satisfied, but we are nowhere near there. The biggest challenge for Scottish Water is a question not of assets but of culture. We need people to understand that our customers and not the technology come first. Our customers pay our wages; we are in business only because we have them. Our major challenge is to get that message across, particularly given where we have come from. At some times and on some days we do terrible things to our customers. I am the first to stick my hand up and apologise for that.

I have a little device in my pocket—it is switched off at the moment, convener—that tells me when and where a burst mains has occurred in Scotland. My wife nearly threw it in the bin on new year’s day because it went off 23 times. That means that there were 23 incidents on new year’s day in which teams of our people were out fixing things for our customers—the guys fixed them so quickly that in only three incidents did our customers know that there was a problem. Although we do a fantastic job, sometimes we get it horribly wrong.

We aspire to be the best in the industry at customer service. Some people think that we are arrogant in having that aspiration. However, because of who and where we are and because of our ownership model, I think that we should aspire to that. For me, there is no reason for being in the job other than to do it best for our customers.

Building assets turns some people on, but it certainly does not turn us on. The cultural shift is the big challenge. In the first three or four years of Scottish Water, we have made huge progress. The next four years are about the cultural shift. These guys in the commission are setting us further tough efficiency targets for the next period. It is not about getting rid of loads of people—we cannot do that. We must drive out inefficiency. For example, when a customer calls us, we should answer his or her query then and there and kill the problem or, if we must go out, we should make just one journey. Historically, we have gone out and then sent somebody else. MSPs will know the stories, because you receive the complaints, too. We make a meal of such matters, which costs money. That has never been seen to cost money, but it costs millions of pounds. Getting it right first time for customers is the focus of the business.

Professor Alexander: I will give you one high-level number that reveals how we have tried to ensure that our customers know us. We participate quarterly in an omnibus consumer survey—we piggyback a couple of our questions on a general survey. When we opened for business on 1 April 2002, 32 per cent of our customers could name who provided their water. That figure is now 65 per cent. We do not have a direct billing relationship with our domestic customers, so the situation is quite difficult for us, but we have put a lot of effort into ensuring that people know who provides the service. That is a way of informing them about whom they should complain to if things go wrong.

Mrs Mulligan: Before I ask Sir Ian to comment on staffing, I will ask about the fact that Scottish Water has already reduced its staffing levels. I recognise that technology is very important in your industry, but so are the staff who deliver the service. Are you confident that you have the necessary skills across the board to respond to the customer needs that you have identified?

Dr Hargreaves: That is a very good question. We are considering a further restructuring in Scottish Water, not for the sake of restructuring, but to do exactly what you just described. We have people who live on the west coast—never mind the islands—who get up in the morning and who get into a vehicle that has a computer, so they need not go to a depot, as all the information is passed to them remotely through the air. They go and do their job. At one point in a day, such a person will be walking up a hill with a barrel of chloros on his shoulders and will add that chlorine to the most basic treatment that we have inherited, which is basically a sieve to keep the fish out and chlorine to kill the bugs. There is no other treatment, so when it rains, the water goes as brown as chocolate and people cannot see their legs in the bath, as we say. The test of when we are succeeding will be passed when those people can see their legs in the bath. Some customers do not like that, by the way.

That person will then drive another 40 miles and end up dealing with some of the most advanced technology in the water industry. We have guys who were brought up to carry chloros, such as big Willie, whom I heard of when I was on Skye recently. He had just retired and I asked what the problem was. I was told that big Willie was an ex-commando who could carry two 50kg chloros drums on his shoulders, but now that he had retired, we needed two people to do his job, because the guys are not strong enough to carry the drums. That is how basic some of the work is.

The skill mix going forward is critical. We have spent a huge amount of time, energy and money on retraining. Sometimes, we must just accept that guys and girls cannot do the new job, so we have to find sensible and humane ways of letting them leave the business or find them a new job and bring in new people with new skills. We are constantly doing that.

Believe it or not, although we have taken more than 2,500 people out of the business, we have also recruited new graduates and we have one of the best apprentice schemes in Scotland. One reason why we created Scottish Water Solutions, which is the joint venture, was to establish proper training for the construction industry. We represent 40 per cent of the construction industry. We are putting much back into skills. However, you are right: if we get the skills balance wrong, we will not manage the new technologies properly and services will deteriorate.

11:45

Mrs Mulligan: Does Sir Ian want to add anything?

Sir Ian Byatt: Yes. Customer service in Scotland is not yet as good as it should be, but it has improved considerably as a result of the measures that we use. In the price determinations that we issued on St Andrew’s day, we allowed for money to improve that customer service.

However, we are concerned with outcomes, not with how those outcomes are achieved. We believe that Scottish Water can produce better customer service, as Jon Hargreaves has said that it can, and we look to other places in order to benchmark what it would cost to produce better customer service. The mechanics of producing better customer service, the extent to which technology and manpower are used and the training of manpower are matters for Scottish Water to deal with, using its business skills. It would be wrong for the Water Industry Commission for Scotland to try to second-guess what Scottish Water is trying to do or is doing.

Professor Alexander: In its final determination, the commission used a phrase that resonates with us. I think that that phrase was “a determined management”—Sir Ian will confirm whether that was the phrase that was used. The management must be determined to deliver a quality service to its customers within the costs that it is permitted to incur. Sir Ian is absolutely right—delivering that service within those costs is our responsibility. If it is not, why does Scottish Water’s management exist? We need to deliver that service within the constraints that I have described.

Mrs Mulligan: What has been said is helpful in considering the efficiency savings that Scottish Water has been asked to make. Staffing reductions represent one efficiency saving and others have been referred to. Do you want to add anything significant about efficiency savings that you have been asked to make in operating costs and expenditure?

Professor Alexander: I would like to reiterate something that I have said to other parliamentary committees—we have a kind of season ticket and we tick off committees as we go. In supporting the economic regulation process, I have said that Scotland has chosen to have a public sector water industry, but there is no justification for the people of Scotland having to pay more for their water and waste water services as a result of that choice. That is why economic regulation is so important to Scottish Water and—much more important than that—to the people who pay all our wages, whom Jon Hargreaves mentioned. It is extremely important to remember that the industry is a public sector industry, but we try to operate within the disciplines and constraints that have been successful in transforming the industry south of the border. Sir Ian knows more about that than anybody.

