The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

INFRASTRUCTURE AND CAPITAL INVESTMENT COMMITTEE

Wednesday 14 November 2012

Session 4

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INFRASTRUCTURE AND CAPITAL INVESTMENT COMMITTEE
20th Meeting 2012, Session 4

CONVENER

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

DEPUTY CONVENER

*Adam Ingram (Carrick, Cumnock and Doon Valley) (SNP)

COMMITTEE MEMBERS

*Malcolm Chisholm (Edinburgh Northern and Leith) (Lab)
*Jim Eadie (Edinburgh Southern) (SNP)
*Alex Johnstone (North East Scotland) (Con)
*Gordon MacDonald (Edinburgh Pentlands) (SNP)
*Margaret McCulloch (Central Scotland) (Lab)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Geoff Aitkenhead (Scottish Water)
Margaret Burgess (Minister for Housing and Welfare)
Ronnie Mercer (Scottish Water)
Douglas Millican (Scottish Water)
John Simpson (Water Industry Commission for Scotland)
Alan Sutherland (Water Industry Commission for Scotland)

CLERK TO THE COMMITTEE

Steve Farrell

LOCATION

Committee Room 1

Scottish Parliament

Infrastructure and Capital Investment Committee

Wednesday 14 November 2012

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

Decision on Taking Business in Private

The Convener (Maureen Watt): Good morning, everyone, and welcome to the Infrastructure and Capital Investment Committee's 20th meeting in 2012. I remind members of the public and committee members to turn off their mobile phones, as they affect the broadcasting system—I just noticed that I had not done mine.

Agenda item 1 is a decision on taking business in private. Do members agree to take agenda items 7 and 8 in private?

Members *indicated agreement.*

Subordinate Legislation

Housing Support Services (Homelessness) (Scotland) Regulations 2012 [Draft]

Homelessness (Abolition of Priority Need Test) (Scotland) Order 2012 [Draft]

Rent (Scotland) Act 1984 (Premiums) Regulations 2012 [Draft]

10:00

The Convener: Agenda item 2 is to take evidence from the Minister for Housing and Welfare on three items of subordinate legislation that are subject to the affirmative procedure. The first two instruments relate to the Scottish Government's 2012 homelessness commitment, on which the committee has carried out an inquiry. Those are the Housing Support Services (Homelessness) (Scotland) Regulations 2012 and the Homelessness (Abolition of Priority Need Test) (Scotland) Order 2012. The minister will also speak to the Rent (Scotland) Act 1984 (Premiums) Regulations 2012. I propose to deal with each instrument in turn.

I welcome the new Minister for Housing and Welfare, Margaret Burgess, to her first outing at the committee. I also welcome the supporting officials: Stephen White, head of the housing options and services unit; Gordon McNicoll, divisional solicitor with the directorate for legal services; Barry Stalker, private rented sector team leader; and Jacqueline Pantony, legal director at the Scottish Government.

The instruments are laid under the affirmative procedure, which means that Parliament must approve them before the provisions may come into force. Following the evidence session, the committee will formally consider each instrument under agenda items 3 to 5.

I invite the minister to make her introductory remarks on the Housing Support Services (Homelessness) (Scotland) Regulations 2012.

The Minister for Housing and Welfare (Margaret Burgess): I thank members for the opportunity to speak about the instruments, which have been laid before Parliament for approval.

Section 32B of the Housing (Scotland) Act 1987, when commenced, will place a statutory duty on local authorities to assess the housing support needs of unintentionally homeless households to whom the local authorities have a duty. Under the duty, local authorities will need to ensure that housing support services are provided to those who are assessed as being in need of them.

To give effect to the duty, the housing support services to which the duty applies are prescribed in the regulations. Following a public consultation and dialogue with key stakeholders, four types of support services are prescribed, as agreed with stakeholders. The purpose of assessing and delivering the services is to enable a person to occupy or to continue to occupy residential accommodation as that person's sole or main residence. The types of support that are prescribed include personal budgeting, debt counselling, tenancy rights and responsibilities, and advice and assistance with settling into a new tenancy. The form and duration of housing support will vary depending on the individual circumstances.

The broad definition of the term "housing support services" will allow local authorities flexibility to approach the new duty using means that can be tailored to a particular individual or household while taking into consideration other local circumstances. Our consultation process revealed that most stakeholders were not in favour of detailed regulations that prescribed not only the categories of support service to be covered but the detailed means by which local authorities should carry out their duty. Instead, the majority preference, particularly among local authorities, was for regulations to set out the relevant categories of housing support service.

In addition, local authorities support the commencement of dialogue on the development of non-statutory guidance on the new housing support duty, based on existing good practice in local authorities. We intend to develop non-statutory guidance early in 2013, in partnership with cross-sector stakeholders.

Many housing support services are currently provided by local authorities, so the new duty and regulations should not place an onerous financial burden on them.

The regulations, and the duty that they give effect to, contribute to the Scottish Government's broader work to prevent and tackle homelessness, such as the 2012 commitment. Housing support is crucial to the livelihoods of many people in Scotland. It enables vulnerable people to maintain their tenancies, avoid repeat homelessness and live independent, fulfilling lives in their communities. Commencing the support duty and implementing regulations will ensure that that vital support is assessed and provided for all unintentionally homeless households in Scotland.

The Convener: As no members wish to comment on that instrument, minister, would you like to make some introductory remarks on the Homelessness (Abolition of Priority Need Test) (Scotland) Order 2012?

Margaret Burgess: Scotland's 2012 homeless commitment to give all unintentionally homeless households the right to settled accommodation is internationally acclaimed, and Scottish homelessness legislation has rightly been referred to as the most progressive in Europe. Meeting the 2012 commitment will be an historic achievement and will send a strong signal about the type of country that Scotland is, where equality of access to settled accommodation is enabled for some of our most vulnerable people.

The latest published homelessness statistics, which were released in October 2012, show that individual local authorities across Scotland have made excellent progress towards the achievement of the 2012 target, with 93 per cent of those assessed as homeless between April and June this year deemed to be in priority need. Eighteen council areas are already assessing 100 per cent of homeless households as being in priority need. In a further seven councils, more than 90 per cent of homeless households were assessed as being in priority need.

A key part of the 2012 commitment is the prevention of homelessness. The joint 2012 steering group involving the Scottish Government and the Convention of Scottish Local Authorities was established in 2009. Over the past three years, the group and local authorities working in hub partnerships have driven forward a preventative approach to tackling homelessness. That has led to the success of the housing options approach. Indeed, the committee's report recognised the transformational nature of housing options and the achievements of the hubs.

Prevention of homelessness is working. One indicator of that is the reduction of homeless applications to local authorities over the past year. We also know that local authorities and their partners are helping many more households than the statistics show, as early intervention is preventing homelessness and helping people into other options that are better suited to them or keeping them in their current accommodation.

The Government is committed to preventing homelessness when it can and tackling it when it cannot, and over the next three years at least £760 million will be invested in affordable housing supply. We also recognise that we are in difficult economic times and we are alert to the potentially harmful effects of the welfare reforms of the United Kingdom Government. We are committed to challenging the UK Government policy when we as a Government think that it is wrong. We are working with partners to mitigate the impact where we can, and we are taking forward plans for the independence referendum in order that Scotland can make its own decisions.

We have seen a huge culture change in homelessness services in Scotland. Beyond this year, we will have a stronger legislative safety net for those who need it, together with a robust embedded focus on the prevention of homelessness. We in the Government are committed to working with our partners across all sectors to ensure that the end of 2012 is the beginning of improving outcomes for those facing homelessness in Scotland.

Jim Eadie (Edinburgh Southern) (SNP): Minister, you mentioned early intervention to prevent homelessness. The committee recommended in its homelessness inquiry report that money advice and debt counselling should be an integral part of the support that is offered to unintentionally homeless households. Can you explain how these instruments address those issues?

Margaret Burgess: The first instrument that I spoke about addresses the issues because it introduces a statutory obligation on local authorities to provide all unintentionally homeless households with debt counselling, money advice, advice about the rights and responsibilities of being a tenant, and support on settling into a new tenancy.

