

ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE

Wednesday 15 September 2004

Session 2

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ENVIRONMENT AND RURAL DEVELOPMENT COMMITTEE 20th Meeting 2004, Session 2

CONVENER

*Sarah Boyack (Edinburgh Central) (Lab)

DEPUTY CONVENER

*Mr Mark Ruskell (Mid Scotland and Fife) (Green)

COMMITTEE MEMBERS

*Roseanna Cunningham (Perth) (SNP)

*Rob Gibson (Highlands and Islands) (SNP)

*Karen Gillon (Clydesdale) (Lab)

*Alex Johnstone (North East Scotland) (Con)

*Maureen Macmillan (Highlands and Islands) (Lab)

*Mr Alasdair Morrison (Western Isles) (Lab)

*Nora Radcliffe (Gordon) (LD)

COMMITTEE SUBSTITUTES

Alex Fergusson (Galloway and Upper Nithsdale) (Con)

Janis Hughes (Glasgow Rutherglen) (Lab)

Jim Mather (Highlands and Islands) (SNP)

Jeremy Purvis (Tweeddale, Ettrick and Lauderdale) (LD)

*attended

THE FOLLOWING GAVE EVIDENCE:

Professor Alan Alexander (Scottish Water)

Nigel Bromley (Gemserv)

Ross Finnie (Minister for Environment and Rural Development)

Dr Jon Hargreaves (Scottish Water)

Ceri Jones (Water UK)

Douglas Millican (Scottish Water)

Lachlan Stuart (Scottish Executive Environment and Rural Affairs Department)

David Watson (Scottish Trades Union Congress)

CLERK TO THE COMMITTEE

Tracey Hawe

SENIOR ASSISTANT CLERK

Mark Brough

ASSISTANT CLERK

Chris Berry

Catherine Johnstone

LOCATION

Committee Room 2

Scottish Parliament

Environment and Rural Development Committee

Wednesday 15 September 2004

[THE CONVENER *opened the meeting at 09:53*]

European Issues

The Convener (Sarah Boyack): I welcome members of the committee, witnesses, the press and members of the public and I remind everyone to switch off their mobile phones.

Our first agenda item is European issues. Members have a paper from me and will remember that we agreed to have regular updates on European issues and legislative proposals to enable us to identify future work programme decisions. This morning we consider our third update, which identifies some of the current issues in the European Union and in particular issues that are relevant to the committee's remit, many of which have an impact on our regular work programme and are being closely followed by the committee.

For the record and so that members of the public and people who read our website have a sense of the issues that are cropping up, I will list issues that the paper identifies. They are: the build-up to the United Kingdom presidency of the EU in 2005; the EU review of the sustainable development strategy; the implementation of the waste electrical and electronic equipment—WEEE—directive; the proposals for directives on batteries and ground water, which are important in the context of waste management; negotiations on the proposed registration, evaluation and authorisation of chemicals—REACH—policy; the review of climate change policy, which is topical this week; the implementation of the European environment and health action plan; the management of fisheries resources and proposals for a new fisheries structural fund; the development of regional advisory councils and the proposed European fisheries control agency; the proposed new rural development regulation, which is important in the light of the work that the committee carried out this year on reforming the common agricultural policy and rural development; and the implementation of the European action plan for organic food and farming.

A lot of heavy issues are covered in the paper, so I invite members to decide how we should pursue them over the coming months. Do members want to hear oral evidence from the

Minister for Environment and Rural Development? We will have a chance to raise issues with the minister today after we have taken evidence on the Water Services etc (Scotland) Bill. Members might want more written briefings or clarification on topics, or they might want to add topics to our work programme. If members do not want to raise anything, are they content to accept and note the paper?

Rob Gibson (Highlands and Islands) (SNP): I would like more details about the action plan for organic food and farming. The minister has made remarks about the need for farmers in various parts of the country to cut costs as part of an overall drive to slim down the sector and to make it more competitive. The organic targets and action plan should be considered in that context.

The Convener: Do members agree with Rob Gibson? We have certainly been pursuing the matter quite heavily; we wrote to the minister about the need to ensure that organics feature highly in the next review of the overall strategy for agriculture.

Nora Radcliffe (Gordon) (LD): I would like an update on how we are coping with the WEEE directive, because its implementation will have a lot of practical implications and I am not confident that we are far enough down the road of putting in place the practical measures that will be needed.

Maureen Macmillan (Highlands and Islands) (Lab): We should ask the minister about fisheries, because the situation keeps shifting. Negotiations continue—for example, an increase in the permitted number of days at sea has been proposed.

Rob Gibson: A paper is attached to the convener's paper on European issues at annex B, which sets out the process by which decisions were made about the regulations on total allowable catch and quotas for haddock. The record shows that I have asked about the process in relation to local offices and the way in which information is fed out. I want to follow that up a little. We do not need an immediate answer, but it would be good to find out what the process is, because many users find it difficult to deal with conflicting reports, or reports that have been withdrawn, for example.

Mr Mark Ruskell (Mid Scotland and Fife) (Green): It would be useful to ask the minister how he will feed into the European Commission's work on climate change and how that work will mesh with the Executive's review of its climate change strategy later in the year.

The Convener: The committee's report on sustainable development was published yesterday and there is clearly an issue about the European Parliament's review of its role in sustainable

development, so I will raise that matter. We have quite a concrete agenda to raise with the minister this morning.

Members will note from annex A to the paper that we are no longer directly represented by a Scottish member of the European Parliament on the European Parliament's Committee on Environment, Public Health and Food Safety or on the European Parliament's Committee on Agriculture. There has been quite a shift in committee membership for Scottish MEPs, so we will have to keep an eye on the feedback that we get from the Scottish Executive European office—we used to have a lot of helpful discussions with, and direct feedback from MEPs, so we will have to refresh our relations with the European office.

If there are no further questions on the paper, we will move on.

Water Services etc (Scotland) Bill: Stage 1

10:00

The Convener: We move on to day 2 of stage 1 consideration of the Water Services etc (Scotland) Bill.

Today, we will examine the bill's approach to competition, regulation and pricing for those who are involved in the industry. We have tried to arrange a representative selection of witnesses, but we have limited time. Before we take evidence, I ask members to declare any relevant interests.

As members have no interests to declare, I welcome this morning's first panel. To represent the Scottish Trades Union Congress, we have Stephen Boyd, who is the STUC's assistant secretary. David Watson is the Scottish organiser for Unison, and Bobby Buirds is the regional officer for Amicus. I thank you for attending this morning and for ensuring that we had a written submission in advance.

I look to members for the first question.

If nobody else has an instant question, I have one. One point that the submission makes is about the water industry's long-term stability under the Executive's proposals. Will you outline why you are concerned about stability? Will you give us more of a sense of why you are concerned about splitting Scottish Water and about whether cost issues would be sustainable in the long term?

David Watson (Scottish Trades Union Congress): There are two issues: one is structural and one will be in the detail if one proposal in the bill goes ahead. Splitting Scottish Water to allow competition in the non-household market would create business separation. The bill proposes a Scottish Water retail business and a Scottish Water wholesale business. Our concern, which is based largely on our experience of other utilities that went down that road some years ago, is that huge costs are involved in such separation. It involves rebranding and the setting-up of marketing, sales and billing operations, all of which have a huge cost that must be passed on to the consumer.

Another problem is how the split will be accomplished. The industry has just undergone a period of substantial upheaval in which many of the substantial savings that were passed on to consumers were achieved by the economies of scale that Scottish Water's creation allowed. If we start to split its operations into small units, we will begin to lose those economies of scale when the next stage of efficiency savings is challenging.

Many of the opportunities for big savings arose through structural and technology changes; making such savings will be more difficult in the future.

Another point relates to costs. We set out some of our concerns in our submission and I think that other witnesses from whom the committee will hear this morning will replicate them. Our concern is that the figures for the alleged efficiency savings, which I understand were produced largely by the water industry commissioner, are clearly out of date. The 42 per cent figure that is being quoted is based on the time when Scottish Water came into being. We have given evidence to this committee and to the Finance Committee on our concern about the adequacy of figures that the current regulatory structure produces—that figure is another example of that. It is way off line and could cause us problems.

There are other questions about how to split and about what percentage of current revenue and costs will relate to the new Scottish Water retail operation and wholesale operation. We are concerned that the regulatory impact assessment implies that the retail segment's figure could be about 15 per cent, whereas we understand from colleagues in England that the Office of Water Services puts the figure at about 8 per cent there. I know that others who will give evidence today think that the figure is even smaller and is possibly as low as 4 per cent. The problem is that if too much cost is transferred to the retail operation, it will become ineffective. Equally, if the wholesale side is undercosted, it will become ineffective. The result will be that the new structure will set up Scottish Water to fail. That is the essence of our concern.

The Convener: Given what the Executive intends to do, how would you set up Scottish Water to succeed?

David Watson: We would not split Scottish Water in the proposed way—that is the essence of our evidence. We do not believe that splitting Scottish Water is the way forward. Our view is that the business should not be separated and that non-household competition should not be created. We start from disagreement with the Executive on that point.

However, if it is going to be split, at the end of the day that must be based on an accurate, current, and up-to-date split of the costs, which for the retail sector is probably closer to 4 or 5 per cent, or maybe up to 8 per cent, with the rest being wholesale. It is vital that that figure is correct. Frankly, it cannot be based on the guesstimates that we have had from the regulatory structure so far.

Alex Johnstone (North East Scotland) (Con): I want to follow on from that. My experience is that

opinion favours the view that retail competition in the domestic energy sector resulted in a significant fall in the relative cost of energy over a considerable period of time. Why do you suggest that similar competition in the water industry—whether as prescribed in the bill or beyond it—would not be equally beneficial?

David Watson: I would be happy to provide you with research that was undertaken by the University of Sussex a couple of years ago, which studied in detail the price shift in the energy market to determine how much was due to competition and how much was due to other factors. The research concluded that most of the reductions at the early stages—bear in mind the fact that we are in a situation of rapidly rising energy prices—were to do with coincident changes in raw material prices, that is, raw energy prices, and were not due to competition at all. The reason for that is that any small saving that competition may introduce is balanced by the additional costs of establishing the system, which are massive.

Our members administer many of the energy systems and they can tell you the huge costs that are involved in running them in terms of billing, maintenance, sales and the mechanism of divvying up the energy market. There is also the profit element and the return on capital invested that is required by the companies. When those costs were all taken into account it was found that they swallowed the small savings that might have arisen from competition. The real savings at the time were due to changes in the energy market, which would have happened whatever the structure of the industry at the time.

Water also has other features that make it different from the energy industry, in particular the nature of the source and the natural monopoly position. In addition, the networks—if they can be called that—are very different. I could take you to the electricity and gas control rooms and you would see a network throughout Scotland and the rest of the UK, and you could see the way our members move power around the UK. There is no comparable situation in the water industry: there is no network. We have an ad hoc collection of largely Victorian sewer and water systems, and people often do not even know where they are, so never mind the idea of sitting in a tent or shed in Livingston to see what is moving around. It is a very different industry in terms of the ability to introduce to it the competitive element. Even under the Executive's proposals, or the equivalent ones in England, Europe or the world, the water industry structure is not equivalent to that of the energy industry. The issue is the nature of the water industry.

Alex Johnstone: Are there any circumstances in which retail competition can be beneficial to the consumer?

David Watson: In a word, no.

The Convener: That was very clear.

Rob Gibson: I will address the section 3 issue. Last week we debated the composition of the water industry commission. Paragraph 8 of your submission states that you want the

"regulations to define how the balance of costs between Scottish Water and developers will be calculated",

because you

"believe there is a strong case for developers meeting a much greater share of the cost of new water and sewerage services so that new development can proceed without detracting from the urgent need to renew the existing infrastructure."

I say that clearly, because it contradicts the written evidence that we have received from Highland Council, which states that, in the Highlands, housing or industrial developments tend to be on a small scale,

"undertaken in groups or small estates rather than by volume builders thus militating against developer contributions which are large enough or at the right time."

There seems to be a contradiction between the kind of developments that you envisaged in the central belt and Highland Council's feelings about what would happen in its area. Have you any comments on that?

David Watson: It is fair to say that local authorities' views differ on developer costs. Indeed, the Convention of Scottish Local Authorities itself does not have a single view on the matter. We have to face the facts. The Executive's consultation paper "Investing in Water Services 2006-2014 (The Quality and Standards III Project)" makes it clear that, over the next 10 years at least, something like £1 billion a year will have to be spent on Scotland's water and sewerage infrastructure. Obviously, that is a huge sum of money to find, which is why the second consultation—on how we pay for it—is the more difficult one. Moreover, the construction industry needs a huge amount of capacity to deal with the issue.

There is no doubt that there have been development constraints and that those in Glasgow have received more publicity than those in the Highlands. The reality is that a cost issue is involved. Why should the public purse pick up the cost of bringing water and sewerage into, for example, a housing estate that a developer is building on the outskirts of Edinburgh? It seems only reasonable that that cost be met by the developer who will, after all, sell the houses at an appropriate profit. That principle seems to be the best way forward.

