

# **TRANSPORT AND THE ENVIRONMENT COMMITTEE**

Wednesday 24 January 2001  
*(Morning)*

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## TRANSPORT AND THE ENVIRONMENT COMMITTEE

### 2<sup>nd</sup> Meeting 2001, Session 1

#### CONVENER

\*Mr Andy Kerr (East Kilbride) (Lab)

#### COMMITTEE MEMBERS

\*Bruce Crawford (Mid Scotland and Fife) (SNP)  
Robin Harper (Lothians) (Green)  
\*Maureen Macmillan (Highlands and Islands) (Lab)  
\*Fiona McLeod (West of Scotland) (SNP)  
\*Des McNulty (Clydebank and Milngavie) (Lab)  
\*Bristow Muldoon (Livingston) (Lab)  
Mr John Munro (Ross, Skye and Inverness West) (LD)  
\*Mr Murray Tosh (South of Scotland) (Con)

\*attended

#### THE FOLLOWING ALSO ATTENDED:

Nora Radcliffe (Gordon) (LD)

#### WITNESSES

Matthew Farrow (CBI Scotland)  
Brian Higgs (United Distillers and Vintners)  
Pat Mennie (Malt Distillers Association of Scotland)  
Hugh Morison (Scotch Whisky Association)  
Adam Rennie (Scottish Executive Development Department)  
Paul Smart (Scottish Executive Development Department)  
Alan Sutherland (Water Industry Commissioner for Scotland)

#### CLERK TO THE COMMITTEE

Shelagh McKinlay

#### SENIOR ASSISTANT CLERK

Tracey Haw e

#### ASSISTANT CLERK

Alastair Macfie

#### LOCATION

The Chamber



## Scottish Parliament

### Transport and the Environment Committee

Wednesday 24 January 2001

(Morning)

[THE CONVENER opened the meeting in private at 09:37]

10:05

*Meeting continued in public.*

**The Convener (Mr Andy Kerr):** I welcome everyone to the second meeting this year of the Transport and the Environment Committee. I have received apologies from Robin Harper and John Farquhar Munro, and from Bruce Crawford, who will leave our proceedings at some point this morning.

The first item on our agenda was to have been the choice of a deputy convener, but I suggest that we defer that matter until next week's meeting. Do members agree to that?

**Members indicated agreement.**

**The Convener:** Does the committee also agree that at our next meeting the short session on lines of questioning for witnesses should be taken in private?

**Members indicated agreement.**

**The Convener:** In addition, does the committee agree to have a private session after the witnesses have been before us so that we can discuss the evidence that we receive and areas that we wish to follow up?

**Members indicated agreement.**

**The Convener:** We require those private sessions to deal with technical matters, such as agreeing where our focus lies and future lines of questioning.

## Work Programme

**The Convener:** The next item is our future work programme, specifically the proposal to inquire into the awarding of contracts for trunk road maintenance. The matter has been of concern to members of all parties. There is a dire need to investigate the process from start to finish. The proposal is that we appoint reporters to undertake an investigation into this matter. I propose myself, Bruce Crawford, Murray Tosh and Bristow Muldoon. It will be the job of the reporters to perform an initial examination of the issue, to agree lines of questioning and areas to investigate, and perhaps to do some of the investigation work.

The inquiry by the reporters will not take place behind closed doors and, once we have had an initial look at the matter, I am sure that the committee will want witnesses to give evidence in public. The idea behind appointing reporters in the first instance is to focus the remit of the investigation, perhaps to do some pre-investigation work and to make recommendations to the committee on how it might proceed.

As members will know, we are tight for time. We have a scheduled work programme. The water inquiry is a major piece of work—it is subject to a great deal of public and Executive interest and it must proceed. We cannot afford to ignore our work priorities but, none the less, there has been such a crescendo in the Parliament on the issue of trunk roads that it is the role of this committee, if members are agreed, to investigate the matter fully. I invite comments on the proposals.

**Mr Murray Tosh (South of Scotland) (Con):** I realise that how this item is worded on the agenda is an economical way of stating the issue, but we do not want to be limited to the narrow matter of the awarding of contracts. We should examine the design and specification of the whole process and the implications and we should go wherever the inquiry takes us.

**The Convener:** Yes. As I tried to indicate in my remarks, the inquiry is about examining the process from start to finish. We should consider how the previous contract performed, the consultation on how the new contracts were to be made up, the new contracts themselves, the evaluation process and everything else in between; if it is relevant, we should also examine what took place before that process started. We need to have a wide-ranging investigation into the matter from start to finish.

**Bruce Crawford (Mid Scotland and Fife) (SNP):** You have set out the essential nature of the inquiry, but we should also examine the impact

of the matter on public policy and public finance. I see that Des McNulty is looking at me, so I will explain that I do not mean that in the widest sense; I mean that we should consider the impact at local authority level of the way in which the contract was drawn up. We should ensure that the report is all-encompassing and transparent.

The issue is highly complex and detailed—it will be particularly so when we get down to talking about tenders—so some pre-work has to be done to ensure that people understand the issues before we have witness sessions. We must draw up a schedule of how we will go about the work, with a guarantee that we will have a process of interviewing witnesses. That will be an essential part of the process if we are to keep the inquiry transparent—some of the processes of the tender have not been as transparent as they might have been. We must ensure that everyone on the committee has the chance to ask questions of the relevant people, whether they be civil servants, consultants, advisers or, indeed, ministers.

**The Convener:** I whole-heartedly concur with that view. That is the committee's purpose. The inquiry will be conducted transparently and openly, in the full glare of the committee. That is definitely the way to proceed.

**Fiona McLeod (West of Scotland) (SNP):** I know that we have a tight work programme, but are we setting a date for when the group of reporters will produce an initial remit for us to consider? That will enable us to keep the issue going—we do not want it to just go away today and perhaps not come back for a month.

**The Convener:** I am certain that Bristow Muldoon, Murray Tosh, Bruce Crawford and I will not let the matter lie. As soon as this meeting is over, I will arrange the initial meeting with colleagues to determine priorities and to consider timetabling issues so that we can come back to the committee with a plan of action. The more work that we do at the pre-investigation stage, as Bruce Crawford said, the more productive our public processes will be. I deem this a most urgent matter and there is a need for transparency throughout the process.

**Des McNulty (Clydebank and Milngavie) (Lab):** I have a procedural question. I have come across situations in the past where one or two people from a committee have been designated as reporters, but I do not recall four people being designated as reporters. What is the difference between that and the whole committee conducting the exercise? I am slightly taken aback by the proposal and am interested to know how the mechanics of it might work.

**The Convener:** Essentially, the logic behind what I propose is this: I would argue that if the

whole committee did the inquiry, it would be extremely difficult to timetable. The reporters can do the work outwith committee time. If the committee does it, we run into issues such as accommodation, timing, resources and the *Official Report*. This is an attempt to progress the matter—we will progress it and then return to the committee. The size and nature of the group of reporters is meant to reflect what I see around the Parliament, which is great cross-party interest in the matter. That was the reason for my proposal.

**Des McNulty:** I want to be clear about this. There are issues to do with the mechanics as well as, I believe, some procedural questions. My understanding of the role of reporters is that they go off and investigate on behalf of the committee and then bring back evidence or a report for the committee to discuss. There is a difficulty with having what is, in effect, a sub-committee. Is it the responsibility of that group of people to conduct themselves as a committee, or should they conduct themselves as a single reporter or two reporters might do, preparing a report to bring back to the committee?

**The Convener:** I would argue that the reporters are not a sub-committee; they are reporters who will go away to do the very job that you indicated they should do in relation to proposals for the investigation. For me, this is about making the best use of resources in the time that is available to us. If we were to programme such an investigation into the committee's work load, I would not see us being able to do it until just before the summer at the earliest.

Given the immediacy of the issue, reporters are our only route. My preference would be to say, bluntly, "Drop everything else. We will do this for the next month or so, get everything done and dusted and get a report out", but that is not a way in which we can do business. The idea is therefore that we move the matter forward via the reporters, who will report to the committee on information and proposals at every stage.

The reporters will not act as a sub-committee, making decisions; they will simply gain factual information, recommend future areas of action with regard to witnesses and provide technical briefings on what is a very technical matter, based on information and evidence that they gain from individuals whom we choose to see. In the initial stages, as Fiona McLeod said, we need to act quickly. That means that the group of reporters must meet to agree a plan of action, bring it back to the committee and pursue that plan. That can be done in the short term.

**Des McNulty:** You have given me considerable reassurance on that point. I am concerned to assert the rights of the committee and to ensure that account is taken of our position.

10:15

**The Convener:** I can give you an absolute guarantee that I want the committee to agree in the full glare of the public on the questions that it wants to put to ministers, civil servants, bidders, consultants and advisers. The committee structure of the Parliament is most effective when we have the opportunity to make people accountable for their actions. That is what the investigation is all about. I can therefore absolutely guarantee that all the matters that the reporters address will come back to the committee. We will do the committee's work in public—the committee will be fully involved in the process.

**Mr Tosh:** So if we arrange meetings, other members of the committee who are not reporters will be absolutely free to attend if they wish to do so.

**The Convener:** Once we have agreed a plan of action—where we will go for information and whether we will visit organisations and individuals to gain it—it will become known to the committee and will become the property of the committee via the reporters. I stress on behalf of the reporters that there is no intention of keeping information confidential to the tight group of reporters. The method of proceeding is more about the mechanics and about our ability to respond to the matter quickly, which is important. The aim is to lay out some groundwork, consider the main issues, agree a course of action and then come back to the committee with those intentions.

**Bristow Muldoon (Livingston) (Lab):** I agree with your proposal, convener. On the question of having a group of reporters, there is a precedent from another committee of the Parliament. When the Local Government Committee investigated the views of local authorities on the McIntosh recommendations, it sent several groups of either three or four reporters to individual local authorities to gather evidence. The basis for doing that was pretty much the same—it would have been impossible to timetable the whole committee going round to gather the evidence. However, as you indicated, the evidence was fully on the record when the members came back and reported to the committee.

**Des McNulty:** That is a fine precedent. There is nothing wrong with that. If the role of the reporters is to go and gather information, which they then present to us, that is fine. I would be concerned if the reporters set themselves up as a mini-group of the committee in informal hearings. I do not think that that would be appropriate. There has to be recognition of the committee's proper role.

**The Convener:** I think that you have that absolute assurance—which I give you again—that that will be the case. The committee has primacy.

The reporters are the route that we are taking to achieve the objective. The reporters will make the committee aware of what they are doing, how they are doing it and what the future proposals for action are at every stage of the process. I would hate to see the matter drift and for the horizon to be longer. Having a group of reporters is the only way in which we can deal with the matter in the short term. Are members content with that proposal?

**Members indicated agreement.**

## Water Inquiry

**The Convener:** The next item on the agenda is our water inquiry. I invite the water industry commissioner for Scotland, Alan Sutherland, and his colleagues to join us.

Thank you for your submission, which has been circulated to committee members. As is our practice, I invite you to make any opening remarks that you want to make to the committee. Welcome.

**Alan Sutherland (Water Industry Commissioner for Scotland):** First off, I thank the committee for inviting us to talk to members today.

My duty is to try to promote customer interest—that is my priority and that is what we try to do every day of the year. How do we do that? We try to encourage, cajole or force—whichever verb you want to use—the water authorities to deliver better value to customers. That means trying to get them to improve service, to find lower-cost ways of delivering that service and to improve the overall sustainability of the industry.

We conduct a range of analyses and surveys that produce both quantitative and qualitative data, and we hold customer meetings, both on a one-to-one basis and in public. The message that comes back from those meetings is that what customers want is a silent and reliable service.

People have little, if any, conception of the size of the industry, so it is probably worth putting the situation in context. We are talking about more than £13 billion of assets in Scotland. The Grangemouth petrochemical plant could be built several times over for that amount of money. In an industry of that size, economies of scale become critical.

