TRANSPORT AND THE ENVIRONMENT COMMITTEE

Wednesday 31 January 2001
(*Morning*)

£5.00

Produced and published in Scotland on behalf of the Scottish Parliamentary Corporate Body by The Stationery Office Ltd.

Her Majesty's Stationery Office is independent of and separate from the company now trading as The Stationery Office Ltd, which is responsible for printing and publishing Scottish Parliamentary Corporate Body publications.

CONTENTS

Wednesday 31 January 2001

Col.

TRANSPORT AND THE ENVIRONMENT COMMITTEE
3rd Meeting 2001, Session 1

CONVENER

*Mr Andy Kerr (East Kilbride) (Lab)

DEPUTY CONVENER

*Mr John Munro (Ross, Skye and Inverness West) (LD)

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 Murray Tosh (South of Scotland) (Con)

*attended

THE FOLLOWING ALSO ATTENDED:

Helen Eadie (Dunfermline East) (Lab)
Cathy Jamieson (Carrick, Cumnock and Doon Valley) (Lab)
Nora Radcliffe (Gordon) (LD)

WITNESSES

Andrew Darling (Bank of Scotland)
Jimmy Farrelly (Scottish Trades Union Congress)
Bob Fullerton (Morrison Development Partnerships Ltd)
Alex McLuckie (Scottish Trades Union Congress)
Dr John Sawkins (Heriot-Watt University)
Dave Watson (Scottish Trades Union Congress)

CLERK TO THE COMMITTEE

Shelagh McKinlay

SENIOR ASSISTANT CLERK

Tracey Hawe

ASSISTANT CLERK

Alastair Macfie

LOCATION

Committee Room 2

Scottish Parliament

Transport and the Environment Committee

Wednesday 31 January 2001

(*Morning*)

[THE CONVENER *opened the meeting in private at 09:32*]

09:55

Meeting continued in public.

The Convener (Mr Andy Kerr): I open the public session of the third meeting this year of the Transport and the Environment Committee. I have not received any apologies for today's meeting, at which we shall continue to take evidence for our water inquiry. As members know, our next meeting will take place on Monday in Aberdeen, and we will take further evidence from West of Scotland Water, the North of Scotland Water Authority and a number of local interest groups. Are members agreed to have a private session before that meeting to discuss lines of questioning, as is normal practice?

Members *indicated agreement.*

The Convener: After discussion with members, I can also confirm that we will seek a meeting in Aberdeen with the north-east Scotland economic development partnership to discuss issues related to the road structure in Aberdeen.

Des McNulty (Clydebank and Milngavie) (Lab): It may well be that we will want to hear from the partnership about the roads before we have the private session on the water inquiry. We should have that flexibility.

The Convener: We will order everything in the right sequence.

Deputy Convener

The Convener: Agenda item 2 is the choice of a deputy convener. In accordance with rule 12.4 of the standing orders of the Parliament, it has been agreed that a member of the Liberal Democrat party should be eligible as deputy convener. I accordingly ask the committee to agree that John Farquhar Munro be chosen as deputy convener of the Transport and the Environment Committee.

Members *indicated agreement.*

Mr John Munro (Ross, Skye and Inverness West) (LD): Thank you.

The Convener: Congratulations, John—if that is the right word.

Scotland Act 1998 (Agency Arrangements) (Specification) (No 2) Order 2000 (SI 2000/3250)

The Convener: The next item on the agenda is consideration of subordinate legislation. The Scotland Act 1998 (Agency Arrangements) (Specification) (No 2) Order 2000 (SI 2000/3250) was laid on 8 January and the committee has been designated as lead committee for its consideration. In accordance with previous practice, the committee has received an Executive note and a committee covering note on the instrument.

As we are following standard negative procedure, the Parliament has the power to annul the order by resolution within 40 days, excluding any recesses. The time limit for parliamentary action expires on 16 February 2001, which means that the committee should report on the instrument by 12 February. The Subordinate Legislation Committee considered the instrument at its meeting on 16 January and agreed to raise certain points on it with the Executive, which are outlined in the Subordinate Legislation Committee's fourth report. The relevant extracts of that report have been circulated to committee members.

Bruce Crawford (Mid Scotland and Fife) (SNP): As I was not involved in the earlier part of the process, I feel a bit naked raising this matter now. However, the second page of the Executive note mentions that the Department of the Environment, Transport and the Regions will take over responsibility for sampling in Scotland. I am not sure about the negative and positive aspects of giving the DETR such responsibility. However, as the instrument has already come before the committee and points have already been raised with the Executive, it is probably too late to raise the matter now.

The Convener: I take your point about time scales. However, I am happy to seek clarification in writing on that matter and will copy any correspondence to you.

Bruce Crawford: We need some more information about exactly what it means to give the DETR such responsibility and why it is necessary.

The Convener: Are you willing to agree that the instrument be passed and then seek clarification at a later date?

Bruce Crawford: I would rather have the clarification first to work out the arguments for and against giving the DETR responsibility for sampling in Scotland and to find out why the Executive cannot take that responsibility on itself.

The Convener: We will put that matter on the agenda for our Aberdeen meeting, by which time we will have received clarification from the Executive.

Water Inquiry

The Convener: We move on to agenda item 4. Our water inquiry is today's substantive business. We have with us Dr John Sawkins, Valerie Dickie, Bob Fullerton and Andrew Darling, whom I welcome to the meeting.

10:00

Before we begin, I will say a few words about how we intend to manage this item, as I am sure that the witnesses and committee members would find that useful. Each of the witnesses has particular interests and areas of expertise that we wish to bring to our inquiry. We have divided up the questions to reflect the witnesses' areas of interest and will put them to the witnesses individually. However, the witnesses should indicate if they have something to add to what someone else says.

Do any of the witnesses have words of wisdom that they would like to impart before we ask questions? If so, they should do so by all means, as long as that is done briefly, given that the purpose of this morning's meeting is to allow members to ask questions about the issues that are important for our inquiry. None the less, I make that offer. Does anyone wish to make brief opening remarks?

Bob Fullerton (Morrison Development Partnerships Ltd): All four of us discussed the session downstairs. We have different fields of expertise—expertise in inverted commas, I hasten to add. For my sins, I look after Morrison Construction's private finance initiative interests, and my questions should be on that field of expertise. I am not your man for technical questions about the treatment of raw sewage.

The Convener: You can pass on those questions—there is no problem about that. We have tried to match our questions to your experience. If we ask a question that you do not think it appropriate to answer, you should indicate that, by all means.

I understand that John Sawkins also wishes to say a few words before we begin the formal process of asking questions.

Dr John Sawkins (Heriot-Watt University): Thank you, convener. My few words were simply to go over my written statement, which members have received already. Given the pressing need to push on, I am happy to pass.

Maureen Macmillan (Highlands and Islands) (Lab): Could you give us your views on how the capital expenditure that is needed to upgrade our water infrastructure can be raised and paid for, as vast sums of money will require to be invested in that infrastructure? Do you believe that regional variations in charges are appropriate? [*Interruption.*] Is my microphone working?

The Convener: Yes.

Dr Sawkins: I will take the second part of your question first. There should be regional variations in charges. At the time of the reorganisation of the water industry in 1996, when there were fairly large regional variations in charges, I argued that, from the point of view of economic efficiency, prices should reflect as closely as possible the costs of providing the goods. The argument against that position is a social one: it would be inappropriate to set completely different charges for households that are near one another for what are essentially the same goods. However, from the efficiency point of view, the best outcome is for charges to reflect costs.

We are in a fix as far as capital investment in the industry is concerned. The trouble has been stored up for many years and now a huge programme of work must be undertaken over a short period of time. Given that full privatisation of the Scottish water and sewerage industry has been ruled out, we are left with the options of raising revenue from non-domestic and domestic consumers, trying to borrow more from central Government and trying to lever in other private sector capital. Each of those avenues has been explored.

I read in the *Official Report* of a previous Transport and the Environment Committee meeting of the ways in which all those options have been shut down. Bob Cairns said that, if water authorities were given the option of having the external finance cap lifted, they would not want to increase massively the amount that they could borrow from central Government, simply because they would not be able to repay that debt or the interest charges on it. Perhaps I should leave it to the gentlemen who are sitting to my left to explain the introduction of private sector capital into the industry, as they have expertise in the field. Since 1996, such investment has been very effective in getting the job done and has proved itself.

My specific concern is the amount of money that is raised from non-domestic and domestic consumers. Historically, there has been a massive cross-subsidisation in the industry from non-domestic to domestic consumers, which has been heightened by the fact that charges across regions have been brought into line. Cross-subsidies have been enforced, packed down and built into the system more and more over the years, but we are beginning to see them unpick and unwind.

The Competition Act 1998 will give non-domestic consumers the opportunity to bargain with those who supply their services. My concern is that those who do not have that choice—households and so on—will have to foot the bill. The research that we have undertaken shows that, in recent years, ordinary households have faced very large price increases over a short period.

I hope that I have addressed all your points.

Maureen Macmillan: Thank you. That is a helpful answer, which raises many interesting points. I am interested in the balance between what non-domestic and domestic consumers pay. Perhaps other members will return to that issue.

What calculations have you carried out to establish the likely charges in the three water authority areas in Scotland, over the next five years, and the local variations? Will the differences increase? What are the implications for less-well-off people in each area? Will affordability become a more significant problem as the non-domestic consumers slip away and domestic consumers are left to pay more?

Dr Sawkins: Yes. Unless some action is taken, domestic customers will have to foot increasing bills. In 1995-96, the bills for domestic households north of the border were about half as high as those for households south of the border. We have now caught up and will, overall, overtake them. Household bills south of the border will hold steady for the next four or five years, whereas the indication is that, north of the border, household bills will rise. The north of Scotland will be hit hardest, as the bills there will rise much faster than elsewhere.

The Competition Act 1998 adds extra pressure. Non-domestic consumers—large firms and so on—will get tougher with the water authorities that they have to work with and will have the option, in Scotland, of sinking on-site bore holes to supply their own water. That would cut the income stream to the different water authorities and, given present circumstances and policies, I do not imagine that the blow to domestic customers would be cushioned.

Bruce Crawford: We need to explore further the impact of the changes on consumers, especially in the North of Scotland Water Authority area. You have told us of the changes that have taken place in the past, and it seems as though that trend will continue. In the local authority environment, we have a system in which there are dampening effects. There is a distribution committee. If a big problem were to arise in Glasgow, it would develop over several years. Other authorities would pick up some of the tab in the short term—that is, I would say to Des McNulty, what rural authorities would argue, although it may not be what Glasgow would argue. That happened in the early years of this

Government, when there was a sizeable changeover of resources from Glasgow into rural areas. However, that was dampened by the rural areas' picking up some of the cost.

Would it be appropriate, because of the problems to be faced in the NOSWA area, to have some sort of dampening mechanism, whereby the other authorities pick up some of the cost in order to allow the price rises to come in over a longer period and to allow the adjustment to be more sensitively handled?

Dr Sawkins: That would imply that, rather than having three water authorities in Scotland, we should have just one. It would imply the finances of the authorities being fiddled about with—if I can use that expression—by people from outwith the water authorities.

Bruce Crawford: I was thinking more of a collegiate agreement between the existing water authorities and Government about how to achieve such a damping mechanism. The water authorities are public authorities, delivering policy on behalf of Government, or rather working underneath a raft of policies set by Government. I would have thought that such an agreement could be arrived at by discussion and negotiation. The model of having one authority would be the alternative to that.

