The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

INFRASTRUCTURE AND CAPITAL INVESTMENT COMMITTEE

Wednesday 21 September 2011

Session 4

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INFRASTRUCTURE AND CAPITAL INVESTMENT COMMITTEE
4th Meeting 2011, Session 4

CONVENER

*Maureen Watt (Aberdeen South and North Kincardine) (SNP)

DEPUTY CONVENER

*Jamie Hepburn (Cumbernauld and Kilsyth) (SNP)

COMMITTEE MEMBERS

*Jackson Carlaw (West Scotland) (Con)
*Malcolm Chisholm (Edinburgh Northern and Leith) (Lab)
*Neil Findlay (Lothian) (Lab)
*Adam Ingram (Carrick, Cumnock and Doon Valley) (SNP)
*Gordon MacDonald (Edinburgh Pentlands) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Richard Ackroyd (Scottish Water)
Professor Gordon Hughes (Water Industry Commission for Scotland)
Ronnie Mercer (Scottish Water)
Douglas Millican (Scottish Water)
Alan Sutherland (Water Industry Commission for Scotland)

CLERK TO THE COMMITTEE

Steve Farrell

LOCATION

Committee Room 3

Scottish Parliament

Infrastructure and Capital Investment Committee

Wednesday 21 September 2011

[The Convener *opened the meeting at 10:00*]

Decision on Taking Business in Private

The Convener (Maureen Watt): Good morning. I welcome everyone to the fourth meeting of the Infrastructure and Capital Investment Committee. I remind everyone to turn off their mobile phones and BlackBerrys as they impact on the broadcasting system.

Under agenda item 1, I seek the committee's agreement to take in private item 5, which is on the committee's work programme. Is that agreed?

Members *indicated agreement.*

Scottish Water Annual Report and Accounts 2010-11

10:00

The Convener: Agenda item 2 is evidence from Scottish Water on its annual report and accounts for 2010-11 and related matters. I welcome to the committee, from Scottish Water, Ronnie Mercer, the chairman; Richard Ackroyd, the chief executive; and Douglas Millican, the finance and regulation director. I invite you to make a brief opening statement.

Ronnie Mercer (Scottish Water): I shall be very brief, convener. Thank you very much for inviting us here. I understand that the principal purpose is a discussion of the annual report and accounts. Normally, we would see this committee or its predecessor once a year. However, there is a forthcoming water bill, which might mean that we see a wee bit more of each other in the future. It is a water bill and not a Scottish Water bill, but elements of it will still relate to Scottish Water.

I encourage the committee—all or part of it, or just individual members—to come along and speak to us, or call us and tell us that you want to come and talk to us, about different parts and things that you might want further explanation of so that you can make the best-informed decisions on the bill. It would not necessarily be one of the three of us whom you would speak to; it could be someone who is an expert on drought orders or trade effluent, for example.

I also invite you to visit a site and get a good idea of it. There is a very good site in Edinburgh, actually—we are building a new water treatment works, which is almost ready. I am sorry that I cannot offer you what the Justice Committee had, which was a Rangers v Celtic game. We do not have anything as exciting as that, but we get excited about water treatment works and waste water treatment, too. Perhaps we can interest you in that.

If you would like to let us know about that privately, we would be happy to see you for site visits or information sessions outwith the glare of Holyrood. We are now ready for questions.

The Convener: Thank you very much. I am sure that once we have seen the content of the forthcoming water bill, we will take up your offer.

What is Scottish Water doing to assist both domestic and business customers who claim that they cannot afford to pay their bills because of the straitened times that we live in?

Ronnie Mercer: I will answer on non-domestic customers and my colleagues will answer on other customers. We have a number of ways of tackling that issue. We try to offer a range of ways to pay. We also try to work out whether someone is a can't pay or a won't pay. Sometimes we go into their business and look at cash flow, and we try to get them on to even a monthly payment plan, because there are difficulties in the retail sector at the moment.

Everyone is considered individually. We give our customers our range of payment options and ask which one would best suit them. For example, we ask whether there is an option that would let them pay off the deficit as well as a bit of the current bill. They have to pay for the services that are provided, but they are offered a wide range of ways of doing that and we take quite a sympathetic view. Ultimately, though, we must ask them to pay for the service, because if they do not, the good payers' bills rise to take care of the bad ones. That is how it is done in the business sense: customers are treated individually, depending on the circumstances. Douglas Millican will say something on other customers.

Douglas Millican (Scottish Water): On the household side, as members probably know, the billing and collection of water charges is done in conjunction with council tax, so it is done by each of the 32 local authorities. At one level, the answer varies in different local authority areas. We work closely with each local authority across a range of different payment measures, looking at ways of improving payment arrangements and considering where flexibility can be given.

From a longer-term angle, we are working with local authorities and the Scottish Government to look at enhanced arrangements with the Department for Work and Pensions for people who are on council tax benefit and the options that we can give customers for paying their water bills.

The Convener: Two issues spring to mind on Scottish Water Business Stream. Over the summer, a lot of our colleagues had businesses coming to them because their water bills through Business Stream were much greater than they had been before. How did that happen? Did you estimate wrongly the amount of water that they use, or were you not aware what kind of business they are?

Ronnie Mercer: In the past, the method of charging was based on the rateable value of the business. Since then, we have put in meters and are metering the actual amount that businesses use. Not all businesses are metered, as some are difficult to do, but the bulk of business customers are now metered. That meter is read, and the bill depends on how much water the business uses. The bill may have changed a bit since the rateable value system, but the meter is the meter and it shows the amount of water that businesses are using. There may be some surprises—I do not know whether there will be many—but that is what is used. The evidence is there: businesses can see their meter and read it if they wish.

The Convener: What proportion of businesses are not yet on meters?

Ronnie Mercer: Very few. We must have put in between 30,000 and 40,000 meters in the four years. I would say that the proportion of businesses that are not metered is not high. There are occasional difficulties, for example when someone is using a place as both business and domestic premises, or when there are flats or various businesses in a building and we cannot meter them all individually; in those cases, we have one meter and the businesses divide up the bill. However, by far the bulk of businesses are now on a metered supply. I can give you an exact figure another day, but the percentage is very high.

Jamie Hepburn (Cumbernauld and Kilsyth) (SNP): I can see the benefits of that arrangement to Scottish Water and your subsidiary Business Stream. What is the benefit to businesses of that arrangement?

Ronnie Mercer: Of the metered arrangement?

Jamie Hepburn: Yes—of the change from basing bills on rateable value to basing them on meter readings.

Ronnie Mercer: It means that the bills are accurate: the businesses are paying for the water that they use. In England, companies are pressing people to do that in domestic premises, but we do not do that here.

Metering water is accurate, and it was deemed to be the best way to give an assessment of what is used. It has been a long programme—we have put in most of the meters in the past four years. Some meters were in use already, as big customers have always had them, but smaller customers have them now. They are an accurate way of measuring water use, and I hope that they also help businesses to keep down their usage because they can see what they are using. When people have flexibility, they might consider what they are using. We encourage people to use less water because it is a valuable resource.

Jamie Hepburn: You might not know the answer to this off the top of your heads, but you could come back to us. What proportion of businesses are now paying less as a consequence of the change and what proportion are paying more?

Ronnie Mercer: I could not tell you that offhand.

Jamie Hepburn: It would be useful to know.

Ronnie Mercer: We could look at that and see. Obviously there will be some in each category.

Jamie Hepburn: You say that people are paying for what they use, but who sets the value of water? You could say that it is somewhat arbitrary to say that people are paying for what they use. They were paying for what they used before; it was just a different mechanism.

Ronnie Mercer: Business Stream is one of five providers.

Jamie Hepburn: You are the dominant provider.

Ronnie Mercer: Of course, but businesses can change. If someone is running a business and does not like the system, they can go somewhere else—there are another four providers—or they can challenge Business Stream about what they are using. They can ask Business Stream to come out, install a smart meter and tell them what is happening. Business Stream does all sorts of things to help the customer. Domestic customers cannot change, but businesses can change supplier and have every right to do so.

Jamie Hepburn: Is there much evidence of that happening?

Ronnie Mercer: About 1,000 businesses have changed supplier.

Jamie Hepburn: Out of how many?

Ronnie Mercer: A hundred and something thousand.

Jamie Hepburn: So not that many as a proportion.

Ronnie Mercer: No, but it is not my job to make them change.

Jamie Hepburn: I appreciate that.

Ronnie Mercer: I am the chairman of Business Stream—I am trying to keep their business. However, there is a market that they can move in if they want.

Jamie Hepburn: Equally, Scottish Water is also in charge of infrastructure. You have that other role, too.

Ronnie Mercer: That is right.

Jamie Hepburn: Okay. Thank you.

The Convener: When domestic customers default, do you leave it to the council to try to get the payments, or do you get involved?

Douglas Millican: We get involved, at an aggregate level with each council, in looking at overall performance and discussing steps that we can take together to try to improve performance levels. The billing relationship with the individual customer is handled directly by the local authority. We do not cut across the contact on billing and collection that the local authority has with the customer.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): I have a few questions about the finances. Two factors that might have influenced your income are, first, the financial downturn, and secondly, competition for non-domestic customers. To what extent have those factors had a positive or negative effect on your income during the past year?

