

FINANCE COMMITTEE

Tuesday 6 March 2007

Session 2

£5.00

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FINANCE COMMITTEE

5th Meeting 2007, Session 2

CONVENER

*Ms Wendy Alexander (Paisley North) (Lab)

DEPUTY CONVENER

*Mr John Swinney (North Tayside) (SNP)

COMMITTEE MEMBERS

*Mr Andrew Arbuckle (Mid Scotland and Fife) (LD)

*Mark Ballard (Lothians) (Green)

Derek Brownlee (South of Scotland) (Con)

*Malcolm Chisholm (Edinburgh North and Leith) (Lab)

Gordon Jackson (Glasgow Govan) (Lab)

*Jim Mather (Highlands and Islands) (SNP)

*Mr Frank McAveety (Glasgow Shettleston) (Lab)

COMMITTEE SUBSTITUTES

Shiona Baird (North East Scotland) (Green)

Mr Alasdair Morrison (Western Isles) (Lab)

Alex Neil (Central Scotland) (SNP)

John Scott (Ayr) (Con)

Iain Smith (North East Fife) (LD)

*attended

THE FOLLOWING GAVE EVIDENCE:

Sarah Boyack (Deputy Minister for Environment and Rural Development)

Andrew Fleming (Scottish Executive Environment and Rural Affairs Department)

Bob Irvine (Scottish Executive Environment and Rural Affairs Department)

CLERK TO THE COMMITTEE

Susan Duffy

SENIOR ASSISTANT CLERK

Rosalind Wheeler

LOCATION

Committee Room 2

Scottish Parliament

Finance Committee

Tuesday 6 March 2007

[THE CONVENER *opened the meeting at 10:02*]

Scottish Water

The Convener (Ms Wendy Alexander): I formally open our meeting and welcome the press and public. As usual, I ask that all pagers, mobiles and BlackBerrys be switched off. This is the last meeting of the Finance Committee in this parliamentary session. We were going to move to agenda item 2 first, but we are delighted to have the Deputy Minister for Environment and Rural Development with us now. I will give the deputy minister and her officials a moment to settle into their chairs.

The first item on our agenda is to take evidence on the quality and standards III investment programme for Scottish Water. I welcome Sarah Boyack, the Deputy Minister for Environment and Rural Development, to the committee. With her today are Bob Irvine, who is the head of the water division at the Executive, and Andrew Fleming, who is head of the capital investment regulatory team in the water division.

Committee members will recall that, in the light of the concerns that we expressed earlier on in the session about successive underspends by Scottish Water, we wanted to find out more about how Scottish Water's implementation of the quality and standards III capital investment programme was progressing, how efficiency savings were being achieved and whether it is anticipated that future capital investment is likely to use Scottish Water's budget or, alternatively, whether Scottish Water is likely to record further underspends in future financial years. On that basis, we invited the relevant minister to give evidence to the committee. I invite the deputy minister to make an opening statement.

The Deputy Minister for Environment and Rural Development (Sarah Boyack): I welcome the opportunity to discuss Scottish Water's performance. I hope that the letter from Tom McCabe—dated 20 November 2006—and my recent letter have addressed any concerns that the committee might have had about the autumn budget revisions and why the adjustments were required.

I will discuss the big picture. We established Scottish Water four years ago and tasked it with pooling three separate and inefficient water authorities into one unified and publicly

accountable business. At the same time, we required Scottish Water to transform the services that it delivered through improved operational practices and the delivery of quality and standards II, which is, in effect, a massive investment programme that is supported by £610 million of borrowing from the Executive.

There is no doubt that delivering on Q and S II has been a tough challenge for Scottish Water, not only in relation to simple delivery but in respect of efficient delivery. Even so, by 31 March last year 86 per cent of the outputs that were identified in Q and S II had been delivered at a cost of £1.9 billion and the Water Industry Commission for Scotland had identified that Scottish Water had delivered £946 million in operational and capital cost savings—just under £1 billion, which is a pretty significant achievement. Those are unprecedented levels of efficiency for the public sector. If that were translated into the average household bill in Scotland over the four years, it would equate to a saving of £211.

We think that the benefits of Q and S II are clear, not only in the correspondence that everybody gets but in tangible improvements on the ground. I got a sense of that from members' comments at last month's debate in the chamber, which was led by the Greens and in which Mark Ballard spoke. The disputes are now less about what is happening on the ground. There is universal agreement that Scottish Water has lived up to the challenges of Q and S II and is delivering for customers.

The challenge now is to transform the water industry over the next four years and to improve the quality of service to customers. That is crucial. In early 2005, the investment objectives for Scottish Water for 2006 to 2014 were set out by the Executive. The clear objectives are to further improve drinking-water quality, to contribute to a cleaner water environment, to support housing and economic growth across Scotland, to improve customer service and to minimise odour problems at waste-water treatment works. In addition, Scottish Water still has to deliver the remaining 14 per cent of the Q and S II outputs.

The cost of meeting all our objectives has been assessed by the WIC as requiring an investment programme of £2.45 billion. It will be one of the largest programmes undertaken by any United Kingdom water and sewerage service provider, but the WIC is confident that it can be delivered efficiently in that four-year timescale. To fund that, the WIC has determined that charges for customers will decrease in real terms and that the Executive will need to lend a further £527 million in addition to the £273 million that is required to conclude Q and S II.