However, we accept that there will always be exceptions to that principle. For example, the public purse will have to pick up the cost of social and other developments that might arise. That said, those costs should be picked up by the appropriate public purse and not simply dumped on Scottish Water. After all, the organisation has to set its priorities in line with the minister's view on those priorities. At the moment, the priority with regard to cost must be upgrading of the infrastructure to ensure that we have a safe water and sewerage system in this country.

Rob Gibson: I must follow that up by pointing out that, at the moment, 38 per cent of all rural settlements in the Highland Council area are constrained by inadequate water services and that three major regeneration projects involving the council are potentially at risk. We have also heard that a moratorium has been introduced in Perth. The water industry commission will have to address major deficits in many parts of the country, a recent example of which is the Western Isles. The suggestion in paragraph 8 of your submission will not meet conditions throughout the country; we need a clearer picture of how such an approach will affect the rest of the country and the background of any personnel who might be appointed to the commission.

David Watson: We need to separate out two issues in your question, the first of which is the importance of extending our networks to areas that are currently not supplied by sewerage or water systems. Clearly, as that involves public expenditure, it is a legitimate public policy issue. The second point relates to commercial developments in new housing schemes and so on. In those circumstances, it seems only reasonable that developers pay all or most of the costs that might be incurred.

We broadly welcome the new commission and feel that many of the criticisms of the current structure might at least be addressed if we could rely on a broader organisation instead of on a single named person. However, as we have pointed out in our evidence, it is important to get the right balance of people on the commission. We agree that it is not a case of stakeholder representation; however, as the history of UK economic regulation makes clear, cabals of economists have usually been appointed to such bodies and have focused narrowly on economic interests. A country such as Scotland has diverse interests; indeed, you have highlighted one of the differences between some rural and some urban areas. A number of other differences affect the water industry. Indeed, when Scottish Water was created, we expressed concern that in the chase for efficiencies that come with a big organisation, local contact and accountability would be lost. I am

afraid that that is a trade-off for going down such a road and having a cheaper water system.

10:15

The membership of the commission needs to be fairly representative of the country and should be made up of people who understand the needs of all parts of the country, from the urban central belt to the northern and southern rural areas. That is important if we are going to get the commission right. If it is left to the normal means of utility regulation, we will end up with the usual suspects. The usual economists will be wheeled out because of their alleged expertise in economic regulation.

The Convener: That is an interesting answer because we spent a lot of time arguing about this matter at our previous meeting. One of the things that we were trying to get clear in our minds was exactly how the public policy framework is set. As you rightly say, the quality and standards III process and the investment consultation are under way. We want to work out at what point an examination of efficiency and value for money delivering the service kicks in and how the calculations about various policy objectives, for example on the environment or social justice, come in. Last week, we were trying to find out whether those considerations are part of the minister's job, in instructing Scottish Water, or whether they are part of the regulator's job. Who makes those decisions? Does the STUC have a view on that?

David Watson: We do. In the first place, there is clear ministerial direction on investment and funding. I am sure that members of the committee have studied the current consultation documents. The "Investing in Water Services 2006-2014" document sets out the investment in Scottish Water in a particularly clear way for the first time—previously, valid criticisms were made, especially by the old Transport and the Environment Committee, about the fact that the investment was not properly explained.

Initially, it is for ministers to set out the public policy. That was the situation before the current structure was put in place as well. The change relates to the role of the water industry commissioner. The problem, under the current structure and the proposed structure, is that the WIC is concerned only with issues of economic efficiency and price control, which are the same issues that concern other utility regulators. However, the bill implies that that role is simply a case of crunching the numbers after the ministers have set the public policy priorities, but that is not the case. We have some difficulty with the idea that there would ultimately be an appeal to the Competition Commission, because it is full of

people who are qualified to comment on crunching the numbers but it is simply not qualified to play that role in relation to a public service such as Scottish Water, which has clear political direction in relation to public policy. A political question arises as to whether it is right for the judgments in relation to the balance between economic efficiency and public policy considerations to be arbitrated by a body of economists sitting in London. Water is a devolved area and it is our view that such decisions are, properly, political matters.

On a flow chart, the process would go like this: a political issue for consultation and direction would be taken on board as part of the plans; the economic efficiency aspects would be haggled over by the regulators and Scottish Water; and conflicts between public policy and efficiency would be dealt with through political decision making. I am not unsympathetic and can understand why, given the history of these difficult issues, ministers might want to pass the buck. However, to be frank, ministers are there to make such decisions, not to pass the buck to a bunch of economists in London.

Nora Radcliffe: What would be your ideal appeal system?

David Watson: That is a political decision for ministers, who are accountable to Parliament. Parliament, not a London-based commission, should decide whether the balance of public policy and other issues is appropriate for Scotland.

Mr Ruskell: It is clear from your submission that you are quite sceptical about the privatisation of utilities. I share some of those concerns, particularly in relation to the pressures that come from outwith the European Union, such as those arising from the general agreement on trade in services. However, put yourself in the position of ministers. On one side there is the Competition Act 1998, which is driving some form of competition in the utilities and, on the other, there is pressure to retain the delivery and control of utilities and services in the public sector. How should that balance be maintained? Do you think that the Executive has got it right in the bill? If not, how does the STUC envisage that balance being addressed?

David Watson: This is a convenient answer, but there is no doubt that we would rather not be where we are in terms of the legislation. The Competition Act 1998 must be the most ill-thought-out piece of Westminster legislation for a long time. It sounded fine at the time, but nobody thought through its long-term consequences, particularly in the devolution settlement. The problem does not end there. One of the reasons why we highlight in our submission the importance of keeping a weather eye on the issue is that the

European Parliament has voted twice against the liberalisation of water, but the European Commission keeps coming back with other proposals. The services directive, which was published in January, is another attempt to liberalise water and there are drives within the general agreement on trade in services, particularly from the United States, to extend the neo-liberalisation of public services. The 1998 act is simply another example of that, but we are where we are and now that we have that piece of legislation we in Scotland have to manage as best we can and retain as much control as we can over our public services, including water.

In those circumstances, it seems to me that there are two ways to approach the matter. The Executive is saying that because there are major risks of legal challenge under the 1998 act—for the reasons that are set out in the policy memorandum and elsewhere—it will safeguard the necessary public policy issues, such as public health in relation to common carriage, and the wider social obligations, such as restricting competition in domestic households. In effect, the Executive will throw something in to show that it is following competition routes by opening up non-household competition. We could take the view that that is a sop to demonstrate approval or a line in accordance with the 1998 act, or we could take the opposite view, which is that it is the thin end of the wedge and gives a foot in the door to the full privatisation of Scotland's water.

We have already had the slow privatisation of water and the bill is simply another step down that road. Our view is that there are public policy exclusions under the 1998 act, both for services of general economic interest and on public policy grounds as set out in schedule 3 to the act. A better approach would be for ministers to set out the public policy reasons for the arrangements in Scotland and to face up to the matter on that basis. I accept that either approach has its difficulties, and we would rather not be in the position that we are in, but we believe that that is a better approach than the partial, thin-end-of-the-wedge solution that is proposed in the bill.

Mr Ruskell: I am not entirely clear whether you are saying that ministers' hands are tied. You seem to be saying that ministers could take more of a role in some areas. Will you explain that?

David Watson: We partially had this debate during the consultation in 2000. One option for ministers is to say that water is a public service issue in Scotland for public policy reasons and because it is a service of general economic interest. There are provisions in schedule 3 to the Competition Act 1998 that arise from the competition directive and they would enable ministers to make the case that water is a public

service that is not open to competition. There are different views and many things have not been legally challenged in the courts so nobody knows what the outcome would be. The view that ministers took in 2000 is different from the view that they take today. In our view, there is scope to go somewhat further and use the full exclusion provisions under schedule 3 to the 1998 act—that is our preferred solution. The current proposals will not only mess up the water industry at a time when it needs to concentrate on other things but open up the possibility of further privatisation in the industry.

Maureen Macmillan: One of the issues that was discussed thoroughly last week was cross-subsidy. The business community feels aggrieved that it is, as it perceives it, cross-subsidising domestic supplies. It also seems that the large water users insist on getting cut prices, which means that they are being subsidised—perhaps by medium-sized businesses. However, the large companies say that if they do not get those special terms, they can go off network and find their own private supplies. It seems to be a Gordian knot that is almost impossible to untie. What are your thoughts on the matter?

David Watson: Provision exists for off-network solutions, which are obviously attractive, predominantly but not entirely, to large business users. There is some evidence of the alleged cross-subsidies; the Executive sets out some of it in "Investing in Water Services 2006-2014", but it is far from proven whether there is a cross-subsidy or how large it is. Everyone accepts that if we had spent millions of pounds setting up grandiose information systems, as the WIC has argued for for some time, we might have a better feel for what the figures are, but that would be millions of pounds not spent on improving water quality and safely disposing of sewage. Such judgments always have to be made and we have always argued that we need to get the political priorities right, but nonetheless if that information was available there might be a clearer view about whether there is a cross-subsidy.

The best judgment seems to be that there may well be a modest cross-subsidy from the business sector to the domestic sector in Scotland. If that is the case, clearly a calculation must be made of what the cross-subsidies are, but it has to be understood that it will be the domestic customer and the small business customer who pick up the bill. Experience in other utilities shows that big users have benefited most from increased competition as they can negotiate larger contracts right across the United Kingdom; most big companies do that now with one or more supplier—usually one supplier—so that they benefit from economy of scale. Small businesses have not benefited from that competition to the

same degree. Frankly, I think that under the proposal small businesses will struggle with the new system; big businesses already have options available to them that small businesses do not have. We often talk about the disadvantaged consumer, but in this case there may be a disadvantaged small business consumer, who may suffer under this arrangement.

A possibility, which we highlight in our evidence, is that there will be cherry picking in the small business area. If I were setting up as a new entrant in that area, there are large parts of Scotland that I would not touch with a barge pole, but there are other areas in which I would concentrate my effort.

The Executive is trying to deal with the issue in price terms, but it is unable to deal with it in terms of the other side of the balance sheet, which is the costs for new entrants. New entrants may be able to focus more effectively; it may not even be a matter of a rural-urban split, as new entrants may be able to cherry pick certain large industrial estates where there may be a market for them to run with. They could save on costs by concentrating geographically rather than providing customer service facilities in, for example, the Highlands or the Borders. It would be much more cost effective to provide some services in a local area.

The problem is that there could be confusion for small business in this arrangement. In the energy industry, our members in call centres deal day in, day out with domestic and business customers who are confused about the various options that are available to them. In the water industry, there is potential for chaos. When people contact customer services and call centres, there will be confusion between what is a retail operation and what is a wholesale operation. If a pipe is leaking and people are not getting water, is that wholesale or retail? All sorts of customer confusion will arise. Even the greatest advocates of competition in the market accept that we are playing with a small and marginal end of the business—perhaps 4 or 5 per cent of Scottish Water business. That is a very small percentage, so is it worth baffling and confusing all the other customers, and adding in extra costs, for that very small gain?

10:30

Maureen Macmillan: What you have said is very interesting, but I want to get back to pursuing the idea of whether there is any value in cross-subsidy. Should there be cross-subsidy between the commercial customers of Scottish Water and the domestic customers? We keep hearing about the dichotomy between the commercial and the social. For example, in the domestic market, should people who live in big houses be

subsidising people on low incomes? Should that be done by Scottish Water, or should the issue be addressed in another way, perhaps through Executive policy?

David Watson: That is not an issue for Scottish Water. As you know, there is cross-subsidy at the moment between north and south. That was part of the reason for establishing Scottish Water. A number of cross-subsidies exist, but they are a matter of clear public policy. Business would rightly argue that such cross-subsidies are not necessarily an issue for them but, irrespective of the business view, Scottish Water's position should be that it is there to provide a service in accordance with public policy considerations. The decisions are political and should be for ministers and Parliament.

Maureen Macmillan: So, any subsidy of small or large businesses, of domestic users, or—as Rob Gibson mentioned—of developments, should come from the Executive rather than from Scottish Water's budget.

David Watson: No, I am not suggesting that the money for subsidies should come from the public purse, but the decision on whether or not to have a cross-subsidy is a public policy decision. We have cross-subsidies now, as a matter of public policy.

When it comes to questions of how we invest in the water service and pay for it, everyone would agree that a big bill has to be paid. Obviously, nobody wants to pay it; suggestions on who should pick up the bill usually involve somebody else paying—usually the taxpayer. Consultations and discussions that I have had with colleagues on a range of issues usually end with the same view being expressed: "Couldn't the taxpayer pick up the bill?" Our view would be that the taxpayer could indeed pick it up, but that would be a matter for public policy. Do you wish to switch resources away from schools and hospitals and put them towards subsidising business users or others in the water industry? You might well want to do that, but there are legitimate political decisions on public policy to be made. If you are having a cross-subsidy, it should be transparent. People should be able to see a clear public policy reason for the cross-subsidy being in place.

Mr Alasdair Morrison (Western Isles) (Lab): I would like to ask the panel about the replacement of the water industry commissioner with a commission of three to five executive directors. What is the panel's view on the proposed composition of the commission? How should members be chosen? Should it be on the basis of technical expertise, or to represent particular stakeholder groups?