Dr Sawkins: It might be a matter for discussion between the Scottish Executive and NOSWA, rather than for discussion between East of Scotland Water and West of Scotland Water. I am sure that the east and west authorities will ask what it has to do with them, as they are responsible for supply within their own regions. They might think that it is a shame that they find it hard up there in the north, for a variety of reasons, but they might get fed up if they are effectively taxed for another authority's situation.

Des McNulty: Are you saying that you cannot see any economic efficiency arguments for cross-subsidisation for different water areas, and that the only argument would be a social one?

Dr Sawkins: Yes.

Des McNulty: A different point of view was put by the water industry commissioner. I am interested to explore that.

The other issue is that the escalation in costs is very closely linked to the timing or phasing of investment. Would it be possible to do a 10-year analysis, going back five years and going forward five years, to find out what the comparative cost of water to consumers would be? Consideration would have to be made of the fact that the English investment was made earlier. Are there any advantages of our having a later pattern of investment in Scotland? It is clearly a problem for us in the next five years, when the charges will rise, but will we get the investment more cheaply in the long run because of our learning from any mistakes that have been made south of the border, or because we can do things more efficiently up here?

Dr Sawkins: My short answer to the first part of that question is yes. Efficiency is not an argument for cross-subsidisation. The only argument for it is a social one.

I do not know whether it is better that we are behind the game. You have already asked representatives of the water authorities—I am sure that they would not think so. They are struggling hard to meet the tight time limits that they face; if we do not meet those, big fines will be imposed. We are later in the game, so some of the new works that are built may be more up to date and efficient. I do not want to go into that in any depth. There are other people who are better placed to answer that question.

The domestic consumer is going to be hit a little harder north of the border than he or she was south of the border. Prices have risen at a faster rate north of the border than they did south of the border between 1989, when the regional water authorities in England and Wales were sold to the private sector, and 1994, the time of the first price cut, and they will continue to rise over the next few years.

10:15

Bristow Muldoon (Livingston) (Lab): I have two questions. First, in your answer to Bruce Crawford, you said that he was suggesting a move towards a single water authority for Scotland. That is not necessarily associated with the question of charging, but how do you think that creating a single water authority would affect efficiency? Secondly, you are arguing, on efficiency grounds, against any cross-subsidisation between areas. To what degree is there already significant cross-subsidisation from urban to rural areas for domestic consumers?

Dr Sawkins: If the decision had been taken in 1996 to come up with one water authority for the whole of Scotland, that would be the situation that we would be in now and that would be fine. I see no economic reason for throwing the whole thing up into the air again by getting rid of the three authorities and putting them all into one. There are good economic reasons for retaining three water authorities so that we can benchmark and compare how they perform against one another, thereby pressing them into improving their performance. South of the border, that has been an effective means of wringing out the gross inefficiencies in the system, and I think that it can work in Scotland too. We can compare like with like and say, "If this is what the north is doing, why aren't the east and the west doing it?" That is an effective means of pressing the water authorities to do better.

Your second question was about cross-subsidisation between urban and rural areas. If you wanted to follow my argument to its logical conclusion, there should be no cross-subsidisation between the two, but from a social point of view that is simply not an acceptable position. Throughout the history of the water supply industry, water firms have supplied parts of towns and cities and parts of the countryside with a largely scattered population, and there has been cross-subsidisation between the two.

If you want to take my efficiency argument to its logical conclusion—that people should pay the charge related to the cost—people in a densely populated part of central Edinburgh would pay more than people in the less densely populated outskirts of Edinburgh. That is where economic theory does not help us. I have to part company with a pure economic theory there and say that, in practical terms, a balance must be struck between pressing the water authorities to be more efficient by giving them the incentives to produce the right goods at the right price and, on the other hand, trying to maintain some sort of social cohesion and a sense that the prices that customers pay are fair and just.

Maureen Macmillan: I am interested in what you say about the balance between rural and urban. If the NOSWA charges are high because it has all of the Highlands to cope with, perhaps the present structure is not evenly enough balanced between the different authorities. I note what you say about efficiency versus social inclusion. Options being floated include mutualisation of the industry or, alternatively, external finance such as a PFI. Do you have views on that?

Dr Sawkins: I have done very little research on that so would prefer not to say anything.

The Convener: I would like your view of arguments that have been put to us on unifying the three water authorities. One argument is that a single authority would then be the fourth largest water authority in the UK, with a reduced prospect of takeover; another is that management expertise and financial credibility and capability would increase. Your argument on the potential difficulties of the single authority was very interesting but there are some possible benefits that people have suggested.

Dr Sawkins: A case can be made that a larger authority could exploit further economies of scale and scope. The small amount of research I have done suggests, however, that that may not be the case and that we have now reached a size where most of the economies of scale and scope have been exploited and there are not many left. The three authorities are comparable in size to the big ten authorities south of the border. There is no real virtue in making it big for the sake of it.

The Convener: You made a particular point about benchmarking.

Dr Sawkins: Yes—a single authority could complain that it could not be compared to firms in England and Wales for various reasons, whereas with three Scottish authorities that is not a problem.

Bob Fullerton: We would certainly agree with that. Morrison is part of the Anglian Water group, one of the so-called big 10. There is likely to be a period of consolidation over the next two or three years when the 10 may become six. We would advocate maintaining the three companies so that benchmarking within Scotland is possible.

Mr Murray Tosh (South of Scotland) (Con): I want to return to the point Dr Sawkins made about the balance between the domestic and non-domestic sectors and how the Competition Act 1998 is likely to be used by the non-domestic sector to reduce its costs, which would transfer to the domestic sector. Is there scope for the domestic sector to strike back? One possibility is that high-income, low-usage households might seek to opt out through metering. Another possibility is that consortia of households might be formed. Although it might sound fantastic, one could imagine Des McNulty, for example, whipping up Milngavie community council into a frenzy of concern to try to make an area deal for a large number of households. Is there scope for such negotiations, and, if so, where would the pressure fall? Presumably it would not be on the non-domestic sector but on the remaining domestic sector.

Dr Sawkins: That question helpfully pinpoints the issue that we struggle with. Domestic consumers are allowed to ask the water authority to install a meter and charge them on that metered basis. If that knowledge got out, many high-income, low-use households might ask for a meter and the revenue of the water authorities would fall. I do not know the strict legal position on whether parts of cities or council areas can opt out and ask a water authority south of the border to supply water for less. The proposed water services bill must contain safeguards—it is not fair for the best parts of cities to be picked off and for the rest to be left, which might happen if there are no safeguards. If the plum parts of cities are taken away, the revenue will have to be raised in the other parts of the city, which would be those parts with low-income households. That would hold no attraction for the sort of suppliers that we have talked about.

Maureen Macmillan: You said that the benchmarking between the three authorities would make for efficiency, as they would compare themselves with one another. However, because of the vast Highland region that NOSWA has to cope with, I am not convinced that there is a level playing field. Do you agree that it will be almost impossible for NOSWA to have lower charges than the other two authorities?

Dr Sawkins: Yes, there is some truth in that. NOSWA is in a special situation. In all the benchmarking studies that are done, great care must be taken to take into account the fact that the population in the Highlands is scattered and long pipes have to be laid and maintained. We have to take great care over benchmarking the north against the east and the west. However, there is still the potential to benchmark NOSWA against firms south of the border, where some areas look more like the north than do our east and west—Wales, for example.

Maureen Macmillan: Yes, but if there is always going to be a disparity between the three Scottish authorities, will it not be more difficult for NOSWA to keep its non-domestic customers? I fear that we will end up with a situation in which the rural areas are abandoned to fend for themselves.

Dr Sawkins: That is a slightly separate issue from the issue of benchmarking. Benchmarking is a tool to make the companies more efficient in doing the job. It is not a way in which to make them do less well or have to cut people off—it is not intended to do any of the things that your question might imply. Benchmarking drives out the gross inefficiencies in a system; how we serve people is a separate issue.

Bruce Crawford: Why do we have to restrict ourselves to benchmarking against firms in Scotland or the rest of the UK? Why not benchmark against firms in the rest of Europe? I am not arguing for a unified organisation; I am asking a question.

Dr Sawkins: I think that that should take place. We should not confine our benchmarking activity to Scotland or to the UK. South of the border, the Office of Water Services has not confined itself to the UK when conducting benchmarking activities; it has examined the overseas experience. That is important.

The Convener: Thanks for answering our questions, Dr Sawkins. We will move on to Andrew Darling from the Bank of Scotland.

Des McNulty: Good morning, Mr Darling. The water industry is becoming an increasingly important customer for the banks, in borrowing terms. Is the amount of money that the water industry wants to access a problem for the banks? What banking criteria are used in providing loans to the Scottish water authorities?

Andrew Darling (Bank of Scotland): The banks view the water authorities as statutory corporations and therefore a quasi-sovereign risk. We consider vires and overall borrowing limits. My expertise is in PFI financing. Typically, we consider the integrity of the underlying PFI project and a water authority's ability to meet the unitary charge. We must understand the funding arrangements of the water authority and satisfy ourselves that its status as a statutory corporation will not change during the life of the PFI project.

Des McNulty: I shall return to the issue of the statutory basis of water authorities. Can you explain the mechanics of long-term securitised debt and how it might be relevant to the water industry?

10:30

Andrew Darling: I shall try, but my expertise is in project finance rather than in securitisation. In financing long-term capital expenditure, the water industry should be able to access long-term debt. The cash flow from its consumers should be capable of being ring-fenced, which, in a sense, is what securitisation means. I would have thought that bond financing would be a more appropriate funding structure than securitisation, although securitisation would be an option. Securitisation would require continual refinancing, whereas bond financing would finance assets virtually over their lifetime.

Des McNulty: What is the typical lifetime of assets in such circumstances?

Andrew Darling: In the PFI sector, financing has been undertaken over 25 to 27 years. Some of the bond financing extends beyond 30 years.

Des McNulty: Are fixed rates or variable rates of interest attached to that borrowing?

Andrew Darling: Without exception, there are fixed rates.

Des McNulty: Are they advantageous rates?

Andrew Darling: The market is very competitive. A number of banks are competing against each other and against providers of bond finance.

Des McNulty: How competitive is the financing? Is it cheaper than other forms of finance? I presume that you undertake analysis of your potential customers. How cheaply can water companies access money from the banks, in comparison with other commercial and public organisations?

Andrew Darling: PFI project finance is more keenly priced than other forms of project finance.

Des McNulty: Can you not give us a rate?

Bob Fullerton: To be fair to Andrew Darling, I should point out that the market has moved on and rates are now more competitive than when PFI projects started some years ago. We employ financial advisers, who trawl the marketplace—Andrew through the Bank of Scotland, for example, and others through the Royal Bank of Scotland and other financial institutions—to ensure that a PFI project gets the most competitive deal available. The rate that we get for a PFI deal will probably have more bearing on its success than the capital costs of establishing the project.

Des McNulty: Are you saying that the rates are competitive compared with those that are commercially available in other settings?

Bob Fullerton: Yes.

Bruce Crawford: Morrison is out there trying to squeeze down the long-term borrowing costs and obtain the best possible preferential rate. Does it do that for good public policy and for the end result to the public purse or because it requires a better profit return?

Bob Fullerton: Morrison does that to win deals. We have bid for nine of the 11 waste water projects in Scotland. It costs us no less than £250,000 to bid for each project. We have been successful with only two and a half projects and we are the preferred bidder for a third. To secure deals, we must obtain the most competitive interest rates in the marketplace. We look for them to win deals.

Des McNulty: When the banks consider giving a loan to a PFI company, what pitfalls do they take into account? From your point of view, Mr Darling, what can go wrong? How do you cover yourself against those risks?