Our research and discussions with customers lead us to believe that there is significant scope for service improvements. There are several ways in which those improvements could be brought about. First, there could be greater collaboration between the three authorities, and we welcome the steps that they have begun to take towards that. Secondly, we could examine best practice in other utilities services and in the water sector in England and Wales in relation to the service that is provided to domestic and non-domestic customers. With the water authorities, we have agreed much tougher standards for the service to domestic customers—five new standards, with a new pressure standard to follow. We have held a range of meetings with the non-domestic sector—both one-on-one meetings and meetings involving a large user focus group—which have told us that what large customers are looking for is the ability to agree price and get a tailored solution rather

than one of the one-size-fits-all variety. Thirdly, we have discovered that customers want a better quality of water and a better environment. In a survey of more than 2,000 people throughout Scotland, 83 per cent told us that they regard the cleanliness of beaches as a major problem.

On the other side of the equation, there is significant scope for efficiency savings. It would be unfair not to point out to customers the scope for that. Let me make clear what I mean by efficiency. I mean providing the same, or a better, level of service for less money; I do not mean any reductions in service, any short cuts or risks to health, safety, water quality or anything else. I am talking about delivering the same or better for less. Collaboration could and should be important in achieving that.

In public meetings and meetings with companies, I am asked all the time whether the water authorities are efficient. I have given you the answer to that question. Recently, we announced operating expenditure target savings that we would like the water authorities to make: £134 million a year by 2005-06. That is £65 a year for every household in Scotland—just over 30 per cent of the average bill. Similar degrees of capital expenditure savings have been made by other utilities and by the water sector in England and Wales. Revenue savings of between 10 and 15 per cent, or more, are achievable in the authorities' capital expenditure budgets.

Sustainability is a critical issue. The amount of money that is taken from customers and the amount that is spent by the water authorities do not match. At present, 78 per cent of the total money that is spent by the water authorities is raised through revenues. If we continue in that way, there will be unpleasant consequences for future generations. Debt among water authorities has increased from £1 billion, at the point of the creation of the water authorities on 1 April 1996, to more than £1.8 billion, and we are borrowing more than £200 million a year extra. That is not in the customers' interests.

More investment is needed—there is no question about that. It is needed because of statutory deadlines and agreements that our country has signed up to. It is worth noting that the penalties for failing to meet those statutory deadlines are severe. The UK Government is now proposing a penalty of £65,000 a day for beach water non-compliance in the north-west of England. It is important that we maintain our assets properly; under-maintenance of those assets is not in the public interest. The opportunities to increase debt further are limited and interest cover—the amount of money that is left available to pay the interest bill—is minimal at this stage.



Customer retention is also complicated in Scotland, although, because of the fixed-cost element, it is vital. The most attractive customers in Scotland—the large, single-site users of water or the multi-site users of large amounts of water—are paying relatively high charges: 45 per cent of the revenue of the Scottish water authorities comes from the non-domestic sector. In England and Wales, the proportion is less: the non-domestic sector contributes 32 per cent of the revenue in the north-west and the percentage falls to 21 per cent in the Southern Water area. The average figure in England and Wales is 26 per cent.

These are challenging times for the water industry and its customers. I wish that I had an easy solution, but there is none. The choices are difficult and there is no panacea. Good corporate governance, good ownership disciplines from Scottish ministers and the Parliament, good management and improvements to current management, and good regulation will, I hope, ensure that customers get the best value and a sustainable industry. That is what we are trying to achieve.

**The Convener:** Thanks very much. Your opening statement raises many issues, which we will address in our questions.

**Des McNulty:** What is your general view on the present corporate structure of the three Scottish water authorities?

**Alan Sutherland:** What do you mean by corporate structure?

**Des McNulty:** The fact that there are three authorities, which operate separately.

**Alan Sutherland:** There are three aspects to that question—the service, the cost and the implications of changing the structure—two of which I am probably qualified to address.

I have already said that economies of scale are possible. Even more significant are what I would call economies of scope. The challenges that the three authorities face are so similar that addressing them separately makes them more difficult—the problem must be solved three times, separately—and collaboration could help to address that.

Undoubtedly, benefits on the cost side could be gained through greater collaboration or changing the structure to create a smaller number of authorities. Benefits of collaboration could also be gained on the service side, especially for the multi-site non-domestic user who must deal with three different service regimes, customer management styles and tariffs.

Against all that, one must weigh up the cost and potential disruption of changing the structure. I am

probably not best placed to comment on those aspects.

**Des McNulty:** What might be the advantage of collaboration among, rather than a combination of, the three authorities?

**Alan Sutherland:** If I were to answer that with my former private sector management consultant's hat on, I would tell you that it is normally much easier to combine entities than to get separate entities to collaborate. However, given the fact that the water authorities are in the public sector and report to the Scottish Parliament through the Executive, it should be possible to ensure that they operate in the same way, through collaboration. I suspect that that is a question of what the Parliament wants.

10:30

**Des McNulty:** From the customers' point of view, what disparities result from the tripartite structure?

**Alan Sutherland:** The level of service for domestic customers differs significantly between the three authorities. We have conducted two rounds of audits of customer complaints against an objective framework that assesses handling and customer service. I am glad that all the authorities have improved over the two rounds. However, North of Scotland Water Authority's standard of domestic customer service remains much higher than that of the other authorities.

In a competitive environment, the structure would be a disadvantage on the non-domestic side of the equation. For example, a new entrant to the market could offer a service and price package that covered all Scotland, which would suit a multi-site commercial organisation such as the Royal Bank of Scotland, Tesco or any company of that order. Unless the three authorities collaborated, they could not develop such a package. That is a potential issue, especially as customer retention is critical.

North of Scotland Water Authority's situation is unique in the UK. Every household in the north of Scotland has 30m of water main. That is more than double the figure for the east and west and about three times the figure for Thames Water down south. There are between two and a half and three times more service reservoirs, water treatment works and waste water treatment works in the north of Scotland than there are in the Thames Water area, although Thames Water supplies a population that is 10 times bigger than that in North of Scotland Water Authority's area. All those facts are ultimately reflected in the price and mean that NOSWA, as constituted, will charge significantly more than the other two authorities in Scotland.

**Des McNulty:** If we ended up with a single Scottish water authority, would that significantly disadvantage customers in the west and east by increasing the price that they paid? Would they be asked to share in paying for the service to people in the north? Would not customers in the west and east feel aggrieved, as their charges have already built up the service in their areas?

**Alan Sutherland:** You raise a point that is an economic fact. If charges for domestic customers were harmonised across Scotland, the change would impact on bills in the east and, to a greater extent, in the west. In Scotland, 80 per cent of households are in the east or the west. For every £10 that could be taken off bills in the north to bring them closer to the average in the east and west, the impact for the east and the west would be about £2. Harmonisation would mean that a relatively small amount was added to bills, at this stage. For example, if charges were harmonised now, the cost for the average household in the east or the west would be about £5 or £6.

**Fiona McLeod:** Would that be £5 or £6 per annum?

**Alan Sutherland:** Yes.

**Fiona McLeod:** I will return to a topic raised by Des McNulty. I have a simple question. Would having one water authority for the whole of Scotland make your job easier?

**Alan Sutherland:** We would handle less data. Instead of handling three sets of data, we would have only one set. The customer service aspect of our work would not change, because we would still ensure that customer service was delivered to the whole of Scotland properly and effectively. The potential disadvantage of the change would be the loss of comparisons between authorities and of our ability to cajole or encourage a water authority to do better on customer service by pointing out that its neighbour had done a better job than it during that quarter. On balance, having one water authority would probably make the job slightly easier.

**Nora Radcliffe (Gordon) (LD):** I will press you on the perceived savings of combining rather than collaborating. I cannot get my head round why having one authority rather than three should make a difference to an industry that has so much money invested in fixed assets. You suggested that, in a competitive market, only a new entrant could offer a pan-Scotland deal for large users with sites across Scotland. Surely any one of the three water authorities could also offer a pan-Scotland deal in such a market.

You mentioned that you would collect one set of data instead of three. However, you would receive data about the same system and the same number of people over the same area. Therefore, I

do not know how you would make savings from collecting harmonised data for comparisons. You mentioned savings from solving problems one time rather than three. Will you zero in on an example that would clarify those savings?

**Alan Sutherland:** I will address the question about one set of data, because that particularly affects my office. I tried to say that the implication for us would be moderately less work. The change would not have a great impact on the economics of the water industry. I would not consider that as one of the possible collaborative or structural benefits. Nora Radcliffe is right to say that it would be open to NOSWA, WSW or ESW to enter into a pan-Scotland contract with a multi-site user. However, if an authority did that, the current structure would mean lost revenue for the other authorities and an increase in charges for households and businesses in those authorities' areas.

**Nora Radcliffe:** Why would that happen? I presume that authorities would increase charges to obtain revenue equal to the loss, but if it is viable for a private company to enter the market, why is it not viable for an existing authority?

**Alan Sutherland:** Entering the market is perfectly viable for the entity that wins the business, but it means that the other two entities lose a little bit or quite a large amount of business. For example, if ESW supplied all Tesco stores in Scotland, NOSWA and WSW would lose revenue, which would result in a shortfall in those authorities' accounts, which other customers would have to make up. However, ESW customers would gain benefits from the contract.

**Nora Radcliffe:** However, if we are talking about common carriage, which there would have to be for such a situation to occur, would not the other two authorities gain by charging for the use of their pipework?

**Alan Sutherland:** Yes, but the authorities would not receive as much as they would for providing the full service. The authorities that did not win the contract would not contribute to customer service, customer billing or other activities.

**Nora Radcliffe:** Can you envisage a swings-and-roundabouts scenario where, for example, ESW does Tesco, WSW does Asda and NOSWA does Safeway?

**Alan Sutherland:** Yes—theoretically, that could happen. However, the caveat is that a commercial company is likely to enter into such an arrangement because the deal that it can get across Scotland is, on average, better than the three separate deals combined. In that sense, there would be a loss of revenue to the Scottish industry as a whole.

**Nora Radcliffe:** It is arguable how it would all pan out.

**Alan Sutherland:** You asked about the benefits of collaboration. The most simple example is bulk buying—procurement. The water authorities are among the top two or three customers of both Scottish Hydro-Electric and Scottish Power. They use an awful lot of electricity. It would be possible for the authorities to get together and use their buying power to obtain a slightly better deal. The benefits would be neither insignificant, nor huge. A bigger benefit might come from joining the three capital programmes together and taking advantage of economies of scale. That would have a particular benefit in the NOSWA area, because in some areas of the Highlands it can be difficult to get high-quality contractors at good prices. Bundling that work with other work in areas where contractors are happier to carry out large jobs would enable the authorities to get a better price.

**Des McNulty:** You mentioned the higher percentage costs that industrial customers pay in Scotland compared with south of the border. What about the actual costs compared to percentage costs? Are commercial customers paying more for water in Scotland than they would, for example, in the Thames Water area?

**Alan Sutherland:** There is a range of costs and the situation is not clear cut. Average domestic bills in the east and west of Scotland are the two lowest across the whole of the UK. The average NOSWA domestic bill is moderately higher than the UK average, but not much. Anglian Water, South West Water and Welsh Water all have higher bills, despite the recent price cuts in England and Wales.

There is a range of costs for non-domestic customers. ESW's small business customers are paying the highest rates in the UK. WSW's large users are paying the second lowest tariffs in the UK, although there are deals in England and Wales that mean that the price list is not necessarily the best guide. On balance, the non-domestic sector pays more in Scotland than it would in England or Wales.

**Des McNulty:** Some of the Scottish water authorities may be less efficient than some of their English counterparts, but they also deliver some services that are cheaper than those of the authorities with which they are compared. Could it be said that the most important factors are the scale of past and current investment and the geographic and economic circumstances of the area that the authorities cover, rather than just the management efficiency of the operator?

10:45

**Alan Sutherland:** No. I am afraid that you have taken a step too far. I wish that that were the case. Bills are at the level they are in Scotland because we are storing up problems for the future. We are not able to cover the current outgoings of the industry and, at current revenue levels, there is no prospect of our covering them. Even if we were to make all the efficiencies in operational expenditure that we have identified, as well as the capital expenditure efficiencies that we are seeking, the investment that would be required to achieve an industry that is genuinely sustainable and is not getting any worse would be such that prices across Scotland would still have to rise.

