TRANSPORT AND THE ENVIRONMENT COMMITTEE

Wednesday 7 February 2001
(*Morning*)

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TRANSPORT AND THE ENVIRONMENT COMMITTEE
4th 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:

Nora Radcliffe (Gordon) (LD)

WITNESSES

Professor Alan Alexander (West of Scotland Water)
Ernest Chambers (West of Scotland Water)
Charlie Cornish (West of Scotland Water)

CLERK TO THE COMMITTEE

Shelagh McKinlay

SENIOR ASSISTANT CLERK

Tracey Hawe

ASSISTANT CLERK

Alastair Macfie

LOCATION

The Hub

Scottish Parliament

Transport and the Environment Committee

Wednesday 7 February 2001

(*Morning*)

[THE CONVENER *opened the meeting in private at 10:18*]

10:43

Meeting continued in public.

The Convener (Mr Andy Kerr): I welcome everyone to the fourth meeting this year of the Transport and the Environment Committee. I have received apologies from Robin Harper.

I would like to express my disappointment that we did not get to Aberdeen on Monday. A lot of hard work and effort went into arranging that meeting and it was unfortunate that it could not take place. The Grampian police advice to motorists was not to travel unless the journey was absolutely necessary and, in those circumstances, we felt it inappropriate to ask witnesses, the public, staff and members to make the visit. We will reschedule all the water witnesses to ensure that we hear evidence from everyone from whom we were going to hear in Aberdeen. This morning we are joined by West of Scotland Water.

Interests

The Convener: The first matter is a declaration of interests by Maureen Macmillan.

Maureen Macmillan (Highlands and Islands) (Lab): I have a bus pass from Lothian Buses, which I am told I must declare because it is worth more than £250. I apologise for not having declared it sooner.

The Convener: Thank you.

Items in Private

The Convener: I ask the committee to agree to take item 5 in private—if we get that far on the agenda. Is that agreed?

Members *indicated agreement.*

The Convener: At our meeting on 14 February, we are taking further evidence in our water inquiry from East of Scotland Water and from witnesses who were going to have been in Aberdeen. The Minister for Environment, Sport and Culture has been invited to appear before the committee on 28 February. I seek members' agreement to meet in private at the start of the meeting on 14 February so that we can discuss lines of questioning for witnesses. Is that agreed?

Members *indicated agreement.*

The Convener: We hope to discuss our work programme at the meeting on 14 February. Is it agreed that we discuss that item in private?

Members *indicated agreement.*

The Convener: At the meeting on 14 February, we also hope to discuss the final wording of our response to the Scottish Executive's consultation on proposed changes to the permitted development arrangements for telecommunications. I suggest that we take that item in private because we are considering a draft response containing a form of words that will not have been finalised by the committee and that has the equivalent status of a draft report. We will ensure that our final response is made public as soon as it is ready and has been agreed by the committee. Is that agreed?

Members *indicated agreement.*

Subordinate Legislation

The Convener: The next item is consideration of the Scotland Act 1998 (Agency Arrangements) (Specification) (No 2) Order 2000 (SSI 2000/3250). Copies of the instrument and a covering note were circulated at our previous meeting. As members will know, we considered the instrument and agreed to seek further evidence from the Scottish Executive. We have now received a letter from the Executive, which has been circulated to members. The time limit for parliamentary action is 16 February 2001, which means that the committee must report on the instrument by 12 February. Are there any comments?

Bruce Crawford (Mid Scotland and Fife) (SNP): Having spoken to the clerk, I realise that it may be too late to raise any objection to the instrument. I am not entirely convinced about the order but, given that it is set out on an agency basis and it is clear that responsibility for monitoring will remain with the Scottish Executive, I do not think that we have any option but to agree to the instrument.

The Convener: Your remarks will be noted in the *Official Report* and will therefore be available for consideration by the Executive and others.

Do members agree that the committee has nothing to report on the instrument, given that Bruce Crawford's comments will be recorded in the *Official Report*?

Members *indicated agreement.*

Water Inquiry

The Convener: We come to the main item of business this morning, which is our continuing inquiry into water and the water industry. Professor Alan Alexander, Ernest Chambers and Charlie Cornish join us this morning. Thank you for the additional submissions to the committee, which we have all read. We would be happy for you to make a short opening statement, should you wish to do so.

Professor Alan Alexander (West of Scotland Water): I think not. We made several points at our previous appearance before the committee and the time today would probably be best spent on questions on the specific issues under consideration.

The Convener: Thank you. That is ideal.

Des McNulty (Clydebank and Milngavie) (Lab): I will deal with "Developing the Public Sector Model", the joint paper from the water authorities. What do you mean by "more room to manoeuvre" to achieve outcomes set by Government? In paragraph 4.3, what do you mean by developing the scope of the water authorities in terms of "market and product mix"?

Professor Alexander: As we say in the paper, we would like to see a move towards influence on the basis of outcomes, rather than control on the basis of inputs. That is the first principle. Given the competitive environment that we are now in and the need to progress as quickly and effectively as possible towards the efficiency targets that were set by the water commissioner, we need greater commercial freedom. That would allow us to enter into partnerships, including some equity sharing and joint ventures, and it would lever resources into the industry and make it easier for us to achieve efficiency targets more quickly.

That would involve an acceptance of what I described during my previous appearance before the committee as cross-sectoral partnerships. Those partnerships would not threaten the public status of the industry, but they would make it easier for us to be effective and efficient in the environment in which we find ourselves. I invite Ernest Chambers and Charlie Cornish to amplify that point.

Ernest Chambers (West of Scotland Water): With the arrival of competition and, as Alan Alexander said, efficiencies, there are reduced opportunities for us to develop in the same way as the industry in England and Wales has developed. If we are to close the gap, we must avoid the mistakes that others have made. It is clear that the industry in England has evolved during the past 26 years and that other utilities have evolved over a period. In order to make progress, we must learn the lessons; we could also cut out a lot of the learning exercise.

Des McNulty: Could you be more specific about the major mistakes that were made south of the border? How can you avoid some of those mistakes? It would be useful if you could identify the mistakes that were particularly costly and how your proposals would benefit in cost terms from those experiences.