David Watson: We would have reservations about turning the commission into a purely

stakeholder body, which would be difficult with only five members. The primary function of the commission is not simply to represent stakeholders.

If ministers are, in effect, arbitrating on public policy issues, rather than handing the issues down to a commission in London, it seems to us that the commission could have more technical members. That would be our preferred solution. I do not mean simply people with technical expertise in economics, but people with technical experience of the water industry, how it is structured and how it works. Geographical issues could also be taken into account.

If you adopt our model, in which ministers would arbitrate, you could have a tight technical body, with three to five members with expertise in relevant technical areas. If you go with the ministers' current proposal, under which some matters will be arbitrated in London, you will need a larger, more representative water industry commission that is more able to take on board the wider social and public policy considerations that ministers will have set out in their earlier directions. Under our model, the water industry commission could be a technical body, with ministers making the final decision, but under the bill, the commission would need to be a larger and more widely representative body.

Karen Gillon (Clydesdale) (Lab): Will the bill's impact on employees be neutral? If not, what are the potential implications?

David Watson: The bill obviously involves further upheaval for employees. Probably some 200 staff will transfer from Scottish Water to the proposed new Scottish Water retail. The bill could have a further impact, assuming that all other things were equal and that competition worked as it is supposed to do in theory. Our concern, which is based on the financial memorandum and the regulatory impact assessment, is that the bill's impact will be anything but neutral. There could be a serious impact for staff not only on the retail side but on the wholesale side because both operations in Scottish Water could be undermined. That is a crucial structural issue. We have touched on it already, but I cannot emphasise enough that it is essential that if the split goes ahead, which we do not recommend, we get both arms of the business right, with the right levels of cost and revenue accruing to both. That would be the best opportunity for the bill to be neutral as far as staff are concerned.

Karen Gillon: Will you expand on what the potential negative implications would be for staff and how those would impact on service to the customers, particularly where infrastructure is concerned?

David Watson: If we get things wrong—or even, to be frank, if the split goes ahead at all—and everything goes pear shaped, there will be impacts on staff job security and morale. In the energy industries, there have been problems with the constant barrage of complaints day in, day out from customers who are confused and bewildered by the structure that was established in those industries. The aggressive phone calls and face-to-face contact and the other problems that our members face daily in those industries will be replicated in Scottish Water and that level of customer confusion and upset is not something that we want to export from the energy industries to the water industry. However, ultimately, the issue is economic viability and our concern is that if the proposed structure gets the balance wrong, our members' job security and ability to provide what they want to provide—a high-quality service to the public—will suffer in the longer term.

Karen Gillon: Might there be an impact on the number of staff who would be employed and therefore their ability to maintain the network at a standard that the customers would expect?

David Watson: Yes. That is probably focused more on the speed and scale of what are wrongly called efficiency savings. The savings that have been made so far have been made in two ways predominantly. The first is the economies of scale that the creation of Scottish Water created. Those have come at a price to local accountability, but nonetheless, any economies of scale make savings. The second way of making savings is to introduce new technology, because, when new plant and equipment are introduced, they tend to use fewer staff than were previously needed. We accept that entirely; whether the service was in public, private or any other hands that would happen as a result of the technological changes.

Some other savings are made by scale. For example, large organisations are probably more able to invest in new technology to make such savings. Scottish Water, being the fourth-biggest provider of water and sewerage services in the UK, is clearly in the position to make such investments and has done so. In fact, it has been so good at it in one or two places that it has sold systems elsewhere in the UK. Scale helps in that.

That process has been fine to date. The savings have been made at a rapid pace—twice the speed that the same savings were made in England—but it must be understood that the savings that the WIC proposes in the current strategic review of charges can be made only by cutting corners. There are two ways to cut corners. One is to cut corners in the handling of maintenance and repair work, such as by multitasking—for example, mixing up the maintenance of sewerage and water systems—which has safety implications. Savings

can also be made by keeping staffing levels in major plants very low, which has safety implications.

Our concern about the next stage of savings in Scottish Water is that the organisation will put customer service and the health and safety of the work force at greater risk than if the savings were not to be made on such a scale. In essence, we are concerned about the size of the efficiency savings and about the speed of change. We are being asked to make changes to the structure of Scottish Water at a pace at which our counterparts in England did not move. Therefore, there needs to be a review of the scale of savings and the speed at which we make the changes that are feasible.

The Convener: I thank the three of you for coming along this morning. We have noted your support for the retention of domestic customers in the public sector and your criticisms of the proposed split in Scottish Water. We have tested some of those issues on other witnesses and I suspect that we will test them on subsequent witnesses today and later. I thank you for putting your representations in writing before the meeting and for being prepared to answer our questions.

We will now have a short break as we change witnesses.

10:42

Meeting suspended.

10:45

On resuming—

The Convener: We move on to our second panel. I welcome Nigel Bromley, who is the chief executive of Genserv, and Ceri Jones, who is the regulation and competition director with Northumbrian Water and who is here to represent Water UK. We will not invite you to make opening statements; we already have your written submissions, for which I thank you.

Nora Radcliffe: Quite a lot of the Water UK submission deals with estimates of retail costs, and much of it is disquieting. Could you expand on that? You state:

"The size of the retail gross margin is ... a very important issue"

and you urge us

"to research it most carefully."

Could you talk us through that and point us in the right direction?

Ceri Jones (Water UK): Yes, I am happy to. Perhaps it is worth saying a few words first on why the appropriate wholesale cost is so important before I move on to the numbers themselves.

We do not think that the separation of the retail function in itself is sufficient to ensure that domestic customers are not disadvantaged by competition. What is critical is that the wholesale price is set at the right level. If it is too high, you will deter any entry and there probably will be no competition. If it is set too low, it might encourage inefficient entry. If it is set at a price that is below cost, it will create difficulties for the incumbent in terms of covering its costs, which is likely to put pressure on domestic bills. Those are similar issues to the ones that were faced south of the border. Our view is that the wholesale price should be as cost reflective as possible.

There is still an issue, in so far as charges are based on average charges. Even if you are able to allocate costs accurately between wholesale and retail functions, any average charge will give some incentive to new entrants to cherry pick, because in reality it will always be cheaper to supply some customers than others. Therefore there may be an incentive for new entrants to focus on those customers from whom they can achieve a higher margin or for whom the costs of supply are lower.

Our conclusion is that it is important to be clear about the appropriate balance of costs between wholesale and retail functions. Comparisons with England and Wales might serve some purpose there, but it is important that you focus on the actual cost to Scottish Water. Comparisons with England and Wales might be illustrative, but they can be no more than a benchmark.

We took issue with some of the numbers quoted by the Scottish water industry commissioner in relation to England and Wales, which suggested that the retail function accounted for 15 to 20 per cent of bills. The calculations were based partly on numbers from my company, Northumbrian Water, so I feel qualified to comment on them. There is no information in the public domain—and there was none at the time—that directly identifies the proportion of bills that relates to the retail function. The estimate relied on fairly major assumptions, which were inaccurate. More recently, the industry did some work with Ofwat to examine the actual level of retail costs in England and Wales. Ofwat concluded that the figure was somewhere around 10 per cent—in fact, it quoted 9.6 per cent—which is much more consistent with the numbers for my company. It is important to note that that figure relates to the total retail cost and not specifically to the retail cost to industrial customers. In general, for industrial customers, retail costs are a smaller proportion of the total cost because, while retail costs might vary slightly relative to domestic customers, the bill will be significantly larger. That means that, as a proportion of the bill, retail costs are generally lower.

The same Ofwat survey concluded that, for large industrial users in England and Wales, retail costs account for closer to 4 per cent of the total bill. I point out that that definition of large industrial users referred to those using more than 50 megalitres a year, which is the definition of the competitive market for England and Wales. The proposals in Scotland relate to a much larger market for all non-household customers, so one might expect the numbers to be slightly higher than 4 per cent.

Using the definition that has been applied in Scotland, our conclusion is that, in England and Wales, the relevant figure for industrial customers is somewhere between 4 per cent and 10 per cent. Using the restrictive definition of large industrial users, it would be closer to 4 per cent. As I say, that is purely illustrative and the key point is that we need to be clear about what the appropriate cost allocation is for Scottish Water. However, I suggest that the numbers that were proposed by the water industry commissioner for Scotland looked rather high.

Nora Radcliffe: I will ask a daft-lassie question. What is meant by retail costs? What is included under that budget heading?

Ceri Jones: That is actually a good question, because that is one of the issues that might determine the answer we are looking for. Broadly speaking, the retail function would not include production and distribution. Essentially, it relates to billing and customer service costs. However, the reason why your question is a good one is that, in order to answer it properly, we would need to define clearly which functions rest with wholesale and which rest with retail. For example, in relation to metering, we would need to be clear about where the metering function lay. Depending on the definitions that were used, it could lie on either side. Clearly, that has an implication for the cost allocation. If you were seeking to separate the functions, it would be important to be extremely clear about what precisely you were including in the retail function.

Nora Radcliffe: That is helpful.

Maureen Macmillan: I am still not totally clear about this. If the retail function is billing and meter reading, why would it be more expensive in one area of the country than in another? How would it be possible to cherry pick?

Ceri Jones: It would be easier to service some customers than others. For example, the level of bad debt might be higher among one group of customers than it is among another. I accept that the cherry-picking issue might be a greater concern in situations involving common carriage, for example, but that is not part of the proposals in Scotland.

Maureen Macmillan: I am aware of that but I did not think that the cherry picking of retail services was an issue. However, I understand what you said about levels of bad debt and so on.

Ceri Jones: The issue is more likely to be related to customer characteristics than to geography.

Roseanna Cunningham (Perth) (SNP): The first page of the Water UK submission made a great deal of play about the difference between the regime in England and Wales and that in Scotland in relation to public health risks and common carriage. In particular, it flagged up the issue of a potential legal challenge. I would like you to expand on that and talk about the reasons why there might be such a legal challenge. Would you accept that it is entirely legitimate for the Scottish Executive to come to a different view from that held by the drinking water inspectorate in England and Wales?

Ceri Jones: We were not trying to comment on the correctness of the proposals; we were commenting that it is interesting that a different conclusion has been reached. It is likely that some commentators will point to those differences and it is possible that some parties might want to challenge the fact that a different conclusion has been reached.

Our point was about whether the proposals in Scotland are consistent with the Competition Act 1998. We were not saying that they are inconsistent; we say just that it is interesting that a different view has been reached. New entrants in particular might wish to question why common carriage is being allowed in England and Wales but not in Scotland. It is legitimate that the Scottish Parliament has a view on that but, like everybody else, it must operate within the provisions of the 1998 act.

Roseanna Cunningham: So your view is that a public health issue would not be a relevant consideration for the Competition Commission.

Ceri Jones: The view that has been taken in England and Wales is that some serious issues need to be resolved. That is why much effort has been exerted to put in place a licensing regime that will ensure that any new entrant must meet the same standards as the incumbents. The industry felt strongly about that.

Initially, we had big concerns about how common carriage could be implemented if it did not fall under a properly licensed and regulated regime. The DWI reached the view that, with appropriate safeguards, common carriage would not necessarily pose a risk to public health. That is the view that the industry has reached. Given the strong safeguards that are in place in the legislation, we feel comfortable that public health will not be compromised.

Roseanna Cunningham: I appreciate that that is the DWI's view in England and Wales and I dare say that it is a welcome view from the industry, but a different perspective is taken north of the border, where the public health issues are felt to outweigh any competition issues, so I am interested in your take on whether competition should override the perceived public health concern in Scotland.

Ceri Jones: Ultimately, that is an issue for the lawyers. I understand that the public health issue is emotive. It received much debate in England and Wales before the DWI reached its conclusion.

It is perfectly legitimate for the Scottish Parliament to reach a different conclusion. Our point is just that some people might question whether that is consistent with the 1998 act and I can easily see that some parties might wish to challenge the view. I do not suggest that Water UK wishes to challenge it, but somebody who was keen to enter the market in the UK on a common-carriage basis might question why they could not do that in Scotland, unlike in England and Wales.

We are asking whether it is sure that the bill is consistent with the 1998 act. The water industry commissioner for Scotland gave evidence recently that suggested that he was very confident that the bill would withstand challenge. That was simply the point that we raised.

The Convener: When the minister appears before us, we can ask him the same questions. The committee's job is to scrutinise the bill and to reach its own view on the public health issue and on whether the Scottish Executive has got it right in the bill. We can follow up the question with several witnesses.

Does Gemserv have a different perspective from that of Water UK?

Nigel Bromley (Gemserv): Gemserv is not in a position to comment on public health issues. We are primarily involved in and can advise on implementation of legislation.

The Convener: Does Roseanna Cunningham have a follow-up question, or is that enough for the moment?

Roseanna Cunningham: I could go on for a bit, because the potential players do not necessarily come from the UK. We could go quite a long way in querying how widely we should impose the same standards. A French water company might have to deal with a completely different standard in France from that here, for example. However, perhaps we should move on.