Ronnie Mercer: Douglas Millican will talk detail. Strictly speaking, Scottish Water continues to supply everyone, no matter who their licensed provider is. Business Stream and its competitors provide metering, billing, customer service and so on, but Scottish Water provides the water. The retail market is down, so there are fewer customers for Business Stream. A number of high street properties have closed, as we can all see, wherever we live.

Douglas Millican: First, on the domestic market, because all bar about 600 of our customers are charged on an unmeasured basis, the key driver for our revenue line is the number of properties that are connected to our system and are occupied and therefore charged. Pre-recession we were seeing about 25,000 new connections a year. We have about 2.4 million connected households, so we were experiencing around 1 per cent growth per annum in our customer base. Houses get demolished, of course, so compound growth tended to net out at about 0.7 per cent per annum.

Since the start of the recession, the rate of house building and new connections has about halved—typically there have been about 12,000 to 13,000 new connections per year. That has meant that growth has dropped from about 0.7 per cent to about 0.3 or 0.4 per cent. Also, for three successive years there has been a household price freeze, so in effect the only growth in our revenue has come from the addition of new properties.

On the business side, Scottish Water the wholesaler sells to all retailers, of which Business Stream is the largest. We have seen a reduction in volumes and/or connected occupied properties of something in the region of 2 to 3 per cent during the recession so far.

Malcolm Chisholm: The other change that took place this year—no doubt it will be reversed this afternoon—was the decision on zero support for borrowing. What effect has that had on Scottish Water's finances during the past year?

Douglas Millican: We operate over a five-year regulatory period. A determination in November

2009, which we accepted at the start of 2010, set out various objectives that we needed to achieve over the five-year period, which included a capital investment programme that was anticipated to cost around £2.5 billion and an expectation that we would need up to £700 million of borrowing to help to finance the programme over the five years.

Because of the way in which our investment programme is phased and because of our strong operating performance as we exited the previous regulatory period—and indeed at the start of the current regulatory period—we were able to carry sufficient cash reserves into 2011-12, such that we could agree with the Government that we did not need to take borrowing in the current year, on the basis that we would get sufficient borrowing in the final three years of the regulatory period.

Malcolm Chisholm: Over the five years, do you expect the borrowing to be as agreed?

Douglas Millican: We expect to have sufficient borrowing to enable us to discharge all our regulatory commitments.

Malcolm Chisholm: Will you explain for the benefit of the committee how the borrowing works? Is it borrowing from the Scottish Government? How does repayment work and so on?

Douglas Millican: We borrow from the Scottish Government through the Scottish consolidated fund. We usually take out long-term loans because we invest in long-term assets. If you looked at our loan book, you would see that our loans have an average maturity of about 17 years, but they range from one year out to about 50 years. They are all taken out at fixed interest rates.

10:15

Malcolm Chisholm: Are most of your repayments to the Scottish consolidated fund, or are you still paying money back to the Treasury from previous loans?

Douglas Millican: It is mixed. All the pre-1996 debt that local authorities passed over to the water authorities came from the Public Works Loan Board. The debt from 1996 to 1999 came from the national loans fund. Only since 1999 has it come from the Scottish consolidated fund. Loan repayments relating to debt taken out pre-1999 are paid back by us to the Scottish Government, which passes them back to the Treasury.

Malcolm Chisholm: You have talked about your big investment programme, which is a necessity imposed on you. A minority of that is paid for by borrowing; is the majority paid for by surpluses on your revenue?

Douglas Millican: That is right. About 45 per cent of the investment programme relates to the maintenance renewal of our asset stock, and the balance is to enhance the asset base either to improve quality or to provide new capacity for customers to connect to the system. Broadly speaking, the majority is paid for out of customer revenue. That covers all the renewal, the capital maintenance and some enhancement. The balance of the enhancement is paid for from borrowing.

Malcolm Chisholm: Have Scottish Water's costs been increasing at above the retail prices index level that is used to determine charging levels? I think that you said that charges had been frozen. Does that create problems?

Douglas Millican: The regulatory settlement was struck to set a real price change across the five-year period. For household customers, we were required to decrease household prices in real terms by 5 per cent over the five years. In the first two years, the decrease has been 3.7 per cent, so there is a further 1.3 per cent to go over the next three years. As we go through the rest of the regulatory period, we expect there to be a nominal increase in prices, but it will be absolutely in line with the determination.

Jackson Carlaw (West Scotland) (Con): Your annual report says that the average Scottish household pays £324 per annum, which is £32 less than the average in England and Wales. How do those figures compare with last year, and what was the relationship of that differential with the rest of the United Kingdom last year?

Douglas Millican: Last year, we were still the third lowest. By the end of this regulatory period, we expect to be the second lowest in the UK. I do not have the exact figures with me, but we could supply them. The differential will have closed a little, because we held our prices flat while there were modest increases across the English companies.

Jackson Carlaw: So, the differential should have increased.

Douglas Millican: The difference between us and the lowest in the table is smaller than it was a year ago.

Richard Ackroyd (Scottish Water): The difference between us and the average in England and Wales will be greater than it was a year ago.

Jackson Carlaw: Would you be able to give us those figures? They would be useful in allowing us to make comparisons.

Douglas Millican: Absolutely.

Neil Findlay (Lothian) (Lab): How will the lack of borrowing impact on surpluses? In the past 10 years, there has been £1 billion of surpluses, and about £700,000 of retained earnings. What is the projection over the next few years?

Douglas Millican: We manage the business on a cash basis, and what matters is the relationship between our sources of cash and our cash expenditure.

The surplus that you refer to is, in effect, an accounting record of surplus. From a cash angle, all the surpluses over the years have been deployed in capital investment. There has been an accounting recognition of accumulated surplus, but the money has all been invested.

Neil Findlay: What are the financial risks to the business?

Douglas Millican: A business such as ours faces a range of risks at any point. There are issues around customers' ability to pay their bills impacting on the income side. On the business side, there is an issue around how many of our current connected premises will stay connected. For example, quite a lot of our business-related income comes by function of the number of connected properties that there are. If, as a result of either recession or public sector restructuring—about 30 per cent of our business income comes from the public sector—there are fewer connected properties, that will have an impact at a revenue level.

On costs, the main risk is that elements of our cost base may increase faster than the RPI. For example, there may be big increases in power costs. We are also capital intensive, and there may be big increases in construction costs—for example, the cost of steel—because of the demand for those commodities in Asia.

Neil Findlay: You did not mention the risk from competition.

Douglas Millican: There are two elements to that: the wholesale side and the retail side. From a wholesale angle, the principal risk of competition is business customers choosing to go off network. For example, a customer who is currently connected to our trade effluent system might install their own discharge point in a watercourse or source their water from somewhere other than the public system.

Ronnie Mercer may want to talk about the risk from a retail angle.

Ronnie Mercer: Business Stream is a commercially competitive business that can disappear if it loses all its customers to its competitors. Scottish Water supplies them all with water and takes all the waste water away, but Business Stream can make a profit that will eventually come back to Scottish Water. If Business Stream disappeared, that would be gone, although the wholesale supply of water would not—so, the bulk of the business would still be there.

The Convener: How has the financial downturn and the downturn in your income affected your staff in terms of wages and salaries?

Richard Ackroyd: As you know, the pay policy this year has been a pay freeze for our staff. It is too early to say whether that is having any consequence for the business, and we do not know what next year's pay policy will be—that will be announced at some point in the future. All that we can say is that we cannot expect to have pay restraint below market levels indefinitely, as there will come a point at which that will affect relations with the workforce and the trade unions. I do not think that we have reached that point yet, and we can only speculate how far away it is.

The Convener: So, you see yourselves competing with the private sector rather than being part of the public sector.

Richard Ackroyd: I do not think that there are two distinct labour markets. Staff have joined us from all sorts of places, both public and private. There are also regional differentials. For example, in the north-east, especially for electrical and mechanical expertise, we compete with the oil and gas industry, but there is not that competitive pressure in other parts of Scotland. It is a multifaceted picture, really.

The Convener: Have the bonuses been affected by the financial downturn, or how do they work?

Richard Ackroyd: The term "bonus scheme" carries connotations. The bonus schemes in Scottish Water are performance-related pay schemes that apply to every person in the business. They are long standing and we have paid out under those schemes this year.

Adam Ingram (Carrick, Cumnock and Doon Valley) (SNP): Let us return to the state of the business and the state of assets. You will have had some setbacks as a result of the severe winters of the past couple of years.

I have experience of dealing with constituents who were severely put out by the loss of their water supply as a result of assets failing. We saw some evidence of flaws in the infrastructure coming through because of adverse weather events. I am thinking of pipes that might not have been buried deeply enough under the roads freezing up, which meant that people did not have access to water for weeks at a time. One of my constituents had to have a plastic pipe from the road put through their letter box into their bath so that they could have water during a two-week period. The water had to continue to flow, so a lot of it went straight down the plughole.

That is anecdotal evidence, but I know from my constituency case load that that happened across the country. What are you doing to repair all that, and to proof the system against severe weather in the future?

Ronnie Mercer: A pipe freezing during the coldest winter for 100 years is not necessarily an asset failure. It froze because the weather was the most extreme that it has ever been, and it would have been frozen even if it had been buried at the right depth. That happens, and we try to help people to get their water back on. Putting a pipe through a letter box was a rather ingenious way of getting someone water. The part of the pipe in their garden would have been theirs, but it would have been frozen as well, so well done to them for taking a hose from the road and whipping it right through the letter box—although it is a pity that we had to waste some water.