Ernest Chambers: Some of the organisational roots have disappeared. For a while, the industry in England and Wales was reorganising every two or three years and each reorganisation had costs, in terms of finance and staff motivation.

In 1994-95, it quickly became clear that no common pattern of organisation had developed in England. Issues arose about how organisational structures work and the industry examined critically how to add value to its services. Inevitably, it found that things were being done in particular ways because that was how they had always been done.

There are clear examples of organisations that, in the past two or three years, have come to understand what work is critical and what is unnecessary, through a mixture of organisational development methods that were backed by technology. We now find that, backed by technology, the process has become much more integrated, linking what the customer needs with how those needs might be met. For example, I know of one company that has recently reduced the number of its out-of-hours centres from nine to two. That company is co-ordinating its work and we can learn from such lessons.

We have reached the stage where some encouraging partnership initiatives and opportunities to learn are being talked about. Charlie Cornish would be better able than me to talk about product mix from the customer services point of view.

Charlie Cornish (West of Scotland Water): It is fair to say that the marketplace for water and waste services in Scotland has changed radically over the past 12 to 18 months. Previously, we would have been considered a core supplier of water and effluent services. Some of our non-domestic customers are considering a range of opportunities, including supply of water and added-value services, such as the design, building and operation of an on-site treatment plant for a private company, although such plants would require funding. Many companies are multi-site companies, with premises in the south. Those companies are considering whether to go for a multi-site deal for the provision of water, waste water management and/or consultancy services.

Those market developments will take us away from our traditional service base. We must be able to respond to the market flexibly by offering added-value services. We must also be able to move outwith our geographical areas—it is clear that the private sector companies in the south are doing so and are moving into Scotland. Unless we have the same freedom and opportunities, we will be hindered and will lose customers and income.

Professor Alexander: It is worth adding two points to that. First, we have made enormous progress in the past six to eight months in developing a relationship with the Scottish Executive. That has brought about consent to the kind of initiatives that the paper implies. We hope that the proposed water services bill will underline the nature of that relationship.

Secondly, on establishing partnerships across the sectoral line—if I may put it that way again—I used to say to my students that, if I could give them all a present, it would be a little plaque that said, "The wheel is a wonderful invention." We can learn from what other parts of the industry have done and thereby improve our model and our efficiency more quickly than may have been possible for others between the late 1980s and the end of the 1990s.

Des McNulty: How would the expansion in the market and product mix and the room for manoeuvre that you refer to impact on the regulatory framework? Given that your company would be a different kind of business, would the current framework need to be adjusted?

Charlie Cornish: The bulk of our business would still be on core service provision within Scotland. We would have to discuss some issues with the regulator—for example, what happens with non-regulated business, which may well be out of the West of Scotland Water area.

Des McNulty: I presume that there are examples down south.

Charlie Cornish: Yes.

Des McNulty: Will you be more specific about what you mean in your paper by "incremental investment" as an option for business development?

Ernest Chambers: What we are trying to say is that we need to establish credibility and to walk before we can run. As Professor Alexander said, there has been a sea change in the relationship with the Scottish Executive. These issues were raised three or four years ago, with regard to external services. At that stage, what we were allowed to do was limited in relation to fee-earning consultancy work.

We are now moving into a situation where opportunities are coming up. Project Aquatrine, for the Ministry of Defence, is one contract in which, if we are to get a reasonable share of the cake for Scotland, an equity stake will be involved—a relatively small amount that will lever in other opportunities. What we were trying to say in the paper was that we are not looking for tens of millions of pounds to make massive acquisitions and to carry out massive expansions. We recognise that we need to walk before we run and that we need to prove that we can make things work. If we do that on a small scale to begin with and gain our spurs, we can take things to the next stage—if that is the way that the market is going. We are talking about an incremental change in direction, not a massive one. If that goes well, the next stage would take place. The question is then balancing the risk with the rewards.

Des McNulty: How would incremental investment affect charges?

Ernest Chambers: That is where judgments will have to be made. Initially, what we do would have to be funded from charges. That is why we need credibility—in order to establish a way forward. At the moment, for the authority to have an equity stake, the money has to come either from charges or from borrowings, which are met by charges. There is no getting away from that, which is why we want to reassure you that this is not a big issue; it is about steady as you go.

Professor Alexander: On Des McNulty's point, part of the reason for wishing to go in that direction is that we believe that it will make it easier for us to defend and retain our existing customer base, especially on the non-domestic side. If we fail to do that, the effect on charges could be dramatic.

Des McNulty: If a venture failed and money was lost, who would pick up the tab? Have you discussed assurances in respect of business failure with the Executive or the banking sector?

Ernest Chambers: In such circumstances, great care would have to be taken with the agreement, to define and limit the risks. We need to walk before we run. Deals would have to be structured to minimise and define clearly the authority's exposure.

11:00

Mr Murray Tosh (South of Scotland) (Con): I read with interest the section on larger-scale investment in the water authorities' submission, which refers to new business, growing the customer base and business development. Ernie Chambers has used relatively low-key terms and said that the expansion would be incremental, but Charlie Cornish took a more ambitious sweep when he talked about expanding your area of operations and going outwith Scotland.

The water authorities have a monopoly that is likely to continue, at least in the domestic sector, and that provides a secure base and a secure income flow from its captive customers—if I may say that without any pejorative undertones. Could that monopoly be seeking to use that base to expand into high-value and higher-margin commercial operations outwith its core territory? Does not that flag up concerns about anti-competitive issues? You have a secure base and you plan to attack the market. Your base customer load provides some protection.

Charlie Cornish: At present, you are right to say that our domestic customer base is secure. If common carriage comes into being on a wide scale, as it has with electricity and gas, that domestic base will be open to challenge. Several private sector organisations are considering bundling services such as gas, electricity and water, to make inroads into the domestic market. The priority of some major private sector companies is the domestic market. They will target that with what they consider core energy services—and water—as well as a raft of added-value services. Competition exists in the non-domestic marketplace. If common carriage happens, competition will also exist in the domestic sector.

Mr Tosh: When that happens—which I admit is some time forward—will you function as a highly commercial and highly competitive business that is like any other utility company in every respect except that it is in public ownership?

Charlie Cornish: Yes. Unless we respond and provide the same levels of service as private sector utility companies do, we will lose business and income.