It is also recognised that most local authorities are already providing that support. Preventative work and early intervention have been recognised as key priorities in reducing homelessness, so we do not think that it will be an onerous burden. Local authorities will work in partnership in many ways with the third sector to ensure that the services are available in their areas.

The Convener: The committee carried out a homelessness inquiry, and we know that most councils will meet the targets in the legislation. How will the Scottish Government monitor how the abolition of the priority need test is working?

Margaret Burgess: We will continue to monitor the statistics quarterly in any case. We do not expect to see the impact of the target being reached fully until the June figures come out, but we will continually monitor the situation through the hubs and through Scottish Government officials' interaction with local authorities. It is crucial that we do not just meet the target now but continue to meet it and look at how we can address things if they do not go as we anticipate.

We are also looking at an analytical tool for local authorities to use, so that monitoring can be consistent across Scotland. We are on the second draft of that.

The Convener: We will move onto the third and final instrument: the Rent (Scotland) Act 1984 (Premiums) Regulations 2012.

Margaret Burgess: The current provision in the Rent (Scotland) Act 1984 makes it an offence to require the payment of a premium in addition to the rent and a refundable deposit for the granting, continuance or renewal of a private rented sector tenancy. A premium, as currently defined,

"includes any fine or other like sum and any other pecuniary consideration"

that is over and above rent and a refundable deposit. Any such charges by landlords or their agents are not permissible under the current legislation.

Evidence suggests that some tenants are being charged for a range of premium fees, predominately by letting agents, and that those charges are often overinflated and unjustified. Furthermore, our recent consultation on this matter highlighted that such charges present significant financial barriers to accessing privately rented accommodation for many people.

Once commenced, section 32 of the Private Rented Housing (Scotland) Act 2011 will amend the definition of a premium. It will provide the Scottish ministers with the powers to make regulations to include further permissible charges that are not to be treated as premiums. The powers will include stipulating maximum fees.

The Government has laid an order before Parliament to commence section 32 of the 2011 act on 30 November this year. That section will amend the definition of a premium so that it covers

"any fine, sum or pecuniary consideration, other than the rent, and includes any service or administration fee or charge".

That will make it clear to letting agents and landlords who currently charge up-front fees to tenants—many of whom believe that the current definition does not apply to the charges that they ask tenants to pay—that those charges are not permissible.

Under the powers to make regulations to include further permissible charges, the draft regulations before the committee will provide that only payments in relation to the UK Government's impending green deal are to be permitted in addition to rent and a refundable deposit. The green deal will provide a means to carry out energy efficiency improvements in properties through finance that will be paid back through a charge on a property's electricity meter.

We have prepared these regulations to establish clarity at this early stage, so as not to impede the green deal's potential contribution to improving the energy efficiency of private rented housing in Scotland.

In summary, the draft regulations outline that only a green deal charge will be permitted as a charge in addition to rent and a refundable deposit in the granting, continuance and renewal of a private rented tenancy and that no other charges are permissible. I recommend that the committee supports the regulations and recommends to Parliament that it should approve them.

10:15

The Convener: Agenda item 3 is formal consideration of motion S4M-04739, which calls on the committee to recommend approval of the Housing Support Services (Homelessness) (Scotland) Regulations 2012.

Margaret Burgess: I am pleased to ask the Infrastructure and Capital Investment Committee to recommend that the regulations be approved, as they will assure that vital housing support is provided for homeless households in Scotland.

I move,

That the Infrastructure and Capital Investment Committee recommends that the Housing Support Services (Homelessness) (Scotland) Regulations 2012 [draft] be approved.

Motion agreed to.

The Convener: Agenda item 4 is formal consideration of motion S4M-04740, which calls on the committee to recommend approval of the Homelessness (Abolition of Priority Need Test) (Scotland) Order 2012.

Margaret Burgess: I think that this is a historic step in meeting the needs of homeless households in Scotland.

I move,

That the Infrastructure and Capital Investment Committee recommends that the Homelessness (Abolition of Priority Need Test) (Scotland) Order 2012 [draft] be approved.

Motion agreed to.

The Convener: Agenda item 5 is formal consideration of motion S4M-04632, which calls on the committee to recommend approval of the draft Rent (Scotland) Act 1984 (Premiums) Regulations 2012.

Motion moved,

That the Infrastructure and Capital Investment Committee recommends that the Rent (Scotland) Act 1984 (Premiums) Regulations 2012 [draft] be approved.—[*Margaret Burgess.*]

Motion agreed to.

The Convener: I thank the minister and her team for getting through that so quickly.

10:17

Meeting suspended.

10:19

On resuming—

Scottish Water Annual Report and Accounts 2011-12

The Convener: Agenda item 6 is an evidence-taking session with Scottish Water on its annual report and accounts for 2011-12. I welcome to the meeting Ronnie Mercer, chairman of Scottish Water; Douglas Millican, its interim chief executive; and Geoff Aitkenhead, its asset management director. I invite Mr Mercer to make a brief opening statement.

Ronnie Mercer (Scottish Water): Good morning, convener and committee members, and thank you for the invitation to come and speak to you about what we are doing. As you will see, the cover of our annual report has a “10” on it, because we are now 10 years old, and I hope that members will agree that in those 10 years we have made pretty good progress.

Scottish Water now has four businesses: the wholesale water and waste water business, which is, you could say, the principal purpose of our job; Scottish Water Business Stream, which is the retailer for non-domestic customers; Scottish Water Horizons, which is a non-regulated business; and Scottish Water International, which is a consultancy carrying out work across the world. Scottish Water itself has had a pretty good year. Our pre-tax profits—or what we call the surplus—have been very satisfactory and our cash and capital expenditure levels have both been pretty good. Operations have gone well, with our overall performance assessment—or OPA—measures pretty much where we wanted to them to be. The control of risks has turned out okay and the outputs from all our work have been fine.

As for what is on our forward radar up to 2015, we want to hit the upper quartile of United Kingdom customer service targets, deliver outputs from a £2.5 billion capital programme and continue our efficiency drive to hold down household bills as best we can. The strapline is that the ministerial directives are all on track; I will not read them out, but members will be able to find them on page 8 of the report.

Business Stream had a pretty good year. Its profit before tax was fine; its market share held up; it hung on to its margins; customer service moved in the right direction; and about two thirds of its customers now pay less than its standard or default charge. The strapline for Business Stream is that this is a competitive business. The good news is that England will be opening up to retail business over the next five years. The bad news is that more competition is tuning up here now, with Thames Water, Veolia, United Utilities and Severn Trent Water adding to the three that we already have, which are Aimera, Wessex Water and Anglian Water.

Horizons is pursuing a green agenda, principally to keep our energy costs down. It mainly works in renewables, including wind and hydro, and is involved in energy from waste. Of course, as a non-regulated business, it is self-sufficient.

Scottish Water International, which has made a good start, is offering a diverse range of expertise. For example, we have carried out operational training in Ireland; we have helped out in the Republic of Ireland, which is about to start a process of restructuring similar to that undertaken by Scottish Water, with many regions being merged into one company; we have a five-year operations and maintenance management contract up and running in Qatar; and we have been looking at asset management issues in Poland that might have some potential and at certain finance and regulation matters in India.

We also have a lot of good apprentice stuff happening. We already have 50 apprentices, with 27 more starting this year, and have 74 apprentice placements in our capital programme and supply chain. In other words, we persuade people to whom we give work that it is a good idea to take on apprentices. For example, we have 30 placements in T.O.M. Vehicle Rental and the Gap Group, with which we have long-term contracts; we also have 47 graduate and 100 work placements per annum to help people go and work elsewhere.

With regard to the hydro nation agenda, Scottish Water has already given evidence on the Water Resources (Scotland) Bill and we will not try to regurgitate what our senior colleagues have already said.

This very day, we have launched our three-month consultation, “Shaping the future of water and waste water services”, which looks at the next 25 years, and I hope that we will get good responses to it. We have also set up a customer forum chaired by Peter Peacock, formerly of this parish, and its big job will be to help us with our next price review and to feed into the 25-year plan.