Andrew Darling: The risks that we perceive during construction are delivery of the project—the assets—on time and to budget. We seek to mitigate that by passing the risk as far as possible down to the building contractor. The risk in the operations phase is that the project company does not deliver the service to the required standard and suffers deductions. We try to mitigate that as far as possible by passing any deductions down to the service provider. We also carry risk on asset renewal over the life of the project. We must make predictions up front on the cost of replacing assets over 25 or 30 years. If that assessment is wrong, it will affect the viability of the project. The cost of running the project company, the impact of inflation and other overheads also involve risks.

Des McNulty: I presume that you base the calculation of your rates on the amount of risk that you expect to carry—the more the risk, the more the borrowing costs. Do you operate on that basis?

Andrew Darling: That is partly correct. The amount of senior debt that was available for a project would or could be reduced. The issue relates not only to the price but to the amount of debt that the project can support.

Des McNulty: Do you consider the PFI method of building and operating assets more risky or less risky than alternatives?

Andrew Darling: We consider it an acceptable risk for the return that we make. It is difficult to compare a PFI project with another form of corporate lending. The PFI is a distinct funding vehicle. We believe that the risk is acceptable, or we would not be in the market.

Des McNulty: I just want to identify the risks of PFI that are greater or less than those of alternative forms of funding. Are costs attached to setting up PFI deals at the outset? Are there problems in dealing with the end of the PFI project?

Andrew Darling: We consider the life-cycle—the replacement of assets—a significant risk. All construction projects are risky. Delivering a complex asset within a tight timeframe is a risk for the bank. The main concerns are those that I described.

We also have to be satisfied that the service provider has priced his contract at a realistic price for the market. There will be an obligation on the project company to continue to provide the service throughout the life of the project. If the service has been mispriced at the outset, there is a problem for the funders and for the project.

Des McNulty: Do you attach a margin to PFI borrowing to cover such risks?

Andrew Darling: Yes. There is a margin over and above the cost of debt on PFI projects.

Des McNulty: Is there an industry average for that margin? I would not wish to ask what your company charges.

Andrew Darling: It varies from project to project. Once the construction phase has been completed, the margins on senior debt are now typically below 1 per cent.

Des McNulty: Can you describe briefly the procedures that the Bank of Scotland would follow before approving a facility to a water authority? What investigation would you undertake?

Andrew Darling: For a PFI project?

Des McNulty: Yes.

Bob Fullerton: Have you got three hours?

Andrew Darling: The process is quite extensive. The quality and track record of the principal subcontractors, the building contractor and the facilities management provider are crucial. The risks that the public sector passes to the project company have to be evaluated. We need to exercise due diligence in respect of the price of the building contract and ensure that it has been properly priced. We need to exercise due diligence to ensure that the service provision has been properly costed for the whole life of the project. Finally, we need to ensure proper assessments for asset renewal and replacement over the life of the project. In banking, we then layer down to some very detailed risks—I do not know how much detail you wish me to go into.

Des McNulty: You are saying that this is not a question of your simply identifying the creditworthiness of a company and lending money to it; you are doing a detailed evaluation of each project to find out whether you want to be involved financially on that basis.

Andrew Darling: That is correct.

The Convener: Maureen, do you have a supplementary question on the same subject?

Maureen Macmillan: My question is about PFIs and the size of the project. Bob Fullerton might be able to answer it.

The Convener: We will get to Bob Fullerton in a minute. In the meantime, we will go to Bruce Crawford.

Bruce Crawford: I wanted to ask how we provide all the finances that will be needed for the future as well as for what has already happened. We will have a process whereby the Government can borrow money in the traditional way, which scores against the public sector borrowing requirement, or whatever it is called now. Apart from PFI, there are potentially two other models. One is mutualisation and the setting-up of a company limited by guarantee. The other is for the water industry to recover the capacity to draw down from a public trust. Money from bonds or from long-term borrowing could be found in a normal fashion, which could be supported by Government finance. That would need to involve a not-for-profit public trust, from which the water industry could draw down money. What are the bank's views on those models?

Andrew Darling: On the mutualisation opportunity, we are aware of the developments and proposals for Dŵr Cymru Welsh Water and Kielder, about which I believe an announcement is due today. There is a view in the market that, in England, mutualisation could offer a route for the assets of the water authorities to be wholly debt financed.

Could that apply to Scotland? We would have to consider closely the business plan for the mutual and understand how the business in question would respond to various factors, such as the implications of the Competition Act 1998, the role of the water commissioner, the financing of additional future costs and the extent of support from central Government—all those factors would have to be examined to ensure that the business was robust.

Bruce Crawford: I wonder about the idea of a public service trust that could borrow money in the long term in the normal fashion, either from the banks—even the European Investment Bank—or by raising bond money. The water companies could then draw down finance from that organisation.

Andrew Darling: I have not examined that option. I am limited to looking at PFI and, at a general level, mutualisation, so I cannot give you a specific answer. I would have thought that the same principles—of how the underlying business plan would deal with the normal business risks—would be relevant.

10:45

Des McNulty: I was going to raise the issue of a potential move to mutualisation or community control. Rather than considering which of the two models would be preferable in an ideal situation, I would like to focus on the transition from the existing system to something like mutualisation. How would the process of moving from one system to another affect the bank's financial calculations? Presumably you have loan commitments to operating companies. How would those be affected by a shift in the corporate structure of the Scottish water industry?

Andrew Darling: My understanding of the PFI transactions in the water industry that have been completed is that they have typically been financed by bonds. The documentation provides that, if there is a change in the status of the existing water authority, the bondholders can look to central Government to ensure that the new entity has the same credit standing as the current water authority.

Des McNulty: If the ownership shifted from the Government to something that was not the Government, would that have an impact on your calculations?

Andrew Darling: It would have an impact on the existing deals. Are you asking whether it would have an impact on new deals?

Des McNulty: Yes.

Andrew Darling: If you are using the PFI structure, there would certainly be an impact on new deals, because you would need to look at the credit quality of the new entity that was paying the unitary charge.

Des McNulty: So that would depend on its structure.

Andrew Darling: Exactly.

Des McNulty: As you indicated, the water authorities in Scotland could be a big growth area for banks, as they are borrowing a lot. What kind of innovative schemes are banks getting involved in to deal with that new market? Can you cope with shifts in the structure of the industry, perhaps to community ownership or mutualisation? Will that present you with a problem?

Andrew Darling: It should not. It should be an opportunity for the banks. I do not believe that there is any shortage of appetite for providing finance to the PFI sector. It is difficult to comment in the abstract on any proposal without having a more detailed business plan to consider. Properly structured, there should be a market for the provision of long-term finance.

The Convener: As there are no further questions for Andrew Darling, we now turn to Bob Fullerton. If members would like to intervene during questions to Bob Fullerton, they should feel free to do so, but the first question is from Murray Tosh.

Mr Tosh: All Bob Fullerton's comments have related to PFI projects. It would be useful if we could start by asking about the various ways in which a company such as his might participate in the water and waste water industries.

Mr Fullerton, do you simply construct infrastructure or do you seek to operate it? Are all your projects PFI or do you bid for conventional procurement projects? What is the range of projects in which you think it appropriate to be involved?

Bob Fullerton: Over the years, Morrison Construction has procured work in many innovative ways. Four years ago, we set up a PFI business unit, primarily in order to cope with a shift in the industry. As we are all aware, PFI has been around for some four years and is still gathering momentum. The business unit was set up in order to procure work for Morrison Construction—there are no ifs, buts or maybes about that—and, within the unit, we set up what we call a concession company, which is freelanced from the parent company.

We set up a concession company called Catchment for waste water industry projects in Scotland. Catchment is a special purpose vehicle that was set up specifically to carry out the PFI project. It consists of Morrison Group staff, who both carried out the design of the project—with staff from International Water (UK) Ltd—and will carry out construction of the project. Also part of the consortium is United Utilities, which will operate the facility once we have built it. Therefore, the consortium comprises three parties to design, construct and operate the project. We believe that at that point we had the right blend.

Once we finish construction, we tend to find that there are a variety of innovative ideas that we can bring to the operation of the project—that is in addition to using such ideas during the design phase.

Mr Tosh: Does the consortium have an element that puts your company at risk? Do you carry the risk for the operation or are you involved simply as a bit of gilt on the gingerbread? If you can find a way to cut costs, all the parties would share the benefits.

Bob Fullerton: There is no real benefit in cutting corners during the construction phase.

Mr Tosh: I was not suggesting cutting corners—I was suggesting finding more innovative ways of doing things in the operating period. You referred to that in your previous answer.

Bob Fullerton: Once we are on the job—whether we are building or operating the infrastructure—if we come up with innovative ideas, they will generally enhance the consortium's bottom line, bearing in mind the fact that the consortium is split into three different parties.

Mr Tosh: What I am after is whether your exposure, as the procurer, is confined to procurement. Are you involved in the procurement process only, or do you carry some risk through your involvement in the consortium during the disparate phases of design, management and operation?

Bob Fullerton: The consortium is split into three parties. We borrow 90 per cent of our debt from the Bank of Scotland; the remaining 10 per cent is obtained by each of the three parties putting up a third of the equity. That equity is left in the project for the full concession period of 30 years. While we procure the construction work, we are also involved as an equity provider for the full duration of the project.

Mr Tosh: When you prepare a bid, what do you consider to be the main foundations of a winning submission? I think that you referred to that in an earlier answer, when you talked about the benefit of forcing down the financing costs. You operate on every front and it would be useful to know what you think you can do as an external contractor to bring down the costs of the project in a way that is beneficial from the point of view of the consortium, the customer and the end user.

Bob Fullerton: Our experience of the past four to five years is that any PFI project of less than £20 million is not a viable proposition for us, although certain individuals and consortia in the marketplace will carry out such projects. Given that preparing a bid costs £250,000, those projects are not viable. However, we have found that there are economies of scale in a PFI project that costs more than £50 million.

I am sorry. What was your other question?

Mr Tosh: I am after two things. First, what are the ingredients of a successful bid? How do you give yourself an edge in the competition? Secondly, how can you reduce the cost of a facility? Why is PFI better than the conventional procurement approach when the financing is more expensive and forms such a major element of the whole cost?

Bob Fullerton: Initially the PFI approach contained many innovative ideas. However, we are finding more and more that the bottom-line price is the driver of a successful bid. As for the risks that we undertake, no matter what my learned colleague Andrew Darling says about the bank taking those risks, most of them are transferred down to the consortium.

We have indications that the constituent parts of a successful bid are the price of borrowing money and the capital expenditure cost—or the actual construction cost of building the plant. During that early phase, we can still come up with design solutions and new innovative ideas because the waste water aspect is still at the cutting edge of technology. Furthermore, the life-cycle risk on a new construction project can account for 20 to 30 per cent of the project's overall cost. Although certain peripheral items must be considered, those large chunks of the project form the three main constituent parts of a successful bid.

What happens throughout the duration of the bid is another matter. Because we are in for the duration—with NOSWA, for example—we tend to work in partnership with the water authorities. Certain items of risk transfer do not necessarily represent value for money. As NOSWA has expertise in certain fields that Morrison Construction might lack, it is sometimes not a good idea to try to transfer that risk down to Bob the Builder—for want of a better expression—because he will hike up the price if he does not fully appreciate the risk that is entailed.

Mr Tosh: In your experience, have there been contracts where that risk has been transferred inappropriately?

Bob Fullerton: Not necessarily within the water industry. However, there has been a move within the PFI marketplace for the end user to transfer as much risk as possible away from himself, which is not necessarily a good thing.