The Convener: I was just giving you the final say.

Roseanna Cunningham: We should flag the matter up as an issue to explore.

The Convener: We will return to it.

Nora Radcliffe: I will ask Mr Bromley about the part of his submission on the avoidance of undue influence. Your submission says:

"When decisions are left exclusively to commercial companies, there is a risk that some parties may exert undue influence, distorting the market design in their favour",

The submission continues:

"New entrant companies need to be encouraged to participate in developing the ... infrastructure."

Would that not interfere with competition, which is supposed to deliver everything that is good and wonderful?

11:00

Nigel Bromley: No. On the contrary, that would enable competition. We have been involved since the beginning of the liberalisation of energy and we have a lot of experience. From our perspective, it is wholly appropriate to go down the route of separating Scottish Water retail and Scottish Water wholesale. It is important that Scottish Water retail starts off on the same footing as any new entrant competitor. To give an example of the issues that we allude to in that comment, if the governance structure is such that Scottish Water wholesale is responsible for managing switching processes, it is possible that it would take one, two or three years, or even more, for business relationships between people in the two Scottish companies to have faded away. We saw some examples of such communication, and therefore of advantage being given to certain companies, in the early days of energy liberalisation. We advocate that the governance regime and the rules associated with switching should be in the control of all players, and that there should be no chance of Scottish Water wholesale tilting the rules, perhaps subliminally, in favour of the incumbent company.

Nora Radcliffe: Further on in your submission, you say that

"it may not be practical or cost effective to create separate companies at this juncture."

How do you envisage the whole thing working if there is not that degree of separation?

Nigel Bromley: There have been examples in Europe in which companies have been ring fenced and have had to move into separate premises, with movement of staff to different places. There are rules in energy whereby staff who move from a distribution business to a supply business that is owned by the same company must take garden leave for six to eight weeks; the rules about companies that own both distribution businesses and retail businesses are quite strict. That

situation still prevails in energy; some of the large energy companies have evolved two separate companies from ring-fenced businesses that were within one company. That is a comment on the evolution of the water industry rather than on where it should start. It might take longer to form separate companies than to ring fence businesses.

Nora Radcliffe: Is forming a separate company more onerous than ring fencing a company? Are there extra costs involved? What is the difficulty with moving from one to the other?

Nigel Bromley: I do not think that there is a difficulty. One precedes the other—that is our comment. I agree with the remarks that have been made about the proper allocation of resources and costs to each of the businesses.

The Convener: In your submission, you say:

“Customers can be afforded protection by the use of an independent central registration authority operated by an organisation that is not connected with any retail or distribution business in the market.”

You go on to say that

“there may be a requirement for an independent ‘policeman’ to ensure adherence to business separation rules.”

When you talk about customers, I take it that you mean business customers. It is quite confusing to think about how things would work in practice with the extra stipulations that you make. Would Scottish Water not be involved in the process by selling to different retail companies? Are you suggesting that something is missing in the bill and that new agencies need to be added to oversee the process?

Nigel Bromley: There could be more direction in the bill on how it is to be implemented. There are roles for independent organisations that are not connected with Scottish Water. Such organisations would enable the process of competition to work better—for example, it would be useful for a small organisation to control the database of which customers are owned by which retailer.

The Convener: Would that system run parallel to Scottish Water and the various water retail companies?

Nigel Bromley: It would not be a parallel system; it would be a master system that would determine which business customer is with which supplier.

The Convener: It would not be held by Scottish Water.

Nigel Bromley: No. The point is that it should not be held by Scottish Water; it should be held by another organisation or body. That would be

perceived by new entrants to be fairer. Further, in the development of switching rules, it would mean that that organisation could be formed by a group of companies who are competing in the marketplace. They could collectively own a small subsidiary that manages the switching process. What surprised a lot of people in energy is that the systems and processes are not necessarily that simple. I suggest that it is worth examining what happened with some of the switching arrangements in energy.

Because of the way in which the water industry is being liberalised in Scotland, the situation is relatively simple. However, the questions that will creep in will relate to which company has a contract, whether a customer has some debt lying and whether he is allowed to change supplier. There will be lots of arguments around commercial issues of that kind and someone will be needed in the ring to maintain order. There must be a reasonable form of governance that will enable the second-order commercial issues to be resolved in a fair manner.

The Convener: Are not the points that you raise just legal issues between someone's supplier and a future supplier? In the energy market, it does not work in the way that you suggest it should in the water market. If you have a dispute with your energy company and want to transfer to someone else, you cannot go to a third party who will arbitrate the situation; you simply have to deal with it. Why do you suggest that a different approach be taken in relation to the water industry?

Nigel Bromley: Your description of the situation is not quite correct. In the energy sector, there are arbitration organisations that are collectively owned by competitors in the market—

The Convener: They will arbitrate for businesses rather than domestic customers, presumably.

Nigel Bromley: That is right.

The Convener: So you are suggesting that we should set up new structures on top of what is already in the bill.

Nigel Bromley: I think that new structures will evolve in any case once the detail of the change-of-supply process is worked through. I have suggested that the bill could be more directional with regard to the way in which those structures are set up.

The Convener: On the subject of the independent policeman, are you suggesting that that role would be played by the water industry commission, the Department of Trade and Industry or the Competition Commission—basically, someone else again?

Nigel Bromley: The independent policeman would certainly be directed by the water industry commission. The example that I was talking about in the submission related only to business separation, where it was found necessary to direct companies to appoint an independent business separation compliance officer. That might be an interim arrangement. For example, for the first year, Scottish Water could be directed to appoint a separation compliance officer to provide assurance to the commission that it was ring fencing the businesses appropriately and playing fair.

Nora Radcliffe: I would like to get a bit more information about the registration authorities that have evolved in the energy market. Did you say that groups of competitors had set them up in order to facilitate switching between them?

Nigel Bromley: Yes.

Nora Radcliffe: So, for the customer, where does undue influence come into the situation?

Nigel Bromley: It is quite appropriate for companies to meet to make arrangements for the market to work well. In fact, if companies do not have a formalised approach to communicating with one another when customers transfer between them, that could inhibit competition.

Nora Radcliffe: Is not a customer who wants to switch in or out of that group of competitors at a disadvantage, in that case?

Nigel Bromley: The idea behind having a formalised approach to switching processes is to ensure that the process is smooth.

The Convener: Is that not afforded for in the bill already? Do you think that the arrangement that we are discussing should be utterly explicit rather than being something that evolves through custom and practice and depends on entrants to the market having a view on how they want to organise matters? Given that we have experience of how the process works in other industries, should we not set out some sort of arrangement in the bill? It seems quite vague to say that we will see how things work out once a couple of companies have decided what they are going to do.

Nigel Bromley: We are advocating that the commission ensures that companies put in place proper switching arrangements and that the commission gets directly involved in understanding that those processes are clear to new entrants and all parties.

Maureen Macmillan: Would Scottish Water retail be part of that, or would only the competitor companies have this arrangement?

Nigel Bromley: Scottish Water would be part of it; however, it should not have undue influence. It

should have the same involvement in determining how switching processes work as anybody else. It would have to be involved, as it is important to be able to lose customers as well as to gain customers.

The Convener: Are you thinking about an independent organisation that would be constituted by a variety of companies? In your submission, you used the term “authority”, which makes me think of public policy. You are saying that it should not be connected with any retail or distribution business. Is it about the water industry commission having a clear set of rules rather than having another organisation on top of the water industry commission, which merely consists of the companies that are operating in the market? I am trying to tease out exactly what that implies for the way in which the structures will work.

Nigel Bromley: I would view an optimal arrangement as one whereby the commission would direct companies to form an association that would agree the baseline design for the switching process and whereby the commission would oversee a very clearly defined process for changing customers between companies—

The Convener:—so that there is an agreed set of rules for everybody to ensure that, whether someone is a customer or selling to a customer, everyone knows what the score is when they get involved in the contractual relationship.

Nigel Bromley: That is right. It is really about ensuring how things operate behind the scenes; it is not a customer-facing activity. The customer should be able to agree to a new contract with a new supplier, then the processes behind the scenes should be effected as smoothly as possible. Without a defined business process for that, there could be delays in transfers or possibilities of dual billing and some of the problems that we have seen with the energy companies. The transfer of customers between the energy companies has evolved significantly over the past 10 years. It is important that the lessons that have been learned in that market are transferred to the proposed water retail market in Scotland, England and Wales.

The Convener: I presume that the situation is slightly less complex because we are not talking about domestic customers but focusing on businesses. Getting that right is a fairly definable task.

Nigel Bromley: Yes, it is more easily defined.

Mr Ruskell: In your submission, you talk about the governance framework and transfer protocols. I presume that those will be functions of the independent body that you are talking about. I wonder what the cost will be of the industry organising itself and setting up new structures. Is

there an advantage to that for business customers? Surely, all the costs will be on the customers themselves.

Nigel Bromley: That would not be a function of the body that I am talking about, and the body would not necessarily have to employ many staff, if any. The body would be a place where a defined process was agreed that everybody would sign up to. You are possibly extrapolating more than the comment in our submission intended.

Mr Ruskell: But you talk about multiparty agreements. Those will need to be brokered and I presume that there will need to be monitoring of the agreements. I cannot envisage there being no costs associated with the commission.

Nigel Bromley: There will definitely be some costs; however, it is our view that formalising the process and ensuring that it is visible and that everybody can evolve it will, ultimately, cost less than the money that could be wasted through having ill-defined processes and misunderstandings between companies.

11:15

Rob Gibson: I want to move to a more general, philosophical point. I have been listening to your arguments about opening up the water industry to competition—at least to the limited form of competition with which the bill deals. From your experience in England and Wales, can you tell me whether objectives such as spatial planning and economic development are served by competition and, if so, how?

Ceri Jones: The competitive regime in England and Wales is still in its infancy and it is probably too early to say how effectively it will work and what impact it might have on planning issues and so on. I would not immediately regard such issues as being insurmountable. It is probably fair to say that they have not had a high profile to date in discussions in England and Wales.

Nigel Bromley: I will step back even further and make a philosophical point. I was interested in David Watson's evidence earlier, particularly his comments about a bunch of economists and economic rationales making certain things happen. Back in the mid-1980s, the Central Electricity Generating Board was a monolithic organisation that was directed towards building bigger and bigger power stations—that seemed to be what the CEGB wanted to do. The advent of privatisation and liberalisation in the energy market changed not only the deal for customers, but the whole strategic planning of the market; indeed, it led to the rapid transformation of the sourcing of gas by power stations for electricity. People can comment that it was not competition but a change of fuel supplies that led to a drop in

prices, but without faster-moving, enlightened management trying to work in a competitive market, the gas stations would have been built later and the impact on the environment would have been felt later.

A wider issue relates to employee safety records. The incidence of accidents plummeted in the privatised, liberalised companies. A by-product of competition in energy is that fewer people get killed in power stations, because a commercial view is taken that accidents are costly and damaging to reputations. Therefore, there are wider advantages to competition. I would argue that companies operating in the private sector are, if anything, more cognisant of the type of planning arguments that you are making.

Rob Gibson: It seems to be the political will to keep Scottish Water, by and large, as a public utility in Scotland. Therefore, your experiences are not helpful to me at the present time in finding out whether competition has helped spatial planning, economic development or social justice. Your comments are interesting, but not necessarily relevant to the bill.

Nigel Bromley: I think that I responded to the wider, philosophical question that you put.

The Convener: Members can read the *Official Report* afterwards and draw their own conclusions.

Nora Radcliffe: You mentioned the basic customer transfer process that you devised. How widely is that being used across England and Wales?

Nigel Bromley: Very defined processes in gas and electricity operate across the whole market.

Nora Radcliffe: So that system is widely used. It has been adopted.

Nigel Bromley: Yes.

Ceri Jones: That is the case in the energy sector, but there is no equivalent at this stage in the water sector. Only when the new legislation takes effect next year will we start to see customers changing suppliers. The current proposal is that the incumbent will manage that process. There is no proposal for a central registration body. At this stage, Water UK does not see any particular requirement for such a body.

Nora Radcliffe: So you are giving us conflicting advice about the benefits of central registration.

Nigel Bromley: We clearly have a different opinion on that issue. It is certainly Gemserv's perspective that the incumbent should not be responsible for holding the ring for customer transfers and registration processes.

Maureen Macmillan: Statistics show that Scots are reluctant to change companies, whether their

electricity company or their gas company—or possibly even their water company. Do you think that companies will be queueing up to compete with Scottish Water retail?

Ceri Jones: It is difficult to say. I think that some companies will want to do so. A similar question would arise in England and Wales. I think that we will see some new entrants who wish to test the market. I suspect that the level of competition will be relatively modest—at least, initially. That will probably be true on both sides of the border. That is one reason why we think that it is important that the processes are simple, straightforward and cost effective. We will find out only by testing the water. Our view is that the level of competition will probably be relatively modest and grow relatively slowly.

The Convener: That seems a good point at which to end this series of questions. I thank you both for answering a broad range of questions, including detailed, pernicky ones. I thank you for giving us your written evidence in advance, which helped us to focus our questions.

