

# **FINANCE COMMITTEE**

Tuesday 10 September 2002  
*(Morning)*

Session 1

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## FINANCE COMMITTEE

### 15<sup>th</sup> Meeting 2002, Session 1

#### CONVENER

\*Des McNulty (Clydebank and Milngavie) (Lab)

#### DEPUTY CONVENER

\*Elaine Thomson (Aberdeen North) (Lab)

#### COMMITTEE MEMBERS

\*Brian Adam (North-East Scotland) (SNP)

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

\*Mr Tom McCabe (Hamilton South) (Lab)

\*Alasdair Morgan (Galloway and Upper Nithsdale) (SNP)

\*Mr Jamie Stone (Caithness, Sutherland and Easter Ross) (LD)

#### COMMITTEE SUBSTITUTES

Mr Keith Harding (Mid Scotland and Fife) (Con)

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

Andrew Wilson (Central Scotland) (SNP)

\*attended

#### WITNESSES

Professor Alan Alexander (Scottish Water)

John Ford (Scottish Environment Protection Agency)

Dr Jon Hargreaves (Scottish Water)

David Howell (Scottish Natural Heritage)

Michael Kellet (Scottish Executive Environment and Rural Affairs Department)

Douglas Millican (Scottish Water)

Elinor Mitchell (Scottish Executive Environment and Rural Affairs Department)

David Reid (Scottish Executive Finance and Central Services Department)

John Thomson (Scottish Natural Heritage)

Evan Williams (Scottish Environment Protection Agency)

#### ACTING CLERK TO THE COMMITTEE

David McGill

#### SENIOR ASSISTANT CLERK

Terry Shevlin

#### ASSISTANT CLERK

Gerald McNally

#### LOCATION

Committee Room 2



## Scottish Parliament

### Finance Committee

*Tuesday 10 September 2002*

*(Morning)*

[THE CONVENER *opened the meeting at 10:01*]

**The Convener (Des McNulty):** I suggest that we start the 15<sup>th</sup> meeting in 2002 of the Finance Committee. I make the usual announcement about mobile phones and pagers: please switch them off. We have received apologies from David Davidson, who will not be at the meeting, and from Elaine Thomson and Brian Adam, who will be late because of the vagaries of the train service from Aberdeen.

### Item in Private

**The Convener:** Before the summer recess, the clerks took soundings from members on the handling of preparation for evidence-taking sessions. The consensus at which we arrived was that we prefer to decide in private, as part of the formal agenda, how we will question witnesses. Do members therefore agree to take in private item 4, which is consideration of lines of questioning for evidence taking on the Water Environment and Water Services (Scotland) Bill?

**Members** *indicated agreement.*

## Work Programme

**The Convener:** Item 2 is the work programme, which covers the period from today until 17 December, when we will have our final meeting before Christmas. Although the programme is pretty full for most of the period, it does not include consideration of financial memoranda for bills that have not been introduced, as the date of their introduction cannot be known. That might mean that we have to find space in the programme for other items.

I understand that the Protection of Children (Scotland) Bill was introduced yesterday. Should we decide that we want to take evidence on it, we would have to do so in the next few weeks. I suppose that ideally we would want to avoid having to schedule in additional meetings. The schedule sets out meetings fortnightly and, if we want to consider bills between now and Christmas, we would almost certainly have to schedule in two or three additional meetings, depending on the level of scrutiny that we want to give the bills.

I draw to members' attention the informal meeting that has been arranged for 25 September to discuss with Peter Peacock the 2002 spending review. We might want to do further work on the spending review after that meeting, so that might affect the programme. Members have received a paper from Professor Arthur Midwinter on the end-year flexibility statement that was made in June. I suggest that any issues from the paper that members want to discuss be covered in the session with the Deputy Minister for Finance and Public Services. Given that the informal session that we had with Peter Peacock in May was valuable to members of the committee, do we agree to have another informal session with him, without prejudice to any formal questioning that we might want to conduct in future?

**Members** *indicated agreement.*

**The Convener:** If we want to consider bills, we will revise the programme. Are members broadly content with the programme as it stands?

**Members** *indicated agreement.*

## Budget Process 2003-04

**The Convener:** Item 3 is on meeting outwith Edinburgh. Members have a paper that outlines options for a meeting outside Edinburgh at stage 2 of the 2003-04 budget process. The committee has met in locations that the Parliament had not visited before and the suggestion is that we aim on this occasion to meet in north-west Scotland.

The paper suggests that we visit Portree, as that would allow us to continue to follow the island theme that we began at stage 1 of the budget process and compare and contrast the situation in the Hebrides with that of the northern isles. The paper suggests Ullapool as an alternative, should we prefer to remain on the mainland. Of course members might want to make additional suggestions.

The paper seeks our agreement on the date of the meeting, which is proposed for 18 November, as well as on the format and venue for it. Do members have any comments to make on the suggestions in the paper?

**Mr Jamie Stone (Caithness, Sutherland and Easter Ross) (LD):** I am delighted that places such as Portree and Ullapool are being considered. There is no doubt that that goes down well. I respect other members' views, but if the committee is amenable to going to such places, that is very welcome.

**Alasdair Morgan (Galloway and Upper Nithsdale) (SNP):** I have no problem with the suggestions. I suspect that at some stage—I say this as a member for a rural constituency—we should begin to visit urban areas outwith Edinburgh, but perhaps that is something to consider for the next occasion.

**The Convener:** I suggested Clydebank to you informally in the lift the other day.

**Mr Stone:** Of course we consider Ullapool to be urban.

**The Convener:** Are members content with either Portree or Ullapool? Shall we leave it to the clerks to identify which venue would be more appropriate for consultation, hotel arrangements and so on?

**Members indicated agreement.**

**The Convener:** Are there any questions on the date or format of the meeting? I think that the format of our meeting in Orkney was successful, so the suggestion is that we try something similar this time. Do members agree to proceed on that basis?

**Members indicated agreement.**

**The Convener:** Agenda item 4 is to be taken in private, so I ask the official report, broadcasting and the public to leave us for a couple of minutes.

10:07

*Meeting continued in private.*

10:15

*Meeting continued in public.*

## **Water Environment and Water Services (Scotland) Bill: Financial Memorandum**

**The Convener:** We now move to item 5 and the taking of evidence from witnesses on the financial memorandum to the Water Environment and Water Services (Scotland) Bill. This will be something of an omnibus session, given the various groups of people who are providing evidence to us.

I welcome Jon Hargreaves from Scottish Water; Professor Alan Alexander, Scottish Water's chairman; Douglas Millican, the finance director of Scottish Water; John Ford, the director of finance and corporate support at the Scottish Environment Protection Agency; Evan Williams, SEPA's sustainable development team leader; John Thomson, director of operations and strategy with Scottish Natural Heritage; and David Howell, who is also from SNH, although I do not know his job title.

It would be helpful for us to hear short opening statements from each organisation. We will then move to questions, if that is agreeable to the witnesses. Let us start with Scottish Water.

**Professor Alan Alexander (Scottish Water):** I will make some broad, general points and my colleagues will pick up on the detailed questioning. Scottish Water very much welcomes the principles behind the water framework directive and the Water Environment and Water Services (Scotland) Bill. We are somewhat concerned about the fact that, in the absence of knowledge of the detailed delegated legislation that is promised by the bill, the bill's financial consequences for Scottish Water are difficult to quantify, although we will do our best to do so in response to your questions.

We believe that our colleagues from SEPA are much further ahead than their colleagues down south on the matter of good ecological status. We are pleased to say that we have had a good dialogue with SEPA on that. We are therefore well ahead on it and will respond to any detailed issues that you raise. In particular, we would very much support the early introduction of abstraction controls in Scotland, which is a key issue for us.

Given that Scottish Water is subject to robust and challenging economic regulation, if I may put it that way, we are concerned that any additional cost to Scottish Water, particularly in the second regulatory period, which runs from 2006, be identified as early as possible, so that that

information feeds into the water quality and standards process. If we enter that period without a clear understanding of our costs, it will be difficult for us to manage the business. There is absolutely nothing in our current regulatory settlement to cover any expenditure on the WFD between now and 2006. We wanted to emphasise that contextual point.

Part 2 of the bill covers how we deal with developers' costs. Scottish Water believes that it is currently at a considerable competitive disadvantage. It costs us—or rather our customers; that is the best way of putting it—£17 million a year to pay developers' costs. Our competitors and potential competitors down south have in place a broadly cost-neutral regime. Given the competitive threat, that presents us with issues of cost and of the effects of those costs on our competitive position. I hope that that can be taken into account during detailed consideration of the bill. The subsidy to developers that it represents—I do not think that “subsidy” is too strong a word for it—was put in place at a time when it was important to stimulate the housing market in Scotland. Most of us would argue that the housing market in most of Scotland does not need a hell of a lot of stimulation today, but the subsidy has an effect on our cost base and our competitive position.