Mrs Mulligan: Finally, where are the particular challenges in continuing to make efficiency savings?

Professor Alexander: It is difficult to answer that question at the moment. One reason why our answer to question 3 on the committee's list of questions to us was general rather than specific is that my board has not yet determined whether it feels that we can deliver what ministers want within the limits that the commission has set—it has said that it will make a decision in two weeks' time. However things turn out, the challenges will be to deliver the capital programme as efficiently as possible and to continue to bear down as we have done over the past three and a half years. We have taken £100 million out of the operating costs. The challenges and general pressures on us will not change. The third leg of the stool—although I should not use that word in this context—is ensuring that customer standards continue to improve. I hope that the committee will not press us to be more specific than that. Ask us back later if you want us to be more specific.

The Convener: The point is understood.

Mr Welsh: I have a question for Sir Ian. Which English water companies are the most appropriate benchmarks for Scottish Water?

Sir Ian Byatt: One should not think of the process as one of simply identifying particular companies, although we do that. We try to identify where a company should be and allow for the time that it will take for the company to get there. Analyses are done, often by the Office of Water Services but also by the Water Industry Commission for Scotland, of the position of water companies in England and Wales in relation to what one might call best performance. I am afraid that I cannot tell you the names of the companies that are the best performers. However, over Christmas I looked at the latest Ofwat report, and I have a feeling that Yorkshire Water is the best performer on sewerage and water.

There are frontier companies. When setting price limits, it is reasonable to say that not everyone can be at the frontier at a particular time and that there is a catch-up process. That process takes account of where the other companies are—we look both at the frontier and where other people are. We then look at where Scottish Water is in relation to that picture and how quickly it can catch up. The document that we published on St Andrew's day indicates the rate of catch-up in different areas in relation to the frontier. The process is slightly more sophisticated than our asking what the appropriate comparators are.

There are other important ways of approaching the issue. For example, if you look out of the window, you will see that Scotland is a hilly place, which can affect costs. However, there are hilly parts of England, such as Cornwall, and hilly parts of Wales. The population of Scotland is quite densely concentrated around the central belt, but there are areas of very sparse population. There are similar circumstances in England and Wales.

We allow not only for the costs of the various companies, but for the circumstances in which they are operating. That is done in part by econometric techniques, which I will not go into in detail, and in part by considering whether there are special factors. Ofwat identifies special factors for a number of companies. The question is, what are the special factors in Scotland? We do not always agree entirely with Scottish Water on the scope of those factors, but we recognise that they exist. Scottish Water thinks that the special factors account for rather more money than we think they account for, but that is part of the natural process of analysis, discussion and disagreement. Decisions then have to be made. We have made our decisions and, as members have heard, Scottish Water will make its decisions shortly.

Mr Welsh: In any catching-up process and in the operation of Scottish Water, benchmarks will be important. They will be used and quoted to judge the success or failure of Scottish Water and the relative advances that it has made. I ask you again what the benchmarks are. Perhaps you can give us the information in writing. There must be some indication from the English experience—on which Scotland is supposed to be catching up—of what the benchmarks will be, because it is on the basis of those criteria that some sort of judgment will be made about success or failure.

Sir Ian Byatt: I will give a quick answer and ask Alan Sutherland to fill in the details. Of course benchmarks will be used—they are critical. However, having benchmarks does not mean referring to a particular company—it means having a system of analysis. When benchmarks are used in the price determination system to identify the lowest reasonable cost and that cost is set, we can see whether Scottish Water is outperforming expectations, as it has outperformed the expectations of operating costs that were set for the period 2002 to 2006. Alan Sutherland can provide more specific information on benchmarks.

Alan Sutherland: It is worth differentiating between the process that we had to follow when advising ministers in 2000-01 and the process that we followed when making our determination. As has been noted, the regulatory process was pretty immature in 2000-01. It was less than two years old when our advice was submitted. During the initial phase, we did not have the quality of information to allow us to make robust adjustments for all the special factors that were likely to affect the operation of the water industry in Scotland. We did not know then all the things that we know now. The information was not available.

We therefore compared our costs with those being incurred by companies that seemed to have geographies and demographic and social breakdowns that were similar to those in Scotland—or, to be more specific, similar to those in the three water authority areas that existed in Scotland at the time. The comparator companies that we used for each of the three water authorities were different. If I remember correctly, the main companies that we used as comparators in 2001 were South West Water, Northumbrian Water and Welsh Water.

In the latest considerations of relative efficiencies, we have made comparisons with the frontier companies for water and sewerage in England and Wales, based on the Ofwat assessment of performance south of the border. We use a series of econometric models that take into account average values across the UK for geography, asset mix, population and so on. The resulting equations and formulae will give different costs for different companies in England and Wales. To the extent that the special factors affecting Scottish Water are not taken into account by the models—or to the extent that the values for Scottish Water are different from the average values across the UK—Scottish Water can make claims. In our analysis, we took a number of such claims into account, and we actually added something that Scottish Water did not originally ask for. We calculated efficiencies on that basis.

Scottish Water's efficiency position will change as the organisation improves. We have made assumptions about the improvements in performance that Wessex Water on the water side and Yorkshire Water on the waste side should make over the next four years. South of the border, the regulator and the providers of capital clearly expect companies to do better than Ofwat has challenged them to do, and the early results show that they are indeed doing better. The frontier position will therefore have moved forwards again by the time we next set the benchmarks. It may well be that Wessex Water and Yorkshire Water are no longer in the lead, but another couple of companies. Remember that Yorkshire Water was not exactly in the lead 10 years ago.

Mr Welsh: The issue is complex. You are talking about economic models, asset mix, population and so on. Would you write to us with more information on exactly what formulae and models have been used for which companies? The benchmarks used will be important for future decisions about Scottish Water.

Sir Ian Byatt: Perhaps we could refer you to the relevant documentation that was provided for the review process. We will happily send that to you.

Mr Welsh: Thank you. You will agree that comparisons should be fair to Scotland. We should not use unfair or punitive benchmarks. It is important to get things right and to give Scottish Water a fair wind that will allow it to make progress.