Mr Tosh: What protection has the public in such an area where public expectations are very high? Does the regulator have a responsibility for reviewing the transfer of risk, or is that all beyond him?

Bob Fullerton: I do not know whether the regulator has any input into that matter. We have generally found in the past that although we as the constructor will agree to take on a particular risk for a price, the bank's due diligence adviser might then ask us to prove whether we have adequately priced to cover that risk. If we cannot, the matter might be thrown back on to the table for the risk to be shared between us and NOSWA.

Mr Tosh: So the due diligence adviser is not simply seeking to reduce the bank's input, but is looking at how all the parties in the consortium are exposed and assessing where such exposure is appropriate or inappropriate.

Bob Fullerton: Absolutely. Not only is he giving the bank comfort that the consortium can pay back the debt, he is ensuring that the builder and the operator have properly priced the project.

Mr Tosh: I want to return to the three main ingredients of a successful bid. We established that the financing is more expensive through PFI. We could accept and understand that at the design stage and, because of the cutting edge of technological innovation, the private sector might bring operational efficiencies to bear. However, to convince us that PFI was a good method of procurement, you would have to make us believe that the PFI approach to life-cycle costs gave better value than traditional management operation.

Bob Fullerton: We have all heard the horror stories about traditional procurement routes. Big capital projects that we ran prior to the PFI era always seemed to run into horrendous problems, such as cost and time overruns. That has been fully documented over God knows how many years. PFI might not be the ideal vehicle, however no one from the financial institutions or from our side has come up with anything better. It is the only procurement route that we know of with which we can procure the infrastructure and construct, design, build and operate within the required time.

Mr Tosh: I am not asking you to defend PFI, I am trying to analyse PFI. I am trying to understand how it is that in controlling the life-cycle cost and operating the facility over the period of the contract you are able to provide a better service than the water authorities could if they had procured conventionally.

11:00

Bob Fullerton: It comes down to value for money. There is the question whether the water authorities could do it cheaper and more efficiently than procuring it through PFI. Is that the basis of your question?

Mr Tosh: Yes. I am trying to find where the advantage to the public purse is in going through the PFI route. We all take the view that the financing of PFIs is more expensive, so we need to see where you give the added value and how the higher financing costs are offset. In earlier evidence, we were led to believe that the benefit might come through the operation of the facility during its lifetime. I am trying to understand how that happens. What are the drivers? What are the margins?

Bob Fullerton: First, let us go back to the design stage. We examine the position and undertake value engineering in all projects that we do. The first thing we will ask is, is it cheaper to increase the capital cost and avoid the life-cycle implications, or vice versa? If you look at the risks, during the construction phase we as the construction company will have to cope with every risk from weather, unforeseen ground conditions and the environment, such as badgers, slow worms, lizards, and all those wonderful things. I question whether a water authority would have the expertise to deal with those risks efficiently.

I do not know if I am the right chap to answer your question on the operating phase, because it is not my field of expertise. We in the Catchment consortium are using United Utilities plc as our expert in the operation phase.

On the life-cycle and the replacement of parts that you asked about, we take the risk. For example, if we design a part for a water treatment works that has a life-cycle requiring replacement every five years, but it transpires that it needs to be replaced every three years, that risk is carried by us. I do not know if the water authorities could cope with that risk. They may not get the same value for money.

Over the full period of 25 years, we are taking the risk of the construction, we are taking the risk of the life-cycle, and we are taking the risk of borrowing the finance. All those risks are within the consortium. To be honest, every risk has a price attached to it. We feel that the market has moved along so far that people are now pricing the risks realistically, so you are getting better value for money now for PFI projects than you were four years ago, and the chances are you will probably get better value for money in another four years.

Mr Tosh: If we asked for it, would United Utilities be likely to give us written evidence about the issues if we wanted to explore those points?

Bob Fullerton: I am sure it would.

We can take that request back to our parent company, which is Anglian Water. I am sure that it too would provide evidence.

The Convener: Is the asset stuck together with Sellotape and Blu-Tack at the end of the life-cycle? How close are your calculations on the asset after the life-cycle that you have attached to it for the project? Does it need immediate replacement?

Bob Fullerton: No. This has moved on in the past four years. When many of the projects that we undertook to start with were finished, the asset reverted to the concession company. Things have moved on. The asset that we have created is handed back to NOSWA at the end of the concession period; it decides what to do with it.

We do not leave the asset in such a state of disrepair that it is stuck together with Sellotape. A joint inspection takes place, involving NOSWA's advisers and our own, five years before the concession period comes to an end to decide which items require to be repaired or replaced. A five-year programme is then drawn up so that the asset is worth having when we come to the end of the concession period. In some projects, there has been an obligation to ensure that the life of the asset continues for five years after we have handed it back.

Bruce Crawford: You said that there would be economies of scale in a PFI project if it was worth £20 million and that it would be better if it was a £50 million project. I understand the issues about transferring a risk. When Morrison or the new Catchment consortium that you have formed is involved in a contract of that size, do you set a target as to the percentage of profit you might want to take out of it? If you do not, what targets do you set to ensure that your shareholders get what they need out of it? What sort of percentage might that be?

Bob Fullerton: As we said earlier, we will invest 10 per cent in equity. We would set up the consortium as a special purpose company. Within it, 10 per cent of the debt would probably be equity. We look for returns on that equity. We used to look for about a 20 per cent internal rate of return. The marketplace has shifted so dramatically that we are now looking at between 12 and 16 per cent as a return.

Bruce Crawford: On a £50 million contract, the consortium may put in about £5 million by way of equity and from that £5 million you would look for about 12 to 16 per cent profit?

Bob Fullerton: Yes.

Bruce Crawford: It would be interesting to hear from an operator such as Morrison about the

Treasury's public-private partnership rules and what stands in the way of making things happen better.

Bob Fullerton: I would need another three hours to do that, so I will deal with the big issues. One is standardisation. The Treasury has set private finance initiative guidelines. As long as both parties agree to adhere to them, that would probably help. Another is European directives, which are probably more pertinent to the water industry. We are working on jobs when we are unclear about what the European directive will require on, for example, enhanced sludge treatments.

If you are asking Bob the Builder to price something but you do not know what standard he must achieve, setting a price is difficult; we will price the unknown at a premium. We need to draw a line in the sand on standardisation of guidelines for the project and European directives so that we know what we are pricing. The water industry will find that more difficult as the years go by.

Des McNulty: You said that you have moved from a 20 per cent calculation to 12 to 16 per cent.

Bob Fullerton: It is nearer 12 per cent.

Des McNulty: Is that compound interest over the full life-cycle of the project?

Bob Fullerton: That is an internal rate of return on our equity provision.

Des McNulty: Meaning?

Bob Fullerton: We have put in £5 million. On a project that is worth £50 million, we would expect to get a return of about 12 per cent in the marketplace.

Des McNulty: Annually?

Bob Fullerton: Yes, as an internal rate of return.

Mr Tosh: This morning we have talked about the transfer of risks to various parties such as the banks and the consortia. What are the principal risks for the authorities that enter into PFI projects? What might go wrong for them in terms of your performance or that of any of the outside parties?

Bob Fullerton: Not an awful lot. There are shared risks and force majeure items such as nuclear wars and other hypothetical situations that hopefully will not occur. With the exception of the main shared risks, however, every risk is transferred from NOSWA to us. Specific items such as planning issues that relate to certain projects will also be shared but, in the main, the risks relating to the design, the build, the operation and the finance are transferred from NOSWA to us.

Andrew Darling: Discriminatory change of law is not a risk that is passed down to the project company.

Mr Tosh: That means that if the European directives changed, we would be dealing with a new form of procurement policy for some form of enhanced treatment, which would remain with NOSWA. What happens if one of the constituent bodies or the whole consortium goes bust? The consortium has a low equity to debt ratio, does it not?

Bob Fullerton: The chances are that NOSWA and the Executive would laugh all the way to the bank if we went bust.

Andrew Darling: The bank would have the option to step in in the first instance and, if it did not want to, the water authority would be able to take over the asset and pay compensation to the senior lenders.

Mr Tosh: That means that the risk is on your shoulders.

Andrew Darling: Yes.

Bob Fullerton: There is also the added benefit that if, during the construction period, Morrison did not fulfil its obligations, there would be a parent company guarantee from Anglian Water that would enforce a step-in by another contractor to ensure that the obligations were fulfilled.

Mr Tosh: What happens to you and your return in the event that the water authority finds that it is unable to generate the money that is needed to pay you? The Competition Act 1998 comes to mind. Would there be pressure on consumers and people defaulting on their water bills?

Bob Fullerton: There are provisions in the contract that cover default by the water authority to the concession company.

Mr Tosh: Does that mean that the Scottish Executive underwrites the water authority if it gets into financial difficulty?

Bob Fullerton: I believe that that is the case.

The Convener: I thank our resident prophet of doom and gloom for his questions.

Maureen Macmillan: Who checks that you are doing your job and are building a proper plant and so on? Is it NOSWA or the commissioner?

Bob Fullerton: Both. We will present our design, which will be checked by the bank's advisers, who have technical advisers who will confirm whether the design that we have produced will work. The plans are also checked out by NOSWA's technical advisers. Counting our designers, that means that three designers will have checked the design.

Maureen Macmillan: Who would conduct quality control procedures when the plant was being built?

Bob Fullerton: We would, as would the bank and the water authority.

Mr Munro: Mr Fullerton, you have had quite a grilling. I will not ask you a question on the treatment of waste water, as you pointed out that that is not your field of expertise.

What is your view on the concession period for PFI contracts? As you mentioned, most of them run for between 25 and 30 years. That has implications for your profitability and the end cost to the consumer, as a longer concession period may mean that the original capital costs are extended over a longer period as a reduced annual clawback from the consumer. Do you have a view on whether it might be beneficial to extend the concession period to 40 or 50 years?

11:15

Bob Fullerton: The clever financial people in our organisation generally consider a project at the bid stage of the process and ask what the optimum period is. When we are asked to bid a job we are generally told that the concession period will be X number of years. We also sometimes apply financial modelling to find the optimum concession period and offer that as a variant bid. The amount of capital cost at the front end of the project will have a bearing on the concession period thereafter. Each project is different, but for most the optimum running period is between 20 and 30 years.

Mr Munro: If, as part of your borrowing consent to implement the project, the concession period were extended beyond 30 years, would the cost to the contractor of that extension be added to the initial costs? You are currently looking for a return on your capital investment in 25 years, but if the concession period were extended to 40 or 50 years, you would have a bigger debt burden to service.

Bob Fullerton: Yes. We have found that the optimum concession period is 25 years. I do not have the expertise to say whether it would be cheaper to extend to 40 or 50 years.

Andrew Darling: It depends on the type and lifetime of asset that is being financed. There would also be a constraint on the availability of capital in the marketplace beyond 30 years.

Mr Munro: We hear a lot about franchising. I am not suggesting that that should concern your company now, but given what is happening with the trunk roads—which are almost going out to a franchise organisation—do you think that a major consortium could be given a franchise to undertake all the waste water and domestic water contracts and maintenance in, for example, the north of Scotland, under the NOSWA banner? Could the water companies become a massive PFI?

Bob Fullerton: Yes. That is a possibility. Any asset must be managed and could be managed in that way. We find more diverse situations every day, and that may be a possibility in the future. However, we would have to be able to convince ourselves, initially, that we had the expertise to carry out the works efficiently, which might mean taking on board all NOSWA's operating staff in our organisation. To be honest, we would entertain that suggestion only if we envisaged being able to carry out the works to at least the same efficient level as we achieve now.