Those were the general points that I wanted to make. A huge number of issues in the financial memorandum and the bill will require more detailed consideration. I have mentioned the one caveat that I wanted to raise—exact quantification of the potential costs to us in some areas is difficult.

**John Ford (Scottish Environment Protection Agency):** I thank the committee for inviting SEPA to give evidence. We have submitted written evidence to the committee and I will not repeat what is in that. It would be more helpful to highlight what we see as the sources of costs in the bill.

SEPA believes that the water framework directive will make a significant contribution to the protection of the water environment in Scotland, but a number of important details remain to be resolved in regulation that will have an important impact on the overall burden of costs and where they fall, particularly in the public sector.

In essence, there are five areas in which costs may arise. The first is in the provision of information to SEPA to allow the characterisation of river basin districts and river basin management planning, which involves the collection and collation of information from a number of public bodies, including SNH. We believe that much of that information already exists and may require collation and re-presentation to be useful for monitoring.

The second area in which costs may arise is in participation in the river basin planning process, which will include participation in public consultation processes.

The third area relates to the provision of information for monitoring purposes. Again, SEPA will depend on other bodies—SNH in particular—for the collation of some of that information.

The fourth area relates to the payment of fees and charges to SEPA for licensing activities. Currently, SEPA is seeking to develop a charging regime to recover the costs that are associated with the implementation of the bill. We anticipate that that scheme will come into play during 2005. SEPA is committed to developing a proportionate charging scheme and will seek early consultation with charge payers and potential charge payers in drafting the scheme.

The fifth area relates to costs in carrying out necessary measures, which include engineering works and process modifications. Those costs will fall principally on the private sector and we believe that they are likely to be in line with the figures that the WRc plc produced. The costs will begin to have effect from 2007, but will largely fall in the period 2009 to 2011 onwards.

SEPA has committed itself to providing provisional estimates to the water industry commissioner for Scotland for inclusion in the quality and standards process. We recognise the virtue in aligning the requirement for measures with investment cycles to maximise benefits and minimise costs where possible.

Throughout the implementation of the bill, SEPA will remain alert to the costs that are imposed on the public and private sectors and on those whom we regulate. We will also remain alert to how those costs are implemented.

**John Thomson (Scottish Natural Heritage):**

Like Scottish Water, SNH supports the principles that underlie the water framework directive and the bill. We believe that such legislation will deliver many natural heritage benefits, which will not be confined to the water environment, but will extend well beyond it. In particular, we welcome the broad, holistic approach that is enshrined in the bill and the move to assess water quality on a wider ecological basis than the relatively narrow and traditional chemical and other criteria allow.

We have always made clear our keenness to contribute to the implementation of the directive at a strategic level. However, in the past, we have also flagged up to our sponsor division the fact that we lack the capacity to get deeply involved in the detailed implementation of legislation. As SEPA and the Executive have begun to work out the practicalities of implementation, the need for SNH input has become increasingly clear. In its

evidence today, SEPA highlighted two areas in which it is clear that involvement will be necessary. One relates to the initial characterisation process. As John Ford said, many of the data already exist, but they require to be collated and fed into the process. The second area relates to the later monitoring process.

The work on characterisation is already generating significant extra work for the relevant staff in SNH and we believe that that will intensify as we run up to the December 2004 deadline. Most of that work has been concentrated at the centre of the organisation but, as the process rolls out, it will increasingly spread throughout the organisation. Once we move to the later stages of implementation, significant costs will arise through our engagement in the river basin planning process, for example.

It is difficult to say exactly what those costs will be. We can say with confidence that they will largely relate to staff time, but there is still much uncertainty about details, as Scottish Water mentioned. We anticipate that activities will be spread quite thinly and widely throughout the organisation—they will tend to take up relatively small parts of the time of many people throughout the organisation rather than be concentrated in a few posts. Obviously, that makes it particularly difficult to estimate costs.

At this stage, we want to flag up the fact that we will find it difficult to accommodate the scale of input that we think will be sought at a time when we are actively involved in the implementation of a number of other key programmes—such as the implementation of our habitats and species and birds directives—and in the activities that will flow from the Land Reform (Scotland) Bill. At this stage, it is important to put up a little warning signal and to say that we will have difficulties in accommodating the scale of activity that will likely be sought from us.

**The Convener:** I welcome Elaine Thomson and Brian Adam, who have just arrived from Aberdeen.

Given that the bill is an Executive bill, we have a series of focus questions to put to the Executive, but we want to explore two main issues with the witnesses. First, we want to explore the impact of the bill on your organisations and, secondly, we want to hear your organisations' views on costs in particular and the parameters that the Executive has placed on the implementation of the legislation.

Professor Alexander, you seemed to say that it is particularly important that the water industry commissioner be required to take account of the cost to Scottish Water of implementing the legislation.



**Professor Alexander:** The water industry commissioner should do so, but the quality and standards process also needs to do so in respect of the determination of our investment programme for the next regulatory period.

**The Convener:** In other words, it would be inappropriate for the water industry commissioner not to deal with the implications of the legislation in terms of the regulatory framework that it establishes for you. At the same time, you seem to say that costs are difficult to quantify. If it is difficult for you to quantify costs, it will also be difficult for the water industry commissioner.

**Professor Alexander:** If I may, I will hand over to Douglas Millican to discuss details. My point was that, at the moment, it is difficult for us to quantify costs in the absence of the detail that will come with the delegated legislation. Douglas Millican may want to add to that.

**Douglas Millican (Scottish Water):** The issue relates to timing. There may be a fixed regulatory settlement until 2006, but we must consider the timing for the next regulatory review period, which will commence in 2006. The preparatory work will begin next year, but the substantive work on consideration of the quality and standards obligations for 2006 and beyond will be done around the summer of 2004, with firm conclusions needing to be reached by spring to early summer of 2005 at the latest. If uncertainties remain in early 2005, the commissioner will have difficulty discharging his functions and giving advice to ministers on the revenue cap for Scottish Water in 2006 and beyond.

10:30

**Mr Tom McCabe (Hamilton South) (Lab):** I appreciate that to some extent we are entering uncharted territory. I am sure that the water framework directive and the intentions behind the bill are good. However, I have the impression that we are marching on with good intentions but with almost no clue about what we are about to spend from the public purse. Most members of the public are getting on with their lives this morning and are not overly interested in our proceedings, but I am sure that some people are. Ordinary taxpayers could be excused for being slightly nervous that good intentions are being advanced with no quantification of cost. That is not a good way of doing business in either the public or the private sector.

In its written evidence, Scottish Water states that the costs for meeting targets for the elimination of priority hazardous substances cannot yet be estimated. The costs of monitoring, administration and consultation "are not yet quantifiable". I worry that we are nudging slowly but surely towards a form of charging for water services that has been

firmly rejected by public opinion—the metering of water services.

**Professor Alexander:** I do not disagree in principle with much that the member has said. Jon Hargreaves will comment in detail on some of those points. In our written evidence we were trying to indicate that it is extremely difficult for us to give the committee intelligent answers until we have more information on which to base those.

**Dr Jon Hargreaves (Scottish Water):** I want to pick up the member's point about the things that we do not know, as opposed to the things that we know. The costs that we know are estimated at about £28 million per year, plus an increase in operating costs.

The cost of implementing other directives that have been introduced over the past 20 years—the drinking water directive, the bathing water directive and the urban waste-water treatment directive—has been higher than was initially estimated. That is true across the UK. When people are trying to deal with dispersed pollution, the water industry is a very easy target, because it has point sources. It is much easier to tell us to reduce the pollution that we are producing than to chase someone with whom dealings may be difficult or sensitive. That is not a criticism—I am just telling members what has happened historically. We are nervous about the figures that appear in our submission and hope that they will be lower than has been estimated.

Mr McCabe suggested that the obvious conclusion to be drawn from our statements about the economic use of water was that metering should be introduced. Our regulator has pushed us in a different direction—not away from metering, but towards having a higher standing charge and a lower volumetric charge. That gives us the flexibility to ensure economic use of water without metering. Introducing metering across Scotland would probably cost several billion pounds. It would not be a good use of public money or, indeed, of anyone's money. We are considering tariff structures that will prevent our customers having to install meters wholesale—particularly for domestic customers—and encourage customers to use less water than they have used historically, or to use it more economically.

We have discussed leakage with our regulator. In Scotland, there are fairly high levels of leakage, because of a lack of investment in the infrastructure over many years. There is a danger inherent in the legislation that it will drive us past what is termed euphemistically the economic level of leakage. There is a point at which it is cheaper to let water leak than to fix the leak. By the time we reach the point that we need to reach—we are nowhere near it at the moment—we will be

chasing small percentages. The bill is useful because it points Scottish Water in a particular direction, but we do not want to have to hunt down every leak in Scotland. The cost of fixing leaks should not exceed the economic benefit of such work.