I can give some examples of the range of prices. A typical small business—a definition that has been created to compare prices across the UK—would currently pay £434 in the ESW area, £246 in the NOSWA area and £211 in the WSW area. Thames Water has the lowest bills for small businesses; businesses there would pay about £155. There is quite a difference. The tariffs for major manufacturers in the ESW area suggest that they would face a bill of about £250,000, whereas a comparable business in Northumbria would pay just over half that.

**Maureen Macmillan (Highlands and Islands (Lab):** How do you judge improvement or deterioration in the overall performance factors? Do you use the same comparison basis for each authority?

**Alan Sutherland:** Yes. Since our office was set up and I took up my post on 1 November last year, we have been taking the definitions that were created by the Office of Water Services, which regulates the industry in England and Wales, and adapting them so as to take account of the special factors in Scotland. For example, there are many very small sewage works in Scotland, which would not fit into an appropriate Ofwat category. They would fit into an Ofwat category with a lot of bigger works, which have different economics.

Everything that we do is strictly comparable across the three authorities. We consider all the operational, capital and customer service elements, according to strict definitions that are provided to and discussed with the authorities. The comparisons are rigorous and objective.

**Maureen Macmillan:** How do comparative balance sheets work? Are they equitable from one area to another? No one has inherited depreciation charges, fixed asset conditions, future capital expenditure and so on.

**Alan Sutherland:** The asset bases of the three authorities vary in two ways. First, they have different sorts of assets, as required to provide their services. That goes back to the point I made

earlier about the fact that the north of Scotland needs more water mains to supply households. On average, the Highlands and Islands need 60m per household, whereas in England and Wales and in the central belt of Scotland, much less is needed. Similarly, in terms of water treatment works and waste water treatment works, there is a need for more, smaller assets in the north than there is in the central belt.

The second way in which the asset bases differ is in the condition in which they were received when the water authorities were set up. On balance, the situation in the north of Scotland is worse than in the other two areas. The condition of the assets in the north requires more attention. The gap between the authority's asset base and the assets that are required to deliver compliance with environmental and water quality legislation is greater in the north than in the other two areas. That is evident from the compliance statistics from three or four years ago and from today. Progress is being made in the north, but the area is still behind.

**Maureen Macmillan:** Are the main tasks in the north still laying pipelines to deliver water and establishing more sewage treatment works?

**Alan Sutherland:** Work to improve the quality of drinking water is being undertaken, particularly in small communities, so particularly in the Highland area.

**Maureen Macmillan:** What are the main tasks facing the other authorities? What do they have to bring up to scratch?

**Alan Sutherland:** Waste water sewerage is a major issue not just for NOSWA but for all three authorities. The quality of pipes is also an issue. For example, WSW has the highest rate of burst pipes per kilometre of mains pipeline in Scotland.

**Maureen Macmillan:** Does it have an even higher rate than the Highlands?

**Alan Sutherland:** Yes.

**Maureen Macmillan:** I find that surprising—the burst pipes must all be in Argyll. Sorry—that was a joke. Do not put that on the record.

Are you anxious about population trends? There are growth spots where the provision of water and sewerage may not be adequate in future, as well as economic trends—industries move into particular areas and leave others. Do those factors bother you at all?

**Alan Sutherland:** There is a clear, universal service obligation on the water authorities. I assume that no one intends to remove that obligation, therefore I hope that we will continue with that approach. There is clear consensus among everyone we meet that that approach

should continue.

Businesses will examine the economics of their location, wherever they may be. Labour and property costs are factors and, for certain industries, such as those that produce paper, chemicals or electronics, water is an important cost. Those industries will therefore also examine water costs. Different water costs across Scotland may influence where those industries decide to locate.

**Maureen Macmillan:** Are you proactive, rather than reactive, about trying to look into the future to predict population trends?

**Alan Sutherland:** Everything that the water authorities do is designed to be proactive. That is why they go through a water quality and standards programme with the Scottish Environment Protection Agency, the Scottish Executive and my office. We consider what, where and when infrastructure will be required, how much investment is required in order to bring water quality up to scratch and where waste water and water treatment will be required. We plan to make funds available when required.

**Fiona McLeod:** I want to return to the comparators. You seem to be giving mixed messages. You talked about rigorous criteria for comparing the three water authorities, but then you explained how different the authorities are and their approach to the service that they must provide. According to the statistic that you gave us, NOSWA takes 60m of pipes in the Highlands to provide services to one user, while Thames Water takes only 10m. You keep comparing water authorities in Scotland to Thames Water. I would be concerned if you measured the performance of our three water authorities against the performance of such an authority, which has a completely different service delivery background.

**Alan Sutherland:** I can reassure you on that point, as we do not compare the Scottish authorities at a macro level. We consider the structure of the assets of each of the three authorities and how much each individual asset should cost to run and then we aggregate those figures. The process is very much bottom up—it is not top down. We are not saying that supplying 1 million households should cost X amount, therefore supplying 1 million households in the north of Scotland should cost the same. We are saying, "This is your mix of assets in the north of Scotland. You have this type of water quality, you have this many small assets and this many big ones and you have this amount of main. Because of that, it is fair to give you this amount of money."

While I am happy to take members through the process, one arrives at that answer through complex, data-intensive statistical work. The

methodology has been used by Ofwat for several years and has been endorsed by several academics and by the Competition Commission as being fair. Members should remember that Ofwat does not regulate only companies such as Thames Water. It also regulates—and must justify how it does so—companies such as Mid Kent Water, which is a tiny entity, even relative to the three Scottish water authorities.

**Fiona McLeod:** I will not ask you to take us through that methodology, but would it be useful for the committee to receive a written submission on it?

**The Convener:** An easy-to-digest summary of the process might be useful for members.

**Alan Sutherland:** We could certainly provide that information. That would be no problem at all.

**Mr Tosh:** I start by picking up on Mr Sutherland's response to Maureen Macmillan on the condition of the inherited asset bases in the three water authorities. Is there any substance to the argument that, to a degree, the poorer asset base in the north of Scotland reflected the largely discretionary allocation of borrowing consent to the relevant local authorities before reorganisation? It has also been argued that, in a sense, ESW and WSW benefited from the local government set-up and from the revenue support grant over a number of years, as they picked up more investment than NOSWA did. Therefore, it could be argued that consumers in the north are being penalised by having more of the necessary investment back-loaded into an era when a far higher proportion of investment was generated by direct charges on consumers.

**Alan Sutherland:** I have never seen data that explains in detail how much money was spent on either the operation or the capital development of any of the former water boards or regional council departments. I cannot comment on that, although I can talk about the situation today. Through the efforts of the water authorities and, no doubt, our cajoling, the information that is beginning to come in is of a much higher standard. We have a much clearer vision about what needs to be done than we had even a year or two ago.

**Mr Tosh:** Fair enough. I will move on to what needs to be done.

I understand that most of the private finance initiative or public-private partnership schemes—which are used extensively by all authorities—are 30-year concessions. Could it be argued that the write-off period is too short? Should the repayments be made over a longer period? Are customers paying for an over-rapid write-off period for PPPs?

**Alan Sutherland:** The authorities could

approach investment in two ways. They could spend capital by borrowing money, were it available, through the public expenditure external financing limits and building an asset that would do the job and would last about 30 years. They would then have to operate that asset during those 30 years.

However, the authorities are swapping that option for a contract with an entity—usually a consortium of some description—that will charge them 30 amounts instead of a capital fee plus 30 amounts for operating the asset. That spreads the capital costs over 30 years, during which time someone else runs the asset on behalf of the authority. If that person is efficient or innovative in their techniques, the PFI version will deliver better value for money. When we have examined such cases objectively, we have found that that option was the better one.

11:00

**Mr Tosh:** Do you think that the water boards are, to any degree, being pushed into inappropriate and expensive procurement methods, such as public-private partnerships, simply because of the limits on their external finance options—their borrowing consents, effectively?

**Alan Sutherland:** The evidence does not suggest that.

**Mr Tosh:** What do you think about conventional procurement as opposed to PPPs? Is it appropriate? Are the water companies using PPPs too much or enough? Where are traditional methods of procurement appropriate and where would a PPP or PFI procurement be more appropriate?

**Alan Sutherland:** A PPP or PFI project will justify itself when the scheme is large or covers a significant area. Bigness is an important factor because of the costs of setting up the structure, which a consortium is more easily able to assume when a project is bigger. For example, a PPP or PFI would be an appropriate way of funding secondary treatment for sewage in Edinburgh or Tayside. It was considered for a much smaller scheme in Montrose and was found not to be viable; traditional methods of procurement worked out better in that case. Of course, in such a situation, local authorities must ensure that they are able to deliver solutions that are as innovative and efficient as those that could be delivered by contractors who would be involved in a scheme funded by a PPP.

**Mr Tosh:** You referred to your belief that the level of debt was unsustainable and that it was putting an unfair burden on consumers. Would an appropriate strategy—although it might be only a

partial solution—be for the client to attempt to gather together smaller projects to procure more economically through a PFI? Would you go down the PFI route for aggregated contracts?

**Alan Sutherland:** I suspect that conventional procurement techniques will start to involve a greater degree of partnering and bundling of small projects. That will enable efficiencies to be made in the authorities' capital procurement, which will have significant benefits.

**Mr Tosh:** In the long run, would that be enough to remove the increasing burden on the customer?

**Alan Sutherland:** I think that I said that even if we get to the stage at which capital efficiency and operational efficiency are as good as they can get, prices would still have to increase to deliver a genuinely sustainable industry. We do not want to be in a situation in which, although we have met the statutory compliance deadlines that will hit us between now and 2005 and again in 2013, we find that we have been undermaintaining the underground pipe networks or existing assets and that we must replace them. We do not want to find that we have been storing up problems for the future; we want a sustainable industry.

**Mr Tosh:** What is your role in examining the specification for capital expenditure, including the important specification that there must be adequate maintenance so that we do get into a situation such as that which you described? I presume that you take a close interest in the investment programmes of the authorities. Are you examining the specifications of modern and efficient plants, for example? Do you have the capacity to examine that or would you need advice from consultants?

**Alan Sutherland:** There are three principal ways in which we can examine those specifications. The first relates to the quality and standards process of the Executive, which includes the Executive's water quality people, the Scottish Environment Protection Agency and the water authorities. That method attempts to ensure that all the necessary projects are being done and that we are providing adequate maintenance of above-ground and below-ground assets. That is what the Scottish Executive is consulting on at the moment.

The second way is to ask for quarterly investment quality returns. Those returns give details of every project that the authorities are involved in. We ask about budgets that are allocated to those projects and expected rates of spend. We monitor those to ensure that the outputs are being achieved at the end of that process.

We are just beginning to develop the third method, which is to examine the investment

appraisal that is made by the water authorities. Before and after the investment is made, we consider the way in which the decision was reached, the specification of the decision, the amounts of money that were involved and whether the process was conducted in accordance with best practice. Auditing the process ensures that it is done in the customers' interests.

**Mr Tosh:** In doing that work, do you find that any tensions emerge? The obvious one would be between reducing current costs and protecting the prospective life of the assets.

**Alan Sutherland:** Absolutely. Whenever money is relatively short, people must make trade-offs. Since I have been in my post—probably before that, as well—the unfortunate situation in the Scottish water industry is that trade-offs have been made. Statutory deadlines are incredibly important and must be met. The implications for customers of our having to pay fines of £65,000 a day are horrendous—if that had happened in Scotland, every household's bill would have increased by 50p. As money is short, less money than I would like has been spent on underground assets.

**Mr Tosh:** How can the water authorities be helped to resolve those tensions?

**Alan Sutherland:** We try to ensure that the water authorities have reasonable levels of income, that they are efficient and that they have money to invest in the maintenance of assets. We also explain at public meetings what issues the water industry faces.

**Mr Tosh:** Is it partly your role to ensure that investment levels are adequate and that the authorities do not duck any of that in the interests of reducing charges?

**Alan Sutherland:** Absolutely.

**Mr Tosh:** I want to ask about the backlog of investment which, in the quality and standards document, you estimated to be £2.5 billion. I assume that that has built up through lack of investment in recent years. Who has the responsibility for monitoring that and for ensuring that that backlog is eliminated?