Mr Munro: But do you consider that a possibility for the future?

Bob Fullerton: It is a possibility.

Mr Tosh: I have refined my doomsday scenario and I would like to cover all the bases. Let us suppose that, in the design or the construction period, there was innovative action to use new technology on the cutting edge, which then malfunctioned and stopped working. The replacement of that technology would be a major financial issue. Who would bear that cost? Are the contracts written so that the consortium carries the risk, or does the risk rebound on the banks or the authority and its paying customers?

Bob Fullerton: The risk of technology not working rests with the consortium, which would have to make the apparatus work. If it cost £X million to rectify the problem and the consortium company did not have sufficient funds, two choices would be available. The members of the consortium could return to their parent companies—such as Morrison or United Utilities and IWL—and say, "Look guys, we've got this major problem. The concession company that we've set up does not have sufficient funds to rectify the problem." The three parent companies could just walk away and let the concession company go bust. Then, the bank or NOSWA could step in. However, if the three parent companies allowed that to happen, none would be likely to qualify for any more PFI work. If we let a concession company go down, we run a grave risk of not returning to the field.

Mr Tosh: Is there no risk to anyone else who is involved in the process from the amount of equity the partners have in the special purpose vehicle being too low to cover refinancing costs or costs plus penalties?

Andrew Darling: The banks would have sought to negotiate recourse to principal sub-contractors should some items not be fit for their purpose.

Beyond the equity strip, warranty claims against whoever had designed or supplied the item involved would be possible.

Mr Tosh: For how long would they be available?

Andrew Darling: Some warranties in Scotland can last 10 or 12 years.

Bob Fullerton: The time is 12 years in Scotland for a latent defect.

Mr Tosh: From the procurement and financing points of view, do you consider all the risks to the public sector and the end customer to be adequately covered?

Bob Fullerton: Yes.

Mr Tosh: I have obtained a personal guarantee.

Robin Harper (Lothians) (Green): I would like to return to Dr Sawkins, if that is possible.

The Convener: That is possible. If there are no more questions for Bob Fullerton, I am happy to return to the general panel.

Robin Harper: During your presentation, Dr Sawkins, you pointed out that there is a loophole that allows large companies to abstract their own water through boreholes free, unmonitored and unlicensed. Can I presume that you would like that loophole to be closed?

Dr Sawkins: Yes.

Robin Harper: Who, from among the three water companies, should take over control of the boreholes? Do you think, as I do, that there might be advantages in setting up a central fund and giving the responsibility for control, licensing, monitoring, metering and charging to SEPA?

Dr Sawkins: Yes, I would favour charging SEPA with that responsibility. If the water authorities were given that responsibility, it would, in a sense, smack of poacher and gamekeeper. An authority would not withhold a concession to withdraw water in its region if it thought it needed that water. SEPA would stand outside that and would be the right body to give the responsibility to.

The Convener: As no hands are raised to indicate that someone wants to ask a question, I thank the witnesses for coming along and staying with us through a session during which technical language has been bandied about at points. Our understanding has been greatly enhanced by the evidence.

In particular, I thank Dr Sawkins for the financial terms "in a fix" and "in a muddle". We will seek clarification of those terms from our financial adviser. None the less, we managed to stick with you.

I ask our colleagues from the Scottish Trades Union Congress to join us at the table.

Members of the committee have made this a natural break. I apologise for the delay, but I am sure that they will be back with us soon. I will adjourn the meeting briefly.

11:25

Meeting adjourned.

11:29

On resuming—

The Convener: I now reconvene the meeting and apologise to the witnesses from the Scottish Trades Union Congress for the slight delay. We have with us Jimmy Farrelly, Dave Watson and Alex McLuckie. As always, we will try to keep proceedings as informal as we can, but there are certain things that we will need to consider. I thank the witnesses for the document that they have submitted; it has been circulated to members, who will, I am sure, have read it carefully. Do you want to make an opening statement?

Dave Watson (Scottish Trades Union Congress): Yes.

The Convener: Fire away.

Dave Watson: I am Unison's Scottish organiser for utilities. Alex McLuckie is from the GMB and Jimmy Farrelly is from the Transport and General Workers Union. We hope that you found our submission helpful; we would like to highlight a couple of key points from it.

There are two big issues that we feel the committee should consider. One is competition. Members will have gathered that we feel that the policy imperative should not be that competition is the solution to the problems of the Scottish water industry. There is no level playing field between Scottish and English water companies and, in the short to medium term, there is not likely to be one. That is largely because of increased investment south of the border over many years and because of the debt write-off following privatisation. English water companies have also had the benefit of multinational backers—they still do—and they have the advantages of flexibility in their non-regulated activities. The consequence of adopting competition as a policy will be that companies will be able to cherry-pick the most profitable consumers in Scotland and domestic and small business users will pay the price.

The second issue that we want to focus on has come up since our original submission to the committee and the submissions of individual unions—the announcement of what are called efficiency cuts. Our main concern is over the impact that those cuts will have on the work force.

We believe that the cuts are not realistic in the current climate. They are based on false comparisons. For East of Scotland Water and West of Scotland Water, the comparisons are with Yorkshire Water. Members will be aware of the difficulties that Yorkshire Water has had with customer services over many years. We would argue that their route is not the one that Scotland would wish to take.

There will be three consequences of the efficiency cuts. One will be massive job losses. We estimate that around 2,000 jobs will be lost. The figure could be slightly lower, but it could also be a lot higher. However, mid-range estimates are of around 2,000. To give members a sense of scale, that is around one third of the work force.

The second consequence will be the impact on customer service: you simply cannot deliver the same response times, for example, with that big a reduction in staff. The third consequence—and perhaps the most important one—will be the impact on safety. We need to learn safety lessons from what has happened in the railway and gas industries and not replicate their problems in the water industry.

We accept that this is a complicated issue with no simple, straightforward and easy solutions, but we have listed four main action points. One relates to exclusion or partial exclusion from the Competition Act 1998. That could be done in the context of a rigorous licensing regime within a sensible financial framework that put safety before the promotion of competition. We accept that gradual efficiencies are possible, but not at a rate that would cause dislocation within the industry. We feel that exclusion from the act would halt what we see as the gradual privatisation of the industry—first through PFI and more recently through other forms of private partnerships. We see the Competition Act 1998 as a nail in the coffin of the public water industry in Scotland.

We suggest that there are two routes for the water industry that the Scottish Executive could take. One is, in effect, gradual privatisation, leading to a shell of a public water authority in a largely privatised industry. That would lead to a poorer service and higher bills for most consumers, but to cheaper bills for the biggest industrial consumers. The other route is that of a public service model within a financial framework that would deliver efficiencies and cost benefits to the consumer and make the necessary investment in Scotland's water industry. Needless to say, the STUC urges that the second route be taken.

The Convener: I was making that assumption as you spoke. I thank you for that concise and straightforward introduction.

Bruce Crawford: I, too, thank you for that useful introduction. Paragraph 9 of your submission talks about the exclusion of the industry or the phased introduction of competition under the Competition Act 1998. We heard evidence at earlier sessions from the three water authorities that the exemption of the water industry in Scotland from competition law would be undesirable in the longer term. Obviously, you do not agree. Why not? Why do you believe that such an exemption would not contravene EU obligations?

Dave Watson: If I were the chief executive of a water authority, I would naturally say that competition was fine and that we were ready for the challenges. It is our job to tell you about the reality on the ground, which is that that is not the case. That is not to say that it can never be the case, but it will not be the case in the short term. We have not had the scale of investment that the English water companies have had. Since before privatisation, English companies have had investment that local authorities in Scotland could only have dreamed about. We are not starting from the same base level. We are trying to catch up by means of the investment programme that is set out in the "Water Quality and Standards" document, but we are nowhere near doing so. The sort of companies that we are dealing with and the level of their financial clout means that we are not on a level playing field at this stage.

The next question relates to what can be done legally. Schedule 3 to the Competition Act 1998 contains two relevant paragraphs: one deals with economic issues and the other deals with public policy issues. We focus on the public policy argument. The schedule outlines reasons for the use of exclusions from the act—which are different from exemptions, which relate to cartels and so on, but we will not get into the legal definitions—on public policy grounds.

The complicating factor is that such matters are reserved to Westminster—the Scottish minister would have to go to the relevant Westminster minister to seek an exclusion. The exclusion might not be an exclusion for all time; it could be a phased exclusion. We would not be opposed to that approach. The regulatory machine, for which the Scottish Minister for Environment, Sport and Culture is responsible, could be coupled with that.

The comparison that we draw is with some of our European counterparts. The French deal with perceived threats to their industries, particularly utilities, by using the competition law provisions, which are all based on the EU competition directives, to restrict or phase in competition in their industries. They sometimes use other means—some are challenged in the European courts and others are simply delaying tactics. The point is that the French have taken a political view that competition is not the right answer to the problems of particular industries. We believe that the Government in Westminster or in Scotland ought to take a similar view in relation to the Scottish water industry. If we take that policy perspective, we will be able to consider ways of working within the legal framework.

Bruce Crawford: Even if the industry is not subject to competition and is not gradually privatised through private finance initiatives, huge investment will still be required. How does the STUC think we can release that investment? That might be dealt with under the model of public service that you give, but I would like you to flesh out exactly what you mean if you do not intend the industry to remain the same as it is at the moment. I am not sure whether you understand my question.

Dave Watson: I entirely understand the point. There are a number of issues. The key is to get the financial framework in place. Regardless of how many water authorities there are or what the structure is, a financial framework that includes sensible efficiencies must be in place. We are not ducking that issue. We understand that technological change—you referred to new design solutions for water and waste water treatment works—creates efficiencies. Efficiencies can be created through examining the ways in which the authorities organise central services. Those efficiencies can be built into the system.

We must consider how to finance new developments on that basis. There are arguments about how that might be done. Our sums do not differ greatly from those that are set out in the Executive document, "Water Quality and Standards". We have not come to a view on which of the three options—and sub-options—in the document is best. Clearly, one must pitch the right kind of investment and then consider how it might be financed. In our view, there are perfectly adequate borrowing consents available to the water industry to enable it to be funded cost-effectively through public borrowing.

There is a range of solutions. In some cases, we might want to buy in expertise from the private sector. We have done that in the past and have no difficulty with it. However, we have a difficulty with handing over great chunks of Scotland's water industry for profit. That is where the difference lies in our approaches.

Bruce Crawford: The water authorities have told us that their borrowings are reaching such a level that the income from their customers may not match it; if it does not, they will need to find other ways to bring money in. That is a real conundrum. How would the unions find a way round that?

Dave Watson: There is no solution to that—it does not matter from whom one borrows, one must still pay the money back. We all know from our personal budgets that there is no short way round the problem. The simple fact is that it is right that water authorities finance their capital programmes from borrowing and have the money to fund that in terms of the revenue cost of managing that debt. It does not matter how or from whom the authorities borrow, be it from a merchant bank, through bonds or by any other means. All that we would say is that, because public water authorities can borrow money more cheaply than anyone in the private sector can, that approach is the more cost-effective one. The use of design solutions may be one answer, but it would require some pooling of expertise. In that case, we should buy in the expertise. What we should not do is hand over millions of pounds to banks so that they can make money out of investing that cash.

Bruce Crawford: There are other models—for example, the English water companies are currently considering mutualisation. That borrowing process would take the money off the balance sheet in terms of the public sector borrowing requirement. In Scotland, that might take the form of a not-for-profit mutualisation process, or even a public service trust mechanism from which money could be drawn down. That route would involve bonds being raised on a trust, supported by Government money, which could borrow in the long term and therefore more cheaply. What do the unions think about mutualisation and the second route that I have outlined?