Ernest Chambers: We need a level playing field. The private English companies have a secure domestic base—that is coming under scrutiny. Public authorities should be able to meet their competitors on a level playing field.

Mr Tosh: The degree of convergence is interesting. Competition law and market forces are driving everyone down the same road.

We are aware that some of the information that you have given us is privileged. We will try hard to respect that status. We will not mention the sums of money, but we would like to clear up why there are such differences. Is the Dalmuir experience that you cite absolutely typical? The answer to that question should give us a clearer sense about the following series of questions on capital investment. Why were the capital costs of the facility significantly cheaper under private finance initiative procedures? Why should the whole-life capital cost be significantly cheaper? Those appear to be the biggest margins.

We considered the operating cost over the 23 years. It was interesting that the conventional procurement method was fractionally cheaper. We wondered whether modelling the PFI procedure over 40 years might have provided a starker contrast. We would like you to explain the differences. What is the impact of counting one procedure on the basis of 23 plus five years and the other on the basis of 40-plus years? Has that distorted the comparison, given a less clear picture and perhaps given less value for money?

Ernest Chambers: We need to put in a caveat: the public sector figure is obviously a best estimate. Moreover, the scheme at Dalmuir was an inherited scheme, which again goes back to the formation of the authority.

You asked me to explain the differences. The first major difference is that the public sector initial project was on a bigger scale. Back in 1994-95, if one built a works that one then had to extend within five or 10 years, it would have been said that an inquiry was needed into why that works had been extended. The public sector comparison is based on a 700,000 population, as against the private sector one, which is based on a 600,000 population. The latter figure is reasonably close to the current population. That population may grow, and additional areas may be brought in. The projects are therefore slightly different in scale, which helps to explain part of the capital difference in the costs.

The explanation of the capital expenditure replacement costs again comes down to risk. In 1994-95, it was presumed that there would be a conservative replacement policy in the public sector to ensure that there was no risk of failure. As we have learned, the PFI contractor takes a different view. To an extent, that is reflected in operating costs. The contractor obviously anticipates slightly higher operating costs. Dalmuir was unusual in that the public sector comparator was different.

You ask about the periods of the estimates. The estimates are based on the operating costs over the periods and can be compared on that basis. In the PFI contract, there is a 25-year concession and the contractor has to leave the project in a state that will allow it to run for a further five years. At the end of the 25-year period, the contract will go out to retender. The authority would then have the opportunity to bring it in-house. If that was its decision, the costs incurred in compensating the existing contractor would then come out of the external finance limit settlement. That would come back on to the balance sheet.

The operating costs are comparable, with the slight difference that the public sector anticipates a higher level of maintenance. Various issues arise. Do you replace control systems after seven years or 10 years? Do you wait until they show signs of breaking down? What is the obsolescence time for electronics? A more conservative view of those issues was taken in the public sector.

Those issues are part of the wider challenges that we now face when we consider adopting best asset management. We have to find ways in which we can reduce our investment programme.

Mr Tosh: So the lower capital cost of the facility under PFI is largely because of the lower population to be served by the facility, rather than because of the superiority of the procurement process.

Ernest Chambers: It is a mixture. Part of the reason is size. The contractor also opted to use fairly innovative technology—what it calls a compact plant. That meant that it avoided building as much concrete and steel. We have to take the population into account, but also the fact that the contractor introduced a technology that had not previously been considered to shrink the size of the plant.

Mr Tosh: It is not that we are after commercially confidential information, but we are anxious to identify the extent to which that procurement method gives you better value for money. Can you give us a better quantification? When you say that the capital cost is lower partly for one reason and partly for another, we do not know how much better the capital element of procurement is as opposed to the population element. I cannot ask you to give a figure right now—I am sure that that would not be commercially appropriate—but we want further information, if possible, so that we can analyse the superiority, as you argue it to be, of the PFI process.

Did I pick up correctly what you said about the whole-life capital expenditure cost? Under both systems, are you calculating the cost over 23 years?

Ernest Chambers: Yes.

Mr Tosh: So the 40 in the table does not come into the equation?

Ernest Chambers: The 40 refers to the design life.

Mr Tosh: Is there a depreciation element? If we apply depreciation over 23 years in one model and over 40 years in another model, do we not get a distortion?

Ernest Chambers: No, I believe that the financial analysis has been done on a comparable basis.

Mr Tosh: Okay—

The Convener: Murray, I have to interrupt—I understand from the technicians that we are not being recorded, which impacts on the official reporters. We will have to adjourn for a few minutes. I apologise for that. I also apologise for the fact that the room in which we are having this rescheduled meeting is so cold. Perhaps we should all huddle round the heater while the recording system is sorted out.

11:10

Meeting adjourned.

11:15

On resuming—

The Convener: I reconvene the meeting and apologise for that short interruption. This meeting is doomed in many ways, but let us proceed. We were getting into the technicalities of funding issues.

Mr Tosh: I think that we had addressed depreciation, but there is a lingering concern that we are not comparing like with like. Under this 23 plus five-year agreement, is the built-in investment sufficient to equip the plant for a 40-year life, so that it can be compared with the 40 years that you would have had under the conventional procurement procedure, or will there be a further requirement for capital investment to achieve that 40-year life? If so, can the investment be quantified? If it can, we will feel that we are comparing like with like.

Ernest Chambers: The contract is clearly worded such that the PFI contractor has the 23 plus five-year period to provide the service. It is likely that beyond the 28-year period there will be a need for further investment. Part of the concern is what the standards will be at the end of that period. That has to be part of the thinking, because we have seen many changes in standards. Because of concerns about standards, we have since the early 1990s moved away from building plant that has an 80-year life cycle. For example, the Muirdykes water treatment works in Renfrewshire was finished in 1967. It was expected that it would have an 80-year life cycle, but it was knocked down in 1990. The Overton plant in Greenock, which opened in 1970, was knocked down three years ago.

The pace of technological change was so quick and the increases in standards were happening so rapidly that we had to address the situation. The solution that we adopted was to move to the concept of a water factory. We decided to use typical factory units with plant that can be removed. The plant in flotation plants probably has a life span of 25 years, and that in membrane plants has a life span of 10 years. We are hopeful that in 25 years' time we will be able to strip out the plant and replace it with what is then current. There has been a change in philosophy and the aim of designing plant to last 40 years has declined somewhat. A reasonable prospect is 23 or 28 years, but with the knowledge that at the end of that period standards may have changed and there may have to be further investment.