Apart from the obvious risks involved in supplying good, clean drinking water and taking away waste water, the risks to our finances and so on, we are also facing local risks such as severe weather. Last year, we did not have much of that, which was great. The two previous years, however, were awful—they were the coldest in 200 years. There is also the risk of critical asset failure; for example, something could just hit us. We also worry about cyberattacks, which are a bit of a problem in some places—indeed, one of our board members had a cyberattack on his company and it was a nightmare—and leadership retention, which is crucial for us.

What is our platform for success? First, we must carry the staff with us. We hope that we are doing that.

We must also have robust regulators, and I must tell you that we have them in the Water Industry Commission for Scotland—some of them are sitting behind me, I think—the Scottish Environment Protection Agency and the drinking water quality regulator for Scotland. Robust regulators and supportive Government are a helpful combination to force us along the road that we should take.

We try always to be a business. We need access to capital. We fund only about 90 per cent of our operations in relation to capital in particular. We also want the Scottish Water non-executive board to be demanding of the executives, and I and my colleagues are demanding of them.

Scottish Water has won quite a few awards this year. I will not go over them all, but it has won awards for safety, communications, personnel, purchasing and business skills. In purchasing, it won a gold award—it is the only water company ever to win one—from the Chartered Institute of Purchasing and Supply.

There is an annual award ceremony that takes place in London in December. It is a huge event; 1,200 people go, and there are all sorts of categories. One of the categories is utility of the year, for which there is a shortlist of three. It is not possible to apply to be on that shortlist. Scottish Water and Business Stream are two of the three; the third is an electricity company—I hope that it is putting up its prices as we speak.

Who would have thought a few years ago that Scottish Water and Business Stream would land there? We might not win and, if we do not, we do not, but I am really pleased that somebody—I do not even know who—has put us on that shortlist. Well done to both of the fellows who are with me here and the Business Stream folk for getting there.

That is my opening statement. I am happy to take any questions that members have or hear any points that members want to make.

The Convener: Thank you very much. That certainly seems good news. Good luck at the award ceremony.

Your annual report indicates that the average household customer's bill will remain at £324 during this financial year. How long can Scottish Water continue to hold the average household bill at that level and maintain the required investment in the network?

Ronnie Mercer: There is a plan to raise it for the next two years by roughly inflation. I ask Douglas Millican to say what our agreement is with our regulators.

Douglas Millican (Scottish Water): Coming into this regulatory period, the agreement that we reached with the Water Industry Commission was that household prices would fall by 5 per cent below inflation over five years. Due to a number of circumstances, including our continued drive for performance improvement and efficiency, we think that household prices will actually fall by somewhere between 9 and 10 per cent over that period. That will enable us to give 5 per cent back to customers beyond what was agreed at the start.

We have done that by keeping household prices frozen by longer than was originally envisaged. Because they have been frozen for four years now, we expect that, for the next two years, we will need to raise them in line with inflation to ensure that the business can continue to be financially sustainable. Beyond that, there is a big question about the future path for prices.

In the consultation to which Ronnie Mercer referred, which we are launching today, we ask customers what balance they want between the future rate of service improvements and the future path for prices. Some choices are available, and we really want to hear their views on the future from our customers and stakeholders.

Malcolm Chisholm (Edinburgh Northern and Leith) (Lab): That was helpful. Some of us were a bit puzzled about the below-inflation requirement and what you propose for the next two years. I will ask for some clarification. What was the five-year period for which you had to keep the prices at 5 per cent below inflation, and when does it end?

Douglas Millican: It was from April 2010 through to March 2015. Over the past three to four years, we have kept prices frozen while inflation has risen cumulatively by something over 10 per cent.

Malcolm Chisholm: So, by increasing prices by the rate of inflation for the next two years, you will hit your target exactly by 2015. Is that right?

Douglas Millican: No. In fact, our prices will be 4 to 5 per cent lower than we agreed with the regulator at the start of the period they would be. Traditionally, we would perform in line with or better than determination over five years and, at the end of that financial outperformance, would give that back to customers in the form of lower charges in the following five years. This time, recognising the tough economic circumstances that we are in, we have, in effect, given that outperformance back to customers early.

10:30

The Convener: Can you give us an idea of how that compares with water companies in the rest of the UK?

Douglas Millican: If we look at the journey that Scottish Water has taken in the past 10 years, our charges 10 years ago were about the fourth highest in the UK—there are 10 large water companies in England and Wales, and we make it 11—and they are now the lowest, at £52 a year below the average in England and Wales.

Adam Ingram (Carrick, Cumnock and Doon Valley) (SNP): That is excellent. I have some questions on financial performance. Scottish ministers set the maximum net new borrowing limit for Scottish Water at £50 million for 2011-12, which Scottish Water fully exploited. What impact did the limit being set at a lower level than in previous years have on your investment programme?

Douglas Millican: The short answer is absolutely none, but I will go on to explain why.

To come back to the concept of the five-year regulatory period, the determination that is agreed between WICS and us—which absolutely involves ministers—is about which objectives we have to deliver, the amount of revenue that we will receive from customers in the form of the agreed price limit and the amount of borrowing that will be made available in that five-year period.

As we have gone on, that sum of borrowing has changed, but that has taken place in agreement with us. We have maintained our intended progress in delivering our capital programme—in fact, we are doing better than that. While we are delivering broadly the level of investment that we expected—or slightly less—each year in cash terms, we are delivering benefits for customers, which we call the outputs, faster than we originally agreed to do.

Adam Ingram: That is very good. Your surplus before tax fell between 2010-11 and 2011-12 from £146.2 million to £107 million. Can you explain the reasons behind that fall, and tell us whether you expect another fall in the surplus this year?

Douglas Millican: At the headline level, the reason why our surplus fell was because we have frozen prices at a time when a number of our costs are rising in line with inflation. To dig a little more deeply, there were three principal reasons for the £39 million reduction in surplus. The first was that our costs rose by £14 million. When I say that our costs have risen, our operating efficiency in Scottish Water, which is the regulated business—on a like-for-like basis, excluding the effect of inflation—improved by approximately 3.8 per cent. However, in nominal terms, taking into account the effect of inflation, our costs were up by £14 million.

The charges that we pay to our private finance initiative companies, which do about 45 per cent of our waste water treatment, tend to be index-linked—they are linked to inflation—and they rose by £1 million. Our depreciation charges rose by £15 million, which is just a function of the fact that, as years go by, we are adding more assets into our asset base. A good example of that happening in the past year involved the Glencorse water treatment works outside Edinburgh, which I know that a number of you have visited. That came on stream in the past year, and it has therefore now been depreciated, whereas previously it was not there to be depreciated.

Those are the reasons that relate to this year. Looking ahead to 2012-13, we expect our surplus to fall again. The reason for that is that household prices have been frozen coming into this year. That is one of the reasons why we cannot keep freezing prices indefinitely—we need to return to a trajectory in which prices rise broadly in line with inflation over the longer term to allow us to maintain the financial strength of the company.

Adam Ingram: So, you are saying that your cost increases have outstripped revenue increases, and that that is likely to continue while you are holding your prices constant.

Douglas Millican: Absolutely. Our total revenue increase across the whole group last year was only £1.6 million—about 0.1 per cent—which was simply because of the effect of the price freeze.

Adam Ingram: What happens with the surplus from Scottish Water Horizons?

Douglas Millican: Horizons is very much in an investment and growth phase. What we seek to do—we are encouraged by the provisions in the Water Resources (Scotland) Bill to do more of this—is look for sensible commercial opportunities to exploit our asset base to generate more renewable energy. At the moment, any profits that are generated by Horizons are fully reinvested in the growth of that business.

Adam Ingram: My final question is about your level of debt, which is in excess of £3 billion. How does that compare with other water companies of a similar size? How do you intend to manage your debts in future?

Douglas Millican: At a headline level, our broad level of debt in relation to the size of our business or our asset stock is absolutely in line with that of many water companies and is less than that of some. In terms of managing the debt, the key issue from a customer's perspective is the impact on our interest bill and how that feeds through into customer prices.