Dave Watson: They are two very different routes. I have not yet had a chance to study the Scottish National Party's proposal on a public sector trust—it is sitting on my desk, waiting to be read. However, I will produce a response. The first issue is how to borrow most cheaply and effectively; the second issue is mutualisation—ownership. We have not come to a final view. The Co-operative movement and others have a view and are putting together a mutualisation model. We are open to discussion about that, but we have some serious reservations.

I notice that the Ofwat regulator has initially approved a mutualisation arrangement for Welsh Water, although his predecessor refused a similar approach for Yorkshire Water. Our view is that that model, which has been talked about in England and Wales, is, in effect, the privatisation of the water industry. The mutualisation element may be not for profit, but the people who make the money are the companies that provide the services for the water authority. A minister in a former Administration talked about that as a plan for local authorities; his view was that local authorities could meet once a year, sign off the contracts, close the doors and go home. In effect, that is what would happen in the water industry. A body would meet once a year and sign off contracts to various English water companies to run different parts—if not the whole—of the Scottish water industry. Frankly, that does not look to us like a public water industry. If it looks like a private company, walks like a private company and talks like a private company, it is a private company. That is our position.

Bruce Crawford: You could not be more clear.

Maureen Macmillan: To what extent do the water authorities already face competition from the fact that non-domestic users can make their own arrangements? I have come across examples of non-domestic users opting out of the water authorities' arrangements, particularly for waste water. How are the water authorities coping with that competition? I know that what is proposed represents a step change, but it seems to me that there is competition already.

11:45

Dave Watson: That is true. There always has been competition. In previous submissions, we said that the Competition Act 1998 and the proposed water services bill would introduce a further level of competition. The Scottish Environment Protection Agency and other witnesses have raised issues relating to the abstraction of water. The public perception in Scotland has been that, because it rains a lot here, we have a lot of water and there is no issue; in fact, the water that comes through our taps has to be treated. There are also issues relating to pollution in the less glamorous side of our industry—sewerage. We think that regulations on the abstraction of water and on sewerage should be tightened. Our members who are more expert in those areas could talk more about technical aspects, some of which SEPA identified to the committee.

There will be competition arising from big industrial users if costs rise. There is no doubt that, once the price of water to an industrial consumer reaches a certain level, schemes that have been shelved for many years are dusted off and brought into play. The Competition Act 1998 is very important. If a private company offers to dig a borehole or provide a waste water system for a big industrial consumer, such as a brewery, it costs the introduction of the particular piece of kit that is required on a fairly marginal basis. However, the private operator is interested in maximising value from that asset. The Competition Act 1998 and the licensing framework are important because they enable the operator to use the same asset to supply water to other customers, at some distance.

We will use the example of a brewery in Edinburgh. An operator installs several million pounds-worth of equipment into that facility, and charges it on a marginal basis to get the business established. It then sees an opportunity to provide water for a housing estate that is being built on the outskirts of Edinburgh. However, it will not be cost-effective for the company to lay its own pipes from the brewery or water source to the housing estate. The company would rather have common carriage so that it can apply water through the public water system and tap a pipe in at the end. I could not even begin to explain the complexities of doing that.

Water is very different from other utilities. Similar arrangements can apply in utilities such as the gas and electricity industries, although you will be aware that there have been difficulties, some of which have been tragic. We all know that water from one place is not the same as water from somewhere else. It has to be treated at different stages of the process. The water that is extracted at one place may have to be treated several times before it reaches somewhere else. There are many issues, such as the possibility of contamination. We highlighted some of the regulatory issues in more detail in our submission last year. Those issues are technical and complicated. The golden principle is that companies would wish to have common carriage on the basis of marginal cost. That is what companies have argued for in the electricity industry. If we provide common carriage, it must be on the basis of a full share of the costs. The cost of competition must fall on those who want to compete rather than on the domestic consumer and small businesses.

Helen Eadie (Dunfermline East) (Lab): I want to explore in more depth the Competition Act 1998. I understand that the UK takes part in negotiations in Europe and that the European Union negotiates on our behalf at the World Trade Organisation. We all received a letter from the World Development Movement telling us that the negotiations that are taking place now are being driven by the Americans, who want to move from the general agreement on tariffs and trade to another agreement—the general agreement on trade in services. The negotiations provide for the exclusion of core services from the agreement, but it would be down to member states to determine which services, such as health, water and roads, they wish to exclude. Is that the case? What stage are the negotiations at?

Are you aware that there are many forms of mutualisation, including not just workers co-operatives but community business models, which enable all the people of Scotland to have ownership of their co-operatives?

The Convener: Five minutes ago, that was described to me as a wee question, but there you go.

Dave Watson: Certainly, there is a move towards liberalisation of world trade. I am not familiar with the details, but, under the current regime, negotiations take place and then a European directive on the framework is produced, which the European nation states have to turn into regulation or legislation. That is effectively how the Competition Act 1998 came about.

We do not have an opt-out from EU competition directives. European law is perfectly clear on that point. Nation states have to apply directives through their own legislation. That is not a matter for the Scottish Executive, although some of us might wish that it was, but there is an issue in relation to the way in which the Competition Act 1998 is worded. Our view is that it could have been worded more effectively in some areas; none the less, we are left with the legislation that we are left with.

However, as I indicated earlier, there is some scope to use the act beneficially for what we would call core services. Our view is that it is the hallmark of a civilised society to have clean, safe drinking water and effective disposal of sewage. Therefore, there is a case for excluding core services from the trade framework, on the basis that those services do not impact on the liberalisation of free trade, irrespective of one's view on that issue. I appreciate that that is probably way outside the scope of this committee. None the less, whatever view you take, I suggest that key services such as water should be excluded from the framework.

Jimmy Farrelly (Scottish Trades Union Congress): My union, the Transport and General Workers Union, commissioned a survey on employment and profit margins in UK water companies from the public services international research unit at the University of Greenwich. The conclusion summarises our view on the matter. It says:

"• The UK's regulatory regime has so far allowed the water and sewerage companies to treat their employees entirely according to commercial objectives of profit. Jobs have been lost without any certainty of the implications for safety, standards of service, or training.

• The companies, by contrast have enjoyed extremely generous profit margins, which are three to four times international norms, with the consent so far of the regulator.

• It is clear that the companies are amply able to afford to achieve the price reductions required by accepting lower profits, without any need to threaten employment and standards of service.

• Ministers and the regulator however need to take powers to ensure that this is done, otherwise the result will be that profit margins continue to be maintained while price cuts are achieved at the expense of the industry's workforce."

That report was published just over a year ago. The key issue for us is that 6,000 people in Scotland are employed in the water industry. In England, there was a 21 per cent reduction in jobs. Moreover, there have been substantial cuts in workers' terms and conditions of employment and an increase in casualisation and outsourcing. Those areas, along with a few others, are the ones that primarily concern us.

The Convener: It would be useful if you could get that report to us so that it could become part of our evidence.

Cathy Jamieson (Carrick, Cumnock and Doon Valley) (Lab): I want to follow up on one of Helen Eadie's points. I have a vested interest in the mutuality sector and the Co-operative movement and I was a wee bit concerned about the interpretation of what taking the mutual option might mean. Do you accept that there is a fundamental ideological difference between an organisation that is set up primarily to provide a service for its members—in the case of the water industry, the population of Scotland—and an organisation that is set up primarily to create private profit? Do you accept that the whole principle of mutuality involves any surplus being reinvested in the industry? Do you also accept that the mutual sector offers the possibility of democratic control and accountability, with all members being able to elect the people who would serve on the boards? A board meeting need not be a once-a-year rubber-stamping of contracts; people could be involved in developing policy in the industry.

Dave Watson: The mutualisation option that I am talking about is the one that Ofwat is promoting. I am a long-standing supporter of the Co-operative movement, and my union and the others represented here today have no difficulties with the principle of mutualisation. However, the only models that have so far been put on the table for the water industry have been the proposal for Yorkshire and the proposal announced this morning for Wales. For the reasons that I gave, I have serious reservations about those.

Alex McLuckie (Scottish Trades Union Congress): The Scottish Executive is on record as saying that it wants the water industry to remain in the public sector; the difficulty we face is how to keep it there when we have the Competition Act 1998. Dave Watson said that our first option would be to have the water industry excluded from the act. We are talking about the provision of wholesome, clean water, which must not be affected in any way by the rush for profit. However, the act will affect it.

My trade union—the GMB—and other unions feel that mutualisation is probably the third option. The second option would be the one that Dave Watson outlined: if the industry cannot be excluded from the Competition Act 1998, we have to ensure that the public water authorities in Scotland are ready to compete on a level playing field. At the moment, because of the investment that they have received over a long period, a lot of companies are at the starting line; in Scotland, we are 100 yards away from the starting line.

People have been discussing the best model to enable water authorities in Scotland to compete within the terms of the act. We have to consider the financing. I was smiling earlier because I felt like Eminem following Bob the Builder at Christmas. Committee members heard privatisation being preached. John Munro asked a witness about franchising and was told that the whole work force could be taken over. That would be privatisation of the water industry. In our submission, we say that we have to consider how water authorities can raise finance. PFI schemes are in place for one reason alone—so that water authorities have only one choice. They do not have the ability to raise the capital themselves. We have to look seriously at that and change it.

When we talked about best value at the Local Government Committee, I made the point that in the health service, for example, there is a public sector comparator. When we want to build a new hospital, we can make comparisons and see whether we are getting value for money. We do not have that in PFIs in the water industry. We do not have the option in the water industry to have direct build—it is PFI or nothing. If a plan impacts on the PSBR, we will not get the money. We must give serious consideration to the method of funding. I apologise—I will get round to mutualisation eventually, but this is my chance and I am taking it.

For many years, the off-network has been subject to open competition. Scotland enjoys the lowest water rates in the UK. The income from off-network services runs at about 40 per cent to 45 per cent. If we lose off-network services, that will have a significant impact on domestic customers. If there is to be a licence system, off-networks should be included in it. If a provider comes to householders in Bearsden, for example, and offers services at less than the top rateable value, it has to pay for that. There is cost to keeping the overall structure going and that cost should be included in any licence regime. That should apply to the off-network as well. If other providers are moving in, there will be a cost to the public because of the loss of that income; that should be taken into account in any licensing scheme.

We do not like the model of mutualisation that we have seen. The assets are mutualised and everything else is privatised. That is why we dislike it.

12:00

Robin Harper: I have a couple of questions about the consumer, which you have already answered in part. Unison indicated that increased competition could bring the prospect of self-disconnection. How serious is that possibility and what is the current mechanism to prevent domestic customers from self-disconnecting?

Dave Watson: Self-disconnection ties in with the growth in metering. That is the only circumstance in which self-disconnection is an issue, except for in some rural areas. Our experience in gas and electricity is that a metering system leads to some self-disconnection. A water industry study on the Isle of Wight showed that disadvantaged consumers disconnect simply by not putting the cards or coins into the slot. That is the major risk.

We do not have extensive metering of water in Scotland. There are a few meters here and there for some small and larger business users. If, to take Alex McLuckie's example, I were interested in developing a water framework in Bearsden, I might decide to install water meters at the same time as offering my new water proposals. As we have a rateable value system for water charges, a metering approach might work to my advantage. That has the same effect as taking out the large industrial users. If one offers a discount to advantaged consumers and big business, the rest of the public water users must pick up the bill. There is no other way round it. That is our concern. If the system led to widespread metering, we would see self-disconnection by disadvantaged consumers.