If it would help the committee, I can take this back and see whether remodelling makes any difference to the figures quantifying how much is due to process and how much is due to scale. I can also look at the financial analysis to see whether we can refine it further.

Mr Tosh: That would be helpful. I understand the point that you are making. I remember Councillor MacLean, the convener of the relevant committee in Strathclyde, telling me about when he went to open a new sewage treatment plant in Fort Matilda in Greenock. By the time it was finished, it already failed to meet the new European directive, so substantial further investment was required. I suppose that your current PFI project is catching up with that.

Ernest Chambers: That is correct. The screen chamber was built at Battery Park, adjacent to Fort Matilda. First, the process was not right; secondly, it had been difficult to build a full-scale works on that site, which is why we are now building it at Underheugh quarry.

Mr Tosh: We still have concerns though. Under the traditional method, you would try to plan a 40-year life, whereas under PFI you are aiming at 28 years, so you are not necessarily comparing like with like. You offered to remodel that—that would be useful. We are not trying to prove anyone right or wrong; we are simply trying to get at how you weigh up the advantages when you decide which procurement method gives the public the best value at the end of the day.

Ernest Chambers: You will never get a perfect answer, because an element of judgment is involved. It depends on what happens when you go out to contract. It is a matter of our making our best judgment. However, I am happy to put that in a letter to the clerk, if that would help.

The Convener: Thank you.

Mr Tosh: The other significant disparity that is shown in the table of comparative costs concerns the whole life service fees. There is a 125 per cent difference. Do you need to add anything to that to clarify the difference?

Ernest Chambers: Again, that is a function of the contract. I will remodel that to check that it is on a comparable basis.

Mr Tosh: I move from the tables—on which we will receive further information—to risk transfer, which has featured heavily in the evidence that we have heard.

The Unison representative at last week's meeting said that in every PFI Unison had analysed—and he made it clear that it had not considered any of the water treatment ones—it found that

"fanciful, notional figures were put down for risk transfer but, in practice, those figures do not exist."

He went on to say that

"notional figures are put down for the alleged risk transfer and suddenly—hey presto!—the PFI option is cost effective."—[*Official Report*, *Transport and the Environment Committee*, 31 January 2001; c 1583-84.]

He was pretty damning about risk assessment.

Can we measure risk accurately? Can we cost it sufficiently precisely to know that consortia dealing with public sector bodies are not inflating the price of risks? Could it be that you are seen as a relatively cash rich sector, especially later this year when the new charges come in? It might be thought that you are on to a good thing and that the real risks are pretty low, in which case you might be taken for a ride. The evidence that we took last week suggest that that is the case—this is your opportunity to put your case.

Ernest Chambers: It is difficult to attach figures to risk, partially because there was really no alternative on those particular contracts because of timing and availability of finance. That was the only procurement route open to us. Our negotiators endeavoured to minimise the risk transfer.

There is no doubt that a pattern develops whereby there is a relatively bullish attitude to risk before the preferred bidder stage. Once you get to that stage, it becomes a difficult negotiating process. In our case, it was especially difficult because we were negotiating against a deadline. There is considerable pressure to try to return risk. We went through a careful process—especially on the waste treatment contracts—of allocating risk to whoever was most appropriate. For instance, on the contracts, the risk to do with the domestic population rests solely with the PFI contractor. It was believed that that was reasonably predictable and that the contractor could take a view on what was likely to happen to the population over the period of the concession. That could then be costed in an acceptable way without putting figures on it.

In the non-domestic sector, a factory closure could have a dramatic impact on the load on a plant. Transferring all that risk to the PFI contractor would be likely to lead to unacceptable increased costs, so the mechanism that was chosen was to cap the amount. The contractor would be liable for some of the risk—a change in the load from the non-domestic sector—but beyond that, the risk would fall back on the client. A careful analysis was made, with advisers, to allocate risks in what was perceived to be the most appropriate manner. However, that is not an exact science.

Mr Tosh: We know a wee bit about major procurement, as the Parliament must procure a fairly significant capital project. We understand that risks are shared among the client and all the contractors. What is different about risk allocation in the PFI and private-public partnership process as compared with conventional procurement methods, and how does that difference affect the final cost—and therefore value for money?

Ernest Chambers: The big difference is that the risks in a traditional procurement contract relate to unexpected circumstances, such as rock or unsatisfactory ground conditions. Those risks tend largely to be in the construction phase. In our projects, another major risk is that the process will not work. A contractor may say, "This plant will meet the specification," but when push comes to shove the plant may not comply. Then, the contractor must undertake further works.

For one water contract, the process did not work effectively—the plant reached only a certain level and could not achieve the full design throughput. It cost the contractor a considerable sum to address that. Dealing with such issues is built into the tendering process.

Under the PFI procedure, the contractor or consortium is responsible for operation, so it must make a further assessment about how to handle risks during that period. That comes back to the figures that we discussed on investment during the contractual period and the amount of money that should be spent on modernising the plant.

As a consortium comprises several parties, it can share the traditional construction risks and the process risks to some extent. The consortium can transfer most of the construction risk back to the construction venture and most of the process risk back to the process venture, leaving the consortium to pick up the overall risks. The situation becomes complex when a consortium of three, four or five parties is involved. There are risks between the client and the consortium, and internal risks. All those have costs built in.

Mr Tosh: I should have gone to a night class to equip myself to ask my questions. I would like to get this right. The consortium bears a range of operational and process risks, which are reflected in its tender price to you. You pay it to carry that risk. What assurance do we have that that method of procurement gives us better value than a conventional procurement method under which you and your conventional contractors carry the same risks?

Ernest Chambers: To an extent, time will tell how that works out. We are in the early stages. We believe that our contracts allocate risk in the best way. Time will tell whether that judgment is right.

The Convener: Des McNulty, Bruce Crawford and Bristow Muldoon want to ask supplementaries. I am bearing the time in mind, but if the questions are on the same issue, I am happy to take them. Des, what is your question on?

Des McNulty: Dalmuir.