**Alan Sutherland:** The quality and standards document is about ensuring that we invest enough to be sustainable. The three options that the Executive has proposed are good in that regard. If we opt for the lowest of the three options, things will get worse on balance, and the expenses for customers over the life of the assets will be greater. I would therefore find it difficult to support that option.

The middle option is enough to meet all the statutory deadlines and to ensure that we invest enough to prevent things from getting worse. The top option, which would be very nice if we could

afford it, would genuinely begin to bring the industry up to ideal condition over a 15 to 20-year period. That third option would probably put us in a situation that is better than that in England and Wales today. The middle option will keep us approximately where we are, but things would not get any worse.

**Mr Tosh:** What would the implications for the consumer be if we went for the best option as opposed to the middle one?

**Alan Sutherland:** One of the problems with the water industry is that there can be few guarantees. Some customers have risks that they do not know about, such as the risk of a basement flooding with sewage. It might not have happened to them yet, but it could and they are not aware of the risk. By spending that extra money, such risks can be eliminated, but would a customer feel any better because a risk that they did not know about was gone? That is the sort of awkward question that we are dealing with. The impact on customers' bills would be significant if we went for the higher option, rather than the middle one. Ultimately, that is a balance for the Executive and the Parliament to make a call on.

**Mr Tosh:** I am glad that that is our choice.

**The Convener:** Before we move on, I remind members to keep their questions as brief as possible—we have a fairly busy agenda today.

**Bristow Muldoon:** How did the backlog in investment build up? Has it built up gradually over decades, or is it the result of an increase in the standards that are required by European Commission decisions?

**Alan Sutherland:** It is probably for both those reasons. The most reliable figures for the period 1990-2000 are for West of Scotland Water, as there are some data from Dumfries and Galloway and Strathclyde. On a per capita basis during that period—which covered the end of the regional councils and the beginning of the water authorities—it spent less than half of what was spent in broadly equivalent areas in England and Wales, such as Devon and Cornwall or Wales. Today we are still spending at the lower end of the investment scale for each connected property, compared to what is being spent elsewhere in the UK.

**Bristow Muldoon:** You commented on efficiency in your introductory remarks and in your briefing note. You say that efficiency targets are related to those of companies south of the border, but are modified for Scottish conditions. In which areas do you envisage efficiency targets being set and how do they vary from authority to authority?

**Alan Sutherland:** The total efficiency target is £134 million annually by 2005-06. Of that total,

£66 million is from West of Scotland Water, £44 million is from East of Scotland Water and £24 million is from North of Scotland Water. The areas that are covered by those targets are what we call controllable operating expenditures, such as premises, chemicals, electricity, manpower and transport. There is no simple answer to what the implications for any of those items of expenditure will be, other than to say that—as an aggregate—they will have to be reduced by the amounts that I mentioned.

11:15

I know that the committee will be interested in employment issues. The data from England and Wales on employment are interesting. The least efficient of the English and Welsh companies, Welsh Water, has cut the most jobs. The most efficient has reduced jobs by 15 per cent over the same period. The implications depend on how management, workers and the unions go about managing their business as stakeholders. It is impossible to say that there will be a specific number of job losses.

**Bristow Muldoon:** You guessed correctly that I had employment in mind when I asked that question. To what degree will outsourcing or externalisation of some services, rather than job reductions, play a part in the water authorities' pursuit of efficiency targets?

**Alan Sutherland:** You should address that question to the senior management of the water authorities. My job is to look after customer interests and to ensure that as good a service as possible is delivered for as low a cost as possible. I can allocate a fair budget to that, but it would be impinging on the authority of management for me to tell water authorities how to spend that money. It is up to them to work out how to do that—that is their job, it is what they are there for and they are capable of doing it.

**Bristow Muldoon:** Have any of the authorities come back to you to say that they feel that the targets that have been set are unrealistic and could not be achieved through efficiency savings?

**Alan Sutherland:** We gave the authorities our final answer on what we thought the efficiencies were some time ago and we have had a number of sessions with them. I would not say that we have agreed exactly on all the factors, but I understand that each of the three authorities has accepted that the target is fair and realistic. I will make no bones about it; the targets are challenging targets and difficult to meet, but they are reasonable. There are plenty of precedents for similar targets having been delivered and I have no reason to doubt that they will be delivered if management sets about achieving them properly.

**Bristow Muldoon:** You have recognised that North of Scotland Water Authority has higher than average charges for domestic customers. It is also recognised that there are quite widespread lower-income areas in the North of Scotland Water Authority area. What do you think the implications will be if those charges continue to rise above trends for the UK, and how will that impinge on the lower-income areas?

**Alan Sutherland:** We will continue to set efficiency targets and pressure management to ensure that, before extra money is raised from customers, savings will be made through efficiencies of all types. Before we start talking about charge increases, it is important to reiterate that. It is difficult to know what the implication for charges over the medium to long term will be. We have just begun working on a review of the industry, which we are due to present to the Minister for Environment, Sport and Culture later this year. We have to take into account all the quality and standards data and we must understand what quality and standards options people want.

Charges will go up in the north, even if all efficiencies are put in place. That is inevitable given the structure of the North of Scotland Water Authority. Nothing can be done—there is nothing in the power of management or the regulator to prevent that.

**Bristow Muldoon:** Many of your recommendations are based on data that are supplied largely by the water authorities. How much of that information is independently audited? How much information do you receive from other sources, such as consumer groups?

**Alan Sutherland:** Customer service data come in from the authorities, and we audit those data. We compare that information with information that we get from surveys, public meetings and the like. I think that we are pretty robust on that side of things.

As for cost data, in Scotland we do not have a system—as exists in England—of reporters and auditors independently verifying returns to the regulator from each of the companies. The belief is—I subscribe to it—that, given that the three authorities are in the public sector, there should be no material reason for them to want to mislead in any way. We check the information that comes in and we question the companies intensely on the information and its implications. We also compare it rigorously with the audited information from England and Wales to ensure that the numbers look reasonable. That is an intensive process that takes up many man-hours. However, it is a pretty robust process.

**Fiona McLeod:** I want to ask about efficiency

savings. You have talked about challenging targets and manpower. You say in your submission that one of the most efficient English companies had reduced manpower by 15 per cent. Are the water authorities in Scotland overstaffed? Could staff levels be cut by 15 per cent? If they could be cut, would you be concerned if that led the water authorities to bring in mixed working practices, or multiskilling, so that someone who worked in the water department might also work in the sewage department?

**Alan Sutherland:** Data on levels of employment in Scotland from the past several years show that considerably more people per connected household are employed in Scotland than in England and Wales. More people are employed in the Scottish water industry than in Thames Water, which serves twice as many customers. There are objective reasons for saying that 15 per cent staff cuts—to use the number that Fiona McLeod used—are not impossible. However, I repeat that it is for management to decide how it wants to deliver savings. It is not appropriate for me to impinge on management judgments, because the people who make those judgments are responsible for doing the fine job of delivering water and waste water services. We take their job for granted, but every time we turn on a tap, water is there. We would complain if it were not.

It is for the water authorities to decide how they want to deliver their services. The extent to which management, unions and workers work together will be one of the influences that determines how the service is delivered, how efficiently it is delivered, and how many people will be involved in delivering it.

**Fiona McLeod:** As the water commissioner who represents customers and consumers, are you concerned about the possibility of cross-contamination in our water supplies because of the way that the authorities use their workers?

**Alan Sutherland:** Absolutely. In my opening remarks, I defined efficiency and said that we had to ensure that we took no short cuts and no risks with health and safety, and that we did nothing that compromised the service that we all value. However, that is ultimately a question for management, which must judge how to deliver the services. If there were any evidence that the authorities were letting services slip, I would not regard them as being efficient. There can be no cuts in services. There can be no lowering of prices merely because services have been cut. I would not regard the authorities as having done their job if that happened.

**Nora Radcliffe:** You mentioned the disparity in customer service levels between the three authorities. Does that correlate with manning levels?



**Alan Sutherland:** No, it does not.

**Fiona McLeod:** I want to ask about competition and regulation. We have been considering the Competition Act 1998. Is there an argument for excluding water authorities from the effects of that act? On page 3 of your submission, you say that your concern is not about

“competition per se, but rather the concept of not unreasonably refusing access to ‘essential facilities’ . . . This may mean that the water authorities could not refuse to transport treated water”.

The implication of exemption from the act is that it may mean that they could refuse to treat such water.

**Alan Sutherland:** I am not a lawyer; if there are lawyers among the committee’s members I apologise for my limited understanding of the law. Competition is very much a reality in the Scottish industry. Deals are being struck between the likes of Northumbrian Water and Scottish Courage, Yorkshire Water and Princes Foods, and Anglian Water and Scottish Nuclear and British Energy. There has also been de facto competition on the waste water side for a long time. Major industrial concerns have set up their own effluent treatment plants, rather than using the public system. In some cases, they have been told by the public system, “We do not want your effluent; can you please treat it yourself?” Competition has been around for a while.

Nothing in the Competition Act 1998 impacts on consultants going to industrial sites and investigating how to reduce water use or trying to help the customer to negotiate better with the water authority. That is happening. Nothing in the act would stop someone approaching a water authority and saying, “I want to supply 10 industrial customers, or 100,000 tenants of a council or housing association, and because I am buying in bulk I want a discount.” That can happen under the existing framework. Exemption from the act would not affect that.

The area that the act impacts on is common carriage—when the water authority does not treat the water or serve the customer, but really acts only as a distributor or transporter of treated water from one point to another, as requested by a potential new competitor.

That is not yet happening, either in England and Wales or in Scotland. Most people—including consumer bodies and the industry association in England and Wales—would say that legislation would be required to clarify how that would happen. In Scotland, the powers of the authorities do not say whether common carriage is permissible; there is no clarity or legislation in place and the decision would be for the courts to make. Such a decision would set precedents that

may or may not be good for customers, therefore legislation is important.

11:30

**Fiona McLeod:** You are saying that legislation is required to ensure application of the Competition Act 1998. Could excluding the water industry from that act be justified?

**Alan Sutherland:** The only bit that would be excluded from the 1998 act would be the common carriage bit, and it is unclear how important that could be. Some people say that it would be unimportant. Access codes have existed in England and Wales for several months and still there is no common carriage. How big an issue that will be is questionable.

From a regulatory and customer interest standpoint, competition is good, as it allows me a lever to encourage the water authorities to be more efficient and increase their levels of customer service. Competition in utilities has brought about much higher levels of service for customers and, ultimately, lower bills. I suspect, therefore, that competition is useful to customers.

**Fiona McLeod:** Let us move on to your regulatory role. Last week, we heard from SEPA how many organisations are involved in the regulation of water in Scotland: we came up with five at one point. How do you fit into the regulatory framework? Do you envisage a co-ordinating role for yourself in that framework?

**Alan Sutherland:** My role is pretty clear. It is to try to ensure that the services to customers are improved and that the costs for the delivery of those services are as low as possible. We work closely with the regulators of drinking water quality and waste water discharge, such as SEPA, to ensure that the policy is being co-ordinated.

Outwith the quality and standards process, consultations are taking place on a revision of the bathing water directive. We are discussing with SEPA the issues of management information, operational expenditure and capital expenditure in the authorities. SEPA is considering the environment and what needs to be done by the water authorities to satisfy environmental directives, and we are working closely with SEPA to ensure that the implementation of that work and future planning—to return to an earlier question—is made as clear and robust as possible.

**Fiona McLeod:** I understand that a department in the Scottish Executive is currently responsible for regulating water quality.

**Alan Sutherland:** That is correct.

**Fiona McLeod:** However, there are proposals to establish a Scottish drinking water inspectorate.

Would that be a useful step, or is the current regulation entirely satisfactory?

**Alan Sutherland:** As the vigilance and enforcement procedures of quality regulation are getting tighter, it is becoming increasingly important for us to ensure that we are complying and that we will not be caught out. We do not want to end up with customers footing the bill for investment and then footing the bill again because we are caught out through not having done everything possible to prevent being fined. I am not an expert, but anything that can be done to strengthen that process must be good news for customers.