Robin Harper: Would you elaborate on the knock-on effects of allowing domestic and commercial customers to choose water and sewerage services simply on the basis of price and service?

Dave Watson: The knock-on effects depend on the scale. The figures that have been drafted by the water authorities—they are in a better position to answer Robin Harper's question—show that the costs rest on the scale of the income and the fixed-cost nature of the industry. If one customer is removed from the system, the only costs that are removed are the very low variable costs—everybody else must pick up the fixed costs. If the big customers are removed it falls on everyone else to pay those costs. It is a simple formula. The exact sums depend on which customers leave, what they currently pay and what the variable and fixed costs are. Those sums will vary depending on the customer. The simple rule—it is straightforward mathematics—is that everybody else pays the bill.

Fiona McLeod (West of Scotland) (SNP): We have talked a lot about efficiency this morning and throughout our inquiry. The evidence from the water commissioner concerned me, particularly when he spoke about efficiency, the efficiency savings that he expected and the way in which he benchmarked Scottish water authorities against English water authorities. You referred to that earlier and I wonder whether you would expand on your comments, given that while the commissioner talked about efficiency savings, you talk about efficiency cuts.

The commissioner said that his methodology ensured that being benchmarked against the likes of Yorkshire Water did not disadvantage the Scottish water authorities. Do you understand that methodology? Do you accept that it is weighted in favour of Scottish water authorities? For example, NOSWA uses 60m of pipe per customer whereas Thames Water uses about 10m.

When you address the question of efficiency cuts, will you indicate whether you believe that efficiencies cannot be made within the water authorities in Scotland? I assume that you will respond that efficiencies can be made, so how do you think the water authorities should go about making them? What areas are ripe for efficiency savings?

Dave Watson: To be frank, our difficulties with the efficiency cuts—as we describe them—that the water commissioner proposes relate to the scale of the aggregate numbers and the time scale.

As Alan Sutherland would say, the methodology is a mixture of science, what he would describe as art and what I would inevitably describe as subjective judgment. Other methodologies could be applied, but the bottom line is whether like is compared with like.

The commissioner has chosen Yorkshire Water as the primary authority against which he benchmarks ESW and WSW in his tables. However, if one makes that comparison, one must first ask oneself, “What type of service does Yorkshire Water provide to its customers?” As I said, there are plenty of good examples of Yorkshire Water’s difficulties: leakage rates, failure to supply, excesses in relation to salaries and other things that went on. If you were a customer of Yorkshire Water, you might well take the view that it is not a model that you would want to promote elsewhere in the UK. That is also our view. It is no accident that the parent company would like Yorkshire Water to go down the Ofwat mutualisation route; it probably thinks that it has made all the money that it can reasonably make out of that model.

The comparator for NOSWA is South West Water. While I accept that parts of Devon and Cornwall might look a little like the Highlands, the scale of the area is massively different. Again, South West Water has not had a wonderful customer service record, and those difficulties have been well publicised.

We do not think that the water commissioner is comparing like with like and, inevitably, there are some subjective views. I do not claim for a moment to be able to analyse the numbers—I have not seen all the water commissioner’s detailed numbers, although I have seen some of them—but I know his broad approach. He would accept that there are subjective views. The bottom line is to decide where to start the process. My view is that, before beginning to use the numbers to compare pipelines, sewage works and the rest of it, one must start by asking, “What is the starter comparator?”

On Fiona McLeod’s second question, of course efficiencies can be made. We are not saying that they cannot be made—they have been made since reorganisation and some were made even before that. Efficiencies fall into two major categories. First, efficiencies can be achieved through investment in new design solutions for both water treatment works and sewage facilities. If an operation is redesigned and the latest technology and so on is installed, it is inevitable that it will require fewer people and that, therefore, efficiencies will be gained.

Secondly, on collaboration, there will be inevitable efficiencies from using technology in central services and other areas. We have no difficulty with that—it is an industrial relations issue that needs to be managed. We are quite happy to sit down with the water authorities in a sensible framework in which we can bargain and negotiate an appropriate way of managing those changes.

That requires willingness on the part of the water authorities to be transparent and open; proper partnership in negotiations; and most importantly, a financial framework that would enable that to take place. We have had discussions with both the commissioner and the Minister for the Environment, Sport and Culture on some of those issues. If there is a long enough time scale and natural efficiencies, it is an industrial relations matter. That is what we are paid to do and we can manage that approach. However, we cannot take an artificial comparator and a set of figures that are not related closely to investment in the industry, and provide the appropriate bargaining flexibility. There lies dislocation and chaos. Such artificial targets would lead to safety issues and other concerns that we have highlighted.

Alex McLuckie: There has been input from water authorities, private companies and us. It should be noted that there is another important element—the work force. In the four years that we have been working together, the work force has faced significant changes in working practice, core conditions, rates of pay, hours of work, shift patterns and so on. We have been involved in many negotiations where the employees have made significant sacrifices to ensure efficiency savings. I am smiling as I say that because some of my colleagues who are sitting in the gallery will know that some of us bear the scars of those negotiations. However, that was done for the right reason: to ensure that the industry could compete and remain within the public sector.

The particular concern that I have about the water commissioner's comments relates to the time scale in which he wants savings to be made. I may be wrong but, as I understand it, long-term projects are not included in the exercise. For example, if we proposed something that would reap benefits only seven or eight years down the line, it would not be included in the efficiency savings. Our fear is that the short, sharp cuts that are required to hit those targets will rest on a head count. There is a danger that that will impact on services. Efficiencies have been made and will continue to be made. We must go back to the start line. We need more time in which to manage the changes to ensure that we achieve the efficiencies appropriately against a background of good industrial relations.

Des McNulty: We heard from a previous witness that there was no match between levels of efficiency in companies south of the border and the extent to which they had suffered from de-staffing. Do you have any information about the approaches that were taken by the different companies in England and Wales and examples of good and bad practice?

Dave Watson: The paper that Jimmy Farrelly referred to shows some of the variations in financial performance and staffing. We did not pluck the figure of 2,000 job losses out of the air; we came to that figure by aggregating the estimates of the water authorities, which carried out some private research. There are variations down south. Some companies, such as Severn Trent Water, halved their staff, whereas other companies, such as Wessex Water, reduced their staff by about 10 per cent. The variations exist because some of the water companies were able to use their non-regulated activities to deal with staffing issues. In other words, they shifted staff from regulated matters to non-regulated matters in order to develop new areas of business in local authorities. Some companies made greater use of outsourcing and privatisation than others did; some tackled the matter in-house and some went outside.

We are concerned about time scales and approach. There has been a creaking privatisation of the industry in Scotland and the approach has been to seek outsourcing and involve private partners, rather than to consider carefully the in-house options that are available to the water authorities.

Members have been talking about PFI schemes. Our first question concerning such schemes is, "Where is the transparency in that process?" How many full business cases have MSPs seen for PFIs in the water industry? I have seen none. None has been published, although that is not the case in other parts of the public sector. When Sam Galbraith was the minister of state with responsibility for health for the former Scottish Office, he introduced a framework that required a degree of openness and transparency, but that example has not been followed in other parts of the public sector.

Last year, Jack McConnell announced a new openness in PFI schemes, but only in schemes that were introduced after June 2000. No such announcement has been made concerning the water industry. A degree of openness and transparency would help us in considering PFI schemes.

Our concern is that, if we pursue the route that we have followed so far, we will be faced with the higher end of the job-cuts scale, which could be nearer to 3,000 than 2,000 job cuts. Although 2,000 is the realistic figure that water authorities are contemplating, it might be difficult to limit job losses to that number without the sort of dislocation that I mentioned earlier.

12:15

Des McNulty: Let us be clear. You rightly raise the issue of PFIs. I understood that the major PFI projects for water and sewage treatment plants were in place and that a lot of their future funding would come from external finance. Can you confirm that? Can you quantify the difference between the impact of that on your members who work for PFI projects and its impact on those who work for projects that are funded through the other mechanism?

Dave Watson: Perceived wisdom says that a PFI scheme must be viable and of a certain scale to get off the ground, or that there must be bundling arrangements. There are plenty of examples elsewhere in the public sector of local authorities being forced to bundle proposals together to make a viable option for the private sector. The private sector is not interested in the odd individual school, for example; there must be a bundle of 20 schools.

Some PFI schemes are in place, although some of them have not been built and are not yet up and running. Over the past year, there has been a move towards broader public-private partnerships. People think that that is another description of PFIs, but it is not. PPPs are frameworks that include PFI, but they also include other forms of partnerships. Some of the schemes on the Ayrshire coast and elsewhere are being developed as public-private partnerships.

Public-private partnerships have some advantages for the authorities. The financial regime that surrounds PFIs is more flexible if different types of partnerships are established, and there are advantages to buying in expertise without the disadvantages of the PFI finance regime. Assuming that we do not opt for the most expensive option of completely rebuilding Scotland's water and sewerage infrastructure—most members would balk at the cost of that—the projects that are in place can be funded by conventional finance and managed in-house, with perhaps some linkage to public-private partnerships and buying in of expertise in some areas. We favour that solution.

The Convener: I warn the committee that we are running short of time.

Bristow Muldoon: Your submission states that public safety should be the top priority; I am sure that all committee members agree with that. Previous witnesses have suggested that the proposals to create multifunctional roles in the water industry might risk the creation of public health concerns. What are your views on that? In what other areas should we consider the risks to public safety in our report on the water industry?

Dave Watson: I have already answered one of those questions, in relation to the licensing that is required—under the Competition Act 1998—to put water into the mains water system. The difficulty is that once water is put into the public mains system it cannot be switched off, as electricity can be. The water that goes into the mains system might be contaminated. Our water engineers say that no matter how many valves and systems are installed, the damage is done when the water becomes contaminated—one must cut off the whole system, clean it out and rely on bottled water. We have seen occasions on which that has happened by accident in Scotland and south of the border.

I will address the staffing consequences of 2,000 workers being taken out of the water industry. We will negotiate to ensure that, where possible, that is done through natural wastage rather than compulsory redundancy. Inevitably, what happened in the rail and gas industries, and to a slightly lesser degree the electricity industry, will happen in the water industry; all the experienced, longer-serving workers will be lost, because anybody who is over 50 will take advantage of the pension arrangements that will be offered.

That will leave a huge gap, which will have several safety implications. When first I dealt with the water industry, I thought naively that we knew where all the pipes and sewers were, but my confidence was sadly misplaced. We have a hotchpotch of sewers and pipes, which have been developed over the past century. Therefore, local knowledge and experience are important. Water engineers tell me that they still ring up retired engineers to ask how a particular problem was solved in the past. There is no wonderful computer system that stores information on where everything is in the water network. There is a concern about skills and knowledge of where things are, how they work and what the best solutions are to problems, particularly in a crisis. In a water quality crisis, local operational staff who know the systems and know what they are doing are needed. That knowledge does not come with a university degree, but from years of local knowledge of the industry.

Issues will arise in relation to cross-contamination if a third of the work force is removed. We do not have an artificial demarcation between water and sewage because the water guys and girls do not like working in the sewage side of the industry and vice versa. The demarcation exists for good safety reasons. Somebody who works in a sewer in the morning cannot use the same tools, equipment, overalls and so on in the water system in the afternoon. However, if the outsourcing solution is adopted and building contractors are employed, those contractors will use the same van and tools for a job in the water system in the afternoon that they used for a job in a sewer in the morning. That is a concern. Workers should have entirely separate overalls and kit, right down to the screwdriver and spanner, for jobs in water and sewage. In rural areas such as Argyll and the islands, where it would not be economic to separate the areas of work, water authorities follow rigorous risk assessment procedures, for which there is a cost—the cost of two sets of wellies and so on. That is very expensive.