One of the key things that we do is ensure that, when we take out loans, we take them for a very long period of time and at fixed interest rates, so that we minimise the amount of debt that comes up for renewal in any particular year. Clearly, if we got into a different interest rate environment from where we are now—one in which interest rates were up at, say, 10 per cent—there could be a big shock for the company if a big chunk of the debt suddenly came up for renewal in a particular year. We therefore try to ensure that typically no more than £100 million a year of our debt comes up for renewal, so that any adverse interest impact is minimised. However, the good news at the moment, in the current benign interest rate environment, is that our interest costs are on a downward trend.

Adam Ingram: Thanks.

Jim Eadie: Good morning, gentlemen. To what extent are the Scottish Water and Business Stream surpluses reinvested for the benefit of the business and your customers? Obviously, you do not have the pressure that companies south of the border have in terms of meeting shareholders' demands.

Ronnie Mercer: Business Stream has made £30-odd million. We tend to have a dividend going back to the parent company, which is Scottish Water, and we retain some money in the business. Business Stream competes for any capital spend with the other parts of Scottish Water. It has not asked for anything yet that we have not done, and it has mainly asked for capital to invest in information technology. There is investment to prepare for the English market opening up, which will happen over a period of five years. Again, that investment is for quite a lot of data-type stuff. We have people working from England, but we do not have offices there. Currently, they work from home, but that might change in the coming years. When the English market opens up completely, we may well spend money on other things—that will come from money that exists for that purpose.

At this stage, we have not denied Business Stream anything that it has asked for, and it tries to raise its customer service as it goes along with some of the existing spend. There is therefore the balance between a dividend going back and Business Stream keeping enough to do what it needs to do. If it wanted to do anything big, it would come along and tell us, and we would consider whether we would go with that.

Jim Eadie: So there are real advantages to the ownership model that we have in Scotland.

Ronnie Mercer: I think that it is working pretty well. We kind of compete with the private companies in terms of efficiency, but at the same time we have a supportive owner. There is always an owner of some sort, and the owner of a private company will have different issues. As I said, we have a supportive owner and we are happy with the way the model is working. I would suggest that it lets us put the money where it should go. There has been some poor publicity about water companies in that regard in the past few days. I can see where your question is coming from, given what I read in the press yesterday about where private water companies' money might go. Obviously, we do not have that situation.

Alex Johnstone (North East Scotland) (Con): The Water Industry Commission for Scotland set an overall performance assessment score target of 317 points for 2011-12, and Scottish Water scored 355, which was 85 per cent of the maximum available points. How does Scottish Water's OPA compare with that of English water companies?

Douglas Millican: OPA is a measure that was introduced in England in the 1990s, to encourage water companies to improve their performance. By the latter part of the previous decade, the regulator in England and Wales took the view that OPA had largely served its purpose in England and Wales, because most companies were performing at a broadly comparable level. Therefore, OPA is no longer formally run in England and Wales. That is an important starting point.

Nonetheless, we have looked at our performance relative to the leading companies in England and Wales, because the target to which we agreed as we came into the current regulatory period was that by the end of the period, in 2014-15, our performance should be as good as that of the leading three or so companies in England and Wales. Scores vary from year to year but are typically in the range of 380 to 400 points. That is why the target that we have accepted is that by next year, 2013-14, our OPA should be 380 or better.

Alex Johnstone: What must you do to achieve that?

Douglas Millican: A number of areas of improvement are required. During the past year, some of our biggest improvement has been in relation to environmental pollution incidents. We have done significant work to understand the root causes of problems and to change how we deal with issues. We have nearly halved problems in the area.

As we look towards the end of the period, our single biggest challenge is to do with how water quality is measured. How water quality is measured for the OPA is demanding in the Scottish context, because we have so many different supply zones. Some operational improvements have been made, but we also need to make investments in particular zones, to help us to get the remaining OPA points.

Ronnie Mercer: It is important to note that we can slide back from a score of 355, too, for example if there is a massive plant failure somewhere. The score is not guaranteed for ever—although we hope that it is.

Alex Johnstone: You mentioned ministerial targets. Can you tell us more about the progress that you are making against ministerial targets for 2015?

Geoff Aitkenhead (Scottish Water): We have given a commitment to hit all the outputs, as defined by quality regulators and built into the ministerial objectives, and we are currently forecasting that we will hit or exceed them all by the end of the regulatory period—always accepting that changes might be made at the margins, in discussion with the quality regulators. Out of the whole investment programme, one or two projects will inevitably have issues and overrun beyond March 2015, but they will be completed. We currently forecast delivery of all the ministerial objectives.

Alex Johnstone: Complaints have fallen by 11 per cent since 2010-11. How many complaints did Scottish Water receive in 2011-12, and how many were satisfactorily resolved?

10:45

Douglas Millican: The total volume of calls that we received from customers fell by 20 per cent last year. That is a good early indicator of the fact that we are getting much better at resolving issues and customers have fewer reasons to need to call us. Telephone complaints were down by 5 per cent and written complaints were down by 11 per cent—that is in one year.

If we look at the figures over a longer period, we have had a 40 per cent reduction in complaints over the past four years, and we are pretty hopeful that, by the end of this year, there will have been a 50 per cent reduction over five years.

Alex Johnstone: Do you know how many complaints went the whole way and into the hands of the Scottish Public Services Ombudsman?

Douglas Millican: Yes, we do, and the number is very small. I think that there were 44 such complaints in 2011-12. That is the figure that I have.

Alex Johnstone: That is the number of complaints that went to the ombudsman.

Douglas Millican: Yes.

Alex Johnstone: How does that compare with previous years?

Douglas Millican: It is much lower. The base target that was set by ministers for this period, which was based on what was previously set by Waterwatch Scotland, was 121. The current total is about a third of that.

Alex Johnstone: That is an impressive performance when we look at the figures year on year. Do you have plans to continue to force the figure down in future?

Douglas Millican: Absolutely. Our whole business philosophy is that we want customers to be absolutely at the heart of what we are about. We are taking a number of measures to look at the extent to which we are meeting our customers' expectations. The overall performance assessment is one measure, particularly around the physical aspects of service, and another key area that we are focusing on is what we call our customer experience score. We look at those customers who have had reason to deal with us and get feedback on how satisfied they were in their dealings with Scottish Water.

We use that data to look at our performance and see whether it is improving, not just in aggregate but in each component area of service. However, we also use that feedback to understand the root causes of problems, and we then drive process changes or changes to the ways in which staff work to address those root causes. For example, a particular issue that we focused on in the past year, which led to the win-win of driving up service and reducing costs, was dealing with issues first time and avoiding having to deal with repeat issues. We have had a big success in avoiding repeat sewer blockages and chokes. That is a win-win, because it drives up service and takes costs out of the company.

Alex Johnstone: Thank you.

The Convener: Can you divide the figures up and identify how many of the complaints related to Business Stream?

Douglas Millican: The data that I have with me, which I quoted, relates to contacts into Scottish Water. Those contacts could be from household customers regarding any aspect of service, or they could be from any of the licensed providers—Business Stream or indeed its competitors—regarding the physical aspects of service to their customers.

Ronnie Mercer: I will quote the figures. In the case of Business Stream, customer satisfaction has increased by 26 per cent in three years and customer complaints have decreased by 50 per cent since 2009. There is no room for complacency, but the statistics are moving in the right direction. We still get more complaints than we want, but that is where we are.

The Convener: Thank you.

Margaret McCulloch (Central Scotland) (Lab): I have some questions on climate change and sustainable development. Has Scottish Water reduced its greenhouse gas emissions during 2011-12? If so, how does it intend to further reduce emissions in the coming years?

Geoff Aitkenhead: As the committee knows, there have been a lot of upward pressures on our carbon footprint and greenhouse gas emissions because of the investment that we have been making and the additional treatment that we have introduced, particularly the treatment of waste water around Scotland's coastal communities over the past few years. However, I am pleased to say that, between 2010-11 and 2011-12, we managed to reduce our energy consumption. We are doing a lot of work on understanding our carbon footprint. Currently, we have an operational footprint of 450,000 tonnes of carbon, but we have plans in place to mitigate that, particularly through the use of renewable energy.

In addition, in common with other water companies across the UK, we are doing some work to understand the carbon impact of our investment programme. We are looking at work that is being done elsewhere in an effort to understand how we might reduce the amount of embodied carbon that comes into the business through the investment programme.