We recognise and welcome the intentions of the bill. However, we need to think some points through carefully and to avoid rushing into things. We must ensure that we do not end up going in the wrong direction because of a measure that is meant to bring about an improvement in the environment.

**Alasdair Morgan:** The financial memorandum indicates that Scottish Water will need to spend £28 million over a few years to implement the directive and will incur on-going expenditure of £5 million. Those are the only costs that the bill specifies for Scottish Water. You have mentioned a number of other costs that you cannot quantify. Can you provide us with estimates—ranging from a best estimate to a worst estimate—of those costs in relation to the figures with which we have been provided? Are the figures that we have received the tip of the iceberg or do they cover a high proportion of the costs that Scottish Water will incur? Are the costs that you do not yet know likely to be trivial?

**Douglas Millican:** Unfortunately, it is extremely difficult—if not dangerous—to put a figure on the costs to which Alasdair Morgan refers. The list of priority hazardous substances has not yet been drawn up. A good ecological status has not yet been defined. The assumptions made about environmental objectives will not be finalised until 2009. Taking all those uncertainties into account, I think that it would be dangerous even to provide a range of figures.

I am not suggesting that the WRc figure of £28 million a year is a material understatement. We just do not know. We do not have sufficient information to say whether it is right or wrong and, if it is wrong, by what factor.

**Alasdair Morgan:** If any of the items to which you refer lead to higher costs—which is almost inevitable—you can recover those only through charges.

**Professor Alexander:** That is correct.

**Alasdair Morgan:** Is it likely to be possible to identify the costs specifically and to target them at particular customers? Is it much more likely that they will be recovered via a general increase in charges?

**Douglas Millican:** Much depends on the precise nature of the charges and on whether there is a level playing field. I will give the committee an example to illustrate the point.

Many of the costs that we have incurred over the past few years, and continue to incur, relate to compliance with the urban waste-water treatment directive. Implementation of the directive has required an increase in waste-water charges, particularly trade effluent charges. A number of industrial companies have the option of discharging waste water not into sewers, but directly into receiving waters. The standard that is applied to those discharges is different from the standard that is applied to discharges into public sewers.

We have been forced on competitiveness grounds to maximise the income that Scottish Water receives to defray the costs that are associated with the urban waste-water treatment directive. However, we have not been able to be absolutely cost reflective, because there is not a level playing field. Industrial companies can choose to discharge waste either into public sewers—which involves meeting the standards of compliance that are associated with the urban waste-water treatment directive—or directly into receiving waters, which involves meeting a different standard.

If we want to maximise opportunities to recover additional costs from those customers who are causing us to incur them, the playing field across industry and the water business must be as level as possible.

**Alasdair Morgan:** Are you saying that because you have to be competitive you are not able to recover some of the costs of implementing the urban waste-water treatment directive from individual customers, and that you recover those costs from customers in general?

**Douglas Millican:** Yes.

**The Convener:** I want to pick up another issue that you raised in your opening statements. Developers' costs are estimated at £17 million per year. At the moment, flooding is a particularly important issue, but we must also consider how the longer-term costs of sustainable urban drainage initiatives will be met. You take a different view from the developers on your respective roles. Can you say more about Scottish Water's view on the issue? What are the implications of your dispute with the developers for sustainable urban drainage schemes?

**Dr Hargreaves:** There are two separate issues. We are talking about paying developers £1,000 towards putting in the pipework when they build a £500,000 house in Edinburgh. That does not address the issue of sustainable drainage or anything else; it is simply a contribution to the developers' costs. In this day and age, that seems slightly odd. On occasion, it might well be sensible to make such contributions but, in general, in the

commercial housing market in Scotland, it seems odd to us that such contributions are made.

You are right, convener, to suggest that issues arise over how we will fund the separation of waste water from surface water and over how we will fund the sustainable urban drainage profile—in the implementation of which Scotland is way ahead of England and Wales. We argue strongly that the capital costs will have to fall on the developers. The issue would then arise over who would be responsible for maintenance. At the moment, we have absolutely no money for that in our agreement with the water industry commissioner. Discussions are going on among the Scottish Executive, Scottish Water, the Convention of Scottish Local Authorities and developers as to who should manage such developments. There are relatively few in Scotland at the moment but they are becoming the norm. It is sensible that that should happen where possible.

If we are funded to look after such developments, we will do so. In the meantime, somebody else will have to pay for building the replacement of the sewerage element in the separate systems. The situation is not clear, but there will be a significant operating cost in future. It is right that the developers should work with us, with SEPA and with others to put in sustainable urban drainage where feasible.

The capital cost should be set against the household. The fact that we contribute up to £1,000 per household for general work means that, by definition, there is some cross-subsidy. However, that is not a specific aim and I am not sure that it should be.

In the context of the whole-life cost of the house, and the whole-life cost to Scotland, separating the surface water from the waste water should be cheaper in the long term—but I do mean the long term. Rainwater would be able to drain away naturally into streams without requiring the increasingly high levels of treatment that we currently give to much surface water. That is important when we consider flooding. This summer, we have seen some very serious flooding. It is a major issue and the costs could be massive. Separating surface water is a very sensible thing to do, so long as that water is not polluted. We work closely with SEPA on such matters.

Interestingly, this whole issue brings us back to the framework directive, affecting how we manage the catchment—the water received—and affecting what we, or whoever is doing the work, can do at the least cost to the community. Our job is to keep engineering and sewerage costs to a minimum. Many issues will flow from the legislation and they will take time to resolve.

**The Convener:** There needs to be clarity about what we are trying to achieve. If I understand you correctly, you are saying that, in the long term, sustainable urban drainage will be very positive for Scotland in general, and for your business.

**Dr Hargreaves:** Yes.

**The Convener:** However, in the short term, on the assumption that developers pay the cost of installing urban drainage, there will be a problem in determining how maintenance costs will be met. I presume that issues will also arise to do with the establishment of the planning framework. It would be sensible for us to deal with those issues in our consideration of the bill. We do not want a perverse incentive to operate whereby people do not separate surface water from waste water. That would be the worst outcome. Does the bill deal with that issue adequately? It seems to me that there is a hole in the bill.

**Professor Alexander:** Issues to do with detailed specification and elaboration will certainly need to be dealt with. We do not see that in the bill. Some work is needed.

**The Convener:** Will that need primary legislation or can it be dealt with by secondary legislation?

**Dr Hargreaves:** The Scottish Executive's view—and we agree—is that it can be done through existing legislation and through directions and regulations. However, clarity is required and, at the moment, there is none.

10:45

**The Convener:** Are the definitions in the bill—to do with sewerage, for example—adequate?

**Dr Hargreaves:** I am not an expert on that, but I think that they are okay. What we need are some clear directions and regulations on this matter.

**The Convener:** Can you supply us with clearer information on the developers' costs that you mentioned and on how the £17 million is made up? I am not sure that we have all the information that we need to make sense of things.

**Dr Hargreaves:** Yes.

**Professor Alexander:** We will supply that information to the clerk.

**The Convener:** Thank you—that would be helpful.

**Mr McCabe:** If the currently available subsidy is withdrawn—and it does not sound as if there is a very good case for it—the charge will be passed on to the consumer who buys the house. However, I am more concerned about the maintenance. It sounds as if we could be setting up a situation where there would simply be an

additional bill for certain domestic properties—or have I misunderstood?

**Dr Hargreaves:** At the moment, an element of all domestic property bills is for surface water drainage. That is fairly difficult to define, but the charge is there at the moment. In the long term, that cost should benefit the customer.

In parts of places such as Glasgow and Edinburgh, we cannot retrofit and would need massive ponds, or even lakes, to deal with this issue. We are really talking about new developments, and the charge would come through in people's normal bill.

**Alasdair Morgan:** I want to pursue the issue of costs. I am looking at the SEPA submission, where it says:

"The costs to industry identified in the financial memorandum are in all likelihood over estimates".

When you say "costs to industry", what industry do you mean? All industry? The water industry?

**John Ford:** Evan Williams will answer that question.

**Evan Williams (Scottish Environment Protection Agency):** The estimates in the WRC report, which were the basis for the estimates of costs to industry, are broken down in that report. If it would be helpful, I could go through the figures. The estimates are based on a partial reading of the bill and the water framework directive. They do not take as much account as they might do of the fact that, in drawing up the measures in river basin management plans, we will use the most cost-effective combination of measures possible, in order to achieve good status. Where it would be disproportionately expensive to achieve good status, it will not be necessary for us to do so—we would be able to derogate and either delay achieving the good status that we desire or, indeed, seek to achieve a lower status.

WRC's estimates were based on the assumption that all water bodies that were at risk of failing would require interventions. The part of the directive that requires us not to take action if doing so would be disproportionately expensive means that the overall cost will come down. We wanted to highlight that point.