Richard Ackroyd had a great time during that period, along with everyone else, so I am sure that he has anecdotes.

Richard Ackroyd: We should start with the big picture. Scotland has about 2 million connected household properties. Those that had frozen water supply pipes last winter amounted to about 2,500, which is an extremely small proportion.

A huge amount of work was done to ensure that we kept all the remaining customers—about 99.9-something per cent—in water without any interruptions. That work comprised a huge effort on leakage reduction, which had been going on before the winter but was really geared up when the big thaw happened. We had crews out on the ground walking around industrial estates and commercial premises that were closed for the holiday period to look for water running out of doors, which we found in a good number of places. We generally ensured that we were on top of the system, and we did not have to face any of the issues that Northern Ireland had to face during that same period.

A variety of issues were at play around the 2,500 customers who had a serious problem. We found some cases in which apparatus such as the main in the street and the toby was not laid at the correct depth, and we are now involved in a progressive programme of work to put all that apparatus at an appropriate depth. We did some research to establish whether the standard depth in Scotland does not give enough protection. The outcome was that it is absolutely fine, but last winter was just so extreme that the buried pipes froze in a small number of cases.

We have explained to customers that we can deal with our part of the apparatus but in pretty much all cases, the length of pipe from the toby into the customer’s house is the customer’s responsibility. We have recommended that, where we have lowered our apparatus, they should consider lowering theirs. Some are doing that, but some have decided not to.

What was the customer response to the big freeze when it happened? We are the first to acknowledge that the circumstances were unprecedented and that they presented us with a challenge that arose suddenly on a scale that we had never experienced before. There was a period of about three to four days around Christmas when our call centre simply could not cope with the demand. We have revised the arrangements for this winter and we are confident that they will cope with a repeat of those circumstances.

10:30

As well as progressively adapting our approach throughout the Christmas and new year period, we ensured that bottled water was available. That turned into a large-scale operation; indeed, by 1 and 2 January, 50 or 60 of our staff were doing nothing but deliver bottled water.

In summary, we experienced unprecedented conditions last year, but in that respect I do not think that we were any different from any other infrastructure provider. We coped tolerably well. It took us three or four days to get on top of the situation but we have learned lessons and have done a huge amount of planning, which the board will review at next week’s meeting, just in case this winter is as bad.

Ronnie Mercer: The percentage affected might have been very small, but we totally understand that if you had been one of those 2,500 households you would not have been happy. These guys fully appreciate that this is not about the 99 point something per cent of people whose connection stayed on.

Richard Ackroyd: The 2,500 tended to be concentrated in about a dozen communities across Scotland. In the Highlands, Blair Atholl was affected but the rest were predominantly in the south-west of the country. We have held community meetings in all those communities and have kept them very much informed about how we are addressing the problem.

The Convener: Did it happen because pipes were not laid at the correct depth?

Richard Ackroyd: In Blair Atholl we discovered that in a number of properties—I cannot quite remember how many but it was probably between 20 and 30—pipes installed five or six years ago had not been laid at the correct depth. We found other examples of that. In some cases, our contractors had laid the pipes while, in others, house builders had done so. To be honest, I am not particularly surprised by it. If you are asking whether I believe that all contractors and house builders follow the rules to the letter every day of the week, I have to say that it comes as no great surprise to find that some do not do so.

The Convener: Do you have any recourse in that respect? After all, you will probably have to fix the problem.

Richard Ackroyd: In some cases, yes. In others, we have taken responsibility for what has happened and are bearing the costs of fixing it.

Adam Ingram: My constituency is in Ayrshire in the south-west. What assurances can I give my constituents that if we have a winter as severe as last year's, they will not face the same problems as they did then, or at least that any problems that might arise will be dealt with more expeditiously? It took two weeks to sort out the case that I highlighted, which, happening as it did over a holiday period, did not make for a pleasant experience.

Richard Ackroyd: Indeed. Perhaps I should explain how we defrosted frozen pipes. We found only two ways, both of which required excavation. The first method involved cutting out a piece of pipe, putting in a hosepipe and pouring down vats of water that people had been boiling; in the second, which also involved cutting the pipe open, steam lances were used to inject steam into the pipe. Using both methods, our squads were able to clear about two pipes a day. Over the summer, we commissioned research to find other—and, indeed, faster—ways of defrosting pipes, but that work did not come up with anything better.

That said, I assure your constituents that if we have a repeat of last year's extreme winter, and if this kind of frozen pipe problem happens again, they will be able to contact us more easily and we will be geared up to get out to the area and speak to them. Our aim with anyone who phones about frozen pipes is to send a person to investigate the problem and then get a squad in to deal with it. We are certainly well prepared. You would not expect me to say that we will be able to avoid such problems or solve them instantly no matter what the weather circumstances might be, but we will do our utmost and I am sure that performance will be better than it was last winter.

Jamie Hepburn: I was very happy to visit your new Cumbernauld anaerobic digestion facility when it was opened. It is a fantastic facility, which has obviously involved a lot of capital investment, which is what we are looking for. I noticed from your report that this year capital investment has fallen quite significantly compared with last year. Why might that be the case?

Ronnie Mercer: I will get Douglas Millican to tell you more but, in the previous four-year regulatory period, we were aiming to spend about £600 million a year; in the five-year period that we are now in, it is down to about £500 million. That is sort of deliberate—we think that we can manage such investment better and much more efficiently. In conjunction with the regulator, which sets us the hurdles, we have kind of come back a bit, but we can still do all the work that we think is necessary. I will let Douglas Millican talk about the detail but, in general, in the period 2010-15, we are about £100 million a year down on the amount in the previous period, 2006-10. That is by design.

Douglas Millican: That is probably the bulk of the answer. In the 2006-10 period, the regulatory capital programme averaged £600 million a year and, in the 2010-15 period, it will average £500 million a year. That is, if you like, the costed value of delivering the ministerial objectives for each of those respective regulatory periods. That is the first reason for the £100 million per annum difference. The second reason is that the previous year—2009-10—was the last year of the previous regulatory period and, by definition, the final year or two years of a regulatory period are very much about the work on the ground: pouring the concrete, putting in steel, putting in kit and building new assets. In the first year of a regulatory period, which 2010-11 is, less work is being done on the ground and much more early work is being done on scheme feasibility, scoping and design work, which, as you can imagine, takes up less of the value of a project than the physical delivery. The fact that in the first year of a new regulatory period we delivered £443 million was really a record for us; it was far and away the best first year that we have had. It represented a mix of real work on the ground, on the delivery side, and early-stage scoping and design for the new regulatory period.

Jamie Hepburn: You said that that was a record for the first year of a regulatory period. What was the equivalent in the previous period?

Douglas Millican: The equivalent in 2006-07, which was the first year of the 2006-10 period, when we were aiming to deliver an average of £600 million a year, was £413 million.

Jamie Hepburn: That just shows you what you can do with figures. That is helpful. Given the current economic climate, how do you intend to reduce your operating costs while maintaining your current standards of service delivery?

Ronnie Mercer: We have a plan to do that over the five-year period. The whole game here is getting the costs down and customer service levels up.

Richard Ackroyd: That is one of the core principles on which we run the business: every year you improve service and drive cost down. We have innumerable initiatives coming up that are about better ways of carrying out particular activities, better ways of using technology and ways of achieving improved productivity. We do that in a host of ways.

People sometimes say that there must be an end to all this somewhere and that you must surely reach a point at which you cannot get more efficient. I think the answer is that you never reach that point. You can always find ways of doing things better.

Ronnie Mercer: Jamie Hepburn's example of the facility at Deerdykes is one of them. We are now producing some electricity there, which means that we do not need to buy it. You will be aware of what electricity prices have done—and continue to do.

The Convener: Are you looking at more schemes of that sort? Your organisation can probably generate some of its own electricity.

Ronnie Mercer: Yes. The next scheme, which is similar to Deerdykes, is in plan. You have probably heard that Scottish Water is looking at having a little more hydro generation. In fact, if you go to the site in Edinburgh, at Glencorse, up the Penicuik road, you will see a hydro scheme there. Water is coming into the site, turning the turbine and then leaving the site. The site will be about 60 to 65 per cent self-sufficient.

On wider tracts of land, we are considering wind farms. They are being studied and test rigs and all sorts of things are being done to find out what the yield might be, how profitable it might be and so on, all in conjunction with others that are in that business. We will either be the landlord or we will get a power purchase agreement—PPA—or something. All that is aimed, naturally, at helping the environment and, very importantly, lowering the electricity bill. Many such developments are taking place.

Neil Findlay: Do your plans to cut costs include cutting jobs?

Richard Ackroyd: That is an emotive way of putting it. Scottish Water's headcount—

Neil Findlay: Excuse me, but it is a pretty straight question. Whether it is emotive or not, I am asking you whether there is a plan to cut jobs.

Richard Ackroyd: We regard cutting costs as being an important thing to do. It is one of the ways in which we keep bills down to affordable levels. Inevitably, people costs—the cost of employing people—are a significant part of our operating cost. They account for roughly a third.