Margaret McCulloch: What is Scottish Water doing to encourage customers to use water efficiently?

Geoff Aitkenhead: We are doing a lot on that front. If you look at the Scottish Water website, you will find our latest contribution to that debate, which is three useful videos that set out ways in which customers can use water wisely and help with the water efficiency agenda.

The first way in which we promote water efficiency is by reducing our own wastage. Some years ago, when we had a serious leakage problem, we might have been reluctant to ask customers to do a lot, but we are now on top of that issue. We are operating almost at the economic level of leakage, and we think that we will reach that level by the end of this year. Therefore, we are now much more proactive in encouraging customers to use water wisely. There is a lot of campaigning going on and trials are being done, one of which is targeted at the social housing sector. Another trial involves working with the building sector to get water efficient fixtures and fittings into houses.

In addition to the three water efficiency videos that I mentioned, we include water efficiency messages in the household charges leaflet that goes out once a year with the billing information. Shortly, we will introduce on our website a calculator that customers can use to look at their household water usage and the associated energy use. We think that one of the routes into encouraging water efficiency is to help people to understand the energy use that goes with water use and, in particular, the heating of water.

There is a lot of information out there and a lot of effort is being put into encouraging people to look at their water efficiency. We are upping our profile in that regard. We have a campaign with B&Q coming up, which will involve our having a presence in 32 B&Q stores across Scotland so that we can promote the efficient use of water and tell customers the things that they can do.

Margaret McCulloch: That is good.

Scottish Water infrastructure used to leak 1,132 million litres of water a day. Since 2010-11, leakage has been reduced by around 70 million litres a day. What is Scottish Water doing to further reduce leakage?

Geoff Aitkenhead: Much of the work to further reduce leakage revolves around two factors. The first is having the water distribution network locked down in small areas so that we can look at how each small area performs and target our efforts on leakage reduction.

Secondly, more and more, we are deploying technology to locate leaks that cannot be seen. We have gone through the phase in which all our activity was on visible leakage and responding to customer calls about leakages that resulted in water running in the streets. Now we look for invisible leakage. We use some quite sophisticated technology to find leaks in our network and fix them.

We are getting close to the economic level of leakage, which has been calculated as 600 megalitres per day. When we started our journey, the level of leakage was more than 1,100 megalitres per day.

Margaret McCulloch: How long will it take you to reach a leakage level of 600 megalitres per day?

Geoff Aitkenhead: We have given a commitment to do so by March 2014, but we are on the cusp of doing it by the end of this year. We have a fighting chance of doing it one year early.

The Convener: I chaired a round-table discussion with Waterwise in the Parliament yesterday. The chair of Waterwise thinks that, although there is a price on water, we do not put a value on it. He thought that a value could be put on it only if we had water metering. What is your view on that?

Douglas Millican: It is interesting that when we look at the evidence on water consumption from around the developed world, there does not seem to be any clear correlation between customers being metered and customers using less water. That is the global position. We believe that there are many advantages for customers in the charging arrangements that we have in Scotland. They are linked to council tax banding and they probably provide one of the strongest levels in the UK of affordability protection for more customers.

If we were to go down the metering route, it would add significantly to the average cost of supplying services to customers. The average bill is £324 per year. Figures from Ofwat—the Water Services Regulation Authority—lead us to expect that the average bill would rise by £50 per year just to cover the cost of installing and maintaining metering infrastructure, reading meters, issuing meter bills, and dealing with all the queries that would arise. We therefore have a significant cost advantage because we do not take a meter charging approach.

We need to make sure that customers are aware of all the opportunities that are available to them to save water. We have been wrestling with that with stakeholders and other industry experts and, as Geoff Aitkenhead said, one of the key routes into that is to highlight to customers the amount of money that they spend on heating water in the home. From data that we have received from the Energy Saving Trust, it appears that about a quarter of household customers' energy bills is associated with heating water. Therefore, the most powerful incentive for customers to save water will come not by metering water use but by increasing their awareness of the amount that they pay for heating water in their homes. That is why we are so committed to the range of different measures for promoting water efficiency in the home.

The Convener: Thank you. That is very helpful.

Gordon MacDonald (Edinburgh Pentlands) (SNP): I want to move on to the subject of road reinstatement after Scottish Water has carried out repairs or improvements to its network. In its 2011-12 annual report, the Office of the Scottish Road Works Commissioner stated that Scottish Water failed to achieve the 80 per cent target that was set for the quality of its road works reinstatement, and that Scottish Water was fined £38,000 by the commissioner for continued poor-quality road works. What has Scottish Water done to improve the quality of reinstatement since the fine was imposed, especially given its operating surplus of £107 million?

Geoff Aitkenhead: We take that issue very seriously because we understand the impact that poor-quality road reinstatement has on people moving around Scotland.

To give you the context, we carried out more than 30,000 permanent reinstatements in 2011-12. Between April and October this year, a further 18,000 reinstatements have been completed. It is a big job.

We recognised that we were underperforming, even though we were on an improving trend from 2003 up to 2010-11, but we still underperformed in 2010-11. Since then, within the operational parts of the business that carry out reinstatements following repair work, we have instigated what we call a reinstatement quality board. That is about sharing best practice between the various subcontractors who work with us on reinstatement. We review all our own coring results to make sure that we have root cause analysis on any failure. We review contractors' performance and presentations on actions, and outputs from our own crews and contractors are audited. We do not wait for the official coring programme to tell us how we are doing; we do our own coring and audit of performance. We insist on the sharing of best practice within the supply chain.

There are two aspects to reinstatement for us. One is operational repair and the other is the capital programme, under which we are out there renewing water mains and sewers. On the operational side of the business, in the internal repairs service, our results for reinstatement completed in August of this year, for example, showed a 95.6 per cent compliance rate and a year-to-date compliance rate of 92 per cent.

On the capital programme side of the business, we have four main contractors around the country. We have a big focus with them on improving their performance. They are all now consistently going over 90 per cent, and in the most recent figures that I have, which are from August, one of the contractors was at 97 per cent compliance and the other three were at 100 per cent compliance in relation to the quality of cores that were taken from their work.

We have a big focus on reinstatement, and a lot of improvement is coming through. I am very optimistic that, by the time we get to the next formal coring programme by the commission, we will be in a much better place.

11:00

Jim Eadie: Will you outline the preparatory work that Scottish Water is undertaking for the next five-year regulatory period, post-2015, and give us a flavour of the timetable for future works? When can we see the draft determination on the level of

Scottish Water charges? What is the timetable for the consultation and for the final determination on the charges that will apply in the next regulatory control period?

Douglas Millican: The process is necessarily long and relatively complex, because of the significance of what we are dealing with. In fact, even before we started on the current regulatory period, the Water Industry Commission started its thinking on how the regulatory regime needs to evolve. We began by discussing with the commission where things need to be made better. A key issue that arose was how we get customers much more at the heart of the price review process and how we ensure that the improvements that we make are the things that customers in Scotland want and value.

That is what gave rise to the customer forum, to which Ronnie Mercer referred, which came into being a year ago. Over the past year, we have met the customer forum to consider the issues and priorities for customers and done fairly extensive research with customers to try to get an understanding of their priorities. One thing that we are testing during the current three-month consultation period is whether we have the right grasp of what matters to customers or whether customers have a different take. That is one aspect.

The draft strategic projections were launched today, and the consultation on them closes in mid-February. We will then work to update the document for formal publication 11 months from now, in October 2013. Once that document is finalised, it will set out our best understanding of the opportunities and challenges that we face as an industry. For example, those will include demographic changes, climate change and future legislation. The document will also set out what we think we need to do differently to best meet those opportunities and challenges over the very long term, which is the next 25 years or so.

Once we have established that long-term context, very much on the basis of feedback from customers and stakeholders, we will position our business plan for the five-year period from 2015 to 2020 in the longer-term context. That will also be issued in October next year. Between then and spring 2014, we will go through a process to debate the business plan with our stakeholders and particularly with the customer forum to ensure that the business plan reflects what is important to customers. We hope that, by April 2014, we have agreed a business plan with the customer forum.