**Alasdair Morgan:** I notice that the financial memorandum indicates that, in the longer term, you will be able to recover the large majority of your costs through charges. Do you have an estimate of how much you will recover each year through charges?

**John Ford:** Current projections are that SEPA's costs will be approximately £5 million by 2009-10. Those costs will be additional to the current charging base of approximately £11 million. So the

current £11 million will go up to approximately £16 million by 2009-10.

**Alasdair Morgan:** So who exactly will be getting charged?

**John Ford:** Our colleagues at Scottish Water, to a large degree.

**Alasdair Morgan:** Very cosy.

**Professor Alexander:** That has saved us the bother of saying it.

**John Ford:** A significant part of that increased charge comes from the introduction of the additional powers to control diffuse pollution, abstractions and impoundments. Again, the charge increase is not based on what SEPA is currently doing but on what it is doing plus the new activities that it will take on board under the water framework directive.

**Mr McCabe:** Paragraph 2.3 of SEPA's written evidence states:

"The WRC report identifies substantial benefits arising from the implementation of the WFD in the range £131m to £325m".

That is quite a comfortable range; I wish I could guess at such figures. Everything we have said this morning indicates that we have a large bill coming, one way or another. Will you explain your statement that there could be benefits to the tune of £325 million? If that turns out to be the case, how does it ameliorate the position caused by some of the additional costs that we have heard about?

**Evan Williams:** WRC's report on benefits was conducted by Professor Nick Hanley of the University of Glasgow. That work sets out the benefits that will accrue to society and individuals from the improvement in water quality.

Some of those benefits will be direct financial benefits because there will be improvements in, for example, fishing and recreational opportunities that can be commercially exploited. There will also be what we might call welfare benefits—people will be more able to enjoy the water environment. Although the individual benefits might be small, they amount to quite a lot over the whole population and over the period of time that we are talking about.

**Mr McCabe:** In other words, the benefits are difficult to define and they all depend on having money left after the hugely increased bills have been paid.

**The Convener:** None of the benefits relate to savings. There are no savings identified in the benefits that you are talking about.

**Evan Williams:** There was no identification of savings in that particular study. It might be a

sensible extension of that work to identify savings.

**Alasdair Morgan:** How are the benefits quantified? If you say that the burn flowing past my house will be much cleaner and that there will be more fish in it, is that the kind of benefit that you are talking about? How do you quantify how much that is worth to me?

**Mr McCabe:** Theoretically, I think is the answer.

**Evan Williams:** Something like that is notoriously difficult to do. The first thing an economist would do is ask you how much you value that benefit.

**Alasdair Morgan:** Yes, but that is not real money. I could tell you any figure because you are not asking me to hand it over.

**Evan Williams:** I appreciate the conceptual difficulty of that. That kind of assessment of benefits has been going on for a long time and, in SEPA's view, it is fairly imperfect. Nevertheless, there is a real benefit to people.

For example, if you were able to use a path by the river for angling or some other recreational activity, you would be better off. That will vary, depending on your use of that stretch of water. However, if many people get a small benefit, that will achieve some of those very high figures.

There are also some explicit cash benefits associated with angling and tourism. I could not give you an exact figure for the benefit of tourism to the Scottish economy, but I understand that it is estimated at approximately £4 billion per year. If that is enhanced slightly, there is a substantial benefit and real money coming in to real people.

**Elaine Thomson (Aberdeen North) (Lab):** I return to what you were saying about costs to industry. I am concerned about the paper industry, which is under a great deal of pressure and is extremely concerned about some of the issues surrounding water abstraction. One of the paper mills in Aberdeen says that the water that it is putting back into the rivers is cleaner than that which it is taking out. It is wondering whether it can charge SEPA rather than be charged by SEPA.

You said that the £5 million referred to in the financial memorandum might be an overestimate. Is it therefore the case that the paper industry might have less to face than it appears?

**Evan Williams:** If there is no issue to do with water being removed from a watercourse, and if cleaner water is being put back into the watercourse, that will be reflected in the overall assessment of the balance of, and threats to, the body of water, although I am not suggesting that SEPA is going to start handing over cash. That benefit will be reflected in the overall achievement of the quality status of the water body. Where that

is happening, it is unlikely that there will be additional pressure on the industry to improve further or to change its practice.

However, it might be that the abstraction or impoundment of water or another water-based activity causes a threat to the quality status of the water. That might be an issue but if, as you say, the company to which you refer is removing water and replacing it with better quality water at the same time, it is unlikely SEPA would do anything to prevent it from carrying on improving the quality of the water.

**Elaine Thomson:** Where there is such a situation, and SEPA recognises that the company's procedures are adequate, do you agree that some of the bureaucracy involved in the process is unnecessarily burdensome, especially when you are dealing with industries that are under a lot of commercial pressure? I am talking about situations where you have reasonable confidence that the companies are meeting or exceeding all environmental requirements for clean water.

**Evan Williams:** Where we are already achieving good ecological status of water bodies, the effort and involvement of all parties such as local authorities—not just the industries—around the river basin are likely to be much less. It is principally in areas where there is an identified risk that good status will not be achieved that there will be a targeting of effort and a requirement for input.

**The Convener:** Your submission states:

"SEPA currently recovers £9m out of the £20m used to protect the water environment."

You are estimating that you will

"increase the level of cost recovery to £11m."

That is an additional £2 million.

However, your statement also suggests that there will be a threefold increase in regulatory activity for SEPA. Those two statements seem to be inconsistent. Do you anticipate that there will be some resistance among people who are being charged, especially if you extend the basis on which charges are made? Do you also anticipate that a question will arise over whether we are getting due benefit for the increase in regulatory activity?

**John Ford:** Yes. We say that there is a threefold increase in regulatory effort and, in effect, our total cost is increasing by 25 per cent.

We square the circle because the water framework directive and the ability that it gives us to implement charges allow us to transform the way in which we carry out our day-to-day work on protecting the water environment. The range of regulatory tools outlined by the water framework

directive are associated with different levels of risk. As Evan Williams said, the approach will therefore be much clearer and more risk based, and the effort will go to where the greatest risk is perceived to be or is happening. Therefore the increase in cost does not relate directly to the increase in regulatory effort.

11:00

**The Convener:** Has consideration been given to identifying the most important regulatory mechanisms in terms of the direct benefit that will be gained in relation to the cost of imposing them? Those mechanisms could be identified as the first phase of the introduction of mechanisms. You could then consider how far you want to progress with the plans on some other aspects of the water framework directive. Have you considered piecemeal rather than wholesale implementation of the scheme?

**John Ford:** The WFD provides for the delivery of the most cost-effective combination of measures that can be applied and provides for the fact that we can set less stringent objectives where costs would be disproportionate. We have the mechanisms to deal with such instances. Does that answer the question?

**The Convener:** You have not given us information that would allow us to validate that judgment. Are you saying that what is outlined in your submission is your assessment of the most cost-effective mechanism? What evidence could you supply to support that contention?

**John Ford:** I cannot answer that question off the top of my head.

**The Convener:** Could you provide the committee with more information?

**John Ford:** Yes, but I will need to come back to the committee with that information.

**Alasdair Morgan:** I have a question for SNH, so that its representatives do not feel left out. The SNH submission states that it was

"surprised to learn ... that Ministers expected such WFD commitments to be absorbed within our existing budget."

Does that mean that the Executive did not ask SNH about that?

**John Thomson:** Dialogue has taken place with the Executive but, as I said in my opening remarks, the nature of SNH's input to the process has emerged only relatively recently, because SEPA has had to focus on exactly how it will get together the information that it needs for characterisation of the various water bodies throughout the country. There were different options as to how that could be done. SEPA could have taken on additional resources and acquired

suitable expertise to undertake the work, but I think that it reached its conclusion partly because of the deadlines to which it works. It is more practicable and better for SEPA to look to SNH for much of that input. The scale of the requirement for SNH has begun to emerge through recent consideration of how to implement the water framework directive. Dialogue took place with the Executive, but at a stage when it was difficult—even more so than it is now—to quantify the resource implications for SNH.

**Alasdair Morgan:** Can you put any estimate on the scale of the current requirement?

**John Thomson:** We have been trying to do that. Our current best estimates are that between now and the end of December 2004 we are talking about the equivalent of about seven or eight posts across the organisation. That represents about 1 per cent of our staff complement, so it is not a huge burden; however, the point that I emphasised in my opening remarks is that it comes at a time when the overall volume of our activities is increasing because of some of the other programmes that we are implementing, and because of the priorities that we have been given by the Executive. The burden is in addition to activity that we were already going to find difficult to accommodate within our budget.

**Alasdair Morgan:** Do you hope that the work of the seven or eight posts will be achieved by reprioritisation, or will you have to recruit extra staff?