The answer to your question is that we always expect progressively to reduce the number of people we employ. When Scottish Water was formed in 2002, the number of people employed was about 6,000; it is now about 3,400. We have achieved that without any compulsory redundancies and we certainly do not envisage having to have compulsory redundancies in the current regulatory period. We use voluntary schemes and find all sorts of ways of working more efficiently and more effectively.

That is the overall answer to your question. This is not about asking: do we employ people or not? It is about how we progressively make the business more effective.

Neil Findlay: I have another emotive question. If your plans include that, what might the numbers be?

Richard Ackroyd: We expect to reduce by roughly 80 over the next three years. Is that right, Douglas?

Douglas Millican: Yes, that is the current plan, but we plan with a view to driving costs down. To a certain extent, the number of people who will leave as a result of that is a function of the cost reduction plans. We never target specific headcount numbers.

Ronnie Mercer: The new site at Glencorse replaces older ones and there is much more telemetry in it now. All that investment means that you upskill people but maybe have somewhat fewer of them.

Richard Ackroyd: We should perhaps add that, although we are reducing headcount, we are putting a strong emphasis on finding opportunities to get young people into the business. We currently have about 60 modern apprentices and a number of graduates. That is important to us, first because we have an average age that is higher than normal across the economy and, secondly, because we have a social responsibility to provide opportunities for young people as they come out of school and college.

Jamie Hepburn: You stated that, in the past, you have achieved reductions in the numbers employed without compulsory redundancies, but you did not mention the situation going forward. I take it that that is how you will take this reduction forward.

Richard Ackroyd: That is very much our aim and intention. In fact, next month we will introduce a new voluntary scheme, which will run for a year. Typically, we establish a scheme, which gets approved by the Scottish Government, and it applies for a finite period of time. We then look at the position again.

We certainly have no intention of having, or any aspiration to have, compulsory redundancies.

The Convener: We will move on. Adam Ingram has questions on targets.

Adam Ingram: I have customer service questions that I would like to follow through on. Has Scottish Water failed to meet the targets set for any of the 17 overall performance assessment indicators? If so, why?

Douglas Millican: The target that we are set is in relation to the OPA score as a whole, which I think is what you are referring to. The OPA is a basket of measures. In effect, the regulatory commitment is to achieve the overall OPA score. In any given year, we plan how we will do that—or, indeed, do better than that—and we might do better or slightly worse that we expect to do on any of the elements, but our external commitment relates to the OPA score as a whole. Last year, we had a very successful year: our regulatory commitment was to achieve a score of 302 and we achieved a score of 330, which was a 24-point improvement on our performance in the year before.

10:45

Adam Ingram: That does not help me very much. I am looking for an idea of how you measure your customer service performance. I have already told you about my experience during the winter. At my constituency office, I regularly receive calls from your customers who are frustrated at their failure to contact somebody in Scottish Water, to get feedback from somebody in Scottish Water regarding a problem that they have or even to get a reference number for a job. They phone repeatedly and are extremely frustrated when an entirely new record is made—apparently records do not carry over from one call to the next. There seem to be significant inefficiencies in your customer service process.

Richard Ackroyd: I recognise what you describe as being symptoms that customers saw in the cold period through December and January.

Adam Ingram: They are still seeing them. I am getting a high number of complaints about Scottish Water, which I have not experienced before.

Richard Ackroyd: We would be happy to follow up any of those individually with you—in fact, we would be keen to do that.

We measure overall customer service—how customers feel about their dealings with us—in a variety of ways. First, there is the number of complaints that we get. In the current year, the number is slightly higher than it was last year, but the number in any of the 10 years prior to that was substantially higher. The picture is one of the number of complaints reducing progressively year on year. It is marginally higher this year because of the wet weather that we have had over the summer, which has required some customers to contact us about sewer issues.

Secondly, we carry out customer satisfaction surveys. If any customer has occasion to contact us over an operational issue, we invite them to complete a questionnaire. Their level of satisfaction is included in the questionnaire and just over 80 per cent of customers say that they are either satisfied or very satisfied with the service that they received from Scottish Water. We know the major issue that we must deal with to push that number up even higher: it is to resolve issues the first time, so that we do not get repeat contacts about them.

There are a few other indicators. About 18 months ago, we launched a scheme whereby we invite customers who have had contact with us to nominate any of our staff for what might be called exemplary customer service. We are getting about 100 to 150 nominations every month through that scheme. If a customer is prepared to put themselves out and nominate somebody for that kind of recognition, that shows good service.

All of that said, we are absolutely not complacent about our customer service. A core part of our business improvement philosophy is to come up with ways of further improving customer service and how customers feel about Scottish Water. One of our core values is wanting Scottish Water to be Scotland’s most valued and trusted business. We have conducted surveys over the past three years in which we have asked customers which businesses they value or trust most. Of the six utility providers in Scotland—Scottish Water, Scotia Gas Networks, the two power networks, ScotRail and, you may be surprised to hear, STV—we came out top. That picture has been consistent over the past three years and our score is going up each time. The challenge for us is to get our score up to the level achieved by the retailers—the likes of John Lewis or Tesco—which tend to do well in such surveys. Quite a gap exists between us and them, but that is our target.

Ronnie Mercer: Every month, the board studies the figures in a customer service delivery report and if the figures dip, the customer service delivery director, Peter Farrer, is pressed on that. Of all the people whom we have serviced for something or other, four out of five think that we are good, but one out of five thinks that we could have done better, and that is the one that members hear from. We keep pushing to see how high the level can go.

Adam Ingram: How do you compare with water companies elsewhere in the UK on customer service or customer satisfaction?

Richard Ackroyd: We can compare two measures, one of which is the basket of indicators in the overall performance assessment. There are 10 water and sewerage companies in England and Wales. Back in 2002, when Scottish Water was formed, we were 11th out of 10 and so far off the bottom of the table that we could not even be seen. By 2006, we were 11th, but we could legitimately claim to be in the league. In the latest set of indicators, we are about mid-table.

The other method of comparison involves more subjective surveys that ask customers for their opinions about water providers. We do pretty well in them—we are certainly in the top three and we top some of them.

Adam Ingram: There is considerable room for improvement, but I hope that you are going in the right direction.

Ronnie Mercer: We have about four roadshows a year round the country to meet the public or—usually—councillors and community councillors, so that the executive team sits a few feet away from people who might have a complaint. That makes more of a mark than an e-mail or a letter does.

Adam Ingram: You are very welcome in my constituency.

Ronnie Mercer: We have been there—we had a record crowd. Such events tend to work, because we hear things at them that we might not otherwise hear about. We will continue to hold roadshows.

Gordon MacDonald (Edinburgh Pentlands) (SNP): I have a couple of questions. Do you have a say in how you present the information on the OPA targets? You score between five and 50 on any one indicator. The Northern Ireland Utility Regulator presents a matrix that compares the Northern Ireland water authority's performance with that of companies in England and Wales. For each indicator, it shows the target, the average and the score, so that it is quite clear whether the body has failed or not.

The report that the Water Industry Commission for Scotland published in January 2011 said that your service had deteriorated in relation to unplanned supply interruptions, ease of telephone contact—more than 10,000 telephone calls did not get through to your call centre—and your response to written complaints. Do you have any say in how that information is presented?

Douglas Millican: Performance is calculated using a formula. In simple terms, a score of five reflects the bottom performance level that has been experienced in England and Wales, whereas 50 reflects the top performance level that has ever been experienced there.

The formula drives out a score for any given performance level. For example, last year, 0.05 per cent of properties were subject to inadequate water pressure, so we scored 34.3 out of a possible 37.5. That is just one example that shows that the approach is formulaic. It is easy to see from the score and the sub-measures whether we have got better or worse from one year to the next.

Gordon MacDonald: Do you produce that information for people to see?

Douglas Millican: Yes, it is public. As well as the annual report and accounts that the committee has, we publish an annual report on our regulatory performance, which is formally submitted to the Water Industry Commission and is available on our website. Page 11 of the current report sets out our performance on each of the OPA measures last year and gives a comparison with the year before.

The Convener: Jamie Hepburn has a question on greenhouse gas emissions.

Jamie Hepburn: Good progress has been made on reducing greenhouse gas emissions, on which you should be congratulated, but I understand that, comparatively, Scottish Water is still a high producer of emissions from the likes of waste water treatment and pumping. What plans do you have to continue the good work and get emissions down?

Richard Ackroyd: That issue is at the forefront of our minds. We are pleased that we have reduced our carbon footprint—I will call it that as the term "greenhouse gas emissions" does not completely capture the method of measurement—because, for many years, a common pattern across the water industry has been a steady rise in carbon footprint. Predominantly, that has been because European regulations on standards for drinking water treatment and particularly waste water treatment can be complied with only through energy-intensive treatment processes. So the carbon footprint in the industry has been rising, but we have reversed that and started a tip downwards.

We have done that in two major ways. One is by reducing leakage, which reduces the volume of water that we have to treat and pump. The other is by taking general energy efficiency measures throughout the business. That can be anything from installing technologies that enable pumps to run more efficiently to putting in place systems that allow us to measure the electricity consumption of a treatment plant or pumping station at certain times of the day, so that we can work out optimum operating regimes.