The difficulty is that there are no real figures on the impact of cross-contamination. If one has a bad stomach, one might put that down to having had one drink too many the night before—I am sure that that is not the case for committee members—or to the spicy food that one ate, but it might be a result of cross-contamination in the water system. One would not know the reason. We cannot pin down particular health problems to particular incidents, but we know that the number of cases of gastroenteritis has grown, particularly in England, which may be a result of cross-contamination. We do not know, but it is self-evident that we should put in place safe systems at work to try to avoid cross-contamination. That is a major concern.

I emphasise our concern about the loss of expertise. We should remember what happened in the gas and rail industries, in which safety was compromised by the loss of experienced workers. We do not want that to happen in the water industry, but that is risked by removing so many workers or of opting for large-scale outsourcing.

Bristow Muldoon: Following on naturally from that, I want to deal with the question of the expertise in the industry. Compared with the English industry, for example, how well does the Scottish industry retain expertise? How do remuneration levels compare north and south of the border? Has there been a loss of expertise in recent years from the Scottish water authorities?

Dave Watson: There has been some loss and there is likely to be a further loss. However, there has also been a good level of retention. People go into the water industry, get trained in that area and continue to work there. Our concern is that that loss of expertise could be accelerated if we lose 2,000 jobs in a short period.

Compared with down south, there are a number of areas in which we could do better, such as training and development, especially in relation to the challenges that face us. Obviously, our water authority structure is geared around the traditional public service model. If we are to deal with new technology in the developing areas, we need some expertise and we need to put more money into training and development. The problem is that that will cost money. In a situation in which £134 million must be found, it is difficult to argue to a board that investment must be put into training. However, that has to be done and experience tells me that the private-sector utilities have put significant sums of money into training and development as well as into infrastructure.

The regulator might want a new management information system to allow him to press buttons and do wonderful modelling and calculations, but systems are needed for efficiency in other areas as well. Greater efficiency will improve water quality in Scotland, which could be better. All of that costs money, however. The committee—particularly members who have been in local government—will know that it is difficult to justify to the electorate expenditure on salaries, training and development, computers and other infrastructure when charges such as the council tax or water charges are going up. Those are difficult decisions, but more can be done in such areas. That is our message to the water authorities and we are saying that in our bargaining approach.

Bristow Muldoon: Do you think that the current structure of the industry is more or less effective than was the structure pre-reorganisation in 1996? Would there be any benefits to having one water authority in Scotland rather than the three that we have?

Dave Watson: Since re-organisation, there have been advantages and disadvantages to people in terms of the charging structure. The new structure is better in terms of creating a more efficient and effective spread of expertise. Whether the structure of boards that was set out in the consultation paper is right is a matter for debate, although I think that we have moved on from the suggestion in the paper that we adopt something like the national health service trust model. At a time when the Minister for Health and Community Care is about to abolish such trusts in the NHS, it would be bizarre for the water industry to adopt that model.

The consultation paper talked about the long-term changes to the structure, which might involve a move away from the current three-authority model. Inevitably, the industry has started to discuss that, but there is no consistency of views. Some people argue that one authority would be more efficient because there would be a common system, expertise would be shared on a scale that it is not at the moment and—more important—such an authority would be big enough to compete for the provision of cross-Scotland solutions, particularly for commercial customers. Others argue that one authority might not be responsive to all the different parts of Scotland, particularly the more remote parts. There is a small issue relating to cross-subsidy and whether east and west of Scotland customers would have to pay more to subsidise the north of Scotland if there was one charge across the board.

A major argument against one authority is the experience of local government and other public sector reorganisations. That experience suggests that at least a year would be spent arguing about the form of the new body—during which time managers and others in the industry would jockey for position or write themselves out of the process—and that, once the new authority was established, we would spend at least another year arguing about whether we should work in the same way as ESW or NOSWA. We are concerned about the fact that, in the meantime, the world will be passing us by. Anyone who has been involved in public sector reorganisation knows that it is a three-year drag.

While there are different views, we agree that moving boxes around is always a tempting approach—it is an approach that is beloved of our management consultant colleagues—not that I refer to the water commissioner, of course. There is a case to be made on which proper consultation should take place, but we agree that that is not one of the big issues. By all means, we can talk about boxes—everyone loves to talk about structures—but we should focus on the big issues that face the industry, which are competition, regulation, safety and prices. While we may come to a view on the best structure, we should not lose sight of those issues.

12:30

Bruce Crawford: As a former council leader who went through the change process, I have a lot of sympathy with Dave Watson's comments.

I want to reflect on the PFI issue. To be fair to the committee, we have been asking the water authorities some pretty searching questions. The authority has been telling us, "Yes, on net cost benefits, PFI is a good idea", but we are still waiting to get information back from them on the whole costs of PFI, from conception to completion, with the costs of consultants and so on chucked in. The evidence from the witness from Morrison Development Partnerships Ltd will help us to build up information on the private sector profits that are taken out of PFIs. I apologise, convener—that point is nothing to do with my question.

The Convener: Is it a teeny question?

Bruce Crawford: Yes.

Efficiency cuts can be a blunt instrument and, if they continue to be made at the current rate, irrevocable decisions might be made. Such cuts can also create uncertainty and I am concerned about some of the rumours that are—inevitably—circulating. I heard a rumour that the water authorities are offering different redundancy packages. Is that true? If so, are you concerned about it?

Dave Watson: One must examine closely the public sector comparator when considering a PFI. I have examined literally dozens of full business cases and I have published our analysis of some of the biggest projects in Scotland.

I heard the witness from Morrison Development Partnerships Ltd talking about risk transfer, and our experience tells us to examine the risk transfer closely. To be frank, in every PFI that we analysed, we found that fanciful, notional figures were put down for risk transfer but, in practice, those figures do not exist. I have friends who are major merchant bankers and who deal with such schemes. They would tell you, "I am a banker. I am not in the business of taking risks with my clients' money". Their role is to minimise those risks down to virtually nothing.

As Alex McLuckie said, either because there is no alternative or for other reasons, the public authority must justify the fact that the raw data in public sector comparator always comes out cheaper via conventional procurement. Then, notional figures are put down for the alleged risk transfer and suddenly—hey presto!—the PFI option is cost effective.

The process in the water industry has not been transparent—members might ask why that should be the case, if the cost comparison of PFI schemes is supposed to be so wonderful. The PFI schemes for the water industry may well be wonderful. I have not seen the details of those schemes, but I have seen the details of most of the other public sector PFI schemes and I have yet to see one that stacks up in cash terms.

Redundancy packages are only part of the problem. It would be wrong of us to leap to the conclusion that we can solve the job problem by throwing huge redundancy packages at everyone—in any event, we have yet to see a huge redundancy package in the public sector being paid to the workers on the ground.

The redundancy issue is about putting money into the system to provide management with what we call change money. In other words, one must build into the financial framework significant amounts of money—millions of pounds—to enable authorities to make some of the necessary efficiency changes. In the private utilities and elsewhere, substantial sums of money have been involved.

In fairness to the commissioner and to the ministers, they recognise that large sums of money must be put into that system to make the changes and to ensure that agreements are reached on job security, management of change and training and development, not only for staff who stay in the industry, but for those who leave it. Voluntary severance packages are also involved. We must reach agreement on those areas.

We have been talking to the Minister for the Environment, Sport and Culture and urge the committee to do the same. We need a financial framework that will put in money to achieve those changes. If that financial framework is established, it will be possible to enter into negotiations.

On Bruce Crawford's point about rumours, it is fair to say that one or two authorities have undertaken partial reorganisations—they have partially responded to the situation—but I do not want to name them.

Our proposed solution is to apply consistently throughout Scotland a co-ordinated and sensible approach that gives people proper job security and that puts in place management-of-change agreements. It would be unacceptable for ESW to apply one rate while NOSWA applied a different one. We believe that the financial framework to be approved by the minister will have to include a substantial sum of money. If that is done, there will be no reason to treat staff in a discriminatory way. Our view is that there should be similar agreements with each of the authorities and that the authorities should collaborate with the trade unions in a partnership to ensure that those agreements are sensible.

The Convener: As no member is indicating that they wish to ask a question, I thank the witnesses for a most interesting session, which provided us with a good historical background to our inquiry. The water authorities will be present at future meetings of the committee and much of what the witnesses said will allow us to develop the context with them.

I also thank the witnesses for giving me another excuse to give to the chief whip when I have not been in the chamber—I can say that I have been suffering from the cross-contamination of the water supply. That sounds like a good idea.

We will now move into a brief private session to discuss, evaluate and prioritise the evidence that we took this morning.

12:35

Meeting continued in private until 12:46.

Members who would like a printed copy of the *Official Report* to be forwarded to them should give notice at the Document Supply Centre.

No proofs of the *Official Report* can be supplied. Members who want to suggest corrections for the archive edition should mark them clearly in the daily edition, and send it to the Official Report, 375 High Street, Edinburgh EH99 1SP. Suggested corrections in any other form cannot be accepted.

The deadline for corrections to this edition is:

Friday 9 February 2001

Members who want reprints of their speeches (within one month of the date of publication) may obtain request forms and further details from the Central Distribution Office, the Document Supply Centre or the Official Report.

PRICES AND SUBSCRIPTION RATES

DAILY EDITIONS

Single copies: £5
Meetings of the Parliament annual subscriptions: £500

The archive edition of the *Official Report* of meetings of the Parliament, written answers and public meetings of committes will be published on CD-ROM.

WHAT'S HAPPENING IN THE SCOTTISH PARLIAMENT, compiled by the Scottish Parliament Information Centre, contains details of past and forthcoming business and of the work of committees and gives general information on legislation and other parliamentary activity.

Single copies: £3.75
Special issue price: £5
Annual subscriptions: £150.00

WRITTEN ANSWERS TO PARLIAMENTARY QUESTIONS weekly compilation

Single copies: £3.75
Annual subscriptions: £150.00

Standing orders will be accepted at the Document Supply Centre.

Published in Edinburgh by The Stationery Office Limited and available from:

The Stationery Office Bookshop
71 Lothian Road
Edinburgh EH3 9AZ
0131 228 4181 Fax 0131 622 7017

The Stationery Office Bookshops at:
123 Kingsway, London WC2B 6PQ
Tel 020 7242 6393 Fax 020 7242 6394
68-69 Bull Street, Birmingham B4 6AD
Tel 0121 236 9696 Fax 0121 236 9699
33 Wine Street, Bristol BS1 2BQ
Tel 01179 264306 Fax 01179 294515
9-21 Princess Street, Manchester M60 8AS
Tel 0161 834 7201 Fax 0161 833 0634
16 Arthur Street, Belfast BT1 4GD
Tel 028 9023 8451 Fax 028 9023 5401
The Stationery Office Oriel Bookshop,
18-19 High Street, Cardiff CF12BZ
Tel 029 2039 5548 Fax 029 2038 4347

The Stationery Office Scottish Parliament Documentation Helpline may be able to assist with additional information on publications of or about the Scottish Parliament, their availability and cost:

Telephone orders and inquiries
0870 606 5566

Fax orders
0870 606 5588

The Scottish Parliament Shop
George IV Bridge
EH99 1SP
Telephone orders 0131 348 5412

sp.info@scottish.parliament.uk

www.scottish.parliament.uk

Accredited Agents
(see Yellow Pages)

and through good booksellers

Printed in Scotland by The Stationery Office Limited

ISBN 0 338 000003 ISSN 1467-0178