**John Thomson:** We are currently trying to reprioritise. That is how we freed up some of the time that we have made available for the exercise. That has inevitably meant holding back some other activities, but we would be reluctant to do that indefinitely. We believe that a combination of reprioritisation and extra resources is likely to be required in the medium to long term. That might apply even more when we get to the later stages of implementation.

**Brian Adam (North-East Scotland) (SNP):** We heard from SEPA about how it was involved in the development of the non-market benefits and cost-benefit analysis. I note that SNH is also involved in that. How well developed is SNH's role in that? Do you see it as a major element? What resource is SNH currently putting into that and where has it come from?

**John Thomson:** It is fair to say that, over the years, economic evaluation of environmental benefits has been a matter on which we have kept a watching brief, rather than one to which we have devoted a lot of effort, but we recognise that it is likely to come increasingly to the fore over the coming years. Recognised techniques exist although, like Evan Williams, we are sceptical of

how well founded some of them are. Take the example that was given of the house beside a burn, which might or might not be polluted. One way in which one can try to capture that sort of economic benefit is by comparing the price of houses beside polluted burns with those that are not, other things being—as far as possible—equal. We all know that in the real world things are never entirely equal, so the difference cannot be completely captured, but that is one of the techniques that can be used. One might be sceptical about that technique at first sight, but if one looks more broadly at the prices that are paid for houses in communities that are seen as having good environments and in those that are seen as having bad environments, one begins to get a feel for the scale of difference that a good quality environment makes.

**Brian Adam:** If neither SNH nor SEPA is doing the analysis directly, who is and how is it being paid for?

**John Thomson:** I am aware that south of the border some work is being led by the Department for Environment, Food and Rural Affairs to try to quantify the value of some environmental benefits, not least those that are linked with, for example, agri-environment programmes. The matter is being addressed in that context. In respect of the reform of the common agricultural policy, what the public at large is willing to pay for environmental benefits that are delivered by farming is being considered. Work has been undertaken jointly by a range of public agencies over a number of years.

Another good example is the Forestry Commission's significant efforts in the past to quantify the economic benefits of forests, both for recreation and more generally for amenity. Quite a lot of work is going on, but it is spread widely across the public sector.

**The Convener:** I am becoming concerned, from what I hear, that the statement in paragraph 145 of the financial memorandum that

"compliance costs will be minimised",

is not what appears to be emerging from the evidence. Do you want to make any further comments on that? You seem almost to be engaged in a bidding exercise. SNH says that it will need additional staff. SEPA says that it will have to put in place three times more regulatory arrangements and that it places a £2 million charge implication on that, which I have some questions about. Is what we are being told consistent? Does Tom McCabe want to add to that question?

**Mr McCabe:** As I said, we are clearly engaged in something that is highly desirable and perhaps to a large degree inevitable. However, on the evidence that we have heard this morning, this is

the economics of the madhouse. We have no clue about what the charge will be to the public purse. To be frank, the general public are entitled to far greater clarity about the potential costs, but we are nowhere near to providing that. The only conclusions that I can draw from the evidence that we have heard this morning is that there will be an enormous bill for the general public and that they should have far more information about what the bill may entail before we go any further.

**Alasdair Morgan:** Another concern I have is that—given that the Executive is unwilling to fund extra costs—clearly the extra costs will have to be met by diversions from other budgets. We have talked about the person in their house beside the burn, but probably their greatest concern these days is not so much the quality of the water in the burn, but the fact that the burn might end up in their front room. To what extent will the extra costs take away from expenditure on flood prevention?

**The Convener:** We might wish to ask the Executive that question.

**Brian Adam:** I believe that tariffs will be developed that more broadly reflect the economics of the service that is provided, which

"will require that the fixed element of the charge faced by customers increases significantly from the current level."

If there is a fixed element, obviously there is a non-fixed element. Can you elaborate on that? What does "significantly" mean, especially against the background of Scottish Water's predecessors, which increased charges by double-digit figures for several years? Often the first of those digits was not "1".

**Douglas Millican:** That comment was made in the context of advice from the water industry commissioner to the Minister for Environment and Rural Development last October, which set out the commissioner's view on the financial affairs of Scottish Water for the four years from 2002 to 2006. The background to that advice is that historically in Scotland, the vast majority of charges on business customers, as opposed to households, have been variable and have been based on charging so many pence per cubic metre of water taken. A small element is charged by way of a fixed or standing charge.

In examining the economics of the industry, the water industry commissioner identified that 70 per cent and perhaps even up to 80 per cent of the costs of Scottish Water are relatively fixed, irrespective of the volume of water that is taken by customers on a given day. The commissioner encouraged the Minister for Environment and Rural Development to consider that Scottish Water should, in future, have a charging structure in which relatively more of its income comes from some form of fixed charges and relatively less of

its income comes from some form of variable charges.

To set that in the context of total charges—I understand the comment that was made about historical charge increases—the total income that we can get from all our customers this year is capped at £888 million. The water industry commissioner's advice—which the Minister for Environment and Rural Development accepted—is that revenue should increase to a maximum of £957 million in 2003-04, that it should increase to more than £1 billion in 2004-05, and that it should then drop back to £988 million in 2005-06. Members can see from that profile of revenue increases that although the increase peaks in 2004-05, the relative level of increase in our revenue is significantly lower in the next three years than it has been over the past four or five years. The issue for us on charging is simply to take the revenue for a given year and to determine, in conjunction with the water industry commissioner, the proportion that is levied on a fixed basis, as opposed to the proportion that is levied on a variable basis.

**Brian Adam:** My recollection of the current significant capital investment is that a lot of the costs have fallen disproportionately on domestic customers, in order to protect industry. Given the increases in the next two or three years—which are double-digit increases, or as near as—how does Scottish Water intend to play out domestic against commercial charges, particularly in light of the comments from the water industry commissioner?

11:15

**Douglas Millican:** From a process angle, all that is set at the moment is the charging arrangements for the current financial year. In November, we will submit to the commissioner a scheme of charges for the following financial year, which will set out our proposals. Given that we are a couple of months away from that, we still have significant work to do, and the board must consider the proposals. However, the commissioner has indicated that he does not expect increases for domestic customers in the central belt—the old east and west water authority areas—to be more than 9.9 per cent next year. He expects that there will be no increases in the north area next year.

In general, I do not expect business charges to rise faster or slower than domestic charges. We must all be careful, because behind that headline there are significant issues around harmonisation of charges throughout Scotland. The issue is partly one of regional harmonisation, but it also concerns harmonisation of charge elements. I will give one example from the waste-water side. The

old North of Scotland Water levied a much more significant proportion of its charges based on rateable value than did East of Scotland Water. As we harmonise, behind the headline increase some customers will inevitably face significant increases, while other customers will face significant decreases. However, on average, the change to business charges will not be inconsistent with that to domestic charges. The picture is complex.

**Brian Adam:** Is that likely to mean that charges might fall disproportionately on particular industries or particular parts of the country? The urban waste-water treatment directive had significant implications for fish processing and all food processing industries, which led to all sorts of schemes to come up with an alternative and to move away from Scottish Water. Have such charging implications been thought through?

**Douglas Millican:** The short answer is that there will be a greater effect on some industries than on others. That reflects the position that Scottish Water inherited. Because the previous water authorities tried to cap the impact on given industries in any particular year, we have not inherited a situation in which our charges reflect the underlying cost for each industry group. As we move from our inherited position—which is a mixed bag—to a position over the coming years that is more cost and cost-structure reflective, there will be a greater impact on some industries overall than on others. However, the picture throughout Scotland will not be generic; the outcome will depend on the old water authority area. If one authority made greater progress on harmonisation and moving to cost reflectivity than did another, the impact for customers in the former authority's area might be less than that in the area where the old authority made less progress.

**Mr McCabe:** Could you go into more detail on the commissioner's view on fixed charges? What will that view mean? I am worried that it will lead to a degree of complacency and that it will be a disincentive to making greater efficiency savings year on year, but I may be wrong. Could you give me more of the thinking behind your interpretation of the commissioner's view?

**Douglas Millican:** The commissioner's advice is open and leaves a lot of flexibility for Scottish Water to develop schemes of charges within the context of that advice. It is possible to develop fixed charging schemes that still give customers an incentive to reduce their demand on the public water system. For example, large industrial customers could pay a reservation charge by reference to the amount of capacity that they reserve in the system, for example 20MI of water per day. If, however, they change their production process on a long-term sustainable basis so that they do not need 20MI but instead need a much



smaller amount, say 10MI, we could take that into account in our forward investment planning and reflect that in a reduced future reservation charge that is based on 10MI a day, rather than on the old reservation charge based on 20MI a day.

**Professor Alexander:** I have a general point to make. The principles that underlie the balance between volumetric and fixed charges are part of a complex regulatory settlement. If we take that regulatory settlement as a package, I can assure the committee that the incentives to Scottish Water to operate as efficiently as possible are pretty strong across the board. Douglas Millican made the point that the revenue cap represents an enormous pressure on us to ensure that we operate in the most efficient way possible.