We will of course continue to do all those things and to look for other approaches. The challenge that we face is that European directives are still around that require new treatment plants to come online. In the coming 12 months, we have the big new treatment plant at Glencorse that Ronnie Mercer described. We have a new water treatment plant coming on stream at Aviemore and a new waste water treatment plant at Dunoon. Those are just some examples of the new plants that we have, all of which add to our energy consumption. That is why we have adopted a push to increase the amount of renewable power that is generated from within the asset base. We are doing fairly well on that, given that we started from a low base. Until recently, about 5 per cent of our power came from self-generated renewables, but the figure will be about 10 per cent by 2014-15. A variety of schemes are in place that we hope and expect to get on stream from 2015 onwards.

We can see how it is possible to generate 100 per cent of our power from within our asset base. I will not say that it will happen or exactly when or how it could happen, because it involves quite a few schemes that require planning permission and, in some cases, large investment, so we need to find partners to work with us, but there is certainly potential for us to make big inroads into our power demand through self-generated renewables.

Jamie Hepburn: Do you foresee a time when you are a net exporter of energy?

Richard Ackroyd: That is certainly possible.

11:00

Gordon MacDonald: On road repairs, the Scottish road works commissioner stated in his annual report that the pass rate for reinstatement was only 51 per cent, which was lower than the figure in the previous survey, and that, at a time when the number of works that Scottish Water has undertaken has fallen substantially, the number of fixed-penalty notices it was issued with increased from 1,717 in 2009 to 1,799 in 2010. Can you explain those figures?

Richard Ackroyd: It is certainly not a part of our business performance that we are in any way proud of. It is not good enough. I think that the road works commissioner figures that you quoted are for 2009—

Gordon MacDonald: For the pass rate for reinstatement, yes.

Richard Ackroyd: His figures up to 2010 show that we have managed to push the figure for satisfactory reinstatements from 51 per cent to 72 per cent. We hope that, in another set of figures that will be published in the not-too-distant future, that figure will go up again. However, the numbers must be verified by third parties and we do not know yet what they are.

The fact is that we must improve significantly in this area. We are on the way, but we still have a way to go yet.

Gordon MacDonald: Does the problem lie with subcontractors or your own employees?

Richard Ackroyd: It is a mixture of both. The reinstatements that you highlighted as a key measure are carried out for us by contractors. We have had some issues with contractors' performance; indeed, we have taken them to task over it and one of them has made some huge steps forward. However, we still have to do a bit more work with another contractor.

Jamie Hepburn: That is interesting. I do not want you to name any names, but have you ended any relationships with contractors because of dissatisfaction?

Richard Ackroyd: No, I do not think so. Generally, however, we undertake on-going reviews of our arrangements with contractors. Contracts get retendered every two years or so and, when that happens, we refresh the contractor base.

Ronnie Mercer: No matter who does the work, getting the right contractor is our problem.

Neil Findlay: The Scottish Government has said that the forthcoming water bill will design appropriate structures for Scottish Water. I am sure that that has not come as a bolt from the blue to you, but what discussions have you had with the Scottish Government about what those appropriate structures might be?

Richard Ackroyd: There have perhaps not been as many as you might think. I have not seen the draft bill—as far as I am aware it has not been drafted—so I do not know what it will contain.

Just before Christmas, the Government published the "Building a Hydro Nation" consultation. Our response to it was generally positive; indeed, it covered aspects such as renewable power and waste disposal and treatment in which we had already suggested to the Government we could play a greater role. We have also seriously taken on board the Government's various propositions about our role on the international stage. Earlier this year, we launched a new business called Scottish Water International, which focuses on taking our expertise abroad and has just won its first contract. We are moving forward on that agenda.

We have had no substantive discussions with the Government about structures or what any restructuring might look like, although I am sure that they will happen over the coming weeks.

Ronnie Mercer: I think that the Government is actually talking about the company's structure—

the fact that its core business is handling water and waste water and that, aside from that, it has a retail business, an international element and Scottish Water Horizons, which deals with renewables. It is not talking about how it should be refinanced or whether it should be nationalised, privatised, mutualised or whatever. As I understand it, from many discussions that I have had, it is about governance. I hope that that is helpful.

Neil Findlay: In your submission to the "Building a Hydro Nation" consultation, you state:

> "With the medium term pressures on available Government resources, access to extensive private capital may be necessary."

Would not a change in the structure of ownership of Scottish Water be necessary for it to access that private capital?

Ronnie Mercer: At the moment, we cannot access private capital because the Treasury rules do not allow it, so we have to borrow from the Government. Like the other big 10 England and Wales companies, we do not fund long-term projects from present-day cash; we tend to borrow for a 30-year plan or whatever. They all borrow from banks; we would if we could, but we cannot, so we borrow from the Government.

When it comes to renewables projects and wind-power projects that require large tracts of land, we access capital by getting a partner to put up the money, so we do not own the development. Under the arrangement, we will either be the landlord or have a power-purchase agreement. Our partner will put the equipment on the site—it will be theirs and they will run it as their business—and we will benefit from that because we will get something back from it. That is a way of accessing private capital somewhat indirectly, and that is what we meant when we talked about it in our submission.

Neil Findlay: In the same document, you state:

> "Creating a hydro nation will require access to significant capital for long-term investment and streamlined decision making".

Can you explain what that means?

Richard Ackroyd: You are taxing my memory of what was in our heads when we wrote that. The concept of a hydro nation probably means different things to different people at the moment. Our view is that Scottish Water will not suddenly transform the Scottish economy to one in which value is generated from water in Scotland. We have a role to play, but a large number of other organisations will also have roles to play, including organisations in the private sector—there is substantial expertise in hydro-engineering of one sort or another in the Scottish private sector—and the universities and research institutes, where there is also a lot of knowledge and expertise. Somehow or other, all that needs to be linked up to generate more potential than there currently is.

Neil Findlay: How many times have you met the Scottish Futures Trust to discuss the future of Scottish Water?

Richard Ackroyd: We have met the SFT probably about half a dozen times.

Neil Findlay: What were those discussions about?

Richard Ackroyd: The discussions covered a wide range of issues. The Scottish Futures Trust published a report sometime last year—I cannot remember precisely when—on options for financing Scottish Water. Fundamentally, that is what we were talking about and the outcome was its report. We have not had much dialogue at all with it in the past eight to nine months.

Neil Findlay: Has Scottish Water made preparations for any changes in the structure of the business that may come out of the proposed water bill?

Richard Ackroyd: We have formed Scottish Water International, as we have mentioned. Beyond that, I do not think that we have done anything in the way of preparations.

Jackson Carlaw: My questions follow on from that. What management experience do you have of running canals?

Richard Ackroyd: I have none.

Jackson Carlaw: The Government envisages canals becoming the responsibility of Scottish Water. Currently, that responsibility resides with British Waterways. There is a funding arrangement in the south whereby more or less two thirds comes from the independent sector and a third comes from the state, but it is the other way round in Scotland. Can it be anything other than peripheral to your interests and business model to be given responsibility for the management of the tourism aspect of running Scotland's canals?

Ronnie Mercer: With canals, there is an asset-management aspect. We spend £500 million a year on capital, so if there is asset management to be done, Scottish Water could offer something. The situation is not as clear cut as has been suggested. I think that the Government is considering whether canals are a regeneration area rather than a Scottish Water area, but nothing has been decided, and we await that decision. Our expertise would be in asset management, but we are really not in the tourism business in a big way.

Jackson Carlaw: That is as I would hope, actually.

Ronnie Mercer: Yes.

Jackson Carlaw: You have confirmed what I thought.

The committee will be looking in detail at broadband connectivity. It has been suggested that Scottish Water infrastructure could offer a route for carrying cabling for next-generation digital broadband. Before our inquiry begins, have you any comments?

Richard Ackroyd: Clearly, there is potential—especially in the use of the sewerage network for broadband and fibre optics. We have done some work—once again, in conjunction with partners, because it is not part of our regulated water and waste-water business, and we do not have capital to put into it.

Some work has been done in Dundee, and some work has been done in Ayrshire. It has not been entirely trouble free: one of the companies that we were working with went bust, which led to our having to find a good way of making progress with the infrastructure that it had put in the ground. However, I am pleased to say that progress is being made.

There is potential, but investment is required. Big institutional customers, such as health boards, universities or larger businesses, will have to sign up. If there is a guarantee that there will be customers, it is much easier to raise the investment to fund projects.

Jackson Carlaw: If the committee requires further information as it gets on with its inquiry, I assume that you would be quite happy to help us with that.

Richard Ackroyd: Certainly.

Neil Findlay: In your submission to “Building a Hydro Nation”, you acknowledge that there will be pressures on water resources from climate change and population growth around the world. Is there a real danger of water resources across the globe being put into the hands of commercial enterprises, at a time when there are major pressures on water resources?

Richard Ackroyd: I am not sure that I understand the thrust of your question.

Neil Findlay: Let me clarify. If you accept that climate change and growing populations will put pressure on water resources around the planet—I think that that is what you are saying in your submission—would you agree that any move by Governments around the world to put water resources on to a more commercial footing, with more involvement from the private sector, would have inherent dangers?

Richard Ackroyd: That is a political question—

Neil Findlay: That is what we are here for.

Richard Ackroyd: We run a water utility. I merely observe that, around the world, several different ownership models exist for providing water services and waste-water services. Owners range from the public sector through to businesses that are equity funded on the stock exchange, with various other kinds of owners in between. All models have their pros and cons, and they all work to one degree or another. I do not think that I can add much more to that answer.

The Convener: We are sitting on a very precious resource, and one that will become even more precious as we move on.