**The Convener:** I advise members that, as we are pushed for time, we will follow up in writing with Alan Sutherland and his staff a couple of the points that have been raised.

I thank you for coming along. This is not the best committee room in which to conduct such an inquiry, but your evidence has been very useful and will form a substantial part of our report.

**Alan Sutherland:** Thanks for your time.

**The Convener:** I thank the representatives of the Scotch Whisky Association for attending the committee today. I understand that Matthew Farrow has come at late notice, which we appreciate. Our other witnesses are Brian Higgs, Hugh Morison and Pat Mennie.

Thank you for your written submission, which has been made available to committee members. We invite you to make a short opening statement on the key issues that you want to raise. Following that, committee members will ask questions on areas of specific interest.

**Hugh Morison (Scotch Whisky Association):** Thanks very much, convener. I am the chief executive of the Scotch Whisky Association. On my left is Pat Mennie, who is the secretary of the Malt Distillers Association of Scotland. To his left is Brian Higgs, from United Distillers and Vintners, who is also the president of the Malt Distillers Association. Matthew Farrow, from the Confederation of British Industry, is providing support from the flank.

The Scotch Whisky Association represents 95 per cent of distillers, bottlers and brokers—all large users of water. The Malt Distillers Association represents the 87 or so malt distilleries that are part of our industry, and our associations work closely together.

The whisky industry welcomes this inquiry into the water industry. Good quality water is a basic raw material for our product. We also produce effluent and, as we rely on a clean and unspoilt environment, we need effective effluent treatment. We export some 90 per cent of our product to

more than 200 markets worldwide, so we face fierce international competition and cost pressures. The industry has no choice but to drive costs down in its operations and we require the same discipline from our suppliers. We have a very strong interest in an efficient water industry that is responsible to its customers and offers value for money.

It might be helpful if I say something about the extent of our water usage, to set our comments in context. There are slight differences in this respect. Grain distilleries produce the grain whisky that is the basic palette on which blended whisky is made. They are large and are substantial users of the public water supply. For example, our largest user uses 1.6 million cu m a year, which costs several hundred thousand pounds. Of the 66 large users in Scotland that use more than 250,000 cu m a year, seven—or more than 10 per cent—are distilleries. Grain distillers are major users not only of the public water supply, but of effluent treatment requirements.

Malt distilleries are much smaller and generally take their water for production and cooling from their own private supplies. However, they use water from the public supply for offices and visitor centres, which will cost about £1,000 a year. We have identified five malt distilleries that take their supplies from the public supply, which can cost them between £1,500 and £8,000 a year. Although the scale is far smaller than with the grain distillers, malt distillers share an interest in a efficient, cost-effective water industry because a lot of malt goes into blended whisky.

We are also concerned about the regulatory side in relation to the malt distilleries. Under the water framework directive, the Scottish Executive now has the opportunity either to require licensing of private water abstractions or to exempt water abstractions from that requirement if there is no significant impact on water status. My colleagues from the Malt Distillers Association of Scotland will comment on that issue later.

The industry welcomes the steps that the water companies have made since reorganisation to improve efficiency and the new structure of water authorities has helped with long-term thinking and strategic planning. However, as the water authorities acknowledged in their own evidence and as the water commissioner has just pointed out, they have a long way to go. I will very briefly highlight a few current issues and then give the committee something of our vision of the direction in which we would like the water authorities to go in future.

As the committee has heard much about cost efficiency from the water commissioner, I will not go into the issue in any great detail. However, I will say that the authorities must vigorously

benchmark themselves against the best in the sector and learn from best practice. Our comparisons with privatised water companies south of the border suggest that there is considerable scope for further improvement. We are concerned that, broadly speaking, business charges for water are far higher in Scotland than they are south of the border. The whisky industry is not mobile; it is rooted in Scotland—but the gin and vodka parts of the distilling industry are mobile. I would imagine that the issue is of concern to Locat in Scotland and others who are trying to attract industry to Scotland.

We are also concerned about price variations. Many of my members have operations across Scotland. Although we have heard the reasons for varying prices across the country, there are concerns about the range of differential between prices in various areas.

My members are also worried that there is insufficient transparency about costs and how charges are built up. Furthermore, they are concerned that there is cross-subsidisation of domestic consumers by business. Although I did quite a bit of work on the back of an envelope to get a handle on this problem, I then read the evidence of Dr Hargreaves of East of Scotland Water. He said:

"Fifty per cent of our income comes from industry and we supply 20 per cent of our water to industrial customers."—*[Official Report, Transport and the Environment Committee, 12 December 2000; c 1366.]*

That statement makes it pretty clear that there is cross-subsidisation, which benefits neither Scottish business nor the Scottish consumer at large, as it means that there are fewer jobs in Scotland than there might be.

Finally, on current issues, although there have been steps to improve customer service, we feel that more could be done.

What of the future? We welcome the Executive's proposals for the further development of competition. Furthermore, we very much welcome the role of the water commissioner and are pleased that, among other things, he is driving forward efficiency improvements and setting challenging targets. I listened to his evidence and, from the industry's point of view, found very little to disagree with.

11:45

There is a case for enhancing the professionalism of the boards of the water authorities by strengthening them with private expertise. The CBI shares that view. Perhaps Matthew Farrow will comment on the issue.

We want enhanced customer service, greater

transparency in costs and pricing and greater use of the existing opportunity for customers to negotiate their own terms with the supplier. Furthermore, we need regulations that are appropriate to local circumstances and do not impose disproportionate costs, which brings me to what we will say later about the water framework directive.

For the longer term, there could be opportunities to drive down overhead costs by establishing a single water authority for Scotland. However, we will not labour that point at this stage. The prime concern is an efficient, cost-effective water and sewerage service that offers value for money to its customers and enables Scotland to take advantage of one of our greatest natural resources—our abundant supply of good water.

**The Convener:** We appreciate that statement. As the committee has questions on some of the areas that you have raised, I will go straight to Bristow Muldoon.

**Bristow Muldoon:** In your opening statement, you indicated that there should be more private sector representatives on the boards of the water authorities. Those representatives would presumably expect to have an impact on the running of the authorities. How do you feel that such involvement would improve the cost disciplines of the water industry or the way it manages its capital expenditure?

**Hugh Morison:** A lot of discipline in the private sector comes from plc non-executive directors who have experience of driving costs down, capital procurement and customer service and are able to ask executive directors the kind of challenging questions that will stimulate improvements to customer service and the management of the organisation. Although that opportunity is sometimes taken at the moment, we feel that more could be done in that area.

**Matthew Farrow (CBI Scotland):** I agree with Hugh Morison's comments. All I would add is that when we discussed the corporate governance of the water authorities with our members, they recognised that the authorities are in a tough and challenging situation. We agree with the targets set by the water commissioner and which the English companies have managed to meet on a comparable basis.

Members also pointed out that Scotland has some really good examples of ex-public utilities such as Scottish Power and Scottish and Southern Energy that have done great things in the private sector. We felt that we could use some of the expertise in this country to supplement and strengthen the boards of the water authorities and to help them to meet some of the water commissioner's very challenging targets.

**Bristow Muldoon:** You also mentioned the differences between Scotland and England in business charges for water. Have you investigated the reasons for such differences? For example, have you taken into account the fact that many whisky plants operate in fairly rural areas in Scotland? As the water commissioner pointed out, some of the piping costs are considerably higher per customer than they are in England.

**Hugh Morison:** We have not undertaken any detailed work on that issue. Although we recognise that certain factors in Scotland will affect pricing—some of my members who buy water across the country also have operations in England—we are concerned about the considerable variation in pricing. The matter comes down to what the water authorities and the water commissioner say about relative efficiencies. Although there have been steps to improve efficiency in the organisation, there is still a long way to go to meet the efficiencies made by the best in class south of the border.

**Matthew Farrow:** I agree with that. We recognise that there may be particular reasons why some charges will need to be higher in Scotland—as we have heard this morning. Our feeling is that companies with sites in Scotland and south of the border, and in fairly similar locations, tend to find the costs up here much higher. There appears to be a lot of cross-subsidy in Scotland between non-domestic and domestic customers, as well as a less good efficiency record. If we could address those two factors, costs could come down for the private sector in Scotland. It may not be possible for that reduction to be to the level found in England, but costs here are still too high.

**Bristow Muldoon:** Have you studied the proportion of charges levied on businesses in England compared with those levied on domestic consumers? How does the balance compare with that found in Scotland?

**Matthew Farrow:** For the revenue raised from the different sectors, we have gone on the figures that were quoted by the water commissioner. The East of Scotland Water figures suggest that the authorities in Scotland raise about half their income from non-domestic customers; the equivalent figure in England varies, but tends to be 25 or 30 per cent. That seems to be a clear indication from the industry itself of cross-subsidisation in Scotland.

**Bristow Muldoon:** What proportion of the costs of your business do water charges represent? We recognise that the proportion for malt distillers and grain distillers will be different. What is the variance between the two?

**Brian Higgs (United Distillers and Vintners):**

The ratio would be the same for malt and grain distilling. Water costs would generally be 4 or 5 per cent of the overall manufacturing cost.

**Bristow Muldoon:** As for the reasons for charges rising, we have heard from the water commissioner that that is related to a backlog of investment and to an increase in the standards for water. I note that you feel that business is already contributing more than its share; are there ways in which you feel the Scottish Executive could enable the catch-up expenditure to be made, other than through increases in charges or through the measures that the commissioner outlined?

**Hugh Morison:** This is a very difficult matter. It is clear that competition law will affect the Executive's capacity to provide grant—which does not seem to be an option. If an increase in borrowing is permitted, that simply feeds into higher charges in the future and would therefore affect pricing.

The first thing to do would be to address efficiency. That is being handled by the water commissioner and the water authorities. Money could be released for investment. Secondly, I would like the cross-subsidisation between the business and domestic sectors to be sorted out, so that if charges have to rise, businesses will not continue to pay such an unfair share. We then come to the crucial question of the poorer customer. That has to be recognised, but it seems to be a matter for support through the social security system or income support rather than one of distorting the finance of the whisky business.

**Brian Higgs:** I wish to clarify something about the cost of the water. The figures that I referred to relate to the actual water supplies from the water authorities. As Hugh Morison said in his opening statement, the vast majority of water used in the distilleries comes from private supplies—obviously at zero cost. If we consider the overall water costs, they would therefore be significantly lower.

**The Convener:** Thank you for that clarification.

**Maureen Macmillan:** You mentioned the difference between the water charges of, say, a gin factory in England and a whisky distillery in Scotland. What about differences within Scotland? How much more does it cost—in water charges—to run a whisky distillery on Speyside than in Islay? Do you have any figures?

**Hugh Morison:** The water authorities publish their scale of charges. I am sure that you would be able to get hold of that information from them. In the west, the charge for users of less than 100,000 cu m of water is 49p per cu m; in the east it is 61p per cu m; in the north it is 91p per cu m. There are discounts of 15 per cent for users of more than 100,000 cu m and further discounts for those using more than 250,000 cu m. However, there is

a similar variation in the costs.

**Maureen Macmillan:** Is that a problem for the industry? I have not heard of any distilleries deciding to move from one area to another because of differences in water charges.

**Hugh Morison:** That is not an option for us. A distillery is in a particular location because of the particular quality of the water, the atmosphere and so on.

**Maureen Macmillan:** And the peat and the granite.

**Hugh Morison:** If the differential is not sorted, there is no doomsday scenario: the Speyside distilleries will not all move to Fife.

**Maureen Macmillan:** Heaven forfend!

Could we return to the balance between the needs of the industry and those of domestic customers? You said that they are out of kilter. Can you give us more detail about how that situation could be resolved in a way that you would like? You mentioned the possibility of the poorer domestic customer being supported by income support. How far have you thought that through? How would that work?

**Hugh Morison:** I am not an expert in the social security system and income support. You would have to seek advice from other people as to what might be done in that regard. My prime concern is that charging in an industry that is providing an important material for Scottish business should not be distorted to achieve social objectives. There should be other means of achieving those objectives—whose importance I recognise. Secondly, costs and charging have to be made far more transparent. From what I hear, both from the water authorities and from the water commissioner, there appears to be a lack of robust data about costs in the industry.