**Dr Hargreaves:** To give an idea of the scale, the targets that the commissioner set for the four years mean in effect that we must reduce operating costs by 40 per cent. In pound notes, that amounts to the best part of £200 million out of an operating cost base of about £450 million. Such a reduction represents a huge challenge.

The fact that the capital investment figure amounts to about £500 million out of the original estimate of £2.3 billion is easily explained. We have never been given the £2.3 billion—we received only £1.8 billion to begin with. We will have to deliver for £1.8 billion what we said we would deliver for £2.3 billion. The danger of complacency is overcome by the way in which the regulatory process denies us the money in the first place. Charges and borrowing represent the only sources of money and both those sources are fixed at the beginning of the period. Although the charges vary year on year, the amount of revenue and borrowing that we can take during the period are fixed. The regime is completely different to the previous regime. The fact that a four-year period is used—the period might be longer in future—gives us time to plan, which is a benefit.

The incentive for industry to use less is that pound notes will be saved, whichever way one does it. If one uses less, one will end up with a smaller meter and there will be a smaller meter charge. Even if we were to reduce dramatically the volumetric charge, which we will not do, there would still be an incentive on industry to use less. That fits nicely with the bill's drive to use less water more efficiently.

We have been concerned about industries that contribute effluent to sewage treatment works, which I think a member mentioned. In such cases, there is an effect on improvement needs, which results in the raising of significant charges. Historically, that issue has not been transparent in Scotland and in parts of England, but we must strive for transparency in such cases. If an industry can clean the effluent that it discharges to

the sewers, it should be encouraged to do that, because an end-of-pipe solution at a sewage works is, in effect, subsidised by other customers. Greater transparency is required. Encouraging industries to clean up their effluent is not popular, because it usually means that they must spend money. We are happy to help with such work. In the context of the bill, it is critical for people to acknowledge that the cheapest way of dealing with pollution of that kind is to deal with it as close to its source as possible, before it contaminates in bigger volumes. Historically, such pollution has not been dealt with in that way.

**The Convener:** I thank the witnesses for their evidence. We might want to ask Scottish Water some additional detailed questions about its view on the estimates of the impact on Scottish Water. We will do that by correspondence, if that is agreeable. We will take a five-minute break to allow for a change of witnesses.

11:23

*Meeting suspended.*

11:28

*On resuming—*

**The Convener:** I welcome the team from the Executive who will give us evidence on the financial memorandum. Emmie Bidston is from the Water Environment and Water Services (Scotland) Bill team. Elinor Mitchell is the head of division at the water environment unit. Michael Kellet is the team leader of the water framework directive team. David Reid is head of division at the finance and central services department. Does David Reid want to make an opening statement?

**David Reid (Scottish Executive Finance and Central Services Department):** For the purposes of this morning's meeting, the bill team will lead. I will provide support on finance matters, but the people who are actually handling the bill will present matters.

**The Convener:** That is a good principle.

**Michael Kellet (Scottish Executive Environment and Rural Affairs Department):** From discussions with the clerk, we understood that an opening statement would not be required. In a sense, the opening statement is the financial memorandum, so it might be more appropriate to proceed straight to questions.

11:30

**Alasdair Morgan:** The main question is not one that the financial memorandum can help us with: how much is it going to cost?

**Michael Kellet:** The difficulty is that the bill is introducing a new planning system for the water environment. That planning system will involve stakeholders, communities, industry, the groups that the committee has heard from today, and the public and private sectors. It is difficult to be firm about costs at this stage, as it is only when the planning system has been established and has worked its way through that we will be able to determine costs.

The first river basin plan will not be provided and approved by ministers until 2009. It is not until then that the environmental objectives for individual water bodies will be established for the first time. Those environmental objectives will be the key drivers of compliance costs and the work that industry and the public and private sectors will have to do to enable us to meet the objectives.

The other uncertainty—we accept that there is significant uncertainty—is the fact that the bill is an enabling bill. Section 20 provides for fairly extensive new control regimes, particularly on abstractions, impoundments and engineering works in the water environment. Until those regulations and regimes are put in place, it is difficult to be clear about the cost. However, we have said that we will consult at every stage of the development of those regimes and will give them a full regulatory impact assessment when they are put in place. In due course those measures will come before the Parliament for deliberation.

**Elinor Mitchell (Scottish Executive Environment and Rural Affairs Department):** The process will be iterative. We are where we are today and, as the system moves on and regulations are made—all the stakeholders will be involved in discussions on those regulations—the costs and implications of implementing the water framework directive will become clearer. As Michael Kellet said, there will be a planning process and everyone will be around the table to discuss what will be in the river basin management plans. The objectives that are set down during that process will determine what the costs will be. Because the bill is an enabling bill, it is hard to determine up front what the costs will be and where they will fall.

**Alasdair Morgan:** I have two points. First, the comparison with a planning process is okay, but a planning process usually affects future developments. The bill will have an impact on what people are doing. It will have a retrospective effect, so it is crucial that we get it right.

Secondly, the fact that the bill is an enabling bill makes us more concerned. We all know that, regardless of what is said, once we are into secondary legislation, the chances of changing it significantly are far less than they are of changing primary legislation. Primary and secondary

legislation are not subject to the same amount of scrutiny. Many of us are concerned about that.

**Michael Kellet:** We accept that a number of stakeholders have said to us that the secondary legislation will be a key issue. We will develop that secondary legislation in an open manner. We have consulted extensively, held seminars and talked to a range of stakeholders about the development of the policy underpinning the bill. We will certainly want to carry that policy through.

Ministers are also committed to the secondary legislation being the key driver and we must ensure that we get it right. One of the main reasons why the detail of the regulatory regimes is not in the bill is that we must take time to get those regimes correct. We have not been able to develop the detail of, for example, an abstraction control regime in the time that we have had since the water framework directive was published. That would take a lot of time and consideration and we wanted to make sure that we have the time to do that.

**The Convener:** I remind the witnesses that we are not the Transport and the Environment Committee. We are here to examine the financial aspects of the bill—it is important for us to adopt that self-denying ordinance.

**Michael Kellet:** The report, which was produced by WRC with the input of the University of Glasgow and the University of Dundee, was an attempt to set out clearly the costs involved. It was possible to do that once we were clear about the provisions of the bill, with independent researchers giving us the best estimate of the likely future costs.

A number of correspondents pointed out difficulties in different sectors and expressed doubts about the report's conclusions. However, we are satisfied that the report gives us as good a general picture of the likely future costs as we can hope to have at present. We have made the report and the detailed case studies that underpin it available to the committee. Should the committee require further information on the research, we would be happy to provide it.

**Alasdair Morgan:** Does the Finance Committee usually consider the financial consequences of Scottish statutory instruments? As the costs of the bill depend on the cost of the SSIs, we cannot tell from the bill what its costs will be. If we do not look at the SSIs, what is the point of the exercise?

**The Convener:** There is truth in what Alasdair Morgan says. It might be useful to get an estimate of the financial implications of some of the more important SSIs. We cannot expect such an estimate to be fully comprehensive at this stage, but it may be possible to set some parameters. Perhaps different sets of estimates could be produced to give us a better view of the situation.

**Michael Kellet:** That is the case, but to enable WRc to undertake its work in order for us to estimate costs, it had to make assumptions about the impact of the regulatory regime. Those assumptions are shown explicitly in the case studies that WRc prepared and we consider them to be reasonable.

**Mr McCabe:** My experience of the public sector is that, when people speak in broad ranges and do not want to define eventual costs, it is because they know that the costs will be high—they do not want to go there. We have all been in the game long enough to know that that is usually the case. Earlier evidence mentioned a range of figures that was very broad, to say the least.

The same point applies to local government. The financial memorandum sets out that the cost to local government could fall somewhere between £25 million and £65 million—again, there is a broad range between those figures. How will local government pick up that burden? Do you expect it to do so through the rate support grant or by absorbing those costs into existing budgets? What is the split likely to be between capital and revenue costs? What will the impact of the bill be on non-domestic rates and council tax levels? If there is an impact, have you discussed it with local government?

**Michael Kellet:** We have had discussions with local government on numerous occasions about the policy that allows us to develop the bill. We have not discussed the detail of the financial implications of the bill. We have talked about the uncertainties already but, as the explanatory memorandum makes clear, we anticipate that the major financial costs will fall in the period between 2007 and 2011. That takes us into the context of the next spending review—not the one that is about to be announced—which gives us time to go into the detail. I understand that the costs that are set out in the financial memorandum—the £25 million to £65 million range—are estimated one-off capital costs that local authorities may have to put in place to allow the environmental objectives of the bill to be met. Those costs will be spread over the four-year period from 2007 to 2011. I can clarify that for the committee if requested so to do.