I will move on to delivery in the first year of the new regulatory period. As was anticipated by

Scottish Water in its delivery plan, its capital expenditure is lower this year than can be expected over the next four years. That is because it takes time to set up delivery arrangements and to progress projects through from the design stage to the build and construction stage. Our current expectations are that £404 million will be invested in 2006-07 against a planned figure of £450 million in the delivery plan, although the committee should be reassured by the fact that Scottish Water reports that it is broadly on course to meet the Q and S III targets for 2006-07 and to meet the full requirements over the four years. What you see now is a gearing up of the four-year investment programme.

I want to say for the record that I am keen that sight is not lost of the remaining 14 per cent of the Q and S II outputs that are still to be completed. By the end of this financial year, Scottish Water expects to have delivered 97 per cent of the outputs from Q and S II, but I am concerned to ensure that we still focus on the need for the remaining requirements to be delivered as soon as possible.

On how the situation affects borrowing for 2006-07, the Scottish Executive has provided £20 million in the budget, in accordance with Scottish Water's upper estimate, to ensure that access to borrowing is not the cause of any capital delivery delays. However, that does not affect our commitment to lending almost £800 million over the regulatory period. That amount has been determined by the WIC with reference to the ratios that he has deemed to be relevant to the continued financial health of the company.

It is a pretty challenging objective for Scottish Water to deliver a programme of that scale while also continuing to drive through further efficiencies in the system. The process that we have set in place should enable us to monitor that work and ensure that over the next four years the objectives on the timescales and the levels of efficiency are delivered. That process includes my direct scrutiny of Scottish Water's board. In addition, the Executive and Scottish Water's regulators are brought together in the outputs monitoring group, which checks a detailed set of indicators to consider Q and S III delivery and the final elements in Q and S II to ensure that it can see the promised improved delivery for customers as well as the required levels of efficiency. It also ensures that that will be achieved as soon as is possible.

It is quite an ambitious challenge. The industry has come a long way since the services of the three regional water authorities were pulled together. I would argue that we now have better monitoring and scrutiny, not just by ministers, but by committees. Regular appearances in front of

the Finance Committee and the Environment and Rural Development Committee concentrate everyone's minds and mean that we make tough demands of Scottish Water. The combination of the regulatory process plus that extra scrutiny has shed a bit more light on how Scottish Water works.

Through rigorous regulation and, in the light of that increased scrutiny, the determination of Scottish Water's staff to deliver, substantial improvements have been made at the same time as we have delivered a massive investment programme and the best part of £1 billion of efficiencies. It should be acknowledged that that is a record for the United Kingdom water industry. Customers are benefiting from one of the largest investment programmes in the UK. We now have charges that are, on average, lower than those in England and Wales and, in real terms, the profile of charges is decreasing. The challenge for Scottish Water is to build on that work and to deliver on the next investment programme to upgrade and modernise the industry. I will stop there because I am sure that the committee has questions to ask.

The Convener: I thank the deputy minister for her opening remarks and will begin by asking about something that she mentioned.

We are interested in reflecting on what happened over the four-year period of Q and S II, from 2002 until 2006 when, as the minister said, Scottish Water consistently borrowed less than the budget figure. For the record, to what extent was that a result of Scottish Water being more efficient than had been forecast and to what extent was it a result of slippage in the capital expenditure programme?

Sarah Boyack: Our perspective is that it was more to do with slippage in the capital programme and, related to that, the need to get in place a vehicle to deliver the capital investment. Scottish Water Solutions Ltd was established to build improvements for Scottish Water. A combination of issues was involved; Andrew Fleming might want to comment on that in more detail. Is there anything more that we would want to say?

Andrew Fleming (Scottish Executive Environment and Rural Affairs Department): No—that was fine.

Sarah Boyack: The headline issue was a slipping capital investment programme but, in addition, we needed to get in place a vehicle to deliver it. That is the explanation of why less than expected was borrowed in the early days.

The Convener: That is helpful. Questions will follow on the extent to which the development constraints that have been experienced over the past four years have been significant.

Mr John Swinney (North Tayside) (SNP): I want to follow up on the convener's question by examining the numbers that we have in front of us. In 2002-03, the amount of borrowing budgeted for was £256 million, but the actual borrowing turned out to be £51 million. The following year, £250 million was budgeted for, but only £42 million was borrowed. In 2004-05, the respective figures were £191 million and £82 million and, in 2005-06, they were £196 million and £162 million.

Although the gap narrows the closer one gets to 2005-06, I am troubled by the fact that, throughout that period, members were expressing concern about the constraints that water and sewerage capacity were placing on economic development. I understand that it takes time to get a capital programme geared up, but even though the Government's top priority was economic growth, there seems to have been no intervention to speed up delivery of the programme. It seems to have taken at least four financial years to tackle an issue that members were raising every week. Could ministers have done more to speed up the process?

Sarah Boyack: There are two issues. The first is about having in place a rigorous system for working out what the priorities were on development constraints. In my opening remarks, I alluded to the fact that, in that regard, we are no longer under the same pressure from local councils as we were in the early days of the Parliament. Development constraints were viewed as an urgent priority that had to be fixed.

We moved from having three water authorities, in which there were different sets of relationships, to having one water authority—Scottish Water—that is responsible for processing everyone. In addition, there was slippage in some of the major capital investment projects. I know that the committee's former convener, Des McNulty, was very focused on the Milngavie investment. When such major developments go through the planning system, it has a significant effect on expenditure.

10:15

Mr Swinney: We are talking about a four-year programme and my point is that it is only in the final year of that programme that the actual borrowing figure is in any way comparable with the expected borrowing figure—there were three years of slippage in the budgeted borrowing. I quite accept that major projects such as that at Milngavie will get into difficulties when it comes to planning policy, but I want to find out why it was not possible for ministers to address the situation over one or perhaps two financial years, especially when they had set out that increasing economic growth was the Executive's top priority. Given the problems at Milngavie, they could have told Scottish Water to intensify its activities elsewhere.