The process of agreeing our business plan is iterative. Therefore, even over the next 12 months, we will discuss various elements of our business plan with the customer forum, so that what we publish in October next year is not just the Scottish Water view but a view that has evolved and been developed in conjunction with the customer forum.

To give an example of that way of working, Ronnie Mercer earlier showed the committee the larger consultation document on our projections, but a much smaller and customer-friendly version has also been launched today. On the back, it has a graphic that shows the key service improvements and 10 questions that we are asking customers. Those questions have been wrestled with by us and the forum. That is what I mean when I talk about joint working. In this case, that was on the projections. In a year’s time, it will be on the business plan. We hope that, by April 2014, we have an agreed business plan. If so, our expectation is that that will be reflected by the Water Industry Commission in its draft determination in June 2014.

Jim Eadie: That is a very full answer about what is clearly an extensive process. That is the beginning of the process, but what is the end point?

Douglas Millican: That draft determination will then be open to consultation over the summer of 2014. Crucially, in that period ministers will need to confirm their objectives and issue the direction for the next investment period, confirm the principles of charging and confirm the borrowing that will be made available. All of that will then be reflected in the final determination of charges that the commission will issue in November 2014, which we hope to be able to agree. There is an alternative option if we do not agree it, but we hope to be able to agree it. We will then reflect that in a delivery plan for the following period that we will put to ministers in February 2015 and by April 2015—the start of the new period—we will be off and running.

Jim Eadie: That is very clear. Thank you.

As you move towards the development of the business plan, what are your thoughts about the key challenges that Scottish Water will face during the next regulatory period?

Douglas Millican: There are a number of challenges, from the strategic down to the slightly more tactical. At the strategic end, we need to be alert to what is happening on issues such as climate change and population growth. We need to consider what opportunities there are through innovation. Many people think that the water industry is a sector in which technology changes relatively slowly, but it is fascinating to see how different the operation of a water company in 2012 is from the operation of a water company even 20 years ago. We will consider how we can harness innovation and new technology to drive performance improvement and take cost out of the running of the company.

We will have a continued focus on efficiency and will look at those areas in which our service is not as good as it could be in order to make service improvements. In our view, making progress on the impact of external sewer flooding will be a key area for improvement into the next period. We also expect to face a rising demand for the maintenance and renewal of our existing asset base. Over the past 15 to 20 years, we have invested very significantly in new, modern water treatment and waste water plants, and a number of those plants will start to need first-time refurbishment of mechanical and electrical kit in the next period. That will drive a rise in the demand for capital maintenance.

In all of that, our aim will be to ensure that we minimise the impact on customers from a charging perspective. Our aspiration over the long term is that, in real terms, customers' prices should not need to rise but should move broadly in line with inflation. However, we still have a bit more work to do before we can nail completely the specifics of what will need to happen in the period 2015 to 2020.

Jim Eadie: I will be interested to read the exact wording of what you have just said. Your aspiration and ambition is to minimise the burden on the customer by keeping prices as low as possible. In extolling the virtues of Scottish Water over the last period, you were keen to emphasise that prices had been frozen and costs were rising but investment had been sustained. That seems to be a pretty good record. You also said that, as part of the consultation, you wanted to gauge the views of the customer on where they thought the balance should lie between investment and keeping prices as low as possible. In conclusion, can you tell us—without pre-empting the process that you are engaged in—how you see the balance between pricing and investment?

Ronnie Mercer: We sometimes show a little diagram of a three-legged stool, but it is not in the consultation leaflet. There is the bill, the capital expenditure programme that Geoff Aitkenhead carries out and the borrowings. None of those three things can move individually without affecting the other two. That is the three-legged stool—bill, borrowings, capital expenditure—and we are asking people how they want that stool to move.

We will give you a copy of this little leaflet. It is great—it has in it six headings of things that we must consider going forward: "Climate change"; "Demographics"; "Legislation"; "Resource availability"—how much water we have, although you might think that in Scotland we have got a lot; "Political, economic and regulatory environment"; and "Science and technology". The question is where the customers see the balance lying, as we cannot do anything for nothing. We can be very efficient but, ultimately, we have to pay for what we build.

That is what we hope to gain from the consultation, and we hope to know by October next year roughly where we are getting with it. In the meantime, we can provide the committee with this little easy-read leaflet, which tells people what we are asking them to advise us on—what Peter Peacock and his people will advise us on as well—regarding where the balance of that three-legged stool should move in response to what people really want.

Douglas Millican: For instance, on the trade-off between service and price, the central proposition that we have put forward for discussion is about a rate of service improvement that we believe we can make over the very long term that would be supported by prices moving broadly in line with inflation. We are asking customers what their preference is on a spectrum, where at one end we say, "No further service improvements, but prices over the long term will rise by less than inflation," and at the other end we say, "We will deliver service improvements faster than we have proposed, but prices may need to rise a wee bit above inflation." We are asking customers where in that spectrum they would like us to be. That is what we want to hear.

Jim Eadie: How difficult would it be for you to have prices that rise with inflation and allow you to meet your investment challenges if customers responded that they want prices to be frozen and not to rise?

Douglas Millican: Given that this is a 25-year time horizon, it would not be credible and we would be misleading customers if we were to suggest that prices could be frozen in nominal terms over that length of time. We owe it to our customers to be fair to them—

Jim Eadie: What about over the five-year regulatory control period?

Douglas Millican: At this stage, we are trying to get feedback from customers on the long-term direction for the industry. Even over the five-year period, if we were to freeze prices right through to 2020, the company would almost certainly be in a loss-making position. That would not leave Scottish Water on a financially sustainable footing, and that would not be the right thing to do.

The Convener: If there are no further questions, let me thank you, gentlemen, for your evidence today. I thank Mr Mercer for the extra work that he has undertaken following the sad death of the chief executive, which has meant that other senior management have also stepped up to the plate. Thank you very much and we wish you success in future.

I will suspend the meeting briefly to allow the next set of witnesses to take their places.

11:12

Meeting suspended.

11:14

On resuming—

The Convener: We will now take evidence on Scottish Water's annual report and accounts 2011-12 from the Water Industry Commission for Scotland. I welcome Alan Sutherland, the commission's chief executive, and John Simpson, its director of analysis. I ask Malcolm Chisholm to start the questioning.

Malcolm Chisholm: Although I am mainly going to ask about the next control period, I have a question about the current control period. I think that you heard what Scottish Water said, but do you believe that it is on track to meet the ministerial objectives that have been set for the 2010 to 2015 control period?

Alan Sutherland (Water Industry Commission for Scotland): Yes, it is well on track. Despite certain additional challenges, it appears to have stepped up quite well. I was waiting for the previous panel to tell you about the rateable value shock that they had and the extra costs that they incurred. However, they seem to be sufficiently confident in their ability to deliver what they have been asked to deliver that they do not need to mention such things any more. I regard that as a reinforcement of their own confidence. In short, Scottish Water has done a very good job.

Malcolm Chisholm: How is WICS taking forward work on the next control period?

Alan Sutherland: Douglas Millican explained in some detail the dialogue that we are having and made clear the importance—agreed by both us and Scottish Water—of getting customers much more involved in establishing what the term "reasonable" means. The statutory test is that we must set charges at the lowest reasonable overall cost to deliver ministers' objectives. As a group of people who analyse costs, we are quite confident that we can get to—and understand—lowest cost within certain boundaries. However, the problem lies in how we position the answer and in the small trade-offs that have to be made between giving customers a bit more benefit, ensuring less risk to customer services and taking an extra tenth or couple of tenths of a per cent off customer prices. Actually, customers are rather better qualified to make that trade-off than we are, which is why we want to get customers so involved in the process.

In addition to Douglas Millican's comments, I point out that over the past several weeks and months we have been giving a lot of thought to the key factors that will ultimately determine the charges over the next period. For example, we might take into account financial strength and the level of customer service that we would expect. We are publishing a series of quite simple guidance notes that Scottish Water and the forum that has been established will see and use to facilitate their discussions. In effect, we want to get the forum to a position where it can have a good solid debate with Scottish Water about the issues and what the realms of the possible might be. That work is going on at the moment.