**Brian Adam:** Surely there is a revenue consequence to a capital cost. Why are the revenue figures not included in the financial memorandum?

**Michael Kellet:** I am not sure that there will be a revenue consequence. It will depend on the planning system, but councils may have to examine their existing coast and flood protection measures to determine whether they can make physical changes that will be more environmentally friendly while providing the same level of protection. In that sense, there will be a

one-off extra cost. Maintenance costs may arise, but such costs would arise for the protection mechanisms in any event.

I hesitate to be completely firm about that—I can certainly look into the matter and provide the committee with more evidence—but that is my interpretation of the situation. We are talking about fixing existing protection measures—if they can be fixed—to mitigate their impact on the environment, and that will be a one-off process.

**Mr McCabe:** If I were in local government, I would interpret your answer as indicating that I would be expected to absorb the costs.

**Michael Kellet:** I do not think that I said that. I am simply trying to explain the costs and why they are capital costs.

**Mr McCabe:** I know that you did not say that, but—

**David Reid:** The Executive's approach to new burdens that may fall on local authorities is on the record. The Executive has given local authorities an undertaking that, when a new burden arises, it will provide appropriate levels of resource. As members will doubtless know, there are always debates about the right level of resource, but there is no reason why members should think that the new burdens policy of funding local authorities would not operate in this case.

As Michael Kellet said, the cost impacts on authorities are still some way down the line—they are at least one spending review away. Between now and then, there will be time for the policy to develop and for the department to put more accurate costs on the likely impacts on local authorities.

**Brian Adam:** I understand your point, but it seems an unusual way in which to approach financial matters. You are saying that you decide in principle what you are going to do and then you go ahead with it, irrespective of how it is to be financed. You think about how you are to pay for it later. You are also saying that you already have to maintain coastal protection mechanisms and that therefore there will be no consequential increases in revenue costs. If such costs happen to arise, you will think about financing them at some point, but they are not immediate.

From the point of view of the principle behind the production of a financial memorandum, I would have hoped that you would have indicated the capital and revenue figures and what the consequences of capital expenditure might be. I would also have hoped that you would have indicated how such expenditure will be financed and how those costs will be allocated to local government or non-departmental public bodies. It is irresponsible simply to decide on a global sum

and to consider how to pay for such expenditure later.

**Elinor Mitchell:** The nature of the bill and the powers that it contains means that, until the characterisation work is done and the planning process begins, we will not have a firm idea about what needs to be done. Until we have a firmer idea about that, we cannot allocate costs. You are right to suggest that we are in a chicken-and-egg situation. The up-front work has to be done before we can determine the state of the water and what we can do to control and manage it. Once that work has been done, we will be able to get around the table again, in the context of secondary legislation, to work out the costs and how to fund them.

**Mr McCabe:** Surely you must see how that would make the taxpayer, or someone who runs a company, incredibly nervous. If you were to put that scenario to anyone who manages their own personal finances, they would refuse to do it—no one would do that with their own money. Perhaps we are operating in an unreal environment in the public sector and we should just accept that and carry on, but I do not see how anyone else—in particular someone running a company or a business—would for even a second consider handling their finances in that manner. It is incredible.

**Michael Kellet:** As I said, the point is that local authorities, industry groups and the public agencies that have appeared here today will all be involved in the planning process, so they will have a say in determining the environmental objectives and the most cost-effective means of achieving them. The process will involve those parties in taking decisions; it will not just happen and be landed on them without consultation or involvement. I acknowledge what you say, but the river basin planning provisions in the bill will seek to establish a process of involvement.

11:45

**Alasdair Morgan:** With respect, given that companies do not have a history of knowing why Governments make decisions, that will not greatly reassure them. They will be consulted and a decision will then be made, but it will still cost them a fair bit of money, and they do not have a clue how much it will be. Once this legislation is passed, that is it; there will be a cost.

**Elinor Mitchell:** There are checks and balances in the system. The bill requires that not only the environmental impact but social and economic impacts must be taken into account. That is a big step forward in policy. In the past, when European directives were implemented, for example the bathing water directive, a standard was set that had to be met, regardless of the cost to business

or the public purse of doing so. Although, as has been said, the costs in this case are not clear up front, there are checks and balances in the system, in as much as everyone is involved in the planning process. There is also a balance to be struck between economic, environmental and social impacts. There is no environmental objective to be met at any cost.

**Alasdair Morgan:** Could you give me an example of how the checks and balances will kick in?

**Michael Kellet:** The water framework directive contains a derogation on environmental objectives, which we will replicate in the bill. That will be key for a whole range of sectors. The derogation can be applied to a water body that is designated as a heavily modified water body, which is the term used in the European directive. The derogation allows us to set an environmental objective for such a water body—a stretch of river or loch—that takes into account the valuable use to which the modification has been put.

The easiest example is the hydroelectric power sector, in which there has been significant modification of water environments to provide for hydro schemes. The directive allows us to alter the environmental objectives that are set for such water bodies to take into account the fact that the hydro schemes are there, so we do not have to set unrealistic environmental objectives.

**Alasdair Morgan:** Do you mean objectives such as knocking the dam down?

**Michael Kellet:** Exactly. We could set environmental objectives that take account of the fact that the dam fulfils a useful function for society by producing clean energy. Derogations might apply to other sectors as well. They will be particularly important in driving the planning process and the costs to which I referred.

**Alasdair Morgan:** Could one factor be a group of firms that said something was going to cost them too much? I do not get the feeling that that would be a ground for applying one of the economic derogations.

**Michael Kellet:** The directive provides for the derogation and then provides tests that must be met in order to use the derogation. One of the tests is the concept of disproportionate cost, so that factor can be taken into account in determining whether the derogation is used.

**Alasdair Morgan:** Does that apply only to heavily modified water bodies?

**Michael Kellet:** Disproportionate cost is used in a number of contexts. As Evan Williams from SEPA mentioned, the default environmental objective is good status, but under the bill and the directive we will have the power to set a less

stringent environmental objective. Disproportionate cost will be an element in deciding whether we can do that. We can also delay the achievement of good status.

The principle behind the directive is that we should achieve good status for water bodies by 2015. However, the directive is flexible in that it allows us to delay the date twice by six years, in effect until 2027. Disproportionate cost is an element in allowing that delay. Other tests such as technical unfeasibility can be factored in.

**The Convener:** As well as the disproportionate cost factor, should not there be something that factors in affordability at any particular time? It seems to me that we run the risk of establishing a framework that requires us to spend money that we might not be able to find in the period in which we want to achieve the objective. Do we need greater flexibility in the system to allow affordability, as well as disproportionate cost, to be a factor in the equation?

**Michael Kellet:** Affordability will be a factor. The matter has been the subject of much debate in Europe. One difficulty with affordability might arise when there are two enterprises that sit beside each other, one of which is more efficient. In that situation, factoring in affordability might penalise the more efficient operator by driving up the environmental standards for that operator but not for the less efficient operator down the road. It would be difficult to use the affordability factor across the board. However, in the general river basin planning process, affordability will inevitably be an issue that the partners and ministers will want to consider.

**The Convener:** The Executive is asking the Parliament to establish a broad legislative framework that will allow the Executive to make requirements on the various bodies concerned, without reference to affordability. You say that affordability might be considered around the edges, but that it will not be a central consideration in implementing the legislative framework. The Executive is asking the Parliament to approve a lot. We are being asked to approve the framework and to give the Parliament little control over the Executive's discretion within the framework. In fact, we are being asked to give the Executive little discretion on cost issues.

**Michael Kellet:** One important factor in the bill is that the environmental objectives that are set in the river basin plan will be the key driver of costs. The bill provides for ministers to have the final sign-off on the river basin plans. The plans will not be delegated completely to SEPA. The Parliament can hold ministers to account for decisions on the river basin plans.

**Brian Adam:** What impact will the bill have on

the price of items such as fish and chips? From what the witnesses have said, the bill will have a big impact on tattie growers, because it will involve more than a one-off cost for people who grow potatoes and who regularly irrigate their fields. What impact will the bill have on the retail price index? Are we heading for the £5 fish supper?

**The Convener:** There will be no more monster neeps in Turriff.

**Michael Kellet:** I cannot answer that question. Mr Adam obviously refers to the report on the work of the Macaulay Land Use Research Institute on the potential impact of abstraction controls on potato producers. That evidence is before the committee. I cannot attempt to extrapolate how the bill will affect the price of chips.

**Brian Adam:** The report suggests that financial margins might be reduced by up to 11 per cent. It states that the minimum impact will be a reduction of 0.5 per cent, but that it could be as high as 11 per cent. In a year when there is a significant scarcity of potatoes, there will also be heavy usage of water for irrigation. That will have a big impact. Perhaps I was being facetious, but my example was real. How can we ameliorate the bill's effect on individual businesses and the general public?