Sir Ian Byatt: We want Scottish Water to win. I want Scottish Water to be better than any water company anywhere in the world. It is not a question of being punitive; that would be a foolish way of regulating. Regulators should encourage, but they should be reasonably strict in their encouragement.

Mr Welsh: An important difference between the companies in Scotland and the companies in England and Wales is that the latter had their debts written off before they became companies. Will that feature in your model?

12:00

Sir Ian Byatt: The question of the starting capital value—which is where that becomes relevant—has been properly adjusted for. It enters into the issue of prices and affects the finances of Scottish Water. Otherwise, the level of debt does not affect the comparisons of capital cost, operating cost, customer service and so on. It affects only the starting point. Again, we can send you the reference to the particular part of the documentation.

Douglas Millican: That is one of the easier aspects of the determination for us to assess. Effectively, the debt that Scottish Water inherited from the water authorities is debt at fixed interest rates and the commission has funded in full the obligations to service that debt.

Dr Hargreaves: The issue of debt is more to do with the impact on prices. When the three water authorities were created from the councils, significant amounts of debt were written off, which is often not recorded by the councils. As Ian Byatt will remember, that happened in England and Wales when the authorities were formed in 1974. Big chunks of debt were written off, although some of the companies in England and Wales that were privatised did not have all their debt written off. The impact of debt is not so much on the comparison of efficiency but on the ultimate price of water to customers. Writing off debt is a political decision. We would be delighted if ministers wanted to write off £2 billion of our debt and I am sure that the regulator would not object to that. There might be a better use of taxpayers' money than writing off our debt, of course, but that is a political rather than a regulatory decision or a decision for us.

Mr Welsh: Why was there an efficiency gap between Scottish Water and English water companies?

Dr Hargreaves: I have the privilege of having worked in both systems. I worked in England and Wales pre-privatisation and post-privatisation and have worked in Scotland since 2001. The answer to your question is simple. The water industry in England and Wales was turned into 12 water authorities in 1974. While those organisations were still funded from Government borrowing, they were set up to operate outside the council regime. Until recently in Scotland, councillors were having to make difficult decisions between building a school and building a water treatment plant, between employing some more water workers or employing social workers, between building a hospital and building a waste water treatment plant and so on. I do not have to tell you that there are not many votes in sewerage works and that there are many in hospitals. Historically, the assets in England and Wales were developed from a much earlier stage than were the assets in Scotland, and those 12 water authorities managed the whole water cycle and were set up quite specifically to do that. In Scotland, that was part of council activity until 1996.

I come from the north-east of England. We spent—in today's money—around £1.5 billion on a world-class sewerage system for Newcastle that was funded from customer charges and Government borrowing. At the same time, there was a similar need for such a system in Glasgow but, for reasons that I do not understand, the work was not done.

A lot of infrastructure was put in place in England and Wales during that period. The Thames ring main that goes all the way around London was started and almost completed in that period.

Two fundamental things happened after privatisation in 1989. Aside from the sale of assets to shareholders, there were some massive changes in management in the water industry and regulation was invented. Regulation removed any excuse for saying that the situation in one area was different from that in another. The greatest excuse that we were able to use when one authority was compared with another during the time of the old authorities was to say, "It's different in Northumbria than it is in Wessex because we've got hills and they haven't." Many such excuses were invented and I hear some of them resonate in Scotland at the moment. However, regulation removes the ability to make such excuses because it creates a level playing field, which means that the issue is about how good the management is and how much money is being invested in the assets.

One of the reasons why England and Wales are where they are today is that they have spent £52 billion and are about to spend another £20 billion on building new water assets. That has been funded privately by banks rather than by the Government and it has had a massive impact on the quality and levels of service that those water companies supply to their customers and on their ability to be efficient. Add to that the fact that some tough management decisions have had to be made about the people who run the industry because shareholders have invested their money and they want a return on it. If the management does not deliver the dividends, it will get the chop.

None of that happened in Scotland until fairly recently. When the three water authorities were created in 1996, at least Scotland started to get some consolidation among water bodies. Although they made huge progress, what they did is often forgotten. A lot of money was invested and Scotland did something that England and Wales have still not done, which is PFI. There are nine big PFI contracts in Scotland and I was on the other side of the table when we bid for those. They were the most competitive water assets in the UK at the time. If I had put Northumbrian Water's capital programme through the same process, we would have saved hundreds of millions of pounds, but for reasons that I cannot really remember, that did not happen.

So there was an interesting evolution in Scotland with PFI driving huge value and providing money to build assets such as Seafield. At the same time, those organisations were starting to address levels of service, measure things, collect data and become more efficient. They did become more efficient. Then regulation, which was a ministerial decision that MSPs voted for, started to bite. Proper regulation was applied to the public sector for the first time anywhere in the world to my knowledge, although perhaps Ian Byatt is more widely travelled than I am. What you have created in Scotland is unique—privatised regulation is not applied in exactly the same way to a public body anywhere else. That is the change in Scotland.

What we have done in the first four years is to close the gap to a huge extent. In fact, we have overtaken some of the companies down south in efficiency—not in all but in some areas—although we still have a long way to go in other areas. I hope that that answers the question about how we got to where we are.

Professor Alexander: In a previous existence, Andrew Welsh and I were attached to local government in various ways. At that time, as he will remember, I was a great proselytiser for the all-purpose local authority. I find myself in a position of some apostasy in this matter because Jon Hargreaves is right—the water industry was the poor relation of the multipurpose authority for the reasons that he gave.

I add one point to the account that Jon Hargreaves gave about how we got to where we are with Scottish Water. Alan Sutherland will correct me if I get the dates wrong, but I think that it was at the back end of 2000 that the commissioner and the three water authorities jointly commissioned what we described as a quick and dirty consultancy. The brief was to find out how much the water industry in Scotland could save if the three authorities co-operated. The numbers came back and showed a range from a pessimistic £200 million to an optimistic £450 million over a four-year period. Nobody can ignore those possible savings.

Over the Christmas and new year holidays of 2000-01, I came to the conclusion that it was impossible to gain that efficiency as long as we continued to have three separate organisations. A hell of a lot of those potential savings would leak away through the cracks between the three authorities. Fortunately, most people in the industry came to the same conclusion and Scottish ministers took a quick decision to act. Efficiency leaks away in an industry such as this when there are too many institutions working in it.