We will have a few minutes' break to let the second panel of witnesses go and the third panel arrive.

11:21

Meeting suspended.

11:27

On resuming—

The Convener: We kick off with our third panel this morning, which represents Scottish Water. We have with us Professor Alan Alexander, who is Scottish Water's chair; Dr Jon Hargreaves, who is the chief executive; and Douglas Millican, who is the finance director. You will note that we have amassed questions in the past couple of weeks. If we can remember them, we will direct them at you. As with other witnesses, I thank you for providing written evidence in advance. Rather than asking you to repeat that, we will go straight to our questions.

Rob Gibson: The bill does not include duties to ensure that water is used efficiently. That issue is regulated differently in England and Wales. Will that inconsistency affect water conservation in Scotland under the new bill? What are your thoughts on that?

Professor Alan Alexander (Scottish Water): I will say something in general, after which Jon Hargreaves will go into the detail. One must see the bill in the context of the other legislation under which we operate. As members know, under the primary legislation that established Scottish Water,

we have a statutory duty to promote sustainability. We in Scottish Water have interpreted that on the broad rather than the narrow definition of sustainability, so that it covers efficient water use as well as the way in which water is supplied, charged for and so on in the Scottish economy. My view is that the bill is not the right vehicle to enlarge on that duty. Steps can be taken on water conservation, but this is not the right bill for that.

Rob Gibson: The Scottish Environment Protection Agency is certainly concerned about the matter, because it—and you—must deal with the physical loss of water.

Professor Alexander: Indeed.

11:30

Dr Jon Hargreaves (Scottish Water): I will expand on Alan Alexander's answer and try to help the member. Water efficiency has impacts on two fronts: one is in the house or the factory and the other is in our pipes. We separate those two matters. It is true that for some time in England and Wales targets have been placed on companies to reduce leakage in their systems. One interesting aspect of that is that a much higher proportion is on the customer side than anybody thought before the process started.

The reason why those targets can be imposed is that district meter areas exist. That means that a confined area such as a part of Edinburgh or a rural area—it does not matter—has a district meter, so the amount of water that is being used is known and losses can be tracked. Scotland has not invested in such a system in the past, but we are doing that now. By 2006, about 60 per cent of Scotland will be covered by district meter areas.

Until we know the extent of leakage in an area, it is difficult and uneconomic to chase the leakage—that must be done in a planned way. Members all know that we have had problems in Dundee. This year, we have saved 10 megalitres of water a day that was leaking before because we have concentrated on it and because the DMAs were in place. Timing is an issue. Until we have the data that I described, sticking a leakage target on Scottish Water would be a bit futile. Obtaining those data will take several years.

England and Wales have got a secondary issue wrong. The totalities and sustainability that Alan Alexander described make a strong argument for going for economic leakage levels. In other words, if the cost of fixing leaks becomes extortionate compared with production cost, customers suffer in the long term. That takes the whole economic argument together.

Scottish Water has done as much as—if not more than—most of the companies south of the

border to encourage our industrial customers to save water. In the past two years, we have been involved in several Government schemes, in the vision in business for the environment awards and in other schemes with SEPA to encourage our customers to reduce water use. We know that we have saved about £5 million of our revenue, which we have given away by helping customers to use less water. The same is also true of effluent. We have assisted companies and advised them on how to reuse their effluent so that they do not have to take water. In that sense, we are active in conserving water by working with our customers.

The other approach that we take arises from our belief that if we catch them young, we catch them for life. About the only initiative that Scottish Water sponsors is a fairly extensive education programme that works through schools. That has two focuses: one is on water being healthy for life, which is supported by the Minister for Health and Community Care, and the other is on using water sensibly. Although it rains a lot in Scotland, it still costs a lot to take the bits out and to take water to people's houses.

We are pretty active in supporting our sustainability requirement. Of course, we can always do more. If legislation required us to do more, we would need funding for that, because that does not come cheap. I hope that that answers your question.

Rob Gibson: That only partly answers my question, because I am interested in what encouragement people are given to conserve water and in the measure of the effectiveness of that.

Dr Hargreaves: Do you mean encouragement through their charges?

Rob Gibson: Yes.

Dr Hargreaves: I think that all members know that our regulator feels pretty strongly about standing charges and feels that charges should reflect costs. In economic terms, he is right: 80 per cent of our costs are fixed and his view is therefore that a large proportion of a bill should be fixed. From a sustainability point of view, a fairly reasonable argument is that that inhibits people from saving water.

I have worked in organisations around the world that have no standing charges and whose revenue has huge flexibility. Revenue can vary by 30 per cent—that depends on whether the summer is dry or wet. A fixed-cost business cannot be run when 30 per cent of revenue depends on the weather, so a balance is needed.

I worked for a while in Australia—a country with full metering—and I will take Sydney as a good example. I was surprised by the amount of water

usage in Sydney. Everybody in Sydney is metered but, if I remember my facts correctly, the per capita usage of water there is about three times that in England and Wales. I know that Sydney is hot, but the uses to which the water is put show that, because water is cheap, cost is no deterrent to using it. Sustainability and conservation stem from being able to measure water usage and from giving people an incentive, but they also depend on price. If water is cheap, people do not bother to watch the meter. If it is expensive, they do bother.

At the other end of the scale, the opposite has happened. We were responsible for a town in the former East Germany, where a lot of money was spent on new infrastructure. It was assumed that people would use the average 145 litres per head per day, but costs went through the roof because of the new infrastructure, so people stopped using that water and started capturing rainwater. Daily usage per head fell from 145 litres to about 90 litres. Funnily enough, that created a huge amount of problems with the pipes, especially the sewers, which had been sized to dilute the sewage that we all flush down the loo. Because the sewers were sized to take higher volumes, the sewage lay in the pipes.

One can never determine what will happen, but two things are clear: first, the issue is price sensitive and, secondly, having the ability to measure water helps people to control the amount that they use. In Scotland, about 50 per cent of our commercial customers are metered, compared with very few—just dozens—of our domestic customers. In an ideal world, we would all rush out and put meters in the ground, but that would cost in the region of £600 million to £700 million as an initial investment. There are also significant operating costs and, of course, meters have to be replaced every five or six years. Considering the big demand in Scotland to catch up with the backlog in relation to new legislation and development constraints, my view, and the company's view, is that metering is probably not a good use of public money, despite the clear evidence that it gives people, especially commercial customers, the ability and encouragement to monitor how much water they use.

Of course, all our big customers are metered and they take conservation seriously; I read the evidence that some of them gave the committee. In our experience, they are certainly much more serious about conservation than they were five years ago. The amount of water that those companies use is declining and consequently the revenue that we collect from them also declines.

Rob Gibson: So the bill will not increase the efficient use of water.

Dr Hargreaves: As Alan Alexander said, it does not set out to do that.

Mr Ruskell: Leakage targets are one of the sustainability indicators that you might choose to use. You would probably not want them to be included in the bill, but you want to be active on a range of other aspects of sustainability in relation to the economy, social justice and other environmental targets. Is there a place for sustainable development in the bill? Should it define the role of the new water commission more stringently? If you do not want leakage targets in the bill, how do you want the bill to address sustainable development? Where do the responsibilities lie to push you towards action on such targets?

Professor Alexander: To return to my original answer, the first thing is for us to produce and consult on a sustainability policy—as we have done—and to implement it. Whether or not there are to be further statutory obligations on Scottish Water in that area—I do not comment on whether that would be right or wrong—the Water Services etc (Scotland) Bill is not the bill in which to do that, because it is about regulation and competition. That is not to say that there is no case for such obligations.

Dr Hargreaves: We have a legal obligation on sustainability, but the regulatory process in Scotland does not specifically require the regulator to take it into account. The minister can do that under the bill through his direction; we welcome the fact that the minister will direct policy in the water industry in a much clearer way than in the past, but it would be useful to us, and therefore to Scotland, for that to be mirrored by the regulator. One of the difficulties that we face is that if an obligation is placed on us but we are not funded to deliver it—as we have seen with development constraints in the past four years, which were not highlighted at the time—we end up with a lot of energy being expended in argument about why the work is not being done. If we are not funded to do work on an obligation, we cannot do it. The obligation must be matched with the ability to fund it.

Energy use has increased dramatically over the past few years in Scottish Water because obligations on bathing waters, for example, involve investing in more and more high-tech technology, which uses more and more energy. There is no point sticking an energy target on us when all the legislation that we are dealing with is driving up energy usage day by day. Every plant that we build requires more energy than the one that we built 20 or 30 years ago. That is just a fact of life. There needs to be a proper balance. Otherwise, we will end up with an obligation that it will be impossible for us to meet.

Douglas Millican (Scottish Water): As Jon Hargreaves mentioned, the bill provides for ministers to set out periodic directions to the water industry commission when undertaking strategic reviews of charges. We are pleased to see that in the bill. As for the clear operation of the whole industry, given the role of ministers in setting policy, the role of the commission in undertaking charging reviews and the role of Scottish Water in delivering, the direction function needs to be clearly specified, so that there is no ambiguity on the part of the commission in calculating prices for Scottish Water. It is clear from ministers' policy objectives, whether they concern sustainability or economics or both, that we are being funded, ultimately, to deliver those objectives. The issue is about clarity of roles and responsibilities.

Mr Ruskell: Do you believe that those are clear in the bill?

Douglas Millican: They are reasonably clear. Whether that clarity could be strengthened further might be worthy of debate.

Professor Alexander: It is worth pointing out that there are other ways in which to bear down on issues such as leakage. Let us consider the biggest single capital project that is currently under way: the water treatment plant at Mugdock. The costings for that assumed a substantial reduction in the amount of leakage that we would tolerate in Glasgow, because that would reduce the capital cost and the operating cost. We build such considerations in where we can.

The Convener: Does anyone else want to follow up on the issue of sustainable development and sustainability?

Members: Yes.

The Convener: It seems that everybody in the committee wants to come in on that. For the avoidance of doubt, and to reassure members, I have allocated a relatively generous slot for the Scottish Water witnesses. I knew that we would be working through a number of issues this morning and I want to ensure that we finish each one. I ask colleagues to keep indicating if they want to come in on a particular issue. Otherwise, I will move on to the next one.

Alex Johnstone: We dealt with this subject previously, so you do not need to go to any great length to answer this question. I would still like to ask it, however. How important is it, particularly in the non-domestic sector, that the charges that are levied actually reflect the service that is provided? Do you believe that the introduction of retail competition will help to deal with the imbalances that exist at the moment? In particular, will it help smaller businesses that believe that they are being overcharged for water?

Dr Hargreaves: The introduction of retail competition will not do that. However, if we get it right, using the result of the consultation on charges, that will be a way in which to tackle the issue. As you heard from Mr Jones, what we are talking about is a relatively small element of the total bill—whether it is 4 per cent or 10 per cent. The costs do not go down to nothing, as the competitors have costs themselves. What is profit and what is real cost is debatable.

Fundamentally, the bill does not address the issue that we have all lived with over the past two or three years: the impact of harmonisation and the introduction of higher standing charges. The way to tackle that is through the discussions that are going on. We pushed hard to get the consultation process going. We saw huge frustration among our customers and an inability to have a debate around the issues of cross-subsidy, standing charges and all the rest of it. The bill does not change those issues. The current regime for collecting charges from customers could be left in place unchanged while retail competition is introduced. The two things happen to be getting addressed at the same time, but they require equal amounts of thought and energy to get them right.

Alex Johnstone: The reason that I asked that question was to open up a broader concept. My concern is that the form that the bill takes will result in the provision of a system that is essentially policy led rather than demand led. That covers both the domestic provision of sewerage services and the problems that I believe Roseanna Cunningham will go on to deal with in relation to development constraint. Do you believe that the bill provides adequately for appropriate demand-led development within the Scottish Water system or does it lead us down an alley where policy will be the main driver?

11:45

Douglas Millican: I take it that you are referring to demand for new services and connections to the system.

Alex Johnstone: That is one of the points, but we could generalise and talk about the balance that might exist between policy-led and demand-led development of the industry.

Douglas Millican: The bill provides a framework for decisions to be made on the back of the "Paying for Water Services 2006-2010" consultation about who should pay for extensions to the network; views were expressed about that earlier. There are big costs attached to resolving development constraints. There is a real issue about the extent to which that burden should be borne by current customers or by those who are

creating the new demand—developers or new customers—and the bill provides a mechanism to deal with that.

The principal provision for dealing with broader customer demand is through regulation. The bill provides for evolution in regulation. Although there are weaknesses in the current regulatory arrangements, there are improvements on what existed prior to 1999. Further steps are proposed to strengthen the regulatory framework, which is the principal means by which customer demand can be satisfied. We have about 2.4 million customers; the most satisfactory way in which the needs of all customers can be satisfied is through regulation, or regulatory pressure.

Professor Alexander: The point that Alex Johnstone raised is important. I do not agree that there is necessarily a clear dichotomy between the industry being policy led and being demand led. It is really a question of how policy reflects demand. Development constraints, for example, require choices to be made. The other point that frames much of this discussion is that, whatever happens to the bill, until a mature market is created the business will continue to be strongly regulated. There is a sense in which the pressure of regulation will be more important until the market is established. I do not want to guess how long it will take for there to be a mature market, but it has certainly taken a long time in other liberalised utilities.