I know of countless MSPs who expressed concern about the fact that pretty minor projects all over Scotland were stalled or halted and that economic development was being constrained because there was a climate in which such investment could not proceed. I am trying to get at why ministers could not take the issue by the scruff of the neck by ensuring that if big projects such as that at Milngavie were stalled, the investment programme could be intensified in other areas.

Bob Irvine (Scottish Executive Environment and Rural Affairs Department): In effect, that is what ministers have done in setting the Q and S III objectives, in which relief from development constraints has been given priority. The experience over the past year, during which Scottish Water has interacted with the developers and the local authority planning and development community, has begun to show what can be done. Over the previous years of the four-year period, there was a difficulty with the establishment of a system of interaction and effective communication involving local authorities and developers. Many MSPs considered that to be a significant issue and raised it continually with ministers, as you have said, but it has now been addressed by being prioritised in the Q and S III process.

Mr Swinney: I say with the greatest respect that I accept that that may be correct with regard to what has happened over the past 12 months and where we are now, but I am trying to get at the cause of the frustration with the system that was experienced between 2002-03 and 2005-06, when the Government's top priority was to achieve economic growth and when there was legitimate pressure from MSPs from across the political spectrum and across the country about development constraints. Frankly, when we asked that development constraints be tackled, we were all blanked. The figures show that, historically, there has been a gap between planned investment and the investment that has taken place. I freely accept that, over the past 12 months, a system for the Executive, Scottish Water, local authorities and developers to tackle the issue has been created, but I am trying to understand why such a system could not have been created in 2002-03 or in 2003-04, when MSPs were raising the matter every week.

Bob Irvine: We must acknowledge that there was such a difficulty over that period. I suspect that many factors should be taken into account, one of which is the significant challenge that Scottish Water has faced in managing a large investment programme while pursuing the set of highly exacting efficiency requirements that were imposed on it by the economic regulator. It is not the case that simply giving Scottish Water more money in line with the budget figures or with any

other figures would have enabled the organisation to fix particular problems. That would have caused the constraints or difficulties in managing the investment programme to come out in another area.

All we can say in response to John Swinney's questions and concern is that ministers and Scottish Water now think that the matter is fixed properly. We can begin to address the other challenges that Scottish Water has and learn from the difficulties in establishing the interactions on that part of the programme over the previous four years.

Mark Ballard (Lothians) (Green): I was not a member of the Finance Committee when the extensive discussions on Scottish Water took place in 2004. Contrary to what John Swinney said, it strikes me that the planned investment over the four years was initially £1.8 billion and was raised to £2.1 billion and the actual capital investment was £1.9 billion. Why was so much of the planned capital investment made without the borrowing from the Scottish Executive being required?

Sarah Boyack: That was broadly because the Scottish Executive has always budgeted for the upper limits on what Scottish Water thought it might need to borrow. I repeat my initial comment that we did not want Scottish Water to be constrained in going ahead with projects by having to come back to us to get permission. The upper limit on borrowing is fairly flexible. We are relaxed that Scottish Water came in under the borrowing requirement; there would be more of a problem if it had gone over it.

Mark Ballard: According to my rough maths, the potential borrowing was £1 billion, but only £230 million of it was spent. That seems to be a fairly substantial undershoot. I cannot understand how Scottish Water managed to invest so much in capital, given that the minister said that the borrowing had not been required because of slippage in capital projects. It appears that capital investment was very nearly at the projected level—the projected amount was £2.1 billion and the actual investment was £1.915 billion.

Sarah Boyack: I suppose that it is partly because we now have a fairly consistent level of investment every year in the work that is going on. Andrew Fleming monitored the expenditure, so I will ask him to answer.

Andrew Fleming: The key issue to understand is that, like all businesses, Scottish Water draws upon borrowing last, because there is a cost attached to that. It will first use its revenue from customer charges then savings in operational performance. Where there has been slippage in the programme, the borrowing is the element that

still remains to be taken. Some of the borrowing has been used up. There is an element of Q and S II funds that still remains to be drawn down.

Mr Swinney: That rather makes my point. There are obviously projects that need to be attended to, which are creating development constraints. Why was some of that borrowing capacity not utilised to ensure that MSPs were not pushed from pillar to post—as they were—in seeking to get projects undertaken? Mr Fleming's explanation of the protocol for investment is absolutely correct. However, why over four years was there no response to an increase in development constraints? I accept that we have responded now, but why did we not respond then?

Sarah Boyack: I do not think that we can add to the answer that Bob Irvine gave you. If you are gearing up for a large capital programme, you cannot bring in new projects overnight. They have to be designed, worked up and then built.

Mr Swinney: I am talking about what happened over four years, not overnight. Given the political pressure that has been applied about the volume of water investment and the number of areas that have been hampered in terms of economic development because of development constraints, it is not unreasonable to expect that something be done over a four-year period. You are saying that we have waited four years to have the matter addressed. We have addressed it now. That is fine, but my irritation is that we had to wait four years, given the emerging pattern.

Sarah Boyack: I honestly cannot think of another answer that is different from the previous one.

Mr Swinney: Right. Thank you.

Mr Frank McAveety (Glasgow Shettleston) (Lab): Members have raised the issue of difficulties with capital investment. The other side of that is charges for customers. Could Scottish Water have considered reducing charges, particularly for domestic users?