There are some interesting figures for the capital spend during the regional council years, the water authority years and under Scottish Water as a regulated business—the graph shows an exponential increase. Given my background, I cannot separate that from a judgment about the structure of the industry.

Mr Welsh: You have given a broad overview and described a period of dramatic change. I will ask a specific question about one aspect of level playing fields in pricing. We see from evidence that was given to the Finance Committee in December last year that revenue targets in the strategic review were set on the basis of the desirability of bringing interest cover ratio up to 1 in Scotland. How was the interest cover ratio calculated for Scotland?

Professor Alexander: That one is yours, Alan.

Mr Welsh: I warned you that it was very specific.

Sir Ian Byatt: I want to be sure what you are asking. Are you asking what interest cover was calculated in the final determinations that were issued by the Water Industry Commission for Scotland on St Andrew’s day?

Mr Welsh: Yes.

Sir Ian Byatt: Your question is about the final decision and how the financial indicators looked at that time.

Mr Welsh: Yes. Was the formula based on Ofwat’s approach? For example, was the formula revenue minus operating expenditure divided by interest? I am talking specifically about the interest cover ratio.

Alan Sutherland: You are talking about 2001.

Mr Welsh: Yes.

Sir Ian Byatt: I wanted to be clear about what we are talking about.

The Convener: We are already considerably over time. Given the specific nature of that question—and in the interests of watching the clock—I would be happy to receive an answer in writing.

Mr Welsh: Perhaps I could speed up the process. Was the calculation done as I described or was it done by calculating revenue minus operating expenditure minus investment plus interest over interest? If the second method was used, that would have produced a vastly different result in Scotland in order to achieve a ratio of 1.

Alan Sutherland: We gave extensive evidence to the Finance Committee, in which it was explained that the ratio that was quoted in the advice at that time was a simplification of the techniques that had been used. We used two techniques that had been used in England and Wales. In hindsight, we probably made the mistake of trying to simplify to too great an extent the technique that was used.

Sir Ian Byatt: It is easy to get hung up on specific figures and the convener is right to say that time presses. We should consider water companies in the context of the kind of risks that water companies have, examine a situation in which water companies are regulated under a similar regime and apply a comparable system of financial discipline to the borrowing. The particular figures will come out at different times in different places.

Mr Welsh: My purpose was to get clarification. I would appreciate clarification in writing. My question was on a major point and I seek the truth of the matter.

The Convener: We can deal with that point in writing.

Margaret Jamieson: My question is addressed primarily to Jon Hargreaves. He said previously that he had just completed his recent round of visits to all 32 councils in Scotland. I hope that during those talks he discussed with the councils the current capital programme and how it would meet the needs that have been identified by the local authorities for the planned new developments within their community plans. How does Scottish Water influence the community plan? My experience—it has not always been a nice experience—is that Scottish Water has ignored local authorities' strategic plans and local plans. It has waited until there has been a development by either a private developer or a public developer and has made an objection when the planning application was lodged. Could you update us?

Dr Hargreaves: I am amazed that we have got this far in the discussion without development constraints being raised.

Margaret Jamieson: I was waiting patiently to ask the question.

Dr Hargreaves: You are absolutely right that development constraint is the hot topic. The letters started to come in on the issue when I had been in the job for two days.

I will give the committee a little bit of background. The first question that the convener asked when the current investment programme, Q and S II, was agreed was how we got from £2.3 billion down to £1.8 billion. Ministers were faced at that time with three programmes. One was costed at £3.2 billion, one at £2.3 billion and one at £1.7 billion. The programmes did different things for Scotland and had different impacts on prices. Sitting in the £3.2 billion was about £200 million for the removal of development constraints, principally in the west of Scotland, where the big issue existed. Some money—about £20 million—was invested in the east of Scotland.

When ministers chose the central £2.3 billion option, they said rightly that the water industry should spend the money on tackling public health issues, which should have primacy. We agreed with that—by the way, so did Parliament—but because of the industry's history, we entered the current investment period with no money worth talking about for spending on the removal of development constraints. However, we need to be clear that Scottish Water has an obligation to deal with those matters rather than the planning issues, which I will come to in a minute.

Historically, Scottish Water has paid developers £2,000 a house to build houses. In the world that I come from, that seems a bit crazy. In Edinburgh, developers have been building houses that sell for £0.5 million and we have been giving developers money for building them. That situation seemed slightly off the pace and, over the period, it has cost the water industry and my customers about £50 million. That is a lot of money.

12:15

That whole debate has been taking place during the Q and S III period. That is why we are where we are today, with ministers now recognising that the situation needs to be fixed. For that reason, our programme contains roughly £150 million to fix strategic assets such as water and waste-water treatment plants, but the onus is now on developers to contribute to paying for provision of other things, such as the size of the pipes and the local network. In many ways, that simply mirrors what happens in England and Wales.

The fascinating thing for me was that, as a result of the debate, it was discovered that we had been sitting on a ticking time bomb for many years. I was a bit surprised that the problem had never emerged before, but I now know why. The reason is that, when the water industry was under the control of the councils and water authorities, the local guys would just say, "Yeah, you can connect some more houses to the water supply. It doesn't matter if stuff ends up being lobbed into the river when it rains." Overflow would simply go into the local river or into the sea. However, under new legislation, SEPA started to say, "Hang on a minute, you cannot put that in the river as that will cause the water quality to deteriorate." I make no criticism of SEPA for saying that, but the two issues started to come together.

When many of our assets were built in the 1950s and 1960s—those that were not built then were constructed by the Victorians 150 years ago—an average 20 per cent additional capacity was built into the size of the pipe or treatment plant. In the years since then, we used up that headroom, but nobody noticed. We need to wait in 8,000 communities in Scotland before we can connect new developments because we would end up acting illegally by polluting their watercourses.

Ministers have accepted that and we have widely discussed the issues with councils. Margaret Jamieson is right to ask about development constraints, which have been the first, second or third item in each of the 32 meetings with councils. Ministers agreed that we should fix the problems over eight years. Our investment programme is in two lots of four years, so we need to decide what we will fix in the first four years and which councils will get their problems fixed over the next eight years. Therein lies the challenge. Guess what? They all want the constraints to be fixed yesterday, but we cannot do that. Huge sums of money are involved not only for us but for the construction industry and developers.