I thank the witnesses for coming to the committee; the session has been very informative. This is a new committee, so, obviously, the members are all new to it. You have certainly given us a basis on which to work.

Ronnie Mercer: Thank you. We will welcome you at a site if you wish to come. We could then chat further about whatever subject you wanted to talk about.

11:14

Meeting suspended.

11:19

On resuming—

Water Industry Commission for Scotland Annual Report 2010-11

The Convener: We will now hear evidence from the Water Industry Commission for Scotland on its annual report and accounts for 2010-11 and related matters. I welcome our witnesses: Professor Gordon Hughes, who is the chairman of the commission, and Alan Sutherland, who is its chief executive. Gentlemen, I invite you to make a brief opening statement.

Professor Gordon Hughes (Water Industry Commission for Scotland): Thank you. Like you, I am new to this in that I became chairman of the WICS in July so, in part, we will be talking about matters from before I took over. However, I repeat Ronnie Mercer's offer that, if there are matters of interest in relation to the proposed new water bill, the committee should feel free to contact and consult us if that would be helpful. I am afraid that we have nothing as exciting as a waste water treatment plant to show you—although we do have some new offices—but we would like to be of as much assistance as possible.

The Convener: Is Scottish Water on track to meet the ministerial objectives that were set out for the 2010 to 2015 control period?

Gordon Hughes: Scottish Water is making more progress on the various targets that have been set for it than had been expected over the regulatory period, so we think that it is on track. We hope that it will continue to outperform the targets as the regulatory period continues.

The Convener: That is encouraging, although the picture is perhaps not quite the same as the one that we got in the earlier witness session.

How does the WICS intend to take forward work on the next control period? Which areas are you likely to focus on?

Alan Sutherland (Water Industry Commission for Scotland): We will seek to do exactly the same as we have done in the past, which is to get the best deal possible for customers in Scotland. How we seek to do that has evolved. We are trying to get away from the process whereby Scottish Water submits a business plan that is, in essence, a bid for resources, and we end up cutting away at that bid to get to something that we consider reasonable. We are trying to do that by ensuring that, in advance of Scottish Water even beginning to write a business plan, we have agreed the key parameters, such as the sorts of returns that it can expect and reasonable operating cost levels. We will also have much more involvement from customers in responding to that business plan, to which end we have been working with Consumer Focus Scotland and Scottish Water to set up a customer forum, which will bring together the non-household and household interests to challenge Scottish Water directly to deliver what is most important to the customer. That will make Scottish Water much more directly accountable to customer representatives than it has been in the past.

Gordon Hughes: I have two further points. In giving evidence to the committee earlier this year, Mr Neil said that he had not yet been in touch with the WICS to discuss the Scottish Government's future objectives for the next regulatory period. That is still the case. We expect to have discussions with the Scottish Government during the next few months. Until those objectives are defined, the extent to which resources and other things are required is a little bit hard to predict, because it will depend on what those objectives are.

The second point is that, as you heard from Scottish Water and as we pointed out, Scottish Water has made a great deal of progress in catching up with other water companies in the UK, particularly on costs but gradually also on customer service. Therefore, there is less scope for large amounts of catch-up. That fits into the kind of process that Alan Sutherland described in that it is more a matter of continuing to ensure that progress is made than large-scale, rapid squeezing out of costs from the business.

The Convener: Do we make comparisons only with English water companies? Are they the gold standard, or are there international comparators that might offer a better standard to their customers?

Gordon Hughes: I have specialised in doing international comparisons. We do not restrict our comparisons to the English water companies. Indeed, that becomes more difficult over time as the nature of the information that is collected and the nature of the business change gradually. On the other hand, the fact of the matter is that conditions are national. There are differences in the access to capital and in the way in which regulatory and other systems operate in different parts of the world, so comparisons with other comparators are different from those with the English water companies. However, we have made and can make comparisons with other parts of Europe, with Australia and with some other parts of the world.

The Convener: Where, internationally, are the good water systems?

Gordon Hughes: If you want something that is excellent but very expensive, the answer is Japan, perhaps followed by Germany. On the other hand, if you want a different balance between the use of resources and costs, parts of the United States are relevant and the UK does not do badly. Some countries put a tremendously high premium on having low levels of leakage, but that is expensive and the resulting water is expensive.

The Convener: I suppose that it depends on how much of the resource countries have available in the first place.

Gordon Hughes: Yes, and how they choose to maintain or replace their capital.

Jamie Hepburn: I think that I saw you gentlemen sitting in the public gallery when we took evidence from the previous panel of witnesses. Perhaps you heard a bit of our exchange with Scottish Water about the provision of water to business customers and about Business Stream in particular. I want to explore that matter with you.

You will have heard me ask Ronnie Mercer how many people have switched from Business Stream to other suppliers. It did not sound like a lot to me. Will you quantify how many businesses have taken the opportunity to switch supplier and indicate what the commission is doing to encourage businesses to think that switching is a viable option?

Alan Sutherland: When we introduced and worked on the system from the passage of the Water Services etc (Scotland) Act 2005, we were clear that the sign of success or otherwise should not be the number of customers who switched but the number of customers who were better off. We should not have to force someone to switch to get them to a better deal.

It is right to say that there are a limited number of switchers. About 2 per cent of non-household customers have switched, but more than 50 per cent of non-household customers are now paying a tariff or getting a level of service to which they did not previously have access. Therefore, more than half of non-household customers in Scotland are better off in some way because they get something extra in the form of a bill that is more tailored to their needs, because they pay a lower tariff or because of the payment mechanism that they use.

Jamie Hepburn: I am trying to get my head round what more a customer could need from a bill to meet their needs than a normal bill provides.

11:30

Alan Sutherland: Let me give you a very simple example.

Jamie Hepburn: Please do—the simpler, the better.

Alan Sutherland: If I send one bill to a business, it must spend a certain amount of time and effort processing that one bill. If I send it two bills, it has to process two bills. If the business is Asda or Tesco and it gets four water bills a year for each store, four sewerage bills a year for each store and maybe separate bills for surface drainage as well, and each store has two meter points, which means that everything is doubled again, it must process every one of those bills. One of the leading supermarkets is on record as saying that it saves £80,000 a year in administration costs because it gets only one bill for Scotland. That is quite a big deal. It would have to sell a lot of pints of milk to make £80,000 profit. Creating pressure in the system for people to do things differently leads to that sort of outcome. Surely we would all welcome that—otherwise, the price of milk goes up.

Gordon Hughes: Scottish Water said that it has non-residential customers who were surprised by the size of their bills when they switched to using a meter. One of the things that Scottish Water can do, through Business Stream, is change the nature of the meter, give customers advice and help in order to save on their water consumption, track down water leaks and so forth. It is quite common around the world for utilities to have an interest in helping their customers make better use of their services, in order to keep the customers' good will and retain their interest, which may be more important than just having the lowest price on offer. It is about bundling a variety of services that go beyond purely the delivery and billing of water.

Alan Sutherland: I will give another example. Procurement Scotland launched a tender for the entire public sector in Scotland, which makes up more than 20 per cent of the non-household demand in the country. For the tender, 35 per cent of the weighting was on price and 65 per cent was on value-added services such as more efficient billing, help to detect leaks, the identification of consumption variations that can be dealt with and benchmarking across different parts in order to identify premises that are water efficient or inefficient. There is a lot of value in that process. To be honest, I think that it is something that we were not terribly good at. However, now that Business Stream is exposed to the opportunity for its customers to choose, suddenly the kind of thing that I have described is happening. At the same time, Business Stream's costs are coming down.

Jamie Hepburn: How realistic a choice is it? What other players are out there? What are you doing to encourage more players?

Alan Sutherland: There are two subsidiary companies of English and Welsh water and sewerage companies: Anglian Water, which is trading through a subsidiary by the name of Osprey Water; and Wessex Water. There are two other much smaller entrants into the market: Imera and Satec, which are both quite active. Some familiar household names, such as Belhaven, Ladbrokes, Debenhams and Gap, have switched suppliers. Others, such as Tesco, Asda and Marks and Spencer, have chosen not to do that but have completely different service levels. As I said earlier, no one should have to switch in order to get a better service. The fact is that they should get the best of service. Competition is not an end in itself but only a means to an end.

Jamie Hepburn: Is there any concern that Business Stream is misusing its position as the dominant supplier?

Gordon Hughes: Not at the moment. The level of switching might be rather more of a concern if we came back in two or three years and still found that only 2 per cent of the market was in the hands of companies other than the dominant supplier as a result of competition.

Jamie Hepburn: That would be a concern because that contradicts what I just heard about—

Gordon Hughes: No, no. This is a process by which, to begin with, there are rather large pressures on Business Stream to improve its performance. If the level of switching remained low over a significant period into the future, we would be worried that Business Stream might become too comfortable and would not feel under significant threat of losing business. We would then have to ask ourselves whether competition was delivering all that it possibly could. There has been a similar opening up of the markets in other places—in England and Wales and in other parts of the world—but it does not happen quickly.

We need to explain the background to all this. Scotland is on its own in the matter. Scotland has a competitive market for non-residential customers, whereas the rest of the UK does not. If the rest of the UK were to change, it is likely that there would be much more competition because it would be in the interests of Tesco, for example, to have a single supplier everywhere in the UK. We must, therefore, wait for decisions about what will happen in the rest of the UK before we can know how the market is likely to evolve.