Sarah Boyack: Our view is that we are now in a position where we are reducing charges to customers. We have lower increases than the rest of the UK and our charges have in real terms gone down. The profile of expenditure in the first few years of the Parliament was for gearing up a fairly significant programme of environmental improvements to meet European requirements. Our constraints programme is now being implemented. Over that period, we still needed a high level of investment. I do not think that reducing customer charges would have helped us to get on with the major investment programme that was required.

Mr McAveety: On the direction of travel for charges, how sustainable is the charging policy over a three, five or 10-year period? Do you see charges levelling out or continuing on a downward curve?

Sarah Boyack: We see charges continuing on a downward curve, because of the Water Industry Commission for Scotland's agreement with Scottish Water and the Executive about what the investment profile should be and where charges should be fixed. By 2010, our water charges for customers should be among the lowest in the UK. Some of our big customers will see pretty significant reductions over that period. Charges are on a downward curve. We will end up higher up the scale of low-charging water authorities in the UK by 2010.

Malcolm Chisholm (Edinburgh North and Leith) (Lab): I will move, at least temporarily, to the future, rather than the past. Are you satisfied that in the period to March 2010, Scottish Water's investment programme will not be constrained by a lack of investment funds?

Sarah Boyack: We are confident that it will be not be so constrained. The challenge is to keep the pressure on ensuring that the investment programme happens. I was not prepared to give John Swinney another answer on the history, but it does tell us that we have to ensure that, at board level, there is constant pressure on ensuring that, if slippage is identified, the system is geared up to bring forward projects so that we have a strong investment profile year on year, and that there are no dips in investment. We are now at about £400 million of investment year on year. That is important in terms of economies of scale and designing projects. I am broadly happy about the next four years, but at the end of the month we should have an updated delivery plan from Scottish Water, which should give us the up-to-date picture on exactly where it is across the range of developments. I am reasonably happy, but that does not mean that every project in the system is being delivered as fast as it could be.

Malcolm Chisholm: Without going through all the ministerial objectives, which you helpfully outlined at the beginning, I will focus briefly on the one that relates to minimising odour problems at waste-water treatment works. You will understand that I have a particular interest in the one that is not too far from here—the Seafeld waste-water treatment works, the odour from which affects my constituents and Susan Deacon's. It is not too far from your constituency either.

On the financial issue, £19 million of capital investment was set aside for the ministerial objectives for dealing with odour problems. However, there have been reports that, because the site at Seafeld is public-private partnership

operated, there might be difficulty with Scottish Water financing the necessary upgrading work. Can the £19 million be used for that purpose? Can an additional pot of money be used? Are those who say that the funding cannot be provided by Scottish Water right?

10:30

Sarah Boyack: The difficulty is not fundamentally to do with funding. I am close to this project not because of my constituency interests but because it was raised in the Environment and Rural Development Committee as an exemplar of a water treatment works that frustrates members of the public because of the inconvenient and unpleasant smell that it creates.

As I said, the difficulty does not seem to be about money; it seems to be about getting a design for the project that will satisfy City of Edinburgh Council, which, after 1 April, under the Scottish Executive's new code on water odour, will have the ability to require Scottish Water to ensure that it meets the council's requirements on odour.

The issue is whether we can get an agreement between Scottish Water and the local authority on what is an acceptable level of odour for the operation of the plant. There is pressure on the plant operator, which has to ensure that there are no inadvertent leakages of odour—which has been one of the problems—and that there is agreement about how the fundamental design of the plant can be improved.

It is not just about the money. Fundamentally, it is about agreeing a plan with which the council will be happy. Scottish Water might need to renegotiate with the contractors so that there is an agreement between Scottish Water and the contractors that any works that need to be done on the site are done by the contractors, although Scottish Water will eventually pay for them. That is what is different from a project that is owned and managed by Scottish Water.

Malcolm Chisholm: I am reassured that there is no financial obstacle to the work being carried out.

Not least because of Susan Deacon's campaigning, there was a big advance in this area due to the Water Services etc (Scotland) Act 2005. We have a Scottish Executive code that means that there is a requirement on Scottish Water to do the necessary work. If there is no financial constraint, and Scottish Water is required to do the work, am I right in thinking that Scottish Water needs to revise its contract with the PPP operator, Stirling Water, as quickly as possible, and that, at that point, money will be forthcoming if financial assistance is required?

Sarah Boyack: Absolutely. The water industry commissioner's calculation is that £30 million is available to change PPP contracts, in addition to the £19 million for Scottish Water owned projects.

The matter that we are discussing was the first item on the agenda at my first meeting with Scottish Water after I was given this ministerial position. The situation needs to be fixed. That is easy to say, but it involves somebody designing a detailed scheme that will address the concerns of local residents and the council. That needs to be done quickly, because the problem has existed for so long that it has affected the relationship between people in the city and Scottish Water.

The Convener: There is a similar situation in my constituency, which involves a directly provided Scottish Water plant and an odour problem from it that is worsening because of rising capacity. Are you saying that it is now for the local authority to negotiate with Scottish Water what the acceptable level of odour emissions is and then to police it? Is the scheme Scotland-wide or is it at the discretion of the local authority?

Sarah Boyack: It is Scotland-wide. When the odour order came to the Environment and Rural Development Committee, we were dealing with a series of petitions on water odour and were being told by local authorities that they did not have sufficient statutory powers to pursue Scottish Water. Odour is difficult to measure. Members of the public can tell you when the odour is bad, but measuring it is a different matter.