The Convener: We will receive clarification of the figures involved.

Des McNulty: I was going to ask for a specific element in that clarification, but perhaps I will do that in writing.

The Convener: Thank you.

Bruce Crawford: I will quickly make a point, but before I do that, I want to clarify one thing. May I refer to the costs in the earlier papers that we received—the white papers that contained PFI company bid costs and are now in the public domain?

The Convener: Yes, as long as you do not touch on the costs on the blue private paper.

Bruce Crawford: I will not touch on the blue paper.

I am interested in the design risk transfer, particularly how it affects the normal procurement processes compared with public-private partnerships or PFI and especially when the PFI company bid costs £1 million more than it would have cost to do it through the public sector. Is a lot of the design risk taken by the PFI company at that stage because it spends more on that part of the process? Is there a real transfer of risk? I would like you to explain that.

11:30

Ernest Chambers: The increased contractor costs relate to financial and legal advisers rather than design costs. I do not believe that significant further costs will be incurred in designing the plant. The costs arise because of the complexities that are involved in having a number of parties, all of whom have their own financial and legal advisers. That makes the clock tick up quickly.

Bruce Crawford: Would it be possible for the public sector to spend more money on design at the start of the project and thereby bring the cost closer to the cost under PFI?

Ernest Chambers: I believe that the public sector costs are the costs that are reasonably incurred in ensuring that the project will achieve its specification.

Bruce Crawford: So there would be no need to do what I suggest.

Ernest Chambers: That is correct.

The Convener: Did you want to ask a question, Bristow?

Bristow Muldoon (Livingston) (Lab): I am happy to pass at this point because my question related to the direct comparability of the two processes.

The Convener: We will deal with that when the relevant paper is submitted.

Mr Tosh: I would like to ask for a little clarification of the company's investment strategy. The briefing that we have been given tells us that WSW is procuring three major waste treatment plants through PPP. Mr Chambers, can we reasonably equate the rest of your capital requirement for sewerage and water to your external finance limits? Do you fund the rest of your procurement through your borrowing or do you use an element of your current charges to fund investment? For that matter, do you borrow to carry out maintenance work and fail to match long-term funding with long-term investment?

Ernest Chambers: Your question relates to one of the major changes in the past five years. In the time of Strathclyde Regional Council and Dumfries and Galloway Regional Council, all the investment was funded from borrowings. This financial year, however, about 50 per cent of the investment is coming from borrowing and 50 per cent is being funded through charges—the investment programme this year is of the order of £180 million and our borrowing limits are of the order of £90 million. Next year, slightly more will be funded from charges than from borrowings. There has been a distinct change, in line with what has happened south of the border.

Mr Tosh: In previous evidence and in one of the papers that we have today, you talked about not seeking significantly increased borrowing consents because you feel that, as it is, you are taking on sufficient long-term debt. Surely if a high proportion of your investment is being carried by charges, it would make more sense to borrow all the money over the long term. We feel that one of the reasons charges to consumers are so high is that so much is being paid from current expenditure. We think that it would be more economical for the customer if the investment could be funded from longer-term borrowing. I do not know why you advise us that that is not sustainable. It seems logical to me that you should be borrowing more to fund long-term expenditure.

Ernest Chambers: We are advised that, while that would be more economical in the short term, a large debt mountain would be built up that would have to be serviced in subsequent years. Concerns have been expressed that if the long-term investment programme were to be entirely funded by borrowing, the financial viability of the authority would come under scrutiny. At the moment—by circumstance rather than design—our turnover to debt ratio is pretty close to that of English companies. If we had continued to fund all our investment from borrowing, that would have become distorted and would have be a millstone around the necks of our successors in their attempt to create a level playing field in 10 or 15 years' time.

Some of our board members, who are more knowledgeable than I am in this area, have expressed concern about the long-term debt. To make the businesses viable, some of that debt might have to be repaid. While borrowing presents an opportunity in the short term, it is a threat to the viability of the authorities in the long term.

Mr Tosh: I understand that, but you have just confirmed that if you had the choice you would not seek to borrow much more. That is the point at which you lose an amateur like me. The way I plan my life—following the Margaret Thatcher approach, you understand—if I know that I cannot buy a house in five years, is to take out a mortgage to allow me to do so over 25 years. I have found that the more economical way to procure the place where I live. In simple terms—and this is the Professor Anderson argument, if I may mention his name in your presence—if one tries to fund major works over five years, one is burdening the consumers and customers of 1999 to 2005 with costs that ought to be borne by consumers in the next 30 years, as they will benefit from the assets. Is not your thinking the wrong way around?

Ernest Chambers: We must recognise that, traditionally, charges have not been sufficient to sustain a long-term business.

Mr Tosh: I am not disputing that charges probably had to rise.

Ernest Chambers: One of the big issues that will become increasingly important is that, having established modern plant to provide the services people expect, we cannot go back to a situation in which we cannot maintain them. We need to recognise the sophistication of the plant. The life expectancy of the electronics is around seven to 10 years. We have to ensure that we have enough money to allow us to modernise, to maintain standards.

We have largely completed the replacement and renovation of water plant and are starting to provide new waste water plant. Shortly, we will have to think about modernising plant. That would almost certainly be better funded from revenue than borrowings. We would get into trouble if we had to make big investments for maintenance when we had outstanding high debt levels. We are bringing the charges up—much too quickly, which is to be regretted—and that will bring us to a sustainable and viable situation much earlier than would otherwise be possible.

Mr Tosh: Last week, we heard evidence that suggested that an appropriate way to do that might be through bonds. If you were a public sector trust and were able to raise funding through bonds, would that be a more effective way to sustain your programmes? Would that have an advantageous impact on customer charges?

Ernest Chambers: It would help in the short term, but it would still leave us with a long-term problem of what we could do when the bonds were used up. The indications are that bonds would cost us more than borrowing in interest rates.

Mr Tosh: Another witness raised questions about the transparency of the process and about whether the benchmarks, the public sector comparators and the PFI business cases were fully transparent. The witness from Unison whom we met last week gave us to understand that he had been unable to examine the waste water treatment business cases.

What requirements are there in terms of transparency about business cases, internal comparisons and benchmarking against companies south of the border? Are you meeting those requirements?