The comparisons that we have done between the percentages of income from the business and domestic sectors here and in the south suggest—as a first impression—that there is cross-subsidisation in Scotland. However, I could not identify the extent of that at this stage. What Dr Hargreaves said—in evidence that he gave to the committee in December—also suggests that. It seems to me that it is in the interests of Scottish business, which feed through into the interests of the whole Scottish community, for there not to be cross-subsidisation to achieve social objectives; those should be achieved by other means.

**Maureen Macmillan:** So you think that there is cross-subsidisation, but you are not sure how much.

**Hugh Morison:** I do not think that anybody is sure how much; the data are not available to

calculate that.

**Maureen Macmillan:** I take it that you would like those data to be available.

**Hugh Morison:** Yes. I would also like charging systems to move, in due course, towards removing that cross-subsidisation. We must remember that, given increased competition, it is—or will be—open to large water users in the business sector to find other procurers of water to drive down their costs. If the water authorities do not work towards that, they may be forced to do so anyway, through competition.

**Mr Tosh:** This question may be more for Matthew Farrow. We would like to know whether there is yet evidence that the water companies are, through the level of service that they provide and the prices that they charge, actively seeking to pre-empt business losses from among the large industrial users. Is there any evidence that the authorities are prepared to amend proposed charges significantly, to keep what they view as their most valuable customers?

**Matthew Farrow:** The evidence is anecdotal. From what we have heard from our members, we have picked out the fact that the water authorities are getting better on this point. They recognise that competition is on the horizon and that large water users are deeply unhappy with the charges that they pay.

A number of companies have told me that the authorities have introduced key account managers, which is the sort of basic customer service staff our members want. Having said that, they also say that there is a long way to go. Members still give me examples of poor customer practice—the key account manager is always too busy because they have such a huge portfolio of accounts that they cannot deal with companies' concerns and needs. For example, a small company may want a meter installed but have to wait months. Overall, however, the sense from members is that water authorities are realising that they will have to provide a better deal to large users.

Hugh Morison made the point that his industry cannot move, because by definition it is based in Scotland, but that is unusual. If you look at the range of sectors that are heavy water users, such as paper, chemicals and electronics, they are all in intense global competition and all face decisions on where they locate. We have a paper company member that has sites in Scotland and Wales. It has clear evidence of the much higher charges that it is paying in Scotland. If the water authorities cannot offer a better deal to large users, some of them may, over time, start to make investments elsewhere, or in some cases they will go to the wall.

We had a large water users forum in November with the Minister for Environment, Sport and Culture, because we wanted to improve the debate with business and allow large business users the opportunity to discuss their concerns with the minister and the water authorities. Representatives of a medium-sized company that is a heavy water user took part in the debate. Two months later, that company has gone into receivership.

The fact that that company thought, when it was in such difficult circumstances, that it was worth going to the meeting suggests that water costs were a major concern. The fact that the company has since gone out of business shows that this is not purely scaremongering. For some sectors, water is a major cost. Such companies face so much competition that if they cannot control their costs, and these costs gradually stack up, their position will become more difficult.

12:00

**Mr Tosh:** From what you say, competition will not have a sufficiently active or timeous impact on the market to resolve the cost difficulties and location implications. You are effectively asking the water authorities to move much more swiftly towards realistic costing.

**Matthew Farrow:** I hope that they will. Obviously, companies' positions vary. The company to which I referred was in a difficult market and a difficult position. The time scale is not so dramatic for most companies, but decisions will be made. Our members hope that, before we get new entrants into the market, the water authorities will recognise the desires of customers who are paying a lot of money. We hope that they will take what steps they can to offer a better level of customer service and some form or another of discounting to readjust their tariff scales so that the cross-subsidisation that appears to be in the system is unwound.

**Hugh Morison:** There is provision under section 74 of the Local Government etc (Scotland) Act 1994, which established the water authorities, for authorities to have either scale fees or tailored agreements, which they can negotiate with customers. Until 1999, that was kept fairly well under wraps. People did not read the act and say, "Here is a possibility." East of Scotland Water in particular has started going round its large users and asking whether they want to negotiate a tailored agreement. One of our member companies is in the course of doing that, which will give it an appropriate benefit.

The possibility of having tailored agreements ought to be publicised more. If the authorities will not do that, we will do it among our members and

the Confederation of British Industry might do it among its members. That, however, requires people to negotiate the agreements, which brings us back to Matthew Farrow's point about customer service and whether the water authorities have enough people who have the right skills to provide the service that is required.

**Des McNulty:** I wish to pick up on a couple of things that you said that strike me as a bit inconsistent. I am not aware of any business that does not engage in some degree of cross-subsidisation between its different areas. I appreciate that you are concerned about the extent of cross-subsidisation, but it is a bit precious to take an absolute position on it. My understanding from what the water commissioner said is that the cost to business, at least from West of Scotland Water, is at the lower end of the English scale, so I was a bit confused by Matthew Farrow's generalisation about the high cost of water to business in Scotland. I wonder how that squares with what was said by the water commissioner.

You made quite a fuss about the need for business input into water boards. As far as I am aware, of the three water boards, the one with the strongest business ethos and the clearest business background on its board is East of Scotland Water, which is the authority that you say is the worst culprit when it comes to cross-subsidisation. We have to be clear about what you are arguing.

**Hugh Morison:** I did not say that East of Scotland Water is the worst culprit for cross-subsidisation, I said that I had a useful quote that happened to come from the evidence that was given by East of Scotland Water, which suggested that cross-subsidisation went on. As I said, East of Scotland Water has trail-blazed in publicising to its large business customers the possibility of having tailored agreements. That is the kind of input that might arise from the fact that it has more business representation on its board. I do not know for sure, because I have not sat in on a board meeting, so I can only speculate. All I am saying is that there are skills in the business community that we feel would help the water authorities to manage themselves better, cope with the challenging targets that they have been set by the water commissioner, and provide a better service to customers. That should be examined.

On the question of being over-meticulous and somewhat prissy about cross-subsidisation, I agree that cross-subsidisation takes place and that it is difficult to prevent it from taking place, but our concern is that, on the basis of the information that we have, cross-subsidisation takes place to such a degree that a particular part of the customer base is being damaged. Because of the

development of more competition, the water authorities will not be able to continue in that line even if they want to. We need far more information to assess the scope of the matter and to reach reasonable and sensible views on what the charging policy ought to be.

**Nora Radcliffe:** I wish to return to cross-subsidisation. You obviously feel that the non-domestic sector subsidises the domestic sector. From my recollection, you gave two statistics that led you to that conclusion. First the water companies in Scotland get 50 per cent of their income from non-domestic users and 50 per cent from domestic users, and that split is different from that which exists south of the border. Secondly, you said that the non-domestic sector got 20 per cent of the water, but accounted for 50 per cent of the water companies' income.

I note that you concede that there is not enough hard data to interpret those matters correctly, but I put it to you that those figures could be interpreted slightly differently. First, it could be said that the water charges include effluent costs and that the discrepancy between the amount of water that is used and what it costs arises because business tends to have more complicated effluent than the domestic sector. Secondly, the 50:50 split between business and domestic income north of the border might reflect the fact that we have more small businesses per head of population, so the distribution of business per capita is different.

**Hugh Morison:** I did not concede that there was not enough data, I was complaining.

**Nora Radcliffe:** We all agree that the statistics are difficult and need to be interpreted.

**Hugh Morison:** There might be something in what Nora Radcliffe says about the effect on the extent of cross-subsidisation. As I said, by simply looking at income streams in Scotland and England, one cannot conclude firmly that they are much out of synch. However, if somebody gets twice as much of their income stream from the business sector than somebody else does, it is fair to conclude that that is due to more than the structure of industry and the number of small firms.

I understand that the number of small firms per head of population in Scotland is lower than the number in England. Therefore, the system should work in the opposite way to that which Nora Radcliffe suggests. However, the problem is that we have the firm impression that cross-subsidisation is taking place. That view is backed by what the water authorities have said—I quoted Dr Hargreaves's comments on that. I am not in a position—I doubt whether the Confederation of British Industry is—to say that the cross-subsidisation is 5 per cent or 20 per cent or

another figure. I have no idea.

**Nora Radcliffe:** Do you agree that we need better information?

**Hugh Morison:** Yes.

**Mr Tosh:** I think that Hugh Morison said that he would not like to speculate too much about the water authorities, because he does not belong to any of their boards. However, I presume that he, as a customer, has a view on the authorities as businesses. Are the water authorities good commercial operators when judged against criteria such as customer care, the way in which they handle or pass on costs and the extent to which they are willing to procure necessary capital investment for the customer? Do you think that the water authorities are now or are becoming good commercial operators that respond to the industrial customer base? In the long run, would you prefer to deal with alternative suppliers?

**Hugh Morison:** I do not deal directly with the water authorities. My members do that and I receive anecdotal information from them. I will give the committee a broad picture of the situation, then ask my colleague whether there is anything to add. The impression that I receive is that, since the authorities were established, many improvements in customer service and efficiency have taken place. There is a long way to go on customer service, but the authorities have appointed customer service advisers to build up relationships with clients. However, they have a massive work load and there is, at least, a question mark over whether they have the time and the expertise to deal with the issues that concern my members and other large commercial users. There is also a feeling that underinvestment in the past has created a major problem.

Over a glass of our product, some of my members might question whether the authorities have the management skills to deal with the considerable management and investment tasks that lie ahead of them. A lack of such skills would feed through in higher costs. We would like improved customer service, efficient capital procurement and improved efficiencies. In fairness to the water authorities, they told the committee that they were working to improve on those aspects. I have no doubt that they, too, have perceived a shortfall. I was glad to read their evidence to the committee, in which they said that they were addressing the problems. I was also glad to hear what the water commissioner said about the way in which his target setting will drive that process forward.

**Mr Tosh:** Do you and your colleagues have confidence that the water authorities are making that progress and that they can progress to such an extent that, across the board, they can expect

to be your major suppliers in future? Are you likely to look to more commercially attuned competitors in the long term?

**Hugh Morison:** I am not in a position to answer that question. However, if the authorities do not make the necessary progress, my members who have grain distilleries—which use large amounts of water—will be strongly tempted to look elsewhere for their water supply and services. Brian Higgs might want to add to what I have said.

**Brian Higgs:** The questions are difficult for me to answer, because most of my dealings are with NOSWA, although some of my colleagues work in the west and the south. My feeling is that an honest attempt has been made to start to improve commercialisation and customer service. Improvements could be made, as in all industries.

Recently, NOSWA collaborated well with the industry in dealing with an effluent discharge situation, and it worked closely with the industry to develop a solution that benefits the industry, the water authority and the domestic users in the local area. Therefore, I am optimistic that changes are going in the right direction. However, I do not feel qualified to say whether that progress is sufficient to prevent the industry from considering alternative suppliers in the long term.

12:15

**Mr Tosh:** Is all the available evidence anecdotal and does no clear strategic picture exist yet?

**Pat Mennie (Malt Distillers Association of Scotland):** The creation of the three authorities has improved relationships. The authorities have wanted increasingly to communicate and liaise with customers, to find out what customers want and to do their best to improve services to customers. The Scotch whisky industry has regular meetings with representatives of the three water authorities—they are as keen to meet as the whisky industry, which considers the meetings beneficial. However, third-party competitors might enter the market, so whether the industry will remain with the three authorities is purely a commercial question.

**Matthew Farrow:** Perhaps I can answer Murray Tosh's question. I agree with my colleagues—there is no doubt that improvement has taken place. Collaboration and co-operation among the three authorities was almost non-existent two, three or four years ago, but it happens much more now. The authorities have made efficiency improvements, but there is further to go.

As for alternative suppliers, the answer to the question depends on the companies about which you are talking. My sense is that most small companies, especially in the non-heavy water user

sector, have pretty basic needs and are fairly happy. Normally, they have no concerns about the quality of the water and are not especially worried about the level of charges. They are often quite receptive to concerns about the need for future investment and higher standards. Larger users would like to have a choice of supplier. That is less because they are unsure about whether the public authorities will raise efficiency enough than because they are business people and tend to be keen on competition. In principle, such users would like the opportunity to talk to other providers, even if they decided that their best bet was to remain with the public authorities.