We realised that there needed to be a more robust process, which is what the new odour order will provide as of 1 April, by giving local authorities more power to go back to Scottish Water and say where they are not happy. At that point, they can either take Scottish Water to court or sit down and agree an investment programme.

Odour action plans should be in place by 1 April. That date was intended to give Scottish Water time to put those plans in place, so that it was not just a case of immediately saying, "You are now not meeting that plan." The aim was to give Scottish Water a bit of space to examine its plants throughout the country and prioritise an investment programme. Because there are a number of such plants, we set up the odour group to consider the situation throughout Scotland in partnership with Scottish Water, so that there could be some agreement on priorities.

The Convener: That is helpful. It would be useful if you wrote to the committee reiterating those points.

Sarah Boyack: I will do that.

Mark Ballard: Minister, are you satisfied that, in the period to March 2010, Scottish Water will be

able to carry out the investment programme of more than £2.4 billion that was agreed for it by the water industry commissioner in the final determination of charges for 2006 to 2010?

Sarah Boyack: Yes. That figure was set by the WIC in discussion with Scottish Water and ourselves. It is deliverable, but only if all the projects are managed effectively and there is no significant slippage—we have spent a lot of time discussing that.

The Scottish Water board will keep an eye on the progress of the projects. It has in place a system to identify projects that give cause for concern, which will enable the management of Scottish Water to focus on them to ensure that they do not fall behind.

We are still working on the closure of Q and S II—we still have 14 per cent that, at 2006, was not completed. There is a question not only of delivering Q and S III by 2010 but of managing the tail of Q and S II. A small number of projects will require significant attention from Scottish Water to ensure that we get closure on that investment.

Mark Ballard: My understanding is that around 40 per cent of civil engineering projects in Scotland will have to be water-related projects. Capital expenditure for 2006-07 was forecast at £450 million but is now down to £404 million, so there is already major slippage. The projected capital expenditure in 2007-08 is £735.9 million. Do you believe that there is the physical capacity to deal with not only Q and S III but the leftovers of Q and S II?

Sarah Boyack: The issue is partly to do with how that is managed and partly to do with Scottish Water Solutions Ltd, which was set up to deal with some of the major elements of Q and S II. The issue is also to do with delivering capital efficiencies. A good example of that is the need to ensure that there are standard template designs for projects so that unique approaches do not have to be designed for every new project that needs to be undertaken. A much more standardised approach will enable lessons to be learned from previous projects. Groups of similar projects will be clustered together to ensure that there are economies of scale in design processes. That will lead to a much more efficient use of civil engineering design capacity.

The WIC has been encouraging Scottish Water to come up with innovative ways of dealing with projects that will ensure that work is done better and faster and with less requirement for complex engineering designs. For example, if when rehabilitating water mains innovative techniques are used, pipes can be laid much more quickly and with much less disruption to customers.

There is a massive programme. Part of the challenge involves ensuring that, once we get up to the optimum investment level, we stick there and do not have slumps. It is important that the investment continues, as that will ensure that the engineering companies know that the contracts will continue, which will enable them to train staff and use resources more effectively.

Mark Ballard: If capital expenditure is less than £2.4 billion—whether because of the innovative measures that you describe or because of project slippage—will that lead to a reduction in borrowing or a reduction in charges?

Sarah Boyack: Andrew Fleming will deal with that.

Andrew Fleming: Do you mean if the same slippage that occurred in Q and S II occurs in Q and S III?

Mark Ballard: Yes.

Andrew Fleming: In that case, depending on scale, the borrowing would probably be the primary area that would flex.

Mark Ballard: In 2006-07, the retained surplus, which is the excess of income over expenditure, is twice the amount of planned borrowing. Is it appropriate to fund so much capital investment out of charges in the form of retained surplus instead of out of borrowing? Surely, the fact that so much of the funding comes from charges—as happened in Q and S II—will lead to an imbalance between capital formation and borrowing.

Andrew Fleming: The WIC has worked out the specific amount of borrowing that is required in the current period to support the capital programme with reference to financial ratios that relate to the company's improvement. As a result, it is probably more appropriate to put that question to him.

Mark Ballard: But is it appropriate to use the income taken through charges as a way of not taking up borrowing, which is what happened in Q and S II and what appears to be happening in 2006-07?

Andrew Fleming: I suppose that the issue in question is the extent to which one can predict the potential underspend. The assumption with this programme—which is over four years and amounts to £2.4 billion with the required level of borrowing—is that it will be delivered, and Scottish Water has indicated that it will be able to do so in that time.

Mark Ballard: My understanding is that total borrowing by any utility company should approximate to the value of new assets. However, in Q and S II total borrowing was much lower than the value of the new assets that were created over the four years. Was that appropriate in Q and S II?

Indeed, will such an approach be appropriate if another situation arises in which the new capital formation is so much larger than the amount of borrowing?

Andrew Fleming: I am sorry; I do not really follow your question. The WIC has set the amount of borrowing over the four years with reference to the nature of the capital programme and the requirement to invest in improving and maintaining infrastructure, and it is really up to him to engage in that debate. I am not sure that I follow your presentation of the issue.

The Convener: I suppose that the question for the minister is whether the decision to use charges or borrowing to fund new infrastructure is a determination for the WIC or a matter of policy. Is it appropriate for ministers or for the WIC to strike that balance and make that trade-off in, for example, the period covered by Q and S III?

Sarah Boyack: We have set a policy framework of stable pricing that is also benchmarked against the rest of the United Kingdom to ensure that, if there are any lessons that we can learn about how the programme might be managed better, we can do so. The WIC's job is to carry out the detailed work on ensuring that that is translated into effect.