Adam Ingram: How would Business Stream be placed to take advantage of its experience of a competitive environment in Scotland? Would it seek to move in south of the border?

Gordon Hughes: Undoubtedly. I am sure that Business Stream would wish to do that. It feels that it has a large amount to gain from the market opening up in the rest of the UK. Given its experience and what it has learned, that would represent a large opportunity for it as a commercial retailer of water.

Alan Sutherland: I will try to give you some colour on that. When Business Stream was first separated from Scottish Water, its cost level relative to its revenues was slightly better than the average for water and sewerage companies in England and Wales, but its service level was considered by its customers to be quite poor. The same customers would now say that Business Stream is among the best—if not the best—in Great Britain. At the same time, it has brought down its costs by more than £9 million a year, which is a percentage in the mid-20s. That would put Business Stream in second place in the costs league and in first or second place in the level-of-service league. By the time the market opens in England, it will also have at least five or six years of experience in working out the sort of packages that keep business and public sector customers happy, so it should be well placed and might be an example of a water business going forth from Scotland and doing rather well.

Jamie Hepburn: I have one other question on the subject. What do private suppliers to businesses have to pay to access the publicly owned water network? Do they have to pay anything?

Alan Sutherland: Sorry—I do not understand the question, I am afraid.

Jamie Hepburn: If I set up a company to supply water to businesses, I would take advantage of publicly owned infrastructure. What would I have to pay to do that?

Alan Sutherland: You would pay exactly the same as Business Stream pays—the wholesale charges for the water that you consume.

Jamie Hepburn: I was counting Business Stream as a private supplier.

Alan Sutherland: Suppliers all pay the wholesale charges that are set at a macro level by us and that are set individually by Scottish Water and approved by us.

Gordon Hughes: In its main business with respect to non-residential customers, Scottish Water is a wholesaler and provides water on identical terms to anyone who is a licensed supplier of water. They must have met the requirements for registering as a licensed supplier, but, once that is done, the process is anonymous and the pricing is the same for Business Stream as for any other licensed supplier.

Alan Sutherland: Before it comes up, I emphasise that there is no question of risk in that. Those retailers pre-pay the wholesaler by 45 days down to 15 days and then they pay again in advance, so there is no credit risk to Scottish Water. The credit risk and the bad debt risk in the non-household sector are the responsibility of the retailer and a cost to the retailer.

Malcolm Chisholm: Let us move on to funding issues. Sir Ian Byatt has expressed concerns about the financial environment and its effect on Scottish Water's investment. In particular, he has flagged up the absence of borrowing this year. What impact could the decision on zero borrowing have on Scottish Water's ability to meet its objectives? How do changes in borrowing influence the charging regimes that you recommend? I presume that they do.

Gordon Hughes: As Scottish Water explained, our overall envelope was for £700 million of borrowing over the five-year regulatory period. As a result of the cash situation of the company in the past financial year, it felt that it would be able to do without borrowing for one year. However, the Scottish Government gave a commitment to make up the total amount over the full period of five years. At the moment, we have no reason to doubt the Government's intention to do so. Were there to be any change, at that point some consideration would have to be given to which parts of the investment programme might be affected by the lack of resources. Ultimately, it is for the Scottish Government to decide whether it has the capital resources to continue to stick by the £700 million overall envelope.

Malcolm Chisholm: At the moment, you do not share your predecessor's concern about that.

Gordon Hughes: I would share his concern if the money was not delivered. We are all aware that there is a great deal of pressure on public funding and that there has been particular pressure on capital budgets. Nevertheless, we cannot plan for something on which a decision has not been made.

Malcolm Chisholm: Would you make up for any deficiency in borrowing simply by increasing charges?

Gordon Hughes: I doubt it very much. No. The squeeze would have to come through reducing capital spending. There is an element in the capital spending programme that we refer to as unallocated spending, which is moneys that are required to meet a variety of environmental objectives that have not been precisely quantified. Two major examples are meeting the bathing waters directive—in respect of which studies are currently being carried out to see what would need to be spent where—and some relatively large plans for dealing with drainage and other problems in greater Glasgow. Those moneys have been nominally allocated to specific purposes, but they do not have the name of a particular project on them. Choices might have to be made between those possibilities for capital spending as well as in other areas.

Malcolm Chisholm: Can you not foresee circumstances in which changes to the borrowing consents would influence the charging regime?

Alan Sutherland: If the Scottish Government were to cut the level of borrowing and require exactly the same level of investment to be made, and if Scottish Water could not make extra efficiency savings to bridge the gap—in which case we would be talking about a serious number of millions of pounds—the only thing that could give would be a price factor.

Malcolm Chisholm: Do you accept the need to meet objectives and targets as a given, and that you have to set your charges within that framework?

Alan Sutherland: The 2005 act requires the commission to set the lowest reasonable overall cost for Scottish Water to meet the Government's objectives for the industry. That must be done in line with the Government's principles of charging—specifying what cross-subsidies there are in the system and who cross-subsidises whom, and that sort of thing.

11:45

Gordon Hughes: It is not even remotely likely that, if the Scottish Government said that all the objectives remained the same, it would also say that there would be substantially less access to borrowing than was originally planned. The whole point of the regulatory process is to try to provide stability in the relationship between spending, charges and environmental objectives, which are all in a balance that I am sure the Scottish Government would not wish to disturb.

Malcolm Chisholm: What percentage of the investment programme is mandatory under European Union regulations?

Gordon Hughes: A large part of the programme is, in effect, mandatory—although there are a variety of timescales over which it has to be implemented. The overall programme is pretty much driven by EU environmental requirements of various kinds, and by the need for some service upgrades as well, which we regard as being of high priority.

Jamie Hepburn: What impact will increases in costs that are above the rate of inflation—especially in capital works—have on Scottish Water's performance?

Alan Sutherland: Inflation in capital works is tending to be very low at the moment. That is one of the ways in which more might be afforded than was once thought likely.

In relation to other operating costs, Scottish Water has protection in that its revenues are linked to the retail price index. Staff costs make up a substantial part of Scottish Water's operating costs, so if staff costs are running lower than the RPI, it helps Scottish Water out.

The witnesses from Scottish Water mentioned energy costs, but the share of its revenues that relate to energy costs is rather lower than the share of energy costs in the RPI, so it gets more than enough protection if the RPI moves. There is no discernible huge upward cost pressure on Scottish Water. The one major exception to that is the rates bill following rating revaluation, which will cost Scottish Water around £24 million. However, it appears able, through other savings and protections, to meet that cost. It will not have any adverse impact on the customer.

Jamie Hepburn: I think that Malcolm Chisholm's question referred to charges being set for a control period. Can charges be reviewed?

Alan Sutherland: Yes, they can.

Jamie Hepburn: What is the process for that?

Alan Sutherland: There are two ways of reviewing charges. First, the Government has a right, at any point it chooses, to ask the commission to reassess the charges that should apply for a revised set of deliverables. Secondly, charges can be reviewed if either Scottish Water or the commission believes that there has been a material change. Scottish Water might come to us and say that it thinks that it does not have enough money because of X, Y and Z—in a different world, the rates bill might have been such an issue. On the other side, the commission may say that Scottish Water has access to too much resource and that customers need to get some back. The facility has never been used, but it could be.

The Convener: Adam Ingram wants to ask some questions on targets.

Adam Ingram: No doubt the witnesses heard my exchange with Scottish Water on customer service. I asked a question about the OPA targets, specifically the ones that it had failed to achieve. I did not get a straight answer to that question, so could you help us out by telling us which OPA targets Scottish Water is failing to achieve?

Alan Sutherland: I will try to help you. We give Scottish Water an overall target across a basket of indicators. We do not give it separate targets for individual indicators. We can tell you where it did a bit worse than last year, where it did better than last year and how it compares with some of the companies down south. We published that information in January and you referred to it. With any long-term business of the same type, it is almost inevitable that there will be fluctuations in performance. The good news is that the overall standards—we accept that they are overall standards and not individual customer experiences—are getting better.

I have slightly different information from the information that Richard Ackroyd gave you. The other thing that has changed is that we have moved to having more indicators within the basket, because we are now able to make more comparisons with England than we were previously able to make, since the Scottish Environment Protection Agency slightly changed some regulations. Scottish Water's performance is improving but still lags a little bit behind that of the 10 water and sewerage companies in England and Wales. It is two points behind the lowest and about 50 behind the median. However, it looks better again this year and takes us comfortably into the range that was observed in 2009-10 in England.

Gordon Hughes: It is not the regulator's job to try to micromanage Scottish Water. That is why we give it an overall customer service target rather than a series of specific ones. We also give it a target over a period of time—the whole regulatory period—and it is up to Scottish Water to decide how it devotes its energy to achieving our overall target over the full five years.

It is encouraging to see the seriousness with which Scottish Water takes that target and the progress that it makes but, in our view, it would be wholly inappropriate of us to tell it that it was getting a specific area wrong and that it had to do something about it. That has to be the responsibility of Scottish Water's management.

Jackson Carlaw: Following on from that, I invite comments on Scottish Water's performance on leakage reduction. Are the targets on that sufficiently robust? That area seems to be permanently dragging.