Alex Johnstone: This example might colour our attitude to the process. Do you agree that in going down a demand-led route in relation to sewerage provision where constraints exist, that the appropriate course of action is to load the costs on to the developer? However, to ensure that the development of sewerage systems is policy led, the Government has to come up with money to support it.

Professor Alexander: There always comes a moment in these evidence sessions when I say that members are leading us into matters of public policy and I think we just arrived there. I will try not to duck the question. Given the costs that need to be incurred to deal with things such as development constraints, particularly in the waste water network, we have to have a way of deciding how those costs are shared. They could be met through general taxation, by Scottish Water customers and they could be, as your question suggested, loaded in some way towards those who will benefit most directly, which would be developers. However, that is a matter that should come out of the "Principles of Charging for Water and Wastewater" consultation. Whatever is determined, we as a delivery company will implement it.

Dr Hargreaves: The committee made a good point during Dave Watson's evidence. The work that we have done over the past two years on constraints in general, whether for water or sewerage, shows a clear difference between building 300 houses on the outskirts of Edinburgh, selling at £250,000 to £300,000 a house, and building a small development in the Highlands. The situation is not exclusive to the Highlands; it exists in Dumfries and Galloway, Ayrshire and most of the rural areas of Scotland where Government policy requires councils—rightly so, one could argue—to provide low-cost housing. Even when low-cost housing is not being provided, there is an issue about the number of houses that are being built on a specific plot.

Historically, developers have had a pretty good ride in Scotland because existing customers have contributed to the cost of building a house irrespective of its resale value. To most people, that seems not to be right in this day and age. One can imagine a situation evolving in which Scottish Water had a responsibility to develop what we would describe as deep infrastructure. A house connects to a small pipe that connects to a big pipe that ends at a sewage treatment works that issues either out to sea or into a river. What we describe as the deep costs are those that enable houses to be connected. By and large, in England and Wales that is what companies pay for.

Historically, developers have paid for the shallow costs—that is, the immediate connections—as they do for electricity, gas and all those other things. Why should water connection be any different? It is part of the cost of building a house. However, in Scotland, a lot of the infrastructure is undersized: it is there, but it is not big enough. There is a view that says that, if the developer wants to add another 20 or 100 houses, he should make a contribution to that infrastructure because Scottish Water customers get back the value of the bill only over a period of time.

My personal view is that, in rural areas, the best way of dealing with that has to be through the councils. Scottish Water should not be determining Scotland's housing policy. The councils and the Scottish Executive have that responsibility. If the councils require some form of subsidy to build low-cost housing, that should be directed through those who best know where it should go; otherwise, we are starting a lottery game and if we are not careful water will end up being the single most important factor after land purchase.

I have heard the minister say—and I think that he is right—that there will be a levelling out. Land prices will reflect developers' costs and, over time, that will level itself out. From the point of view of Scottish Water, customers should pay for the bit

that we can recover through their bills over time and, in the case of big developments, pay a significant contribution to those costs. However, in some areas that cover an awful lot of Scotland there needs to be another mechanism. I am not in a position to say what that should be, but it should be allocated by those who are best capable of deciding where the money is spent. If that is not done, Scotland's water industry will end up in a position that you should not put it in—driving development and deciding where it does and does not take place.

I do not know whether that answers your question.

The Convener: I am sure that it does. The entire committee probably wants to ask you about that.

Roseanna Cunningham: I am glad that we have got on to this general area and I was relieved to hear some of your comments, especially in connection with the enormous range of organisations that could come under the umbrella of the term "developer". I was interested to hear you say that Scottish Water should not dictate housing policy in Scotland. In many areas, however, that is in effect happening right now: Scottish Water is dictating housing policy in Scotland. As the MSP for Perth, I have a particular, recent interest in what has been happening. Under the single umbrella term of developer, Scottish Water has imposed development embargoes the length and breadth of Scotland. However, a developer could be a massive developer, such as the one behind the Gleneagles west development, or it could be a small one such as Perthshire Housing Association. Do you agree that it would be completely inequitable to apply the same standard to both kinds of developer?

Professor Alexander: Can I say yes and no? In policy terms, it would be inequitable to apply the same standard. I grant you that absolutely. If the same standard is applied, there is a danger that any kind of social housing development will be squeezed out. I said "and no," because when Scottish Water has to object to a development, we must do so on the ground of not condoning the breaching of our consents. There is a sense in which that is not sensitive to whether the development is one house or a major development. However, you are right in what you say, because a distinction must be made in policy terms; otherwise, as Jon Hargreaves said, we get to the point where we become the planning authority for the whole of Scotland, which is not what we are here to do.

Roseanna Cunningham: Is development constraint affected in any way by the bill—positively or negatively—either in the short, the

medium or the long term? That is a bit of a multiple-choice question, but I am sure that you understand what I mean. Will the bill's overall impact be positive or negative in respect of development constraint? Will we get more development constraint or less as a result of the bill? Either way, might we see that impact in the short, the medium or the long term?

Dr Hargreaves: The answer is that it depends on the regulations. As I understand it, how the primary legislation will actually work will be fleshed out in regulations. The bill has raised—rightly—the issue of development constraint and it is creating the opportunity for a different solution to the current one. However, the regulations will decide how much developers will bear, how much Scottish Water customers will bear and how much the social aspect of development will be dealt with.

It might help if the bill recognised more explicitly that there are two aspects to the issue. That might strengthen the regulations. However, we know from our discussions with the Executive that it is acutely aware of the fact that multi-differences are involved and that development cannot be tackled with a single blunt instrument. Irrespective of whether the bill needs strengthened, it is the subsequent regulations that will really bite in this sector.

We talk to developers an awful lot and have done since development constraint became an issue. Believe it or not, we actually have a very good relationship with them. We have done a lot of work with them and with councils. One of the great advantages of Scottish Water is that this is the first time that we have had a clear picture of the whole Scottish development scene. We have been able to get that through working very closely with councils. The situation does not look good, but at least we have the information now.

I can understand from their perspective what the developers are saying: "Please, will you give us clarity as soon as possible? We need to understand what the rules of the game are because we are buying land today." Developers buy land every day of the week. Councils also plan for new developments further down the road. Therefore, as far as we are concerned, the earlier we can get direction on the development issue, the earlier we can have clarity. That will remove many of the current problems, which are caused by confusion. People do not understand the rules, which makes it difficult for them to plan—just as it is difficult for Scottish Water to plan.

If we know that we are responsible for all developments, our business plan will include a large sum of money to resolve the problem. If we know that developers will bear a certain amount of the cost, our investment plan will have less money in it. We are all trying to work out the right way to

deal with the development situation. However, Scottish Water must know what costs to include in its business plan, which ultimately decides prices for the next four years. Therefore, it is key that the issue is resolved early.

12:00

Professor Alexander: The bill would be implemented after the conclusion of the consultation process on the principle of charging and investment, both of which feed directly into the question of how much development constraint can be relieved, and at what cost and what rate. I would regard the bill as broadly neutral as far as changing that situation is concerned. As Jon Hargreaves says, changes can be made in the implementation process and in the regulation process after the bill is passed.

Roseanna Cunningham: Do you have a rough timescale for that?

The Convener: We are effectively taking evidence on all three things at the same time: on quality and standards, on the investment framework and on the bill. When we have the minister in front of us, we will be able to put the same sets of questions to him.

Professor Alexander: There is a clear answer to the question of timescale. We know that our investment programme will cover the next regulatory period of four years, with some indication of where we will go in the four years after that. It is into that context that decisions about how much of the investment bears on development constraints need to be fed. There is very little in our current investment programme that is specifically directed at development constraints although, wherever possible, using the process of design and investment, we try to achieve the relief of a development constraint at the same time that we have to achieve a set of outputs under a regulatory settlement. There is little in the bill that specifically addresses that, however.

The decision that has to be made in the third quality and standards consultation—Q and S III—is how much of our investment programme should be related to development constraints. As far as the pricing consultation is concerned, who should pay and how should the money be paid?

Karen Gillon: This is a pretty complex argument. I have been on the other side of the debate and have seen people suffer because there was not a development constraint and their houses were flooded. There was then a difficulty with your being able to secure the resources to provide the solution because of the Q and S II process. How will it help resolve such difficulties, or will it not?

Dr Hargreaves: Do you mean the bill?

Karen Gillon: Yes.

Dr Hargreaves: It will come firmly down to ministers' direction to Scottish Water through the regulatory process for investment from 2006 to 2010 to resolve the issues to which you are referring. The money set aside specifically for flood relief, for investment in improving drinking water quality and so on will be allocated in that direction. The bill itself does not impact on that process, although the regulatory process that will determine prices will ultimately be different, because it will be undertaken by a commission rather than by a commissioner. On the face of it, the bill does not alter how much money gets spent on what. That comes under the current extensive consultation process.

I am delighted to say that there has been an awful lot of interest in the documents that the Scottish Executive has put out. On the previous such occasion, there was very little interest. People did not quite understand the importance of the regulatory process. I have met representatives of just about all the councils over the past few months—all of them bar one, I think. People still do not understand that our programme of investment is very specific and that it is owned by individual regulators, including the drinking water regulator and SEPA. The programme is project specific. It is only with the regulators' agreement that we may swap money from one project to another. It is not within Scottish Water's remit simply to do that. A lot of people have found that difficult to understand. We should bear in mind where the industry has come from. Historically, councillors directed such actions and, when the three water authorities were in existence, that was done through the relevant minister.

Karen Gillon: When you responded to Roseanna Cunningham, you said that a percentage of the costs for developments should be picked up by Scottish Water. What do you think a reasonable or realistic percentage would be?

Dr Hargreaves: As Professor Alexander said, that is a policy decision. If ministers decide that all the costs can be picked up by Scottish Water, then they will all be picked up by Scottish Water. There is not an easy answer to that, although people can have a view on the matter. I have tried to express our view as clearly as possible.

We can back-calculate this. We can establish that a household generates, say, £300 a year; we can consider how long the asset will last; we can collect that amount of money from the customer; and we can apportion a portion of the money collected towards the relevant part of the service. If we do it that way, it does not come to an awful lot of money.

At the moment, we work under what are called reasonable cost rules. If somebody has developed a house, whether it is a new facility without a sewerage system or an existing facility that somebody wants to connect, we have historically used reasonable cost, which is currently about £2,000. In rural areas of first-time sewerage, the cost of connecting houses can be £60,000 to £100,000 per house. Just using "reasonable cost" does not give us the total answer. It is perhaps some guide as to what Scottish Water customers should contribute to the process, but in some cases, that leaves a massive gap.

Professor Alexander: It is worth returning to the point that Alex Johnstone made about demand and public policy. The way in which the Q and S III process will operate means that eventually we will get to the point where ministers will decide what the quantum of investment should be that Scottish Water will be tasked to achieve in its next regulatory period. At that point, our investment programme becomes a zero-sum game, in the sense that the more that is taken out for development constraints, the less there is for everything else—water quality, waste water compliance and so on. That is what makes the decision a public policy decision.

We can import flexibility into the process by deciding that somebody else should be paying for a chunk of something. The obvious candidate, as the minister hinted in something he said a couple of weeks ago, is to think about what cost developers should incur and for what. As Jon Hargreaves said, our view is that in our investment programme we should be responsible for the deep infrastructure, but there is a debate to be had about what happens with the costs for the rest. That is a public policy decision. In the end, we are the delivery company.

Dr Hargreaves: It is interesting that at the moment a number of developers—I have to admit that although they are in rural areas they are in big communities—are quite happy to discuss investing millions of pounds directly in Scottish Water's existing infrastructure to allow their developments to proceed. What they require in return—not unreasonably—is that they bag that capacity. There is an interesting debate along the lines that, although that seems a reasonable way of solving the problem, for how long can we exclude others from taking some of that capacity? In other places, if the developer decides that he does not want to use that capacity and another builder comes along, be it for social housing or whatever, he gets recompense for the money that he has invested in our assets.

We need to ensure that the bill allows us to do that, because we are pretty convinced that that is a good way forward. It mirrors pretty well what

happens in England and Wales, which has worked well for a long time. England does not have big development constraint problems, but there are some in Wales, where the rurality issues are similar to those in Scotland, but on a smaller scale. It is interesting that England is not facing the same issues as Scotland, partly because the way that the mechanisms down there have worked over the years has enabled that sort of arrangement to be in place. We are pretty keen to have the powers to enter into that sort of agreement; it does not matter whether that is with councils or developers. The issue is how long one can reserve the capacity, because, in effect, they have paid for it.

Karen Gillon: Would that capacity be a completely separate water and sewerage system?

Dr Hargreaves: No.

Karen Gillon: So why should someone get exclusive use of something that is going into the public system?