We should also remember that, besides the new infrastructure and capital investment, there is a huge amount of operational investment. For example, a huge amount of water is wasted through leaks. Although tackling those leaks requires new investment, the work is more a matter of repairing existing pipes than putting in place new facilities, and we need the capacity to pull together and take forward such projects. Indeed, the target is to tackle 50 per cent of leaks in terms of their economic effectiveness. I realise that that kind of detailed target sounds a bit odd, but the point is that we are talking about not only investment projects such as new buildings but the whole infrastructure.

To that end, the WIC has spent a lot of time putting pressure on Scottish Water to find out the quality of the infrastructure and, for example, to ensure that, in such a dynamic system, efforts to tackle leakage in one area do not disadvantage another area. All those matters must be taken into account, and the WIC's role is to strike a reasonable balance compared with other UK water companies in delivering ministerial objectives.

10:45

Jim Mather (Highlands and Islands) (SNP): Having read Jim and Margaret Cuthbert's report on current cost and regulatory capital value, I am interested in the mechanisms used by you, Scottish Water and the WIC to ensure that investment is directed at projects that represent

the best value for money. For example, in the Highlands, pipelines have been built across lochs to supply schools in Scoraig and Lismore with drinking water. However, when the 14 pupils from Lismore primary school go home at night, they drink water from the burn supply to their homes. The pipe supplying drinking water to their school cost about £2 million, when—I am reliably informed—a borehole and filtration system could have been installed for about £10,000. What mechanisms are in place to ensure that we are getting best value? Moreover, have you thought about the questions that have been asked about regulatory capital value? If not, why not?

Sarah Boyack: The member's example shows very well how certain issues need to be addressed not only by the WIC, as the economic regulator, but by the drinking water quality regulator and the Scottish Environment Protection Agency. Their views must also be taken on board in deciding which projects should go ahead. As that example makes clear, it is important to ensure that other regulatory functions apart from economic regulation are delivered.

Jim Mather: Children might drink a couple of glasses of water at school, but they might drink far more back in their own homes. This issue is going down badly in the Highlands.

In the current financial year, Scottish Water's net new borrowing is only £21 million. However, from 2002 to 2006, 82.4 per cent of capital expenditure was paid for by current water charge payers. Why did that situation arise?

Sarah Boyack: That is the balance that has been struck by the WIC and Scottish Water. We have already had a lot of discussion about whether the investment programme is on track and I do not think that I have anything to add to my previous comments.

Jim Mather: According to the strategic review of charges in 2002 to 2006, the forecast debt was to be reduced from £2 billion to £17 million by 2016. Because of the committee's work, which has, by and large, been informed by the work of Jim and Margaret Cuthbert, we now have *prima facie* evidence that increases have been modified down and that debt is being held at a more steady level.

The hallmarks of the Executive's responses to date have been denial by assertion and the use of the committee's majority report as a kind of get-out-of-jail card. However, we have now received, through a freedom of information request, evidence that civil servants have tried to maximise the complexity of the matter in their dealings with us; that there has been disquiet in the Scottish Executive about the evidence that Andrew Scott gave the committee; and that concern has been expressed about whether the Executive's position

is adequately joined up in the face of the Cuthberts' proposition. More important, we now know that our adviser Arthur Midwinter passed his draft report to your civil servants and had it edited by them. What do you think of that approach to informing the committee?

Sarah Boyack: All I can say is that there have been extensive debates, particularly by this committee, about the Cuthberts' critique. I do not want to make detailed comments about reports that I, as minister, have not necessarily seen, although I know that, for committees and the Executive, one agreed standard procedure for approving reports is to check matters of fact. However, I honestly do not have any detailed comments on the reports in question. In fact, it would not be appropriate for me as minister to make any.

Jim Mather: I was merely keen to establish the general principle. I have with me the edits that were made, and they go beyond what could be classed as matters of fact. Is it a good general principle for a committee adviser to pass his report to civil servants for editing before it is supplied to the committee?

Sarah Boyack: You will have to ask the person in question whether he was satisfied with the process. Indeed, as it is a report for the Parliament, it is a matter more for parliamentary committees than for ministers. I do not want to comment on work that was done for the Parliament. It is up to the Parliament to decide whether it is satisfied with the quality of such reports and the process by which they were produced.

Jim Mather: Okay. I will move on to where we are now with the capital expenditure. How were the first and second contracts awarded to Scottish Water Solutions?

Sarah Boyack: Andrew Fleming will answer that one.

Andrew Fleming: Sorry, Mr Mather; did you ask how the first contract was awarded?

Jim Mather: How was the process run? Was it an open tender process? What criteria were used in awarding the contract?

Andrew Fleming: I cannot provide all the detail on that, as the matter is more for Scottish Water. The contract was developed early in 2002. There was a tender and an *Official Journal of the European Communities* notice. European Union procurement rules were followed. I would need to check the date when the contract was finally awarded.

Jim Mather: Do you have any plans to ask Scottish Water to benchmark individual installations that are supplied by Scottish Water

Solutions against installations that other companies supply for water companies elsewhere?

Andrew Fleming: I expect that part of the process that Scottish Water has in place involves benchmarking to ensure that Scottish Water Solutions provides value for money.

Jim Mather: You expect that, but you do not know for certain.

Andrew Fleming: The process that Scottish Water uses in granting contracts establishes that the contract provides value for money. Benchmarking will be an element of that.