Once we get Scottish Water's business plans, we will go through them and again publish a series of short briefing notes on the elements that we agree with and those that we think should be questioned to encourage the debate between Scottish Water and the forum. I hope that the process will make the price review much more transparent and allow those who want to read about the process to understand why a particular view and agreement between the forum and Scottish Water has been reached and what, in the case of such an agreement, the commission's determination is likely to be. After all, all the published guidance notes will highlight all the things that have a material impact on charges.

Malcolm Chisholm: It is good that so much emphasis is being given to customers' views. However, given your comments about achieving ministerial objectives at what is described in the legislation as the lowest possible cost, does the legislation say anything about customer involvement? Although I fully support such an approach and believe that it is desirable, will it not make the process far more complicated?

Alan Sutherland: The legislation makes no specific mention of the customer forum. It is not a statutory body; instead, it has been co-sponsored by us, Scottish Water and Consumer Focus Scotland. It is chaired by Peter Peacock and comprises representatives of the retailers who buy wholesale services from Scottish Water, ordinary citizens and a representative from the Scottish Council for Development and Industry.

Statute says that we must take account of the needs of rural customers and future customers. In essence, there is an understanding in statute that we will cast our net quite widely in trying to understand the issues, but exactly how we do that is not specified.

Malcolm Chisholm: What are the key challenges that face the Scottish water industry in the next regulatory control period?

Alan Sutherland: They are probably threefold. First—this is a motivating factor for us—we are trying to encourage Scottish Water to focus less on what we, the regulator, say that we want and to think more about what its customers expect of it. That is one part of the dynamic. Members might remember comments along the lines of, "We can't address this constraint or build that, because the regulator is not giving us any money to do that." We are trying to get away from that attitude and to a position in which Scottish Water must proactively explain to its customers what it needs money for, so that all charge-payers feel better about paying their bills—so that that feels more legitimate.

That is an important challenge. Scottish Water has come a long way in this period, and the fact that it forwent price rises rather than waiting for us to take the money away from it at the end of the period is a positive sign that culture change is happening in the organisation. We are not completely there, but we are getting there, in a good way.

The second challenge is the need to think very hard about how the industry delivers better outcomes for the environment and for the consumer. It is an industry in which historically, over the past 20-plus years, solutions were all about committing new capital expenditure. There are reasons to do with carbon—in the context of not just the embedded carbon in the civil engineering structure but the operation of infrastructure going forward—why that is not always the best solution. Alternative ways of working with the farming community and landowners or with councils and others in urban areas might mean that we avoid having to make some of that capital investment.

Such solutions need to be pursued assiduously, because they have the potential to be not just much lower-carbon and more environmentally friendly but cheaper. However, the culture in a water business is typically about designing, building and operating assets—and the people are typically civil engineers. There is nothing wrong with that; I am not decrying them in any way, shape or form. However, how people in the water business typically solve problems is not necessarily going to be the best way of doing so.

The third challenge is to do with building on the good work that is being done in the retail market with non-households—I am thinking about Scottish Water Business Stream areas, in which Scottish Water must compete with other suppliers. There is a growing expectation among businesses of much more help with managing their water resource. Historically, the water industry delivered water, almost always of a regular quality, to a point at the boundary of the customer's site, but nothing was then done apart from collecting the waste water that was being discharged.

Many customers would prefer to have help with how they manage the water on their site. For example, on industrial sites and the like, many customers have their own networks of pipes that also have leakage problems, which could benefit from expertise that the industry can bring to bear. The industry will often be more expert in such things than the people who operate the site. Operators of industrial sites also have to meet all sorts of environmental, health and safety and other regulations, so there is a huge opportunity to go that bit further in helping and supporting customers. That will be a big challenge, but as businesses feel the impact of the need to be more environmentally sustainable, businesses will look to those people who can help them. Scottish Water needs to ensure that it can deliver that because if it does not, others will.

Malcolm Chisholm: My last question is about bills in the coming period. Will customer bills have to rise during the next control period to maintain high levels of investment in the water and sewerage networks?

Alan Sutherland: In my view, there is no reason why bills would need to rise above the rate of inflation, unless the Scottish Government were to decide that it wanted a substantially larger investment programme than it has indicated so far and was prepared to offer substantially less borrowing for that. Last time, we were comfortable that Scottish Water would be able to live with a challenging target of something like retail prices index minus five. However, given that inflation has averaged around 1 per cent to 2.5 per cent or less, we need something that is not zero. Douglas Millican has explained why being at zero might be difficult, but the price increases should certainly not be at the rate of inflation either. It is not necessarily a political fudge to say that they should be somewhere in the middle, but I think that we will want to ensure that there is an appropriate but achievable challenge for management.

Jim Eadie: Good morning, gentlemen. I want to ask about competition in the non-domestic sector. Clearly, Business Stream remains the dominant player in the market for the provision of services to non-domestic properties. As a commission, you have a responsibility to foster competition within the market. What steps are you taking to do that?

Alan Sutherland: To be clear, our duty is to facilitate entry into the market without doing detriment to the core business of Scottish Water. One thing that perhaps characterises what we have done in Scotland versus what is apparently being discussed in England is that we and the Government have felt—I think that there has been a consensus on this in Scotland—that there should be no losers as a result of there being competition. Some of what is being discussed in England could involve some people losing out. However, given the extent of the interconnection of social cross-subsidies and all of that, I think that that is to be avoided.

On what we do to try to facilitate entry, we spend a lot of time explaining to the Westminster Parliament, English water companies and anyone else how the Scottish market works, how it delivers benefits, how many people benefit and the fact that it is a relatively low-cost market to participate in. That seems to be having a fairly positive effect. Anglian Water, through its subsidiary Osprey Water Services Ltd, is an active participant in the market. A small entity called Aimera is also very active.

In the past six months, we have issued licences to Veolia, which is a major French company; United Utilities, which is the third-largest company in the sector in England; Severn Trent Water, which is the second-largest; and Thames Water, which is the largest. Those are in addition to Wessex Water, which also had a licence.

Thames Water was in a big article in *The Times* two or three weeks ago, telling everyone that it was going to be successful in Scotland. We will see how it does.

11:30

Jim Eadie: Do you have any concerns about the opening-up of the market in England and the knock-on effect that that might have?

Alan Sutherland: I have permanent concerns about that. If I did not, I would not be doing my job. As I say, one of the things that is critical is the fact that we are going to ensure that we work with whomever we need to work with to ensure that there are not going to be losers in Scotland. We have a framework that is working well, and 70-odd per cent of our customers are paying less than they would otherwise have been paying because of the market structures that we have. A huge amount of water is being saved through water efficiency advice, which has positive implications for carbon emissions. Further, customers are starting to get the on-site services that I talked about. I am not prepared to have that put at risk by what I regard as being a less than successful reform south of the border.

Jim Eadie: We look forward to monitoring developments on that point.

Alan Sutherland: I might come back to you for some help at some point.

Jim Eadie: That was not in my head, but it is helpful that you have put that on record.

Is the commission doing anything to encourage businesses to consider switching as a viable option?

Alan Sutherland: When the market first opened, we tried to ensure that there was an awareness that there was a market and that choices were available. Early surveys done by the Federation of Small Businesses initially did not show high awareness of the fact, but the latest one that I saw—which is a couple of years old now—said that just over half of all customers knew that they could switch. I think that the figures will be higher than that now because, as I said, around 70 per cent have renegotiated the terms of their supply, either in terms of price or in terms of enhanced services. One assumes that, if they have done that, they know that there is a market.

Alex Johnstone: The Scottish Government decided to set a lower borrowing limit for Scottish Water in 2011-12. What impact did that have on Scottish Water's ability to achieve progress towards its ministerial objectives and its OPA targets?

Alan Sutherland: None—that is the answer with hindsight, because it has clearly delivered in terms of outputs at least as quickly as it expected to. Had it not been able to find some of the savings that it found, things might have been more challenging. However, no doubt that was discussed by Scottish Government officials and Scottish Water and the decision about the borrowing arrangement was taken in the light of that performance information. It is not something that we are directly party to.

Alex Johnstone: Scottish Water's costs increased significantly more than its revenue did during that same year. What impact did that have on the measurable targets?