Alan Sutherland: Customers and many of us rightly get exercised about leakage. It is fair to say that Scottish Water has made dramatic progress on that over the past four years or so. Leakage has come down by something in the order of 35 to 40 per cent over that period.

Jackson Carlaw: Yes, but it needed to.

Alan Sutherland: Yes, it did. There is a concept of economic leakage, which one could never explain to any customer, so it is probably esoteric at best. The expectation is that we must get performance to levels that match those of the better companies in England, not only because of the wasted water but because of the carbon implications of that. There is still some way to go on that. Reductions of upwards of another 15 to 20 per cent could probably be justified as being worth paying for, but it depends on where customers want it to go. Customers would probably prefer no leakage that they can see.

Gordon Hughes: Can I pick up on an important point? In answering a question from the convener, I referred to other parts of the world where there is better performance. I will tell a little story about a conversation that I had with the director of the water company for Yokohama, which is a very large city in Japan. I was told that the company had reduced leakage to 7 per cent but that the cost of doing that was so expensive that it could not afford to maintain it. It had reverted to regarding a leakage rate of 10 per cent as reasonable.

In Europe, an economic level of leakage is regarded as being typically in the 15 to 20 per cent range. By that, we mean that the cost of saving further leaks beyond that range exceeds the benefits through reduction in water loss, reduction in carbon and so forth.

Scottish Water is not there yet—let us emphasise that—but it gets increasingly hard and expensive to save further leaks as we get closer to those levels. The task is particularly difficult for a company with a large rural water service network, as it is much more costly in terms of repairs, assets and operational time to monitor a system that is very dispersed than it is to monitor one that is very concentrated. So, what was good for Yokohama, which is a very dense city, is never going to be feasible for Scottish Water. Those are the kind of choices that must be made.

Jackson Carlaw: I have never been to Yokohama and I was not borrowing from that example. It is also important to say that I am not imposing the targets—they have not come from me. The targets are the ones that have been set, so they were obviously thought to be achievable. I appreciate that, as long as there is water aplenty, the argument about how far Scottish Water can afford to manage waste and leakage is perfectly legitimate. I am not arguing about the general principle as you have outlined it; I am referring to the targets that have been set, which were obviously thought to be ones that Scottish Water should be working to achieve.

Gordon Hughes: Scottish Water is making substantial progress towards achieving those targets.

Alan Sutherland: It has been meeting them each year.

Jackson Carlaw: So, you are pleased with the progress that is being made.

Alan Sutherland: We are pleased with the progress, but we are not necessarily pleased with the current resting point that we are at on the journey to where we need to get to.

Jackson Carlaw: A 15 per cent reduction is half as much again, is it not, given the 30 per cent reduction that you said that you would like to see?

Alan Sutherland: I was talking about a 30 per cent reduction from where Scottish Water currently is—there is a difference.

Gordon Hughes: There is a fair way to go and it will take time; however, at the moment it seems that Scottish Water is on the path to meeting its targets. No doubt, in the next regulatory review period, we will look at whether those targets should be made tighter again.

Jackson Carlaw: Now that you have mentioned it, I will refer to it as the Yokohama standard. Where will Scottish Water ultimately be in relation to the Yokohama standard?

Gordon Hughes: If you interpret it as being 7 per cent of the total water treated, that is the percentage of water that they treat in their plants that they cannot account for as having been delivered to customers. A figure of between 7 and 10 per cent is outstanding around the world; it is very unlikely that Scottish Water's figure will fall much below 20 per cent.

Jackson Carlaw: So, we are only half as good as the Japanese.

Gordon Hughes: It would be very expensive to go much below that.

Jackson Carlaw: Thank you. It helps to clarify all of that.

12:00

Neil Findlay: You will have heard our exchange with the previous panel about structures. What discussions have you had with Scottish Water, the Scottish Government and the Scottish Futures Trust—I do not know whether you have been involved with SFT—in relation to the forthcoming water bill and potential changes to the structure of Scottish Water?

Gordon Hughes: There are two issues, which Scottish Water highlighted, the first of which is the internal organisation. We can think of Scottish Water becoming a holding company with a series of divisions that do different kinds of business, from Business Stream to the wholesale business and so forth. As I understand it, that is the main thrust of the change in the structure that is envisaged.

We have had no discussions about the alternative, which is more radical change in the nature of Scottish Water as a company, for example with it no longer being a statutory corporation.

We are wholly in favour of separating the different bits, to protect the customers of Scottish Water—the main operating business—from ventures that are in the commercial and non-water sectors, because our responsibility is to protect the interests of the customers of the wholesale and retail business.

Neil Findlay: The briefing that the committee received before the meeting says:

"WICS is a non-departmental public body, which acts independently of Scottish Ministers. It is responsible for the regulation of the Scottish water industry, ensuring that suppliers provide a high-quality service and value for money to customers. WICS is also responsible for facilitating competition in the water and sewerage market for non-household customers."

In 2007 you produced a report in which you considered alternative ownership structures, and in 2010 you produced a report on regulatory reform in the Scottish water and sewerage industry. There are interesting aspects to both papers. Overall, it seems that you are advocating competition not just in the non-domestic sector but across the water sector. Over the years, many people have commented that the commission is straying into policy territory, which is the domain of the Scottish Parliament and the Scottish people. Do you accept that you are straying into policy areas into which you should not stray?

Gordon Hughes: You referred to our responsibility to promote competition in the non-residential sector. I prefaced my introduction by saying that I am new, but I have no cognisance of any significant discussion that has taken place in any way in the commission about promoting competition in the residential market. That seems to be something in relation to which we have no specific focus or concern at the moment.

On other policy areas, such as ownership structures, if we are asked for our opinion on a proposal that is being considered, we will give it, on the basis of our experience in Scotland and elsewhere.

Neil Findlay: I refer you to some of your organisation's publications, then—

Gordon Hughes: That is in the past. I can talk only for our position now.

Neil Findlay: Some of the publications are from the quite recent past. I am concerned that papers are circulating that are often difficult to find on the commission's website or in annual reports. However, that is another matter.

WICS has said:

"Companies are currently rewarded for pursuing capital intensive solutions. It is not clear that this approach will always deliver better value for the customer or better outcomes for the environment—particularly if the cost of carbon is factored into the equation."

Will you explain that assertion?

Alan Sutherland: With pleasure. Let us consider a water catchment area—a valley, basically. If there is intensive farming on the sides of the valley, pesticides can get into the watercourse, which must be taken out and treated if the water is ultimately to become drinking water. Indeed, the presence of pesticides could be the reason for a general environmental water-quality failure. There are two ways of dealing with the issue: we can put in the appropriate waste-water treatment or we can work with the farmers to change their land-management processes so that the pesticides never make the river in the first place. A growing body of evidence suggests that doing the latter is more effective and cheaper. Therefore, we are keen that it be pursued by Scottish Water. That is why we included some allowances for Scottish Water to explore the options in different catchment areas.

Neil Findlay: I am assuming that Scottish Water could look at different solutions that could be delivered in a more cost-effective manner, quicker and in a more environmentally friendly way.

Gordon Hughes: Part of the general problem of regulatory pressure on water companies—not just Scottish Water—is that it is easy to focus on operating costs, which are reported in a straightforward way and allow comparisons to be made easily on the efficiency side. The example Alan Sutherland gave is a case where one may need to spend money on operating costs in order to save money on the capital side. We may not be rewarding the fact that people are adopting the least expensive option in the right kind of way. As regulators, we must consider whether we are giving companies the incentive to choose the right balance between spending money on treatment plants and spending money on operating things in a different way.

Neil Findlay: Is it your view at present that the balance lies the other way, rewarding capital investment?

Gordon Hughes: Yes.

Neil Findlay: Is there anything likely to come out of the bill that will change that?

Alan Sutherland: I do not know whether there is anything that will come out of the bill to change that. The regulatory framework for the next price review will explicitly remove from the current framework the bias towards capital expenditure. It will reward the achievement of the outcomes that ministers want, which are not necessarily achieved by pouring concrete. That is important because the Parliament has put the obligation on us, as public bodies, to do what we can to reduce carbon emissions in Scotland. This is potentially an important contributor to that.

Neil Findlay: I find it quite surprising that we have the Water Industry Commission for Scotland and Scottish Water and neither of them knows what will be included in the water bill.

The Convener: Watch this space. I thank the witnesses for attending. It was an informative meeting and we look forward to working with you in this session of Parliament.

12:08

Meeting suspended.

12:09

On resuming—

Subordinate Legislation

Local Democracy, Economic Development and Construction Act 2009 (Commencement No 1) (Scotland) Order 2011 (SSI 2011/269)

Private Rented Housing (Scotland) Act 2011 (Commencement No 1 and Saving Provision) Order 2011 (SSI 2011/270))

Public Services Reform (Scotland) Act 2011 (Commencement No 5) Order 2011 (SSI 2011/278)

Local Democracy, Economic Development and Construction Act 2009 (Commencement No 2) (Scotland) Order 2011 (SSI 2011/291)

The Convener: Item 4 is a series of commencement orders, which are not subject to parliamentary procedure. Do members agree to note the instruments?

Members *indicated agreement.*

The Convener: That ends the public part of this meeting.

12:09

Meeting continued in private until 12:19.

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e-format first available
ISBN 978-0-85758-789-3

Revised e-format available
ISBN 978-0-85758-803-6

Printed in Scotland by APS Group Scotland