Sarah Boyack: The WIC also carries out benchmarking. As part of the agreement between Scottish Water and the WIC about how Scottish Water will develop its investment programme, the WIC benchmarks projects from throughout the UK. There is an interaction between the WIC and Scottish Water to ensure that projects are designed and delivered as efficiently as possible.

Jim Mather: To what extent has the money that has been released back to the Executive this year and in previous years been a function of reducing costs, unrealistic budgeting by the Executive and the overcharging that we claim takes place? Has an analysis been performed to break down the amount into its component parts?

Bob Irvine: We can give figures on the level of efficiency savings. The WIC's report of last October contains extensive information on the efficiencies that have been delivered in the programme. Ministers do not accept that there is evidence of overcharging in the system leading to improved performance, nor do we think that the WIC accepts that. I am sure that if the WIC identified overcharging, he would intervene appropriately to correct that.

The WIC's report sets out, in a fairly detailed manner, efficiency gains in Scottish Water's performance in relation to the capital programme and operational matters. The expectation for the regulatory period 2006-10 is that such pressure will continue. The target is to have about 20.5 per cent efficiency savings in the capital programme and 12.5 per cent efficiency savings in operating expenditure. The WIC will report from time to time on progress against those targets and he will itemise examples. The minister has already given a few such examples.

Jim Mather: What is the explanation for the deviation from the original strategy in the strategic review of charges for 2002-06 to bring the debt down to about £17 million by 2016? What caused the strategic decision to keep the debt at about £2 billion?

Bob Irvine: That is a question for the WIC, as he considers the company's financial

sustainability. In the statement on the principles of charging, which is one of the framework documents that guide the review of charges, ministers said that they want the company's financial health to improve. The WIC interprets that in considering the company's costs, the capital investment requirements that are placed on it and the continuing strength of its cash flow. As you know, in doing so, the WIC uses a set of ratios that are derived from the English utility experience and the views of the financial community, and arrives at a view as to the appropriate borrowing level and gearing for the company. He will consider those matters again during the next statutory review of charges, which begins this year.

Jim Mather: Has the WIC reported to the Scottish Executive on that major change in Scottish Water's balance sheet, which is a material change in strategy?

Bob Irvine: No. I am not sure that we acknowledge that the situation is a change in strategy. As I said, in the statement on the principles of charging, ministers said that they seek the continuing financial health and sustainability of the company. In the WIC's final determination and the documents leading up to it, he presents a view on what that implies.

Mr Andrew Arbuckle (Mid Scotland and Fife) (LD): I seek clarification on the issue that Mark Ballard raised about the source of funds for capital expenditure. Depreciation and infrastructure charges are by far the largest sources of that funding. I understand half of that, but what role does depreciation have in funding capital projects?

Andrew Fleming: As I understand it, depreciation is the element of investment that is required to take into account the fact that assets get older. That must be acknowledged and money must be invested to improve and maintain assets.

Mr Arbuckle: But depreciation in itself does not release funds. That is what I struggle to understand.

Andrew Fleming: It would probably be better if I wrote to you on that.

Mr Arbuckle: That would be helpful, because depreciation is a major item in the funding sources, but I do not understand what role it plays.

The minister set out the amount of money that Scottish Water is allowed to borrow under the budget. She said that that sum has been generous in the past and that, although the investment programme has been slow to start, it is generating more mass. Is that amount the top limit that Scottish Water is allowed to borrow or, if Scottish Water achieves enough momentum in the capital scheme, will it be allowed to borrow more?

Sarah Boyack: Scottish Water would have to come to us and the WIC about that, because that would mean a significant change in expenditure. As I said, we have been flexible and have provided an amount that is at the upper limit of what Scottish Water thinks its borrowing requirement will be, the aim of which was to ensure that Scottish Water would not seek more just because it got the capital programme going. Were there a requirement to go significantly beyond that amount, we would expect Scottish Water to come to us and the WIC to review the programme.

Mr Arbuckle: Some of the questioning has been about the fact that there is the amount that could be borrowed but it is not taken up fully. Could the layout of the next draft budget be revised to make it clearer that the Executive is providing an optional borrowing facility?

Sarah Boyack: That might be helpful, given that members have returned to the issue again and again. As a matter of principle, it is good for us to examine how we present our budget and accounts. If members want to write to me with any thoughts on how we can improve transparency, I am happy to take them on board.

Mr Swinney: The minister said earlier that 14 per cent of Q and S II is yet to be completed. Does that mean 14 per cent of the projects or of the investment total? What is that a measure of?

Andrew Fleming: It is a measure of outputs.

Mr Swinney: Do you mean matters such as the number of sewage works that have been upgraded?

11:00

Andrew Fleming: It relates more to regulatory outputs, by which I mean specific requirements and drivers to be addressed, such as improvements under specific drinking water quality regulations, kilometres of mains that have been renewed or unsatisfactory intermittent discharges to be upgraded. "Quality and Standards II: Delivery Position as at 31 March 2006", which has been published on the Executive's website, explains the linkages between those and the outputs and the derivation of the 86 per cent.

Mr Swinney: That is helpful. I will go away, look at that report and pursue the issues—if I have nothing better to do with my life. *[Laughter.]* It is amazing what we can come up with.

My second point relates to Q and S III. On that measure, what percentage is under way, if you get my drift? If 14 per cent of Q and S II is left as a hangover, how many boxes have we ticked in Q and S III so far?

Sarah Boyack: Andrew Fleming has just told me that the measurements are slightly different in Q and S III—

Mr Swinney: Excellent.

Sarah Boyack: My heart is sinking.