Dr Hargreaves: They would not get exclusive use. Let us say that we have a town of 1,000 people, the sewerage system is at capacity—it cannot take another house—and a developer wants to build another 100 houses, which would add another 200 people to the population. We would say that we needed to build a bigger sewerage works and increase the size of the pipe. Let us say that that would cost £1 million, for the sake of argument. The developer would contribute that £1 million, which would allow 100 houses and maybe more to connect to the system. Let us say that he was going to phase that development over five years by building first 30 houses, then more and more over time, which is what tends to happen. He would say to us, “I’ll pay you that £1 million so I can add these extra houses, but I’m going to add them over five years. What I don’t want to have happen is that you spend £1 million with a view to creating that capacity, I build 30 houses and then find that Professor Alexander’s company comes along and wants to build 50 houses and you give him that capacity, which I have paid for.”

The developer is not excluding others from doing what he has done, and in the short term it is a way of funding the extra capacity that is required. That methodology is proven; it works elsewhere. It is not brand new. Currently, a number of developers are willing to enter into such agreements to free up that capacity.

The Convener: May I take you back a step and ask whether that is the right approach? Historically, local councils used to take decisions on the long-term planning policy for a settlement, based on the potential long-term investment costs. Let us suppose that we are talking about a

development of 1,000 houses. Surely councils should weigh up the relative merits and costs of that settlement against those of a neighbouring or different settlement. Councils might want affordable housing. In Edinburgh, for example, the average house costs £250,000—it is not an affordable house, but the price reflects the market rate. What happens to the people who cannot afford 250 grand and need affordable private housing, rather than social housing provision?

There seems to be a gap between a strategic approach and an individual approach: your solution works for incremental extensions as and when individual planning applications are made, but it does not address the wider issues about towns and settlements and priorities, because it puts the onus on the developer to decide where to develop. Should there be a stage before that, at which councils consider all development plans? That would enable councils to direct public policy with the developers, so that people would know what the costs would be and could make an economic judgment about how much to pay for land.

Dr Hargreaves: I am pretty certain that in all the cases that we are currently dealing with discussions are taking place with developers and councils. The developments are part of councils’ development plans, some of which include low-cost housing because councils insist on that. Members will be aware of a fairly famous example at Garthamlock in Glasgow, which has attracted a lot of publicity. That situation was resolved through the process that I described, but the process has involved working closely with Glasgow City Council.

It is possible to achieve both ends, but you are right to say that the start point should be joined-up planning. One issue for us, which councils and COSLA acknowledge, is that our investment periods do not coincide with councils’ planning periods. Some councils involve us deeply in their plans; others do so to a lesser extent—perhaps that needs to change but if that is not happening, it is not through want of trying. We have sat down with councils and said, “Yes, you can do this, that and the other”, only to find that there is not the money in the economic settlement to go ahead. That is the nub of the problem—it has been a problem for many years. That is what has got us out of line. We are in discussions with planning departments and others about how best to resolve the problem, but it would be terribly convenient—given that you own all of us—if the approach could be joined up a little more, to ensure that planning and investment at least come in waves. Councils look 20 years ahead and we look four to eight years ahead, so we are not on the same timescale. However, we could at least go back to councils after the investment discussion and say,

"Right. We have been allocated X amount towards increasing the infrastructure as part of your area plan."

Professor Alexander: The interesting point about the Garthamlock example is that by putting money into relieving the problem, Glasgow City Council was acting—in a sense—as a surrogate developer in exactly the same way as a private developer might act, as we described. It is possible. However, I emphasise Jon Hargreaves' point: one of the great problems that we face in Scotland is that we do not do joined-up government well. If we could join things up and get the cycles right, it might be easier to bear down on the issue.

The Convener: We will capture that thought and take up the matter with the minister.

Maureen Macmillan: Perhaps it is time to move away from that interesting topic, but I take issue with the suggestion that the matter has not been raised. I distinctly remember raising the matter with the minister in relation to rural housing development when we discussed the Water Environment and Water Services (Scotland) Bill. SEPA raised the matter then, too. I was extremely disappointed that not enough resources were provided for rural housing development.

However, I will move on and ask about water customer consultation panels. The submission makes the cryptic remark that

"It would be appropriate at this time to consider whether any changes or clarification are required in the role and responsibilities of the Water Customer Consultation Panels".

That suggests that you feel that something needs to be done.

12:15

Professor Alexander: Whether we are dealing with economic regulation or customer relations, the general point is that we need absolute clarity about how the system works. My view, which I think my colleagues and board share, is that there is a lack of clarity because we have an economic regulator who is also by statute the customer champion, and we also have water customer consultation panels, which are intended to canvass customers' collective, rather than individual, views. If we move towards a commission rather than a commissioner—which the bill proposes and which, as our submission says, we support—the question arises of where customer issues should go in that structure. We must be absolutely sure and clear about who is responsible for what.

Maureen Macmillan: Do you have any thoughts about who should be responsible?

Dr Hargreaves: The panels have been a success. When we talk to customers throughout the country, we find that the panels are well respected for their ability to capture collective views and feed them into the various processes, whether that is through consultation or directly to the WIC. However, at present the panels do not have any teeth and they have only one member of staff plus the convener and the members. I do not want to put additional costs on customers, who pay for the WIC and the panels through their Scottish Water bills, but by strengthening and clarifying the panels' role, customers will have a more direct voice.

I have been in regulated industries since 1989. Personally, I believe that, south of the border, it is difficult for economic regulators to take on board customer views and separate them out from economic views. An economic regulator exists to balance all the parties' needs and to come up with a pricing regime and efficiency targets for the industry. If that person is also responsible for customer issues, rather than simply representing customers' views on prices, he will have a difficult job. That is not a criticism, but it is just the way that things have evolved in England and Wales. It is interesting that England and Wales have finally given up the case on the Office of Water Services and have created WaterVoice and a new consumer panel for water issues. Members who read the press from south of the border will know that a price-setting process is being carried out there. The WaterVoice chairman has a strong voice in the debate on behalf of customers and is independent of the regulator, Ofwat.

To return to the debate about how big the new commission should be and what sort of people should be on it, unless we have some pretty strong lobbying groups, there is a danger that we will end up with just an economic view rather than a view that takes into account the whole scene. We believe strongly that customers need a strong voice in the debate. MSPs, as customers' representatives, regularly make their views pretty clear to Scottish Water, but those are not collective views and are not necessarily policy views; they are on individual issues. Clearly, there are exceptions to that, such as with business customers' views on charges—a pretty collective view came from most MSPs on that issue. If one asks how much we should spend on the environment, for example, one tends to get a bit of a deafening silence, because customers' views are not being collected on that issue, although we have done research, which will be presented in our business plan.

We must balance the various aspects. We feel that it would be better to clarify the role of the panels. Some structural changes could be made—that is not for us to say—but customers need to

have a strong voice in the process and, apart from through MSPs and ministers, they tend not to be heard.

Maureen Macmillan: Is that because there is no intimate link between the general public and the water consultation panels? It could be that the public do not know that they exist or what their role is.

Professor Alexander: It is partly that and partly the fact that, if you have a complaint about how Scottish Water is operating, the water customer consultation panel has no locus on that matter at all. Jon Hargreaves is absolutely right. I would like the economic regulation to be separated from customer representation in general and specific circumstances. If we are not simply to tear everything up and reconstruct it all from scratch, the only way to do that is to accept that what the bill says about the replacement of the commissioner by a more broadly based commission is right, but something must be done to balance that on the customer side. Since the water customer consultation panel already exists, it would be better to redefine what it is for rather than to reinvent the wheel and come up with an entirely new structure. Further, as Jon Hargreaves says, there is a model for that down south.

The Convener: I am conscious that we have only another 10 minutes scheduled for this part of the agenda and that we have not yet touched on whether the bill has got the regulatory system right. Earlier, one of our witnesses said that the bill sets you up to fail. Do you agree with that assessment?

Professor Alexander: Absolutely not. I said earlier, in a different context, that we are essentially the delivery mechanism for water and sewerage services across Scotland. We operate in a regulated environment and we will operate in the way that our regulators tell us to. We have already been operating in a way that has made the industry in Scotland much more efficient now than it was two years ago, and we will continue to do that. Frankly, we do not recognise the concept of failure.

The Convener: I do not think that our previous witness was criticising Scottish Water. The comment was more to do with the framework of the bill. Given the different roles that Scottish Water has to play, others have raised its long-term stability. The crucial factor seems to be whether the price assumptions that are set at the start enable you to run a stable business in the long term. There is a wider political issue as well as some specific issues.

Professor Alexander: That is right.

The Convener: I would quite like a detailed response on the issue.

Douglas Millican: New risks are created because of the bill. The wholesale business and the new retail business have different risks.

The first source of the risks relates to the setting of the wholesale price. Part of that is the issue of what constitutes wholesale activities and what constitutes retail activities. Our understanding of the bill is that it contains certain prohibitions. For example, it has a prohibition on anyone other than Scottish Water putting water into the public system. It then allows companies to apply for a licence to be a water services provider. Therefore, by definition, the scope of that licence could be anything that is not prohibited under the bill. That means that there will inevitably be an ambiguity around precisely what is wholesale and what is retail. If we say that what is wholesale is purely that which is prohibited, a market element could develop over time whereby one new entrant could apply for a licence purely to bill while Scottish Water wholesale carries on doing everything else, and another applicant could say that they want to do anything and everything that is not prohibited. The nature of the bill is such that wholesale cannot be precisely ring fenced from retail on day one unless you reduce the definition of wholesale to that which is explicitly prohibited. However, that would be a particularly aggressive interpretation.

It flows from that that if the price that is set for the activities or services that a licensed retailer buys from Scottish Water does not properly reflect the costs of the future Scottish Water wholesale in conducting wholesale activities, new risks will be created. If the wholesale price does not fully cover the cost of carrying out all the wholesale activities that are being bought by new retailers, either there will be a risk that Scottish Water will be unable to fulfil all its obligations or, more probably, there will be a risk that the generality of customers, and in particular domestic customers, will pick up part of the financial burden that should properly be the domain of the business customers. That risk also goes in the other direction. If the wholesale price is set too high and more than covers the costs of the wholesale activities, household customers could receive a benefit at the expense of business customers. That is the risk on the wholesale side.

On risks on the retail side, we are dealing with uncertainty, because we do not know how the market will develop; we are putting in place a framework. Clearly, it is important that business customers throughout Scotland are able to have, at the very least, a water services provider that will retail services to them, and ideally they will have a choice of suppliers. We believe that it is important that customers can be assured that, at least for as long as there is not a fully developed market—in other words, until there are a number of active players in the market—they can if they want continue to get their services from Scottish Water

retail. The risk is that the regulatory arrangements for Scottish Water retail must be set up in such a way that there is sufficient incentive for Scottish Water to want to conduct a retail operation. If retail services are to be carried out in a separate retail subsidiary, Scottish Water will set it up and run it only if it can be viable.

We are considering different risks in the wholesale and retail businesses.

The Convener: It is useful to have dealt with that in detail, because Nora Radcliffe raised the issue with the previous witnesses. Does she have anything to add?

Nora Radcliffe: I seek reassurance on issues such as data requirements and whether the data are robust enough to progress efficiently and effectively. Previous witnesses raised that point. The amount of resources that are put into management information systems are also an issue, because that takes away from fixing pipes and so on. Will the witnesses expand on that?

Dr Hargreaves: I think—and I give the water industry commissioner credit for this—that two years ago the Scottish water industry did not know a lot about the condition of its assets, what its customer base was and so on, but an awful lot of effort, and therefore an awful lot of money, has been spent on correcting that deficiency. You cannot run a regulated industry without the correct data. Looking forward into the next period, we will be looking for substantial sums of money to continue building and improving the data. If we do not, we will just go back to where we were. It is a bit like painting the Forth bridge: if you stop painting it for a few years, it costs a lot more to catch up.

On the business customer base, as members know we have merged three billing systems into one. We are going through a torrid time trying to clean up the customer base that the three water authorities inherited from councils. As you all know, because you send us letters on it, many customers complain about their bills. The primary reason for that is the quality of the data that we inherited. There is a view that we supply only one service, but we actually supply five services. With the switching engine that was described before, the customer has five options—not just one—because there is water, sewerage services, trade effluent, metered and unmetered. If a customer had all those, they could select them from five different retailers. To say that the issue is just straightforward water is an oversimplification, because there are five services and people can choose five different retailers.

12:30

To be able to transfer that data so that we do not end up with the problems that customers have

faced in the past in other industries, we have to ensure that the database is clean. I agree with one of the previous speakers that chaos will be caused in the market if it is not clean.

If you look at our evidence and everything that we have said, you will see that although we have our own views, it is absolutely essential that we are all sitting round this table in 10 years' time discussing how successful we have been, not saying that it did not work because we did not put the right switching engine in or because we did not get the right split between wholesale and retail, as Douglas Millican aptly described. If we do not get those fundamental things right, it is not us in this room who will suffer but the customers. We are keen to ensure that that does not happen. The fundamental issue is getting the data right. If we do not get the data right, everything else will become difficult to manage.

We are putting a lot of effort into that at the moment. One of the things to learn from down south is that the exercise is not a one-off. Customers are constantly moving house and they do not tell us when they have moved, sometimes because they do not want to tell us.