**Des McNulty:** When the water commissioner gave evidence, he talked about the trade-off between standards and costs. He implied that he took a middle path, compared with his English equivalent. Is it your view that business is satisfied with that approach, or do you believe that we should expect a standard that is beyond that and which the commissioner should adopt in imposing his regime on companies?

**Hugh Morison:** Are you talking about water standards and effluent standards? I am not quite sure what you are driving at. I think that the commissioner said that the statutory requirements and those of SEPA could not be compromised—we agree. We need good quality water and good quality treatment work for our product. The commissioner said that he did not endorse the approach of forgetting about standards and driving costs down that way. We do not support that approach either. However, if you are asking whether services need to be gold plated, I say that they do not.

**Matthew Farrow:** I will add to that answer with the CBI's perspective. The Executive has published a consultation paper that sets out the options fairly clearly. There are three options—a minimum, a middle and a high-level option. We are consulting our members about the paper, so I will not prejudge our final answer on that.

I sense that the response depends on the company. As we have said a few times this morning, price is the main concern for larger users. They feel that they pay too much and that they are providing cross-subsidisation. That issue must be addressed. Going down towards the small and medium-sized enterprises sector, especially in the non-heavy water user sectors, I find some recognition that the issue is important and complex, that there has been a history of underinvestment and that there may be a case for price increases.

In conjunction with the water commissioner, we conducted a survey of our members, to try to get a handle on some of these issues. The question that we put to them was similar to the one in the



consultation document that we received. We gave them three options: prices to rise by the minimum amount; the basic legal standards to be met but no more; and a middle or higher option.

One of the companies—a subsidiary of a large company in a sector that uses water fairly heavily—replied as follows:

“Why assume that prices should rise”,

because, in that sector, companies must minimise prices at all costs. It continued that the company recognises

“the need for future investment. As a responsible company we might accept some price increases provided these are appropriate.”

The company’s concern is that any price increase should happen only when all possible efficiencies had been pushed through the system. It is wary about agreeing to price increases—or having increases forced on it—if those efficiency savings have not been made.

A lot of small and medium-sized enterprises tell us that this is a difficult issue, and that they accept that there is under-investment. They accept that prices may have to rise for standards to be met. However, the larger users, who feel that they are already paying too much, want some sort of unwinding of the cross-subsidy to ensure that their prices do not rise.

**Des McNulty:** Might they want a choice of water standards?

**Matthew Farrow:** In what sense?

**Des McNulty:** Might there be a choice of different suppliers or of two standards of water: good enough and high standard.

**Matthew Farrow:** We have not asked them that question.

**Hugh Morison:** A lot of the water that we use is for cooling purposes—it need not be of the same standard as that which is required for the product.

**The Convener:** East of Scotland Water launched an innovative project to use lower quality water for industrial purposes, because that water need not meet the standard that is required of drinking water.

In your opening remarks, you discussed the water framework directive. We will revisit that at a later stage of our inquiry and will get in touch with you regarding your views on that.

**Hugh Morison:** We would certainly like to give evidence to the committee on that.

**The Convener:** Absolutely. There is no problem with that. I thank you for your attendance. It has been a most useful session for us, although we are initially taking a broad approach to our inquiry,

to ensure that all views are made known. If, because of time pressures we did not cover certain areas, Shelagh McKinlay will write to you about them.

**Hugh Morison:** Thank you, convener.

## Public Petition

**The Convener:** Item 4 is consideration of petition PE96, from Allan Berry. We have discussed the petition. It was referred to the Rural Development Committee and the Transport and the Environment Committee, because it requests an independent inquiry into the environmental impacts of sea-cage fish farming.

We agreed, in principle, to support an inquiry and to appoint reporters to look into the matter. The reporters' remit was to give further consideration to the issues that the petition raises and to examine the possible mechanisms and terms of reference of such an inquiry. The reporters unanimously agreed a paper, which has been circulated to the committee. The Rural Development Committee considered and agreed that paper at its meeting on 19 December. The matter was discussed again on 16 January, and the Rural Development Committee agreed that, if this committee agreed with the recommendations of the report, the conveners of both committees would write to the Scottish Executive seeking a progress report on the matter.

I ask the committee to accept the recommendations of the report and to agree that the conveners of the Rural Development Committee and the Transport and the Environment Committee should write to the Scottish Executive.

**Members indicated agreement.**

**The Convener:** We will take a break while the witnesses arrive.

12:23

*Meeting adjourned.*

12:27

*On resuming—*

## Rail Industry

**The Convener:** Our final item is information from the Executive on current developments in the rail industry, with specific reference to the franchise process. I welcome the two officials from the Executive, Adam Rennie and Paul Smart. I understand that you have prepared a short introduction.

**Adam Rennie (Scottish Executive Development Department):** Thank you, convener. We are grateful for the opportunity to give evidence to the committee. I am the head of transport division 3 within the Scottish Executive's development department. Paul is the head of the railways branch in that division. The clerks have handed out a short submission of two or three pages. Before we talk about the consultation paper on strategic priorities, it might be useful to remind the committee of the statutory background, which is not straightforward.

The policy on railways devolution was announced by Mr McLeish in the House of Commons, during the passage of the Scotland Bill in 1998. Rail transport is a reserved matter under schedule 5 of the Scotland Act 1998, with the limited exception of certain types of grant. However, Mr McLeish set out various measures of executive devolution and two transfers of legislative competence. The package was to be delivered in the context of the proposed new Great Britain regulatory framework for railways, which was eventually introduced under the Transport Act 2000. That act received royal assent in November.

Our handout summarises the three main strands of implementation of the devolution policy. I will be happy to elaborate on them if the committee wishes, but, in view of time pressures, I shall now hand over to Paul Smart, who will talk about strategic priorities and our recent consultation paper.

**Paul Smart (Scottish Executive Development Department):** All committee members will have received a copy of the consultation document that we issued on 28 November. The document was sent to about 500 stakeholders and other interested bodies as part of a consultation exercise that will last until the end of February. We are receiving a steady stream of responses. I take this opportunity to provide a summary of what the strategic priorities document covers. As members will see from the slide, I will cover four main areas.

The document sets out a vision and a set of

objectives, and emphasises the importance of partnership in delivering strategic priorities for railways in Scotland. As Adam Rennie pointed out, we are working within a set of devolved responsibilities. This document is the first major expression of our exercising those devolved responsibilities. It sets the scene for the Scottish Executive's strategic steer for a new Scottish passenger rail franchise, which we have said will need to be in place before the end of the current franchise, which is due to last until March 2004.

The vision draws its inspiration from the Scottish white paper on transport, which was published in 1998, and from the programme for government. It sees railways as a critical part of a sustainable and effective integrated transport system. It envisages a railway that is safe, accessible, supports economic development, assists with the provision of social needs and helps to reduce peripherality. The objectives are drawn from that vision and are geared towards seeking to increase the number of people who use the railway, supporting a reduction in congestion and assisting in greater accessibility to rural communities and regional centres.

12:30

The document points out that it is critical to the success of those priorities to develop partnerships, principally with agencies such as the shadow strategic rail authority, local government, Strathclyde Passenger Transport Executive, the rail industry and representatives of passengers—principally the Rail Passenger Committee Scotland. Those strategic priorities will inform how we develop our directions and guidance to the shadow strategic rail authority on the Scottish passenger rail franchise.

As I have said, the principal objective is to attract more people to rail. There is an opportunity to increase demand for rail transport. We can do that by improving the quality of the service and through the provision of new trains and associated improved track. In urban areas, we want an increase in the frequency of trains on key routes and propose the provision of longer trains on key routes to reduce overcrowding and to assist in the reduction of congestion in key transport corridors. In rural areas, we suggest that there is a need to increase the speed of train services to compete effectively with the car. We want to improve reliability and punctuality. That is a continuing commitment; it already exists within franchises, but we want it to be stretched even further. Overcrowding must also be tackled, especially on key commuter routes in central Scotland.

We know that the safety of the railways is a reserved matter, but we believe that the safety of rail passengers must extend beyond the train to

the routes to and from stations. Secure stations must therefore be a priority. Our priorities include improving service quality, improving the quality and comfort of the journey, simplifying ticketing and improving the quality of customer care and staff.

We believe that rail will play a critical part in the integrated transport system. We have already said that we see it assisting in the reduction of congestion and that we believe that it will have a critical impact in improving the environment through the reduction of pollution. I have already mentioned that we want rail transport to assist in the reduction of peripherality. By making rail transport affordable and accessible to all people in Scotland, we also see its potential to assist in the reduction of social exclusion.

There is an opportunity to widen demand for rail transport. Developing a seamless journey must be a priority—through-ticketing is a clear example of that. Another priority is working more effectively with operators—not only the current ScotRail franchise holder, but also cross-border operators and freight operators—to ensure an integrated rail system for Scotland.

That has implications for attempting to secure investment. We recognise that railways cost a considerable amount of money—investing in new trains and track does not come cheap. There is a challenge for the Scottish Executive in supporting rail projects in association with the rail industry and there are opportunities for leveraging in private investment. There are opportunities for considering alternative means of investment through joint ventures and single purpose vehicles. We must also work more effectively with the shadow strategic rail authority, which—under the terms of the Government's 10-year plan—is being vested with a considerable amount of money to invest in the rail network throughout Great Britain. We want to consider ways in which we can work with it to match its funding with funding from the Scottish Executive.

That gives the committee a brief outline of where the strategic priorities come from and how we think they will contribute to a debate in Scotland about how Scotland's railways will develop in the future.

**Mr Tosh:** I will start with a point about investment, as the idea of the longer franchise period is to maximise the investment that the train operating companies will be prepared to make. I had always understood the strategy to mean much more than investing in the rolling stock. I had understood the investment to be co-investment with Railtrack and other interests. To an extent, I thought that the Railtrack investment would be funded through the charges that the train operators would make. I was surprised that the

consultation document did not indicate the Executive's priorities for major enhancements or extensions to the network.

The paper from the National Union of Rail, Maritime and Transport Workers, which we have also been given today, points out that there is not a vision of where the Executive might want to see improvements. I find it difficult to believe that when it comes to the evaluation of bids, the Executive will not consider carefully where the potential operators want to invest. The Executive should have shared and debated that vision, so that we were aware of the criteria. Are you authorised to tell us what quantitative and qualitative improvements the Executive is looking for on major routes? If not, can you explain the thinking behind not being location specific? The proposals are admirable but general, so it is hard to see what is likely to pick up or improve materially in five to 10 years' time.

**Adam Rennie:** I will respond generally to that point and ask Paul Smart to say a few words about the channels for investment. The approach that the paper takes is, as Mr Tosh said, deliberately not location specific. At this stage in the exercise, we do not want to pick certain projects and say that one project is important and, by implication, that another is less so. We want to set out the general objectives, as Paul Smart outlined in his summary of the paper, that we want the next franchise to deliver in specific situations in Scotland.

Transport needs in Scotland vary from place to place. In some areas, the issue is congestion; in others it is journey time. The Executive is not in a position to identify specific projects and say that one is a winner and one is not. We want to indicate to the shadow strategic rail authority the sorts of projects that we want to emerge in response to opening the bidding exercise for the next franchise, so that it has a template against which to assess the proposals that are produced. The exercise will become more refined as it goes through the various stages. Specific projects will start to emerge. If we are too specific at this stage, we will unnecessarily close off options and creative thinking by potential franchise bidders, who are probably in a better position than we are—or at least as well placed as we are—to produce ideas and cost them.

That is the broad thinking behind our approach. Paul Smart will comment on the various avenues for funding capital investment in the railways.

**Paul Smart:** I appreciate the point that is being made. We can all make shopping lists of the things that we would like to see on the rail network. The document tries to set out the priorities against which those shopping lists might be assessed. There are different priorities in

different locations for how the railways can assist in developing an integrated transport system.