At the moment, having received from the councils their prioritised lists of projects based on their structure plans and community plans, we are trying to map those against all the other things that we need to do over the four-year and eight-year periods. We will soon respond to councils on when we can carry out their projects. I have no doubt that we will be subjected to a lot of local pressure to get certain projects completed early, but the bottom line is that, if we are to get the work done, some projects will take priority. In some places that will not be a problem; for example, in some of the big planned developments in Glasgow, the enabling work needs to be done in the next four or five years, but developers will not start building houses until 2010-11. That is what is in the plan, so we can fit in with that.

I am pretty optimistic—perhaps overoptimistic—that we will be able to work our way through problems, but I am also acutely aware of the huge political pressure that exists. However, what often happens—this really annoys the councils, which is not surprising—is that developments take place outside the community or structure plans. The plans need to be able to change and some structure plans are already out of date. Just a few days before Christmas, I was sitting with a developer whose client wants 2 million square metres of storage space on the M8 corridor. It is no use our telling him that we have capacity available in Dundee, because he is not interested in Dundee. He wants to put the facility either in Manchester or on the M8, but such a development is not in the structure plan. Therefore, we need flexibility in the plans. That is what we are doing with the councils.

Ministers have promised us that all the development constraints will be removed from Scotland over the eight-year period. That move will be funded through the process that Sir Ian described. We have estimated the number of properties that we will service in both four-year periods, but that estimate might or might not be right. None of us is clever enough to predict the demand for housing and industrial land.

As for the other part of the question, Scottish Water has a mixed pattern of intervention in planning in Scotland, because we are not statutory consultees in the normal sense. Some councils invite us to take part in proceedings, but others do not. At this point, I should put my hands up and admit that, historically, we have not been brilliant at responding. We must get a lot better in that respect.

That said, we cannot sit on every community council planning group, because we simply do not have enough people and, indeed, we should not do so. Despite certain attempts to put it in such a position, Scottish Water will not become the planning authority for Scotland because that would be totally wrong, but we must be able to respond. Each year, ministers ask us to publish a plan of capacity for Scotland. My goal is that, in two years, the plan will be web-enabled to ensure that any developer, councillor or individual who accesses the website will know whether they can connect to the system in a particular town, village or hamlet. There will be a huge amount of data to put on a computer system, but that is the point that we have to reach. I hope that that answers the question. I am happy to provide more information in writing.

Margaret Jamieson: Are you satisfied that, with its four-year plan, Scottish Water will be able to meet the demands of developments that will be necessary for Scotland's future?

Sir Ian Byatt: Jon Hargreaves has just made some very important points, particularly with respect to financial arrangements. We are satisfied that our price limits allow a substantial amount of additional housing to be built; indeed, the limits allow for the construction of an additional 15,000 houses a year over the four-year period. Moreover, money will be available for commercial development over a very wide area that is equivalent to the centre of Edinburgh.

The money is there; the financial arrangements will be changed to make the system work much better and I am heartened by Jon Hargreaves's comments about introducing a system that will allow people to find out exactly what is going on. I have always been puzzled by the fact that a country such as Scotland, whose population is not growing rapidly, should have such development constraints. However, those arrangements are being changed and I am quite optimistic about our ability to deal with the matter.

Margaret Jamieson: Obviously, it will take more time to remove all the development constraints. What consideration will you give to businesses and homeowners who will be adversely affected while the system is being upgraded? After all, recent experience suggests that you do not seem to be very good at dealing with circumstances in which, for example, you have to inform commercial premises that you will need to close a road for four weeks and that they might be affected by that closure. How will you overcome that aspect of dealing with customers?

Professor Alexander: I put my hands up and say that our performance in that area has not been as good as it should be.

Margaret Jamieson: I think that the best description would be that it has been appalling.

Professor Alexander: I admit that some of what has happened in Margaret Jamieson's area has been pretty bad, but we have, under the control of our customer services director, introduced a community relations team. It is intended that that team will get in early to keep the community informed and to take into account locally sensitive timing issues. For example, last year, we changed the timing of digging up roads in Tarbert because the works were originally scheduled to take place at the same time as the Tarbert regatta. Members will know what the road into Tarbert is like during the regatta—every car that goes into the town has a boat behind it—so we moved the works back three months to accommodate that. We need to get better at doing that, however.

The committee must also take into account the fact that we are constrained by the need to do things within regulated periods and we are trying hard to get to that point. I have visited one of Margaret Jamieson's parliamentary colleagues because of a rather silly decision that we made about Cumnock.

Margaret Jamieson: Was it about Auchinleck Main Street?

Professor Alexander: Yes. I took one look at what happened and decided that we should have done better.

Dr Hargreaves: The other part of the question was about compensation. We are a public body, and throwing money at problems is not the answer. The answer is to get things right. If businesses can genuinely show that they have suffered, they will get compensation because we have an insurance policy to cover that. It is not often reported that thousands of people are compensated every year, but every now and again either people want more or we do not get things quite right. Some people will try anything to get compensation. There are some classic stories floating around at the moment about people trying to get compensation through channels that are not necessarily the correct ones. We need to be sure that compensation is correct, because we are dealing with public money.

The Convener: We have dealt with performance capacity and efficiency, and we shall now move on to questions about the relationships between Scottish Water, the commission and other bodies.

Margaret Jamieson: How will the Water Industry Commission for Scotland measure its efficiency and effectiveness?

Sir Ian Byatt: That is a good question. We shall always explain what we have done and how we have done it. At least part of Scottish Water's efficiency gains have been a result of our activities. It is Scottish Water that increases efficiency, but if we are doing our job properly, we will be putting the right pressures on Scottish Water to do that. Scottish Water has said certain things about how regulation can help. Ultimately, the efficiency of the commission depends on what water is delivered at what price, what dirty water is taken away at what price and how well the job is done for the Scottish people.

We shall, in being more specific about answering how we might measure our efficiency, publish plans of what we intend. The Scottish Parliament will hold us to account on whether we achieve those plans, and we shall come and explain to you how we are doing our job. When I say that we shall come to explain to you, I am talking about the Scottish Parliament generally. One of my aims is to make contact with as many members of the Scottish Parliament as would like me to make contact. In the case of Audit Committee members, we have already had a discussion outside the committee room, and I hope that we shall go on having such discussions.