Ernest Chambers: In relation to PFI contracts?

Mr Tosh: In relation to everything really, because there is a broader issue of comparative costs. Everything impacts on charging to the customer. We want to know about the whole process of what you do, how you pay for it and what you charge people.

Ernest Chambers: With the appointment of Alan Sutherland and the introduction of combined cost and economic regulation, there will be transparency. At the moment, we are going through a process with the commissioner. He has looked at the operating costs and come up with a view and we are looking at the quality and standards process. The drinking water regulator and the environment regulator are identifying quality issues. A price will be put on that, which is still being defined. Alan Sutherland will then take a view on the capital efficiency—whether the customer will get value for money—and there is little doubt that he will ask us to procure our individual projects at a lower cost that is more in line with what happens in England and Wales. Transparency will come through the commissioner, both in setting the targets and in monitoring whether the outputs that are being achieved reflect the costs that were provided in the estimates.

Mr Tosh: Do you divulge to him everything he needs to know? What information on business cases goes beyond him to us and to the wider public?

Ernest Chambers: We have to divulge the information he wants. Although there are confidentiality clauses in relation to the PFI, they are worded in such a way that information will be made available to members of Parliament or to the Executive if requested.

The Convener: We are under some pressure for time. Are there any other supplementary questions on finance issues before we move on to water quality and investment?

Bristow Muldoon: I would like to ask another question. You mentioned the fact that current debt levels in the Scottish water industry are broadly comparable with those in the English water industry. To what degree is that distorted by the major write-off of debt that occurred in the English water industry during the privatisation process?

Ernest Chambers: That is the outcome of that process. We need to recognise that, in 1996, the inherited debt from local authorities was £1.7 billion, which was reduced to £1 billion, so there was a £700 million write-off. There are certainly figures that indicate that that was a comparable level of write-off to that in England and Wales. The jury may still be out on that. The situation in England and Wales was complex because there was debt write-off and a green dowry. There have always been arguments about just how much that cost, but I believe that the Scottish Executive takes the view that the £700 million write-off in Scotland was comparable to what happened in England and Wales. However, as I say, there is some debate about the true position.

Maureen Macmillan: I have some questions on water quality and the investment that is necessary. I know that you can speak only for West of Scotland Water, but do you believe that you received a fair inheritance of plant infrastructure and debt when the three authorities were set up in 1996? What have the implications of that inheritance been for current operations?

Ernest Chambers: We received what we received—I should be careful about what I say—as I had been involved in that process for some time beforehand. When water was under councils' control, their ability to invest was extremely limited. In Strathclyde, in 1980-81, the investment in water was about £7.5 million. Some £4 million or £5 million of that was spent on extending the system. Several new communities were being established at the time and the money that was available was largely spent on extending the system to meet the increased demand. The implication of that was that only about £2.5 million was available to modernise the rest of the system.

11:45

The pattern of investment began to change in the early 1990s, when more money became available to meet the requirements of the drinking water regulations. If we compare our assets with those in England and Wales, we can see that conditions are comparable in our water treatment works. That is true in the west, but I cannot comment on the other water authorities. The vast majority of West of Scotland Water's waterworks have been modernised or replaced since 1987.

The situation is not positive in relation to the networks, however. Because of the commitment to treatment works, the majority of the money was spent on that and very little was left for the network. We have some 16,500km of mains and we think that 8 million metres of those are in a condition that will require renovation or renewal over the next 15 to 20 years.

Maureen Macmillan: I notice what you have written about the investment in the networks in Argyll. I am sorry that there are no representatives from the North of Scotland Water Authority here today, or we could have asked you all to compare the impact of having a large rural hinterland to deal with. I wonder about the amalgamations and the establishment of West of Scotland Water, NOSWA and East of Scotland Water and whether there was a fair inheritance for the new authorities.

Ernest Chambers: I do not think that that was a big feature of the amalgamations. The question was the logical supply arrangements. There was an element of history in that, as Argyll was part of the Strathclyde area. Dumfries clearly linked in, with the benefit that we now supply cross-boundary services. I do not think that the asset condition was a big feature at that stage. People were more concerned about the historical supply arrangements and the political boundaries. Out of that came the situation that we have today.

Maureen Macmillan: The Executive's consultation document on water standards lists three options for quality and investment, which have been described as the Rolls-Royce, the Mondeo and the Mini. I would like your views on the pros and cons of those three options. What do you think would be the implications of the chosen option, the Mondeo?

Ernest Chambers: The investment plans have to be seen as a sensitive balance between absolute investment needs, what we could do if we had an unlimited pot of money to provide Rolls-Royce services, and affordability for customers. At the moment, and throughout the consultation period, a significant proportion of expenditure has been committed to statutory requirements. In the current year, some 80 per cent of investment is committed to meeting statutory deadlines. European directives on drinking water, urban waste water treatment, bathing water and shellfish, and the United Kingdom cost-benefit analysis must all be taken into account.

The discretion relates to the speed with which we can begin to address network issues and bring the system up to scratch. From a customer service perspective, the more investment we can commit, the quicker we will be able to deal with historical problems. In the west, there are about 400 houses that we know are at risk tonight of flooding from the sewers—depending on weather conditions, those 400 houses could find themselves flooded with sewage. The speed with which we can address that risk depends on how much investment we can commit. In some areas, there are repeated dirty water problems and pipes are bursting too often. The quicker we can spend money, the quicker we can give customers the service that they want.

The balance is affordability. I think that, despite the lack of investment, the vast majority of customers can still take the service for granted. They can go to the tap and run water that does not smell or taste of anything and they can pull the plug and the water goes away. Why should those customers pay more money for investment in esoteric things such as beaches?

There is a sensitive balance between the customer services requirements and what is affordable. We need to go through the consultation process and then make what is almost an onerous decision about the right way forward.

Maureen Macmillan: Do you think that we need more customer education?

Ernest Chambers: That would be helpful. The trouble is that there are two polarised customer groups. There are the people who are receiving a satisfactory service and are probably wondering why we need to spend all that money and there are the people whose service is not satisfactory and who want immediate improvements.

Maureen Macmillan: People cannot afford to do it on their own. As I well know, many rural communities do not even have water piped to them; their systems need a lot of investment.