**Michael Kellet:** I have two responses to that. First, as the witnesses from SEPA explained, in establishing the bill and the regulatory regimes, we will ensure that we put in place a system that is risk based. The bill is not about seeking to regulate activity for the sake of regulation; it is about regulating where environmental degradation is being caused by the activities that are being regulated.

Secondly, in situations such as those that Brian Adam described, which are related to water-stressed catchments, the use of derogations may be particularly important to ensure that potato growers or other abstracters can continue to do what they have done and support their businesses.

**The Convener:** I think that we have had enough on potato growers, otherwise Brian Adam will get the same reputation for parochialism as his colleague Richard Lochhead.

**Mr Stone:** You will not be surprised to hear me ask this question. Two committee members were late today because of the situation in Inverness. The flooding of Inverness flies in the face of everything that you are trying to do in the bill, in respect of mixing storm water with sewage water, so environmentally it is a disaster. I have not talked to Highland Council, but I imagine that the flooding will create something of a headache in relation to the capital and revenue budgets in the Inverness area.

A few more Invernesses, which may be upon us as a result of global warming, could seriously derail the bill. Perhaps this is not a fair question at this stage, but it will not be entirely unexpected. What consideration have you given to such possibilities in the past and might you have to give to them in the future? Might you have to amend the bill accordingly? Let us face it, some Scottish local authorities—I am not naming any, least of all Highland—are a bit vague when it comes to coastal protection and similar matters. The cost of an Inverness or two could wreck the bill.

**Michael Kellet:** It is difficult for me to answer that question as we do not have responsibility for flooding control, although we think that the river basin planning system will provide a useful forum for discussion of issues related to flooding because it will bring together local authorities and other partners on a catchment basis, which is the most sensible basis on which to think about flooding. The bill does not deal with the institutional responsibilities for flooding. Other colleagues in the environment group have responsibility for that, so I am sorry to say that it is difficult for us to say more than that this morning.

**Mr Stone:** Surely you recognise that the subject impinges on what you are trying to do in the bill and that yourselves and ministers should consider it.

**Michael Kellet:** We think that the bill will have a positive impact because of the creation of the river basin planning forum. We do not think that our proposals will have a negative impact. Far from it, we think that providing a forum to consider matters on a catchment basis should be helpful in bringing partners together. As I have said, we do not propose in the bill to change the institutional responsibilities for flood prevention.

**Elaine Thomson:** I will ask about some of the estimated costs to industry. Paragraph 159 of the financial memorandum refers to distillers and the paper industry. There seems to be a lot of uncertainty about what some of the costs might be. Paragraph 159 states that further research will be conducted to

“investigate and quantify the possible impacts”.

The paragraph goes on to state vaguely that such research may also be necessary in relation to paper mills.

What discussion and consultation has taken place with different industrial sectors? Several sectors have been mentioned this morning. Fish processing is another sector that has, in the past, suffered negative impact as a result of new waste-water directives. There seems to be much uncertainty about the costs of the bill, yet my feeling is that if you asked the paper industry what it thought the costs would be, it could probably tell you quite accurately.

**Michael Kellet:** We have had general discussions since the directive was agreed. The directive was not published until the end of 2000, but it was agreed in June 2000. Since then, we have turned our minds to consider how we should implement it and we have had regular discussions with a range of industry sectors, distilling being key among them. We have had discussions with the hydropower companies and textile companies and limited discussions with the paper and pulp industry, which we identified as a sector that could be particularly affected. That is why we asked WRc to consider the paper and pulp manufacturers as one of its case studies. It has done that in the report that it has put together. The case study on paper and pulp is the basis of the information in the financial memorandum about the likely impact. As we have described, there are inevitably uncertainties for all sectors because of the setting up of the planning process.

Evan Williams made the point that for a paper industry that takes water and discharges it on a clean basis close to the point from where it takes it, the likely environmental impacts are fairly slight. On that basis, we would not seek to control it for the sake of controlling it. However, because of the uncertainties that we have mentioned, it is difficult to be any more certain at this stage than what was provided for in the WRc report.

**Elinor Mitchell:** The same arguments apply to other industries. Until the environmental objectives are set for a particular body of water, it is impossible to determine what the impact will be on the industry and the associated costs. The commissioner will work on the distilling industry to get a fairer idea of costs, but the result will still be ballpark figures.

**Elaine Thomson:** You recognise that there is nervousness in several industrial sectors because of things that have happened in the past. The fish processors are the most obvious example—they were not consulted early or adequately enough.

12:00

**Michael Kellet:** We recognise that nervousness: it has been expressed to us directly in our discussions with various sectors. One of the things that we said in the second consultation paper on the implementation of the directive that underpinned the meat of the bill was that we would seek to introduce the new regulatory regimes in phases from 2005 onwards. That will allow the industry to have some certainty about the likely impact before it has to do anything. The directive provides that the measures do not need to be fully in place until 2012. We envisage a phased implementation to allow industry and others to build up the things that they need to do to meet the requirements set in the river basin plan. I hope

that we will avoid the situation that might have arisen in relation to previous directives where industries have had to turn about face almost overnight in order to meet more stringent environmental objectives. We are trying to avoid that by implementing the regimes in phases.

**Mr Stone:** I hear what you say, but the fact is that some industries—Elaine Thomson mentioned the fish processing industry—have no fat left on them. For several reasons—not least what is going on in the North sea and our seas in general—many businesses are extremely marginal. Therefore, even phased implementation is a problem. I can think of one business in my home town that is really up against it. It would not take much for that business to pull up and say, “Stuff it”. At the end of the day, we are talking about jobs in rural areas. I understand where you are coming from in relation to environmental planning, but do you think that the Executive recognises that it is not that businesses are nervous, but that they fear for their survival? Secondly, what discussions have you had with the tourism industry, which is key in the Highlands?

**Michael Kellet:** The second question is easy. We have not had any discussions with the tourism industry. That is perhaps a failing on our part. We have always anticipated that the impact on tourism would be positive, because the aim is to protect and maintain the quality of Scotland’s environment. In that sense, the outcome should be positive for tourism. However we have not made direct contact with any of the tourism bodies.

In terms of coping with vulnerable operators, one of the things that is explicit in the bill is that SEPA is taking a lead role in planning and, for the first time, we have given it a duty to take on board the economic and social priorities as well as the environmental ones. SEPA will take on board the three legs of sustainability and should not approach the issue from a rigid environmental point of view. That duty on SEPA is made explicit in the bill. Such issues will be addressed.

**Elinor Mitchell:** We have not been in direct contact with the tourism industry, but in the cost and benefits report that was done by WRc, many of the benefits that are outlined are attributable to increased tourism—better angling and better facilities in Scotland.

**Mr Stone:** I accept that. However, the point is that such benefits will roll out more slowly—it may take years. In the meantime, Mrs Mackenzie who runs a small business could be a wee bit marginal; her time scale is much shorter. I would like to be confident that you recognise the contrast between the short-term problems and the long-term benefit.

**The Convener:** I am sure that Mike Kellet will take on board that comment.

Have you any comment to make on the subject of sustainable urban drainage and the apparent lack of a mechanism to deal with maintenance costs in the bill? How will you deal with that? Will subordinate legislation be an entirely adequate vehicle for that?

**Michael Kellet:** The Executive is very supportive of the moves to promote sustainable urban drainage across the board. As my colleagues said, in many ways we are ahead of the game on that point. The Executive realises that there is a problem with arrangements for the future maintenance of SUD systems. There does not seem to be a problem with SUD systems being put in place in Scotland, but we acknowledge that there may be a problem with the arrangements for future maintenance. We are working closely with colleagues in Scottish Water and SEPA as well as the developers in the SUD working party—the committee will be aware that there has been a SUD working party under SEPA’s chairmanship for many years—to determine how we best resolve that problem. At this stage we are not in a position to say whether primary or secondary legislation would be the most appropriate vehicle for a solution. However, the issue is important and we are trying to determine the best way to take it forward.

**The Convener:** There is a financial regime issue that needs to be resolved.

Thank you for giving evidence. We may be in touch for more detailed information, particularly on the costing. Any additional information on that would be welcome.

**Michael Kellet:** Mr McCabe asked about the likely impact on charges for water services. In the first consultation paper that we published on the implementation of the directive, we made it clear that ministers’ view is that neither directive nor bill will force us to change policy in relation to domestic metering. That point might be useful, given our earlier comments that we are confident that current arrangements comply with the terms of the directive. There is no desire to change the policy that has been explained to the committee and that has been widely set out.

**The Convener:** Thank you; that was very helpful. Our objective now is to prepare a report for the Transport and the Environment Committee, which is the lead committee on the bill. I anticipate that we will consider the report at our next meeting.

12:07

*Meeting continued in private until 13:27.*





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