We are a fairly small organisation of 18 people and our relative expenditure is quite small. I think that we need to be judged, and we will be judged in part, by the Scottish Executive, so I will have to call on the Scottish Executive every year and explain what we have done, how much money we have spent and whether we have spent that money wisely. Of course, we are also judged by Audit Scotland, which has already considered the regulatory regime in the report that is before us. Audit Scotland will start work on the capital programme later this year and it will examine our activities. I hope that all that will continue.

Transparency is enormously important. As someone who first entered the civil service in the 1960s, I belonged to an old public service tradition, which was that explanation was given only on a need-to-know basis. I am extremely glad to say that that world has changed completely. I like to think that I might even have played a little part in that process; Ofwat, for example, led the way in publishing material and presenting facts on the industry and our activities so that people could judge what we were doing. That tradition is deeply embedded in Scotland. When he was commissioner, Alan Sutherland published a great deal of detailed material about Scottish Water, the work that he was doing and how he made his judgments.

12:30

The next stage of justifying our position and allowing people to assess whether we are doing our work properly will be to publish more in the way of what I would call simply accessible material. A great deal of what we do is quite complicated and it is right and proper that that is the case. For example, the issue of how to calculate the interest cover ratio is a matter of great concern to the experts, but it is of no great concern to the average person who goes to Tesco; the results are what matter to them.

We have a lot of work to do on the provision of simple explanations of our activities, so we will publish short notes and assessments, for example. I hope that, increasingly, we will reach the Scottish people so that they know not only who delivers the water, but who regulates that delivery. We will do that in close consultation with the quality regulators. As Alan Alexander pointed out, there are several regulators in the water business and unless they work together properly, the system will not work. Each regulator has its own responsibilities, expertise and capabilities and although they should be held to account separately, they must also be held to account collectively on how well they work together.

It is a challenge to us to set out the richness of what we are trying to do in a way that allows MSPs to judge whether we have done the job properly. If we can do the first part, I am very confident that Parliament will be able to do the second part.

Margaret Jamieson: Thanks very much.

Susan Deacon: My question follows on from what Sir Ian has just said. As the economic regulator, is the Water Industry Commission—or any other body—engaged in considering the cost of regulation and the regulatory process? By that, I do not mean simply the direct costs of your office and of the offices of the other regulators, but costs such as that of producing the 80 million pieces of data to which Jon Hargreaves referred. Given the complex and unique nature of the regulatory regime within which Scottish Water operates, can the efficiency and effectiveness of the regulatory process be improved?

Sir Ian Byatt: We must be acutely conscious of the compliance costs of regulation. It is easy to say, “Collect this, that and the other,” but the costs of doing so quickly build up. We must regularly review the information that we collect and it is crucial to ensure that the information that is collected for regulatory purposes is basically the same as that which is collected for management purposes. Although management and regulation are not the same—some information will be needed for one activity, but not for the other—the information that is collected in those two areas must be consistent. If that were the case, we would have more efficient regulation and, dare I say it, more efficient management. It is a question of tailoring not simply the volume, but the kind of information that we collect. It is certainly true that one often wants to go for quality rather than volume of information. The process of building up the information that is gathered has been important and necessary, but there is still further to go. For example, Scotland lags behind England and Wales in information on assets.

The quality of the information is extremely important and the appointment of a reporter is a significant aspect of that. In England and Wales, we had reporters who had a duty of care to the regulator as well as to the company. They were concerned with the quality of information and they advised the regulator about it. There is now a reporter for Scottish Water who has experience of reporting in England and Wales. He has been extremely useful in the strategic review.

There is need for constant care about compliance costs. However, we must recognise that more information is needed and that we have to keep pegging away at the quality of the information that we receive. I hope that that gives you the beginning of an answer to what is a very important and complex question.

Susan Deacon: What is the Scottish Executive’s role in looking at the alignment of the information that is produced for regulatory purposes and the information that is produced for management purposes? I am trying to get a sense of who would take the lead in ensuring that improvements continue as the system grows and evolves.

Sir Ian Byatt: One of the things that we have been thinking of—and it is interesting that it is mentioned in Scottish Water’s evidence for this meeting—is a high-level monitoring group. Delivering ministerial objectives is at the heart of what we do. However, there are interesting issues about how those objectives are translated into action on the ground. Among the objectives will be, for example, that so many kilometres of river have to meet a certain standard. It is absolutely right and proper that the ministerial objectives should be set at that level; they should be about outcomes.

What is done depends on the skills of the water company in choosing the most effective—the most cost-effective as well as the best—method for doing the job. The water company must have the consent of the quality regulators that they are satisfied that what is planned will happen. Throughout the four-year period further work will be done on the most effective way of achieving particular outcomes. The Scottish Executive must be very deeply involved in that process—indeed, the Executive should probably lead it—because the process is there to implement the Executive's objectives. Information is required for the management of a water company and for economic regulation. SEPA requires information for its regulation. Then we have to look at how information is put together to achieve the ministerial objectives in which everybody will be involved.

Dr Hargreaves: It is essential that there is clarity in the process about who is responsible for what. There is a great danger that we will end up with blurred lines. Ultimately, it is all about consequences: have we made rivers better or not? After all, we have spent a great deal of money doing that. Who is responsible when things happen? Equally important is knowing who is responsible when things do not happen. Often in the water industry—and in the public sector in general—there is confusion about accountability. We are working closely with Sir Ian on everybody being absolutely clear about who is responsible for what. The minute that we move away from that, we end up with increasing costs and frustration for customers and their representatives. We have seen that happen with development constraints, for example. Who is primarily responsible for increasing the infrastructure in a new development in the south-east wedge of Scotland? Is it the water company? Is it the developer? Is it Scottish Enterprise? It is critical that we have clarity on such matters so that we can deliver. Our job is to deliver the Parliament's wishes.

Sir Ian Byatt: I have been absolutely amazed in my career at how important it is that human beings should be clear about what they are supposed to do. That is a simple and obvious point, I know, but we neglected it to a considerable extent. Only since the 1980s have the utilities begun to say who is accountable for what and to ask how clear their remit is. Transparency goes with accountability and responsibility, so that we can see who is responsible for what. That has produced wonders, which is amazing. If we look at what has happened to the quality of water and the cost of producing it, and at what has happened in the other utilities, we see a great success story. Transparency and accountability can be developed in the Scottish model of the water industry to produce the best water model in the world.