Ernest Chambers: Yes. In the west, there are about 1,030,000 houses, all but 19,000 of which are connected to the water supply system. If we used the normal connection criterion of £1,000 per property, we could not extend the system to any of those 19,000 properties cost-effectively. As part of our rural policy, we have made a considered decision to invest £1.5 million a year to extend supplies. That will address the supply to about 5,000 to 6,000 of those properties over the next 15 years. It is very costly—up to £20,000 per property—to extend the supplies. Again, we need to strike a balance between the aspirations of individuals to be connected to the system and what the rest of the customers are prepared to pay.

Maureen Macmillan: I realise that you will probably never be able to connect everyone, but how long will it be before most rural customers are connected to the mains? Will it be 10 years, 20 years or even longer?

Ernest Chambers: We believe that we will be able to deal with the groups of properties—half a dozen houses in a hamlet and so on—within 15 years. I do not think that we will ever be able to deal with the shepherd's cottage. We estimate that there are about 10,000 to 12,000 houses in the west that would cost more to connect than is reasonable, unless we were in an extremely strong financial position.

Maureen Macmillan: Thank you.

The Convener: There are several more subjects to cover. It would be helpful if members and witnesses kept questions and answers fairly pointed.

Bruce Crawford: We have about five or 10 minutes left.

The Convener: We can push it a wee bit.

Bruce Crawford: Good, because there are some meaty questions to be put. We might not get through them today, so perhaps we could ask for further written answers.

One issue that is beginning to cause some concern and give rise to comment in the press is that of the efficiency savings targets that have been set by the water commissioner. I notice that appendix 3 of your submission contains a useful list of areas in your operating costs where you can start to make a difference and achieve efficiency savings of £66 million per annum by 2005-06. As one might expect, the trade unions that represent the water industry staff are concerned about the impact on jobs. The seventh bullet point of paragraph 3.2 suggests that productivity and flexibility

"will lead to a reduction in staff numbers".

Some of the information would suggest that as many as 2,000 jobs are at risk in the water industry because of the efficiency savings that need to be made. What models have you produced to evaluate the impact on staffing levels from now to 2005-06? That is something that should be considered in terms of overall

Government policy, rather than just the impact on the water industry.

Professor Alexander: I will make a brief general point before handing over to Charlie Cornish to pick up on the specifics. We have said to the commissioner that the target is challenging, but achievable. One of the reasons that we have been able to say that we think that it is achievable is that we have used the time between now and when his target period begins—2002—to begin investigations into our efficiencies and, by extension, our inefficiencies. We are trying to get ahead of the game in the 15 months between now and when the commissioner's clock begins to tick.

Charlie Cornish: Over the best part of the past year, we have been examining many areas in which we might be able to improve productivity and efficiency and ultimately make cash-releasing savings. Many of the projects are still at an early stage and we have not concluded what level of efficiency we can get through them. For example, on non-capital procurement, if we have an opportunity to achieve greater discounts, we may make significant savings—millions of pounds rather than hundreds of thousands of pounds. There are other areas where efficiency savings do not impact on staff, such as better transport management, procurement and energy efficiency. We also need to consider the work that consultants and contractors are carrying out in West of Scotland Water. If we can skill our people and resources to a sufficient level within a reasonably short time, that will present an opportunity for achieving a cash-releasing efficiency that will not have a significant adverse impact on staff.

It is probably true to say that realising £66 million of efficiencies by 2005-06 will result in changes to the staff profile of West of Scotland Water in terms of numbers, skills and areas of work. However, at the moment it would be very difficult to put figures on that.

Bruce Crawford: It may be difficult, but I want to press you on it. In most public sector organisations, 60 to 70 per cent of fixed costs relate to staffing. What are your overall operating costs, and what percentage of those is the wage bill?

Charlie Cornish: In round terms, we have operating costs of about £225 million and a pay bill of £75 million. Wages represent a significant proportion of the overall cost.

Bruce Crawford: Are you saying that, although there are many areas that you can investigate, the number of job losses could be significant? I realise that you cannot give us figures at this stage, because you are working through the models.

Charlie Cornish: It would be reasonable to reach that conclusion. The issue is tied into the many reviews of areas where we can generate new business opportunities. If we generate new business opportunities and secure new contracts, that will give us an opportunity to move staff into productive work where we are generating income. However, it is likely that, by 2005-06, the total number of employees in West of Scotland Water will have fallen.

Professor Alexander: One thing that makes it difficult to be specific is that, even before we come up with a ballpark figure, we must go through all the consultation processes with the work force, through our partnership agreement. We will be moving towards that over the next few months.

Bruce Crawford: In that case, when will you be in a position to make reasonable assumptions and projections about the impact on the work force by 2005-06?

Charlie Cornish: Sometime over the next six months, we will sit down with our trade unions to initiate their involvement in the efficiency projects. By that time, we should be more able to produce indicative numbers.

Bruce Crawford: Finally, I want to ask about the case for a single authority. We all want more information on the benefits of having three water authorities compared to the economies of scale that can be achieved by a single authority. As a council leader, I was heavily involved in the difficult disaggregation process—particularly in the Tayside area—and I know about the many difficulties that arose and the great effort and time that was involved. I know that it will be difficult to put the answer in a nutshell, but are the economies of scale that would be achieved through a single authority outweighed by the aggravation of getting there?

Professor Alexander: I wish that there were a simple answer to that. As you imply, there is no doubt that there are some economies to be gained from having one authority rather than three. However, as you also suggest, those might be bought at too high a price.

The position of my board is that any decision to change the structure of the industry would leave us with two clear responsibilities. First, we should make the transition as effective, efficient and fast as possible. Secondly, we should ensure that, during any transition period, nothing compromises the investment programme, the search for efficiencies or the service to our customers. Once that is put into the calculation, we might get closer to making a judgment. However, I do not find it easy to say much beyond that. Charlie, do you want to comment on that?

Charlie Cornish: No. I think that that is fair comment.

12:00

Professor Alexander: I honestly do not think that we can go into any more detail. We have already considered some of the economies and efficiencies that might be won by collaboration among the water authorities. However, any calculation must include considering whether greater efficiency can be won by changing the structure of the industry and whether the cost of reaching that point is bearable. We do not yet know the answer to those questions.