I genuinely expect that a lot of people will respond to the consultation. I hope that they will respond with an idea of how they would like to see railways develop in their localities. I expect local authorities to come forward with proposals along those lines. I do not think that the Scottish Executive is the sole guardian of what those priorities and schemes might look like. We need to provide a context in which people can express their aspirations for the rail network within a set of strategic priorities, to allow us all to prioritise those shopping lists.

From experience of franchise replacement, I expect that we will also see a lot of innovation from bidders for franchises, as is happening south of the border. We want that in Scotland, as we believe that there is room for innovation in the rail network. We and the strategic rail authority see that process as being output driven rather than input driven. We want people to have a set of broad principles and to come forward with ideas that we can cost and prioritise accordingly.

**Mr Tosh:** When the SRA makes the decision, with all the appropriate guidance and representation built in, will it look specifically at the material considerations behind proposals? If an operator comes up with a proposal for an express service from Glasgow to Edinburgh, for example, will the decision be founded on the material considerations?

**Paul Smart:** Absolutely.

**Maureen Macmillan:** Because I represent the Highlands and Islands, I am interested in what will happen to the far north line, the Kyle line and the west Highland line. I am concerned about whether there is enough commitment to those lines. They are underused, although they have tremendous potential. In discussions with ScotRail, Railtrack and user groups, I have not got the impression that the potential of those lines is likely to be realised in the near future unless there is massive investment.

The consultation document contained some good things and asked questions about the speed and length of trains, but I felt that it concentrated too much on long-distance journeys and not enough on short journeys on the west Highland railway—commuter journeys from Mallaig to Fort William, for example, into Oban or from the west into Dingwall and Inverness. A good commuter network is building up around the inner Moray firth, but a lot more could be done and there is demand for it. Your document did not address that demand or ask questions about it.

**Adam Rennie:** The starting point for any new franchise will be the current public service

obligation—that will be the minimum level—which is built into the current ScotRail franchise, plus any agreed enhancements. What we have at present will certainly form the floor of the future franchise.

We are interested in proposals from bidders for the franchise, particularly in respect of journey time priorities. That is particularly relevant for the north line. We are also aware of suggestions for developing some sort of local commuter network around Inverness. Paul Smart mentioned access to regional centres as being one of the priorities that we want delivered. Simply because something is not mentioned in the document does not mean that it is not happening or that it is ruled out.

**Maureen Macmillan:** We need a proper definition of regional centres. Everybody recognises Inverness as a regional centre, but there are smaller regional centres in the west Highlands that need to be considered in the same light.

**Adam Rennie:** We will certainly take that point on board. We want to see the proposals that are made in response to the priorities set out in the document.

**Fiona McLeod:** I would like to ask about investment and about the part of your document that deals with attracting more people to rail.

On investment, Paul Smart mentioned the Department of the Environment, Transport and the Regions' 10-year programme and fund for the whole of Great Britain. I understand that the fund is about £7 billion over the period. How does the Scottish Executive access that fund? Will it come to Scotland under the Barnett formula or does the Scottish Executive have to bid for funds for specific projects in Scotland?

12:45

**Paul Smart:** The rail modernisation fund, which has been allocated £7 billion over 10 years, will be allocated by the strategic rail authority against a set of criteria that will apply across the rail network of Great Britain. Bids will therefore be expected to come from Scotland as well as from other parts of Great Britain. Those bids will not come from Government or from local authorities, but from the rail industry itself, which will bid for significant capital investment in major projects. That is what the rail modernisation fund is there to do. Any Scottish project will be assessed against the Britain-wide criteria. That is how the system will work.

**Fiona McLeod:** So it is not a Barnett formula share. If, at the end of the consultation, the Scottish Executive decides that the priority should be electrification of the east coast line, could Great North Eastern Railway bid for funds for

electrification of the Scottish part of the line as part of achieving its franchise in Scotland?

**Paul Smart:** If GNER saw that as a strategic priority for the franchise, there would be nothing to stop it doing that. However, the strategic rail authority would consider the bid against other priorities.

**Fiona McLeod:** Will the directions and guidance that the Scottish Executive gives to the SRA encompass that sort of scenario?

**Paul Smart:** The directions and guidance will apply to services provided by operators whose services start and finish in Scotland or to services operated by the same franchise that start or end in Scotland. That means that we can give directions and guidance on the services that are currently operated by the ScotRail franchise. Those will be broad strategic steers as to where we want the franchise to go and will form the basis on which the strategic rail authority will invite notes of interest for a new franchise. We will then have to wait to see what the bidders come up with to meet the strategic priorities indicated through the directions and guidance.

We have already given advice to the strategic rail authority, which is non-binding but which it has to take into consideration, on the east coast main line franchise replacement. We made it clear that we want an improvement in journey times on the Scottish leg of the east coast main line. How that is delivered is up to the rail industry, which should price it accordingly.

**Fiona McLeod:** I want to move on to what your document says about attracting more people to rail. I assume that you are also talking about other users, including freight customers. There are some pretty ambitious targets for moving people and freight on to rail. Is our infrastructure capable of fulfilling those targets? I was going to ask about Railtrack, but that is a specific private company. I ask instead whether we have the right standard and quantity of rail infrastructure to meet the targets.

**Paul Smart:** We accept that a 50 per cent increase in rail passengers in the next 10 years is a target worth pursuing. The reason for issuing the strategic priorities is to recognise that we will need to do things to the rail infrastructure and to the train operating companies' provision of services to reach that sort of target. You can infer that there needs to be an increase in the number of trains and a lengthening of trains on key routes to access new demand and to reach the targets. That is the sort of challenge that we have set out in our strategic priorities.

For freight, the target is an 80 per cent increase in tonnage over 10 years. The Scottish Executive does not have a function in defining a separate

freight strategy. However, we administer the freight facilities grant and the track access grant, in recognition of the fact that the current infrastructure needs to be enhanced, improved and supported to meet the sort of targets that were set out in the programme for government. There is a recognition that, in its current state, the rail infrastructure needs to be enhanced to meet the targets.

**Fiona McLeod:** Do we need to carry out an audit of the rail infrastructure to find out where we are and what we have to invest in to achieve those targets?

**Paul Smart:** That is a legitimate question. We will have to examine the way in which the network functions currently to establish the pressure points. Having carried out such a review, we will have to take a view on where investment would be best targeted to avoid those constraints and to enhance the ability of the industry to deliver the targets.

**Des McNulty:** I want to ask about the considerations that lie behind attracting more people to rail. Clearly, there is a broad transport strategy, an important element of which is relieving congestion and reducing pressure. Given the congestion overload across the whole transport sector, will you consider improving the speed of the service on the Glasgow-Edinburgh rail route—the busiest rail route in Scotland—and the suburban network in the west of Scotland when you develop the criteria for the strategic priorities for attracting more people on to rail? Will you consider light rail alternatives and so on, or is that a matter for local authorities?

**Adam Rennie:** Light rail is not tackled directly in the consultation paper, which focuses on heavy rail. Light rail is principally an issue for local authority proposals. However, we would expect the operator of any franchise in Scotland to take account of light rail options, including the possibility of joint running. So far, there are no such proposals.

As Paul Smart said, we would expect the successful franchises to address the issues that you raise. The particular issue in the central belt is congestion, rather than journey time. There are already capacity constraints on the Edinburgh-Glasgow line and on the Fife circuit. If the trains are already full, any ambition to get more people on the railways depends on an increase in capacity. That is not a problem on some other routes in Scotland, where the issue is lack of competitiveness with the car, because the train takes longer or is not much quicker.

**Paul Smart:** In parallel with re-letting the franchise, consulting on strategic priorities, issuing directions and guidance and conducting a capacity

study, we are conducting multimodal studies on the A8 and A80 corridors. Those studies will throw up opportunities for the rail industry, as well as other public transport modes, to assist in the reduction of congestion on those key corridors. That is an example of how we are trying to integrate our analysis of the pressures in central Scotland's transport system to facilitate a better appreciation of how rail can alleviate congestion.

**Des McNulty:** I want to follow up Adam Rennie's comment on capacity constraints. If there is capacity constraint on rail services between Edinburgh and Glasgow, it is as true that there is capacity constraint on the road network. That raises the issue of where the investment should be targeted. Should investment go into rail to improve the service or should it go towards improving the road network?

**Adam Rennie:** That is a fair point. It is a question of horses for courses. There is general recognition that increasing capacity on the road network is unlikely to provide sustainable long-term solutions and that that is not the general direction that the minister is pursuing, although, as members will know, she is pushing ahead with certain roads projects. Expanding capacity on the railway network has an advantage, in terms of producing less congestion in inner city and wider city areas, over increasing the ability of the road system to bring cars into those areas.

**Nora Radcliffe:** I want to ask about getting goods onto rail and about the fact that the modern, larger freight wagons do not go through some of the tunnels and narrow points in the north-east, where I come from. Two of the major pinch points are the bridge at Montrose and the tunnel at Dundee, which are major, expensive projects. When we bid for the money that is needed for them—outwith the £7 billion that has been made available—it is obvious that we cannot compete on volume with places further south. Do we get a sympathetic weighting on the basis of distance from markets and the desirability of extending through-routes from the continent up to the north-east, which exports many goods?

**Paul Smart:** The shadow strategic rail authority has kept us fully up to speed with the development of its freight strategy, which considers strategic priorities for developing rail freight across the British rail network. That will have an impact on how we target our freight facilities grant. We recognise, as does the shadow strategic rail authority, the constraints on the rail network carrying certain types of freight. Efforts are being made to identify strategic freight routes, to examine their capacity to support larger trucks and wagons and to consider what can be done to improve the network to take account of that. We have emphasised to the SSRA the strategic

importance to industry north of the central belt of ensuring effective freight routes to terminals in central Scotland and onward to deep sea ports south of the border.

**Nora Radcliffe:** Do you think that we will get sympathetic consideration for distance to markets or are we on a level playing field with everyone else?

**Paul Smart:** In conjunction with the shadow strategic rail authority, we have been considering the specific characteristics of some of those routes. We have made a strong argument that the specific characteristics of the freight network in Scotland merit a distinctive approach. The authority has shown a strong willingness to consider the matter in that light.

**Nora Radcliffe:** That is encouraging.

**Paul Smart:** The same applies to those parts of the rest of Great Britain that have extended freight routes.

**Nora Radcliffe:** Power to your elbow.

I want to ask about two passenger issues. First, has disabled access been flagged up? It is another expensive issue and we must not lose sight of it. Secondly, can details be included in rail contracts to say that passengers should have access to hot drink and food on journeys over a certain length?

**Paul Smart:** The Disability Discrimination Act 1995 applies to rail vehicles as much as to any other public transport vehicle. As members will have seen with the introduction of the 170 Turbostars, extra provision is being made for disabled passengers. That standard will apply to the introduction of all new trains and underpins our insistence on a steady replacement programme that incorporates the requirements of the Disability Discrimination Act 1995. We would apply the same argument to access to stations. It is all very well to have a train with disabled access, but if a disabled person cannot get to the train in the first place, it is pretty useless. We have made several public transport fund awards to help stations improve disabled access.

**Nora Radcliffe:** I have a vested interest in the issue of food and drink because I travel regularly between Aberdeen and Edinburgh—a two-and-a-half-hour journey—and have often found that there is no provision of food and drink at all.

**Paul Smart:** Those are the sorts of quality issues that we will expect operators to demonstrate awareness of when they put in their bids for a new franchise. Clearly, the more additional passenger benefits they offer, the better the hearing they will receive. We will be seeking improvements in the quality of service across the board.

**Nora Radcliffe:** That is quite an important issue, particularly for tourists who, on a journey of such length, would expect to have access to refreshments. It can be very trying if they do not.

**Paul Smart:** Indeed.

**The Convener:** Several members have told me that they have to leave at 1 pm. Now that we have solved Nora's tea problem, it might be appropriate to end the meeting.

I thank Paul Smart and Adam Rennie for attending the meeting. It has been a short but useful session on current rail issues. If there are any subjects that have not been covered, I am sure that they would be happy to receive written queries from members.

**Adam Rennie:** Yes, indeed. Thank you.

*Meeting closed at 13:00.*





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