Susan Deacon: My final question is in a similar vein of thinking broadly about the lessons that have been learned from the developments in the industry in Scotland in recent years and about where we go from here. I do not mean to make you blush, Professor Alexander, but it is fair to say that you are and have been for many decades an established authority on public sector management.

Professor Alexander: That is different from putting your money where your mouth is for 30 years, though. I have to say that right away.

Susan Deacon: Given your experience of taking forward one of the biggest ever transformation programmes of a public sector organisation in Scotland—appendix 2 to the Auditor General's report gives us a sense of that—will you share with us any lessons that you think should be learned? In particular, will you give us a sense of how the process of strategic change might be enhanced? Are there any particular matters that the committee ought to consider in that regard?

Professor Alexander: I start from my personal commitment to the principle of regulation in a monopoly business. That is what has driven us to take a hard look at everything that we do, as I said earlier. Within that context, transparency and clarity—particularly the clarity about roles that Ian Byatt mentioned—are key. We should get to a position at which all the multiple players know precisely what their responsibilities are and by whom they will be held accountable. We are much closer to that than we were when Scottish Water set out on the journey on 1 April 2002. I said in my first answer, and Alan Sutherland echoed the point, that we had an immature, even nascent regulatory process when we started the journey, but the process matured as all the stakeholders examined their relationships. Some of that is covered in the Auditor General's report.

Both Scottish Water and I welcomed the move from an advisory regulatory process to a determining regulatory process—that is, the move under the Water Services etc (Scotland) Act 2005 from the water industry commissioner to the Water Industry Commission, which has a determining role on prices, and the possibility for the company of an external appeal. I support that because it goes a huge way towards clarifying the roles, which can now be written down on a simple flow chart. Ministers say that they want something to be done, the commission says that Scottish Water should be able to do it for a certain cost if it is operating efficiently, then we get on and do it. There is great clarity in that process, but as we develop it during the next four years the closeness of the relationships between us and the regulators will be key.

I was happy to hear Sir Ian make the point—he has made it to me privately and I am glad that he made it publicly today—that in a regulated single business the regulators have to work together. In the day-to-day operation one cannot separate out their roles and how those roles affect what Scottish Water has to do.

12:45

In terms of what the report says about how we strategically approach the management of the industry, we will have sometime later this year—either very soon, or further ahead if my board decides that an appeal is necessary—a clear statement of what we are required to do. Our role will be to ask whether the structure and procedures of Scottish Water are fit for that purpose. Jon Hargreaves has already referred to the fact that we are currently restructuring the business in response to what we have learned over the past four years.

Let me emphasise that the process of reviewing how well we are doing within the regulatory framework is continuous. We all need to remind ourselves that, just because we do things in four-year chunks, the world does not come to an end on 31 March 2006 and start again on 1 April. There is a continuity of which we must be aware. Sir Ian made a really important point on this. If we are to achieve the efficient operation of the water industry, we need to ensure that data that we develop or generate are multiply used. One of the ways in which our efficiency will leak away is if we have to produce ad hoc information for particular purposes. The stakeholders, including the Scottish Executive, need to be aware of that. Any time and effort that we spend generating information is time and effort that we do not use for delivering services to our customers. To return to what Jon Hargreaves was talking about earlier, we are a customer-oriented business. That is what we are there for, and that is what we will be judged by. We must ensure that, within what is a much better, more transparent and much clearer regulatory process, we maintain that focus.

We have learned lessons about how an external regulatory process can push us to ask ourselves whether we can do things better, more efficiently and more effectively. Whether or not there are broader lessons beyond our work is a matter for others to judge.

Dr Hargreaves: I would argue that we need pretty good people to do all that, but then I would say that, wouldn't I? We can have all the processes and clarity in the world, but if we have average, we end up average. I have been in business 30 years, and that is a lesson that I have learned. If we start with average, we end up with average. If we have good at the start, we end up with good. If we have excellent, we end up with excellent. As Ian Byatt indicated, one of the great exponents of that is Yorkshire Water. It was right at the bottom of everybody's tree eight years ago, but it changed management and it is now at the top. That was not because the processes changed, but because the people changed.

The Convener: That is an observation that we could make about MSPs, I am sure.

Dr Hargreaves: We start with excellent, convener.

The Convener: I invite Margaret Smith to ask the penultimate question.

Margaret Smith: So, no pressure. I was hoping to ask about the likelihood of Scottish Water appealing to the Competition Commission were it to be unhappy with the charges determination. However, having heard what Professor Alexander said earlier, I will be charitable. What impact will Scottish Water's decision whether or not to appeal have on the production of full business plans and of the plans that are to go to the Scottish Executive? What progress have you made on those plans?

Professor Alexander: We have an agreed scenario for each possibility, which Douglas Millican can outline.

Douglas Millican: If we decide to accept the determination, we are required to submit a plan to the Executive by the end of January. Clearly, that is an extremely tight timetable. We will make our decision on 25 January. If we decide not to appeal—that is, we accept the determination—we must have our business plan with the Executive five days later. Inevitably, given the difficulty of delivering a complex programme over four years, that will be a first plan. There will be some areas where we can be quite specific, and there will be other areas where the plan will be highly provisional and indicative. The plan needs to be a living, breathing document, which will be revised as we go over the four years, at annual intervals at a minimum.

We have agreed with the Executive that, if we decide to appeal the determination with the Competition Commission, we will submit a one-year plan for 2006-07 only. That would be submitted to the Executive by the end of February.

Margaret Smith: Do you think that those targets are achievable in either case?

Douglas Millican: Do you mean the targets for submitting plans?

Margaret Smith: Yes.

Douglas Millican: There is no question that we can submit plans by those deadlines. The question will be the level of content and the degree of certainty that can be attached to the issues contained in those plans. Undoubtedly, given the very tight timetable to which we are working, this will be a first plan. It will be the first view and a commitment to deliver for one year only if we appeal, or to deliver over the four years if we do not appeal, but a lot of detail will have to be coloured in during the coming years.