In answering your question, I suppose that we could say that we are a year into the 2006 to 2010 programme.

Mr Swinney: That is undeniable.

Sarah Boyack: One of the committee members asked whether I was happy with progress, and I commented that I was broadly happy. We are at the start of gearing up to the programme, not at the point of implementing it fully, and we have the overhang from Q and S II, so a huge amount of work is going on at the moment.

My interest is in going back to the board to ensure that it is happy with progress on its own programme. As I said, the board now marks projects as red, amber or green. A project is marked green if it is progressing happily, amber if a bit of attention is required or red if the board needs to ensure that the operational, delivery side of it is brought up to speed and, if there is a problem with the project, to determine whether something else can be brought forward in the programme.

The board has learned from the past four years how to manage the process more effectively. That relates to the point that was made earlier about civil engineering contracts: we need to ensure that the number of projects is relatively even so that the industry is capable of delivering them and we get best value for money.

Mr Swinney: The point was made to me that the level of activity that was planned for the run-up to Q and S III between 2002 and 2006 would get the programme off to a flying start. Has performance been in alignment with that expectation? You were not starting a new programme with a clean sheet of paper on 1 April 2006, so has it got off to the expected flying start?

Sarah Boyack: Bob, do you recognise that description?

Bob Irvine: Yes, I think that it is called the early start programme. The WIC agreed to release a certain amount of funding last year to allow early work on design, for example, which certainly happened, although perhaps not as much as was allowed for as a result of pressure on completing Q and S II.

The real answer to the question is in the figures: the delivery plan projects capital expenditure of £450 million, which would have assumed a certain amount of early start work by Scottish Water, but the forecast is now that £404 million of that

expenditure will be completed this year. Scottish Water had a bit of a slow start while it geared up for the programme but, as the minister said, the outputs that it is monitoring this year look fairly healthy and positive, and the board is forecasting with some confidence that it will hit the required levels of outputs and expenditure in 2010.

The board would say that, without the facility for the early start last year, it would have been in a worse position this year. Ministers have invited the WIC to consider in the next review of charges, the start of which is imminent, how to get a better level of continuity from one programme to the other so that we do not have a dip in year 1 of a programme, which has been a feature in Scotland and elsewhere in the United Kingdom for a number of years.

The Convener: Several operational and financial issues have properly arisen, including what are essentially operational issues under Q and S III. It might be helpful if the committee drew to the attention of the Environment and Rural Development Committee—whose work the minister is familiar with—the *Official Report* of this meeting and highlighted to it that there are on-going issues relating to Q and S III that it should consider.

We have talked to the minister only today as a result of time constraints, but it is inevitable that as soon as we get into the debate, we will want to talk to the WIC and Scottish Water as well as to the Executive, as happened when the matter was progressed in 2004. We should urge the successor committee to the Environment and Rural Development Committee to keep a close eye on matters in the next session. That accords with our encouraging committees to take more interest in operational and financial matters relating to their portfolios, which we are about to discuss in the context of our legacy paper. That said, the evidence session has been useful for discussing the progress that has been made so far, which the minister talked about in her opening remarks. I think that committee members feel that progress might have been somewhat slower without our searching scrutiny.

I want to raise one more issue for the record. When he was questioning the minister, Jim Mather mentioned the nature of the exchanges between the committee's budget adviser and Executive officials. For the record, at my request, not only our committee clerks, but the Parliament's most senior clerks reviewed exchanges that have been released under the Freedom of Information (Scotland) Act 2002 and were satisfied that the budget adviser had sought advice on factual accuracy, rather than Executive views for the purpose of translating those views to the committee. Therefore, the exchanges were not

improper. Everybody knows that it is often necessary for committee staff and advisers to liaise with Executive officials in order to ensure that committee business runs smoothly and that material is accurate. Such liaison was particularly necessary in dealing with a matter as technical as the financing of Scottish Water, which has a unique financial structure. I do not expect everyone to share my view, but as Jim Mather gave one perspective, I thought that I should clarify that I had asked the clerks on behalf the committee to find out whether any of the exchanges had been improper. As I said, they judged that they were not. Therefore, the matter is closed for the session.

I thank the Deputy Minister for Environment and Rural Development and her officials for attending the meeting. As I said, the committee will say to the Environment and Rural Development Committee that its successor committee might want to consider in the new session what we have discussed.

Annual Report

11:10

Meeting continued in private until 11:37.

11:08

The Convener: Agenda item 2, which is the only other item that we will take in public, is consideration of our draft annual report. Members will see from the paper that the clerks have provided that the draft report is formulaic, short and factual. I have been told that it cannot be more than 750 words. Currently, it contains 731 words, so we have 19 words to play with.

Obviously, the draft report is required to go to the Conveners Group to ensure that there is consistency across committees and that a common format has been used. The draft report seems to do the job excellently, but I would be happy to consider any suggested amendments from members.

Mr Swinney: It is lovely.

The Convener: Thank you.

This is the committee's final meeting before the end of the parliamentary session, so it is important that I thank the committee's clerks, Scottish Parliament information centre officials, the official report and everybody else who has served committee members in this session with their customary expertise and professionalism. We are enormously grateful to them and to all the advisers and witnesses. I also thank all current and past members of the committee during the session, including the previous convener, Des McNulty, who convened the committee for much of the session. The committee has done nothing in this session that will diminish its reputation for rigour and vigorous analysis. We hope that our successors will pursue that legacy in the next session. On behalf of us all, I thank everyone who has made it possible for us to carry out our business so effectively.

That ends the public part of the meeting.

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