Bruce Crawford: The issue is obviously fundamental to our consideration of the final shape of water service delivery in Scotland. Perhaps a bit further down the track we could receive some written evidence from West of Scotland Water—or from an amalgam of the water authorities—giving some more considered thought about the benefits or disbenefits of both options.

The Convener: That evidence would be useful, as we will ask the question of each water authority. You will want to ensure that your views are made known. Obviously, we would also be interested in any collective view.

Professor Alexander: It might help the committee if we took some information from what we call our new project, which was a collaborative study undertaken in the run-up to Christmas. If we can reach some conclusions based on that joint paper, we will feed them to the committee.

The Convener: Okey-doke. Bruce Crawford has another appointment to attend, so I will move to John Farquhar Munro.

Mr John Munro (Ross, Skye and Inverness West) (LD): Have we got time?

The Convener: Yes. I will push things a wee bit.

Mr Munro: There was some discussion about competition within the industry, which I am sure is a matter of concern to you and many of your customers. How would such competition affect your efficiency and profitability? Any competition within the industry will happen in the more populous urban areas rather than in the remote rural communities.

Professor Alexander: Charlie Cornish will be able to provide some detail on that question. However, I will say that the key issue for the industry will be the rules that govern competitors' access to the domestic market in particular. We should distinguish between competition that we might face in the domestic market and competition that already exists in the non-domestic market. Those two quite different issues must be addressed in different ways.

Charlie Cornish: We are currently engaging most of our major non-domestic customers. For example, we have introduced a key account management framework, through which we will provide different types of services and deals. We have also secured long-term contracts—ranging from three to five years—with many of our customers, which takes them out of the immediate competitive market for that period.

One of our major concerns is the multi-site deal, where companies have headquarters in London, Birmingham or Manchester. Decisions about the future provision of consultancy, management contracts for water or waste water contracts are often taken outside Scotland and unbeknown to local people. We need to move into that area of development both to protect income in Scotland and to generate new income outwith Scotland.

As Alan Alexander has pointed out, the key issue for the water industry in Scotland as far as the domestic sector is concerned will be the establishment of the right access charges for potential new entrants to the market. If that does not happen, new entrants will be able to come in and cherry-pick certain groups of domestic customers, which means that revenue will drop and charges may have to increase.

The Convener: Just for the record, could you tell us what you mean by "the right access charges"?

Charlie Cornish: The right access charges will have to take account of the operating cost—the real cost of providing the service within the local area—and the costs of meeting a fairly substantial investment programme throughout the West of Scotland Water area. The charges will not be based on a particular cost for a service that is delivered from a particular treatment plant.

Mr Munro: There is a conception that the industry would be interested only in whether market opportunities exist. That concerns me, because I do not think that remote and rural areas provide such opportunities. Coming from the west Highlands, I note that NOSWA has been serving small communities by spending millions and making tremendous efforts to provide water and waste water treatment plants. I would hate to think that the industry will be market driven in future and will disregard the important needs of rural communities. I hope that you will consider that issue.

I return to my earlier point about the commercial customers being attractive to everyone. Have you made any calculations about or devised any criteria regarding the effect that the loss of that customer base might have on the competition? It is obvious that the competition will direct its attention at that area.

Professor Alexander: Again, Charlie Cornish will be able to provide some details. The general principle is that we have a high fixed cost and that, if we lose the revenue from big non-domestic customers, we still have to maintain the asset. As our costs do not decrease in line with any revenue loss, it is important that we retain those customers. As I said at the committee meeting on 12 December, the additional cost of maintaining assets that are no longer entirely necessary or used goes straight to the domestic customer.

Charlie Cornish: That is fair comment. It is probably also fair to say that there has always been competition in the non-domestic market. For example, companies have become involved in waste minimisation, water recycling and the construction of on-site treatment plants. Such issues are real threats to our current levels of income.

West of Scotland Water's top 50 or 60 customers generate significant sums of money—about £40 million or £50 million—for us. Over the next year or two, we will be seeking to secure those customers on long-term deals, although that will partly depend on their ability to access markets and decision makers outwith the West of Scotland Water area. Undoubtedly, we could lose significant income if we get things wrong.

The Convener: Our time is very limited, and I want to hear your views on two specific issues before we close the meeting. There will be an opportunity to follow up on areas that we did not manage to discuss today. First, our witnesses have felt that either we should be totally excluded from competition in the short to medium term or there should be a phased introduction of competition. Do you think that either option would be legal or desirable? Secondly, will you also briefly address the issue of mutualisation, which has been raised in our discussions? If you could bundle up both questions, we could bring this session to a close.

Professor Alexander: In answer to your first question, if the Scottish Executive can find a way of phasing in competition over a five to seven-year period, that would help to ensure a level playing field and would provide some protection against the cherry-picking that Mr Munro mentioned. As for the legality of phasing in competition, we would have to defer to the Executive's lawyers. However, we have received advice that any attempt to exclude us completely from the Competition Act 1998 or European competition laws would be a case of hunting the snark. The management of competition is within the competence of Scottish ministers and the Scottish Parliament.

As I thought that the issue of mutualisation might come up, I took the opportunity to read the analysis of the pros and cons of the proposal in the 1997 water services review. At that time, there were powerful arguments against mutualisation as a way of running the industry. Not much has changed since then to undermine that view; indeed, given the pressure on us to achieve efficiencies quickly over the six-year period up to 2006, I cannot see how mutualisation as a way of structuring and managing the industry provides us with any great incentive. Perhaps my colleagues would like to comment.

Ernest Chambers: Mutualisation has become an issue north and south of the border, and our paper highlights the difficulties of establishing the management arrangements. Although it might make life easier for the Executive from a corporate governance point of view, it is not a terribly productive way forward at this time.

The Convener: Thank you very much. I look around the room and see a number of frozen individuals; indeed, I thought that our water inquiry was going to turn to ice halfway through this morning's proceedings. However, Murray Tosh heated us up by raising the prospect of Mrs Thatcher.

Although the meeting was quickly arranged because of difficulties with our visit to Aberdeen, we have had a good session and will follow up some of the issues that were raised, such as modelling. I appreciate our witnesses' presence this morning and thank everyone in the room who has managed to bear the cold climate.

Meeting closed at 12:11.

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