Margaret Smith: The Water Services etc (Scotland) Act 2005 opened up the water industry in Scotland to retail competition in the non-domestic sector. In its response to one of our questions, Scottish Water says that one of its priorities is to establish its retail company. Could Dr Hargreaves give me some idea of the progress that Scottish Water has been making on that? Also, in the quest for clarity about roles and purposes, could Sir Ian Byatt give us an overview of the roles of the Water Industry Commission and of the Competition Commission in this area?

Dr Hargreaves: Under the 2005 act, by 1 April 2006 Scottish Water has to create a subsidiary that will carry out retail for our 130,000 business customers. We have until 2008 to prepare ourselves for the market opening fully to competitors. I remind everyone that this is about the billing and service element, not the provision of water. You guys made the decision that Scottish Water wholesale will continue to supply whoever does the retail at a price that will be determined by the water industry commissioner, which will be the same price for everyone.

We are well on the way. On 20 December, just before Christmas, we submitted a tome to the regulator because Scottish Water retail—which we are going to call Business Stream, incidentally—has to apply for a licence to allow it to be a retailer. The regulator will then determine whether we are fit persons to be a retailer. It will be interesting if he decides that we are not, but that is for discussions down the line. Over a period of two years, we will then separate out the people, processes, information technology and all the rest of it. There will be accounting separation from 1 April, so that we are not in any way favouring Scottish Water retail.

After 2008, we intend to run a viable retail business that fights its corner in every way possible under the restrictions that ministers have put on us. For example, we are not allowed to sell other products and services. We can sell only water and waste water services. However, within those restrictions, we intend to be a successful competitor in the retail market. Our business plan was submitted on 20 December and we are waiting for questions—we got one from Alan Sutherland yesterday. We are starting to see the usual process whereby the regulator comes back to us for clarification.

We have agreed with ministers how the retail business will be funded and the funding is in place. We have recruited internally the top six people in the business so that they can start to develop it. Over the next two years, we will transfer 130 people into that business and then we will be up and running.

In the meantime, Scottish Water's objective is to cause the minimum of disruption and confusion for our customers. They have had a pretty rough time with the introduction of a new charging scheme. We have harmonised charges—again, that is unique to Scotland. That was a challenging time for our customers; those who got big benefits were not exactly sending Alan Sutherland and me thank you letters, but those who did not benefit sent us the other kind of letter. The objective is to avoid unnecessary disruption in the next two years. After that, the customer has a choice about who supplies them.

Sir Ian Byatt: We have to start with the 2005 act, which says that there should be business separation. It does not give the exact form of that separation and there are various aspects to it. We feel that the retail business has to be separate from the wholesale business. The retail business will deal only with non-household customers, but anybody who is thinking of coming into the market must see clear separation between the wholesale activities of Scottish Water and the retail activities of Water Stream—or whatever the name will be.

Dr Hargreaves: It will be called Business Stream.

Sir Ian Byatt: The separation will have to apply both to the governance of the new body and to its activities and ownership of assets. The ownership of assets will involve the Scottish Executive as well as the Water Industry Commission. Clear separation is crucial so that anyone entering the market sees a level playing field. You asked about the role of the Competition Commission. We will license the existing retailer—in a form that ought to be discussed—and we will also be in a position to license entrants. The licence conditions will be subject to appeal to the Competition Commission.

The Water Industry Commission received the business plan from Scottish Water on 20 December and we have been reading it carefully while eating our cold turkey. We will have our first discussion of the plan next week, and there is a lot to think about and discuss. It will be most important to get it right first time, if I may use Jon Hargreaves's words from an earlier occasion. We will have to take the time to do that.

If it is possible, we would like to see whether a full licence could be given to Scottish Water by April 2006, but that will depend on many serious discussions and much analysis and consideration.

The Convener: Eleanor Scott will ask the last question.

Eleanor Scott: The Water Industry Commission's function remains that of promoting the interests of Scottish Water's customers, so how in practice will the role of the commission differ from the role of the water industry commissioner?

Sir Ian Byatt: A prime objective of the commission is to look after customers—subject, of course, to ensuring that ministerial objectives are met. I believe that the commissioner also regarded customers and their interests as extremely important and that he had close contacts with the water customer consultation panels. We will continue the tradition that he started of having regular stakeholder days and close contact with customer panels. I will meet the convener of the customer panels regularly. If the Water Industry Commission is to do its job properly—and it certainly intends to—it will be crucial that it listens to what its customers want on service and price.

Eleanor Scott: Will anybody notice any difference as a result of there now being a commission rather than one person?

Alan Sutherland: One difference is prescribed by statute. As commissioner, I used to be responsible for dealing with complaints that had not been resolved by Scottish Water, but that responsibility has now transferred to the water customer consultation panels. The legal responsibility lies with the convener. The individual who dealt with that work in the old office has now begun the process of transferring it to the customer panels, with a view to formalising that part of the act.

Eleanor Scott: It sounds as if a panel is now doing somewhat less than a single commissioner used to do. Is that an unfair comment?

Alan Sutherland: As has been said, the commission is responsible for determining prices that represent the lowest reasonable overall cost of delivering ministerial objectives. That is what we are doing. In one sense, the focus has not changed; after all, the commissioner's focus was to ensure that customers got the best possible value for money. Clearly, the commission shares exactly the same focus.

Katherine Russell (Water Industry Commission for Scotland): As Sir Ian said, the commission's role also covers the establishment of the retail environment in Scotland.

The Convener: I thank Sir Ian Byatt and his team and Professor Alexander and his team for attending today's meeting. We have usefully covered a very broad range of subjects. I am pretty certain that we will follow up some of the matters that have been raised this morning and seek written evidence on them; when we receive your responses, we will take things from there and let you know later about any outcome. As I said earlier, this evidence-taking session was more about information gathering than about producing a report.

Professor Alexander: Before we go, I should say that we might follow up the question of the water that you serve at the committee.

The Convener: As a member for Mid Scotland and Fife, I would have something to say on that matter.

Professor Alexander: There might be a conflict of interests.

The Convener: I will suspend the meeting for a couple of minutes to let the room clear, then resume the meeting in private.

13:01

Meeting suspended until 13:03 and thereafter continued in private until 13:08.

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