Alan Sutherland: Again, it is the same answer. It has delivered at least what it expected to deliver. Had it had extra money, maybe it would have delivered extra things. That is possible, but it is equally possible that, if a company has a lot of extra cash available to it, it feels less of an imperative to make efficiency savings elsewhere in its business. Many in the regulatory game would say that keeping a company feeling as if it is a little bit short of cash is actually quite a good thing. Internally, we call that a hard budget constraint. We like to keep people feeling that they need to try just that little bit harder to get to where they need to get to.

Alex Johnstone: If that position is maintained over the next two or three years, will it still be a good thing?

Alan Sutherland: Ronnie Mercer used the analogy of a three-legged stool—it is the second time that I have heard him use it—and I think that it is a very good analogy. Scottish Water can cut back on borrowing, but if it cuts back on borrowing it must cut back a bit on how many goodies it wants as well, and people must be prepared to accept that the charges might be a bit higher. We have tried to be clear about what we regard as a sustainable level of financial strength—the financial health of Scottish Water as a business—over the medium to long term. If the Scottish Government is successful in being allowed to issue bonds for Scottish Water, the cost of the funding that comes from those bonds will be very competitive indeed. We want Scottish Water to be strong financially.

As has been explained, one of the big benefits for customers in Scotland is the fact that large shareholder dividends are not being paid as they are being paid by some of the companies in England. That is one of the reasons why our bills are much lower than they would have been otherwise. There is a tricky balance to be struck.

If you are asking, in more general terms, whether it is quite a good idea that Scottish Water has to keep stretching to be certain of meeting its targets, I would say that, yes, that is a very good idea. That is, ultimately, what all businesses in competitive markets have to do. All that we are doing is replicating that same sort of pressure.

Alex Johnstone: My final question is one that you have discussed already. I just want you to repeat your answer to make sure that I have understood you correctly. We have heard from Scottish Water and from you about the fact that there has been a freeze in water bills, in effect, which is not sustainable. Do you agree with the timescale that Scottish Water presented for beginning to ease water bills up, at least in cash terms, or do you feel that Scottish Water is doing enough to keep prices down?

Alan Sutherland: In this particular period, if Scottish Water is overperforming to the extent that, on a permanent basis, it can spend £40 million to £50 million a year less than we thought that it could generate while delivering everything else, that is a pretty good outcome for customers. There is a choice between having a freeze in customer charges, which typically gets little mention but is always appreciated when we all calculate our budgets, or taking a little bit less than inflation each year. Scottish Water has opted to have an extended freeze rather than to ask for inflation minus 1 or 1.5 per cent for the past two or three years of the programme. An answer might be something around the rate of inflation. Does it need to be the full RPI?

Alex Johnstone: Are you comfortable with the vision that Scottish Water set out earlier for how it intends to move forward with water pricing?

Alan Sutherland: An increase of around the rate of RPI over the next two years would be okay. What will it need to be beyond that, in the next period? I do not think that there will be a freeze, but I do not think that any increase will need to be the full RPI either. We can have all the things that ministers want and the sort of borrowing levels that ministers are prepared to give as well as reasonable charges but still have a very financially strong Scottish Water and further improvements for the environment and customer service.

The Convener: I want to explore the targets a bit further. Do you compare Scottish Water's OPA score to those of water companies in England and Wales? If so, how does it measure up?

John Simpson (Water Industry Commission for Scotland): We have compared OPA performance with that of other companies for about the past 10 years. We can no longer do that because, as Scottish Water's representatives explained, Ofwat has stopped using the OPA. I worked for Ofwat when the OPA was being developed and I saw it being introduced in England. It has been useful. Being able to benchmark performance in Scotland against that of companies as a whole in England and Wales and against that of leaders has been extremely useful in driving up performance in Scotland.

When we were last able to look at performance, Scottish Water was knocking on the door of achieving leading performance. That was in the financial year 2010-11—the latest figures that we could get hold of were for that year. We are now looking at how we target Scottish Water's performance under the OPA without the ability to compare performance, and we are involving the customer forum in that.

Earlier this week, I met the customer forum and told it that the OPA scoring system could be improved or extended. I asked the members whether they would be so good as to think about what they would like to be added to the OPA and how they would like the weightings that are in the OPA to reflect customer priorities in Scotland, so that we can use the OPA purely in a Scottish context to continue to target performance, albeit without the comparisons with England and Wales.

The Convener: I do not really want you to go into how England and Wales will measure water company performance, but could we benchmark Scottish Water's performance in another way, internationally—in a European or worldwide context? How is such work done?

John Simpson: The secret is to get absolutely consistent information from the people against whom we are benchmarking, which is easier said than done. It took several years to get a consistent body of data from the regulated companies in

England and Wales, to allow the OPA to be set up. Collecting precisely the same information in Scotland, to allow us to benchmark, took a lot of effort from us and Scottish Water.

Once we extend out of the water sector or out of the UK, getting consistent comparisons becomes extremely difficult. If we have to make do with comparisons that do not rely on consistent data, the company that is being benchmarked always has a get-out—it can say, "Oh—we're not quite like that, because there's something different in our numbers." The bottom line is that a lot of that external benchmarking does not wash.

Alan Sutherland: One thing that John Simpson said that is worth emphasising is that we are asking the customer forum to add to a successful way of measuring performance. If one set of performance measures is replaced wholesale with a new set, the regulator opens itself up to the opportunity for a company to play a little bit of a game with it. The company may let performance slip on the things that the regulator used to measure and start to perform better on the things that are now being measured.

To avoid that, we must keep measuring all that we were measuring and add a few things. That is how we know whether things are getting better over time and that is why we are keen not to lose the OPA measure and not to lose the progress.

In five or 10 years' time, we want people to be able to look at the level of performance and track back to see how it compares with the level five or 10 years previously or when Scottish Water was first established. That is the only way in which we can keep claiming that Scottish Water is moving forward and doing its job. We do not want to have to make a judgment call on whether it is better than it was; instead, we want to be absolutely confident that it is performing better.

11:45

The Convener: So you are quite satisfied that, even without benchmarking with other companies, you can challenge Scottish Water enough to ensure that it keeps raising its game.

Alan Sutherland: Yes, I think so.

The Convener: Finally, are the leakage reduction targets sufficiently robust? Scottish Water might well have exceeded them every year but, as Margaret McCulloch has pointed out, a huge amount of water is being lost every day through leakage. I realise that there is a certain economic level that one reaches in this respect, but is there still a lot of work to be done on the matter?

Alan Sutherland: I have two comments. First of all, all network industries have leakage of some description. The postal system, for example, is a network—and, unfortunately, some mail always gets lost. Those who, like me, gave up schoolboy physics at the earliest opportunity will still remember that the reason for having high-voltage power lines is to reduce the amount of power that gets lost. I have also been quite horrified to discover that gas mains leak. For whatever reason—I am really not sure why it is, but I am sure that we could speculate—water leakage has taken on a symbolic status beyond that of leakage in other network industries.

Is the data as good as it can be? No, because we will always be improving our understanding of the water mains that are underground and which are not readily observable. Are we better today than we were a year, three years or five years ago? Absolutely. We know that we are better and that we have come a long way. Have we got to where we should be? That might be more a question of how much more we want to push things. The answer is probably yes, there is still a fair way that we could go and which would, for various reasons, be sensible and justifiable. However, we should not take away from the progress that Scottish Water has made, especially through two very difficult winters that typically would have resulted in companies missing leakage targets—as indeed happened down south—rather than meeting them, as Scottish Water did.

I do not want to be the party pooper here. Yes, we can go a bit further and no, our understanding is not completely perfect; but we should give credit where it is due. After all, Scottish Water has brought leakage down by nearly 50 per cent.

The Convener: As members have no more questions, I thank the witnesses for their evidence.

Before we move into private session, I put on record the fact that this will be Lauren Spaven-Donn's last meeting with the committee, as she is moving to the European and External Relations Committee. I thank her for all her behind-the-scenes work, such as in getting witnesses to the meeting, and I wish her all the best in her new committee.

11:48

Meeting continued in private until 13:08.

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e-format first available
ISBN 978-1-4061-9958-1

Revised e-format available
ISBN 978-1-4061-9973-4

Printed in Scotland by APS Group Scotland