There is also the issue of debt, which has had a bit of an airing today. Perhaps Douglas Millican will elaborate on this, but debt is the biggest risk. For all sorts of historical reasons, Scottish Water customers have a much higher level of debt than do customers in England and Wales, and that debt is a major threat to Scottish Water retail. How debt is dealt with and whether it transfers with customers or whether customers can transfer when they have not paid a bill are all issues that have to be sorted out; the previous panel made that very clear. We need absolute clarity on that, because otherwise we will end up in a real mess, and the people who suffer will be the genuine customers who pay their bills and want to save a few bob by moving suppliers. They are the customers who we have to protect. There will always be people who play the market, and we have to safeguard against that.

Douglas Millican: On the specific question of whether we have sufficient data to make the separation, it is helpful that the market is not going to open until 2008. The principal data that we need are cost data. If there is clarity on what is wholesale and what is retail, and there is a clear division between the two, we will have a clear view of the costs attributable to wholesale and retail long before 2008. We have a reasonable view now and that is what we are able to give in evidence to the committee. If the definitions of wholesale and retail are clarified, I am confident that the opening of the market in 2008 should not be a problem.

The Convener: Okay. We are running over time—

Nora Radcliffe: I have two more questions.

The Convener: No, not two extra questions. I want to close this evidence session. We will have to hold back several issues for future witnesses and for the minister, such as debt, pricing and the definitions of wholesale and retail. We will come back to those points in subsequent weeks. I thank the witnesses for being prepared to answer questions for slightly longer than our previous witnesses. It has been extremely useful to us.

I suspend the meeting for a brief period so that we can change witnesses.

12:33

Meeting suspended.

12:37

On resuming—

Dutch Presidency of the European Union (Scottish Executive Priorities)

The Convener: We move to the final witness panel today. I welcome the minister, Ross Finnie, and his officials. We have an agreed method of scrutinising European matters and I provided the committee with an update on European issues earlier. We have agreed to take evidence from the Minister for Environment and Rural Development each time there is a different European presidency. All members should have a copy of the statement from Ross Finnie about the ministerial priorities of the Dutch presidency of the European Union. I invite the minister to introduce his officials and to make a brief opening statement.

The Minister for Environment and Rural Development (Ross Finnie): The officials who accompany me are Dougie Atkinson, Ingrid Clayton from the agricultural side of the Environment and Rural Affairs Department, Andrew Mackie from the environmental side of the department and Lachlan Stuart from the fisheries side.

Members have my statement, so I will highlight briefly the four key priorities of the Dutch presidency. They are: to implement the environmental dimension of the Lisbon strategy; the registration, evaluation and authorisation of chemicals regulations; the international negotiations on climate change; and sustainable mobility.

The three key elements of the Lisbon strategy and the knowledge-based economy are the economic, social and environmental pillars; the same pillars as for sustainable development. The presidency hopes to ensure that the third pillar—the environment—appears in the conclusions that are drawn by the European Council.

The Executive has a keen interest in a number of matters on the legislative agenda. We continue to work with the UK Government on the new European chemical strategy: first, to develop a fast, efficient and workable process to test and screen chemicals and to tackle those that are of most concern; secondly, to balance that against competitiveness in the Scottish chemicals industry; and thirdly, to minimise animal testing.

During the Dutch presidency, the ad hoc working group that has been set up in the Council will continue to discuss those issues, and a major seminar on the impact assessment will be held at

the end of October. We expect to have a policy debate at the environment council in December, but the complexity of those issues will take discussions way beyond 2005.

The climate change agenda is, as members understand, truly international. We hope to be involved in the preparation of the international conference in December on achievements, risks, energy and investment. There is a proposal for a regulation to control emissions of fluorinated gases by operators of equipment, such as refrigeration and air conditioning.

There are two further items. The first is that the Commission has produced proposals for the implementation of the outstanding parts of the United Nations Aarhus convention, which is about improving public access to, and participation in, environmental processes, the application of Aarhus to the institutions of the EU and public challenge to the application of environmental law. Secondly, the Commission has produced its long-awaited communication on financing Natura 2000, which deals with the future funding of sites in member states that have been designated for protection. Given the number of sites in Scotland, that is of particular interest to us and we look forward to exchanges with the Council about that.

Finally, sustainable mobility is a broad and slightly uncertain topic at present. I understand that the presidency is interested in stimulating discussion on the use of soot filters for diesel-fuelled cars, on greenhouse gas emissions from the transport sector and on noise pollution. A conference entitled "Energy in Motion" will be held in October to explore means of achieving clean and climate-neutral transport. There will be two environmental council meetings during the Netherlands presidency, one on 14 October and the other on 20 December, and there will be plenary sessions for us to gather months of agreement and direction.

One of the more important issues on the agricultural side is that the Commission has now published its initial proposals for a new rural development regulation that will be needed from January 2007. Those proposals will be progressed under the Dutch and subsequent presidencies.

A key issue for us is the future distribution of EU funds between member states. As members know, we have a small allocation under pillar 2. Another key issue is the adequate and flexible use of funds to meet national priorities. The new rural development regulation will be the outlet for modulated funding directed from platform 1 and will therefore provide for how we develop the land management contracts as envisaged in our forward strategy.

The third key point is the future of less favoured areas. Currently, 85 per cent of Scotland's

agricultural land is classified as less favoured areas. The Commission proposes a review of the eligibility criteria for LFA designation, which could have implications for us. It will be important for us to be fully engaged with that review; we already are.

The Dutch presidency might also try to tackle aspects of animal health and welfare, but it now appears unlikely that the controversial issue of welfare of animals during transportation, which stalled last year, will make it on to the agenda in the near future. The easing of restrictions on beef sales and exports remains a priority for us and we continue to press the Commission on that.

Without a shadow of a doubt, the main business on fisheries during the Dutch presidency will be the outcome of the discussions in the next few months during which total allowable catches and quotas for 2005 will be fixed. We are already engaged in discussions with representative groups in the industry to start forming the kind of lines that we wish to develop in advance of the December council meeting.

The Convener: Thank you, minister. That was a useful overview of the key issues. Several members want to ask questions and I have had indications of particular points that people want to raise. On the environment side, there is the organic plan, the WEEE directive, climate change and sustainable development and then a block of questions about fisheries.

Mr Morrison: I want to add a question about animal transport that I failed to intimate at the beginning of the meeting. Should I just take my turn?

The Convener: I just want to make sure that I have everybody's requests logged—I want to ensure that everybody gets a fair crack of the whip.

Alex Johnstone: There are a couple of agricultural issues that I would like to raise.

The Convener: I expect Alasdair Morrison to come in on fisheries. I would like to proceed relatively swiftly. Rob Gibson has a question on the organic action plan, which the minister mentioned.

12:45

Rob Gibson: We can read in the paper that is before us about the roll-out of the proposals. How do you think the Dutch presidency will alter the momentum of the roll-out of our organic action plan? Given that quite a lot of producers are small producers, and given the nature of the areas where they work, do you see them making any savings through how they work, as you asked farmers in Orkney to try to make cost savings in their activities?

Ross Finnie: We are interested in the Dutch presidency being able to inject some momentum. As I understand it, there is a paper that indicates the range of issues. I have focused on the key issues that the presidency is seeking to take forward. I am bound to say that the agenda is very cluttered.

Rob Gibson is asking me two questions: where the action plan fits in and whether I think the Dutch presidency will bring some momentum. I very much hope that it will. It would be wrong of me not to suggest that, in a fairly cluttered agenda, that will not be easy. We would welcome a further rounding of the applicability of the plan and of the methods according to which we make progress. I would be anxious for us to be able to meld whatever preliminary conclusions come out of Europe on the organic front with the existing organic action plan.

I do not think that any of the plans under my portfolio can be allowed simply to sit there. All of them are intended to set the framework for where we are going. My view is that, if there are significant developments, whether they emanate from this committee and the Parliament or from the Council of the EU, they should be incorporated.

As far as costs for the smaller producer are concerned, I have highlighted the situation in Orkney because issues are being raised in Europe that are largely about state aid. There is a notion that some assistance in the northern isles confers a benefit upon people there. It is possible to argue a case for benefits' being conferred, but when costs are demonstrably increased by virtue of location, I challenge the basis upon which people could conclude that any form of support equals a benefit. That is a slightly different issue, but that is why I highlighted that example.

All producers across the whole agricultural front have increasingly to recognise that subsidy support is on the wane, even if that is happening over a long period. All those who engage in farming—organic or traditional—must recognise that they have to be commercially focused in their approach. Our plans do not preclude the amount of support that is given to people working in agriculture, organic or otherwise. Farm advice is directed towards people with that in mind.

The Convener: You have a report on the agenda for the Dutch presidency. We have some follow-up questions that slot in with that—that explains our list and your list, minister.

Ross Finnie: It means that we have a long list.

The Convener: It means, however, that you might not be asked a question about absolutely everything. We will try to prioritise. Part of the process is that this evidence goes on the record,

so that people outside the committee will see what you view as being the key priorities and what issues the committee is interested in.

Nora Radcliffe: I do not suppose that this relates directly to the Dutch presidency, but I am concerned about how we are getting on with the practicalities of implementing the WEEE directive. Could you give us an update on where we are with the practical things that need to be in place on the ground to enable the directive to work?

Ross Finnie: I hope that it will not sound as if nothing has happened, because the situation has moved, but not visibly, since the last time I reported, so I welcome the question. There are clearly a large number of elements within the WEEE directive that affect Great Britain as a whole. It is an issue on which my officials and officials in the Department of Trade and Industry and other departments are using the DTI as a sort of clearing house in trying to liaise with industry to ensure that we get uniform acceptance across the whole of Great Britain. Responsibility for implementing the directive has been placed on producers, so there is not much point in the persons who distribute goods in Scotland not understanding that the obligations do not stop at Hadrian's wall. It is important that we have a co-ordinated United Kingdom approach; we are making good progress on that.

The consultation process that we are engaged in is continuing and we hope very much that, before the end of the year, we will be able to put the necessary action in place. I am sorry that progress is not as visible as it might be, but it is quite difficult when we are having those indications, and we do not want to put off a number of major producers by having a public argument. That is not to say that we are not being firm in making clear the obligations that will transfer to producers under the agreement. We are making progress, but I regret that we have not gone much further. There is to be a seminar on 23 September at which we aim to inform waste managers about how the directive will affect them. We will also want to update them on the fact that they are not the sole people responsible, but they have to be aware of whom they will liaise with.

Nora Radcliffe: It is reassuring to know that that process is continuing.

The Convener: One of the issues that you highlighted was climate change. Mark Ruskell has a question on that.

Mr Ruskell: You mentioned the climate change review and in particular the Dutch presidency's priority to have a common EU position ready for the meeting in Buenos Aires in December. I also wanted to raise the issue that was highlighted by the Prime Minister yesterday, which is the UK's

involvement in pushing for air travel to be included in the EU emissions trading scheme. How are you and your department getting involved in those initiatives? I know that the Executive's climate change strategy is up for review. Could you tell us a bit more about the timescale for that and about how you wish to involve the Parliament as a whole in that review?

Ross Finnie: I shall take the latter part of that question first. When we set our climate change strategy, we were perhaps at a rather early stage in developing the Scottish Executive's adjustment to servicing its governmental responsibilities in Scotland. I believe that there has to be a thoroughgoing movement in what we do on that. What was not so easy to manage at that time was the setting of general targets and themes within the strategy, and that has to be examined very seriously indeed as part of the review process.

It is also clear that some of the statistics that are used are not necessarily as helpful as they might be. For example, there is a statistic on progress in the United Kingdom since 1995 that many people, including Mark Ruskell, have been quoting. My difficulty with that—and Mark Ruskell's too, I am sure—is that it assumes that everyone was the same in 1995, but we all know that that is not the case. In England, huge numbers of coal-fired stations were still operating, so the fact that they are not operating there now has had a hugely significant effect on progress. In Scotland, we did not have lots coal-fired stations. That makes it clear that if we are to have a sensible and rational discussion in Scotland we need to have a firmer basis.

I will make two comments on linking that work to what Europe is doing. First, I make it clear that my officials remain in touch with their relevant counterparts in Europe, both directly and through the United Kingdom permanent representation in the European Union, so we maintain a dialogue at official level. Secondly, there is contact through the Council and also through the United Kingdom Government. It is not as if those things happen remotely. As I said in my exchange with Rob Gibson, our review of climate change will not only be informed by consultation within Scotland, it will also have to take account of proposals on climate change that were discussed by the Prime Minister yesterday, and of the fact that the presidency is committed to co-ordinating and taking forward key parts of the Kyoto proposals.

Mr Ruskell: Is there a timescale for the Executive's review?

The Convener: I think that we have heard a date of 2005 for the review of climate change policy, but will it be early 2005 or mid-2005?

Ross Finnie: It will be 2005. I suspect that you would like me to refine that if I could. I will write to

you on that; I know that it is next year, but I will get back to you on the timing.

The Convener: That would be very helpful.

The next issue that I will raise is fisheries. You have given us quite a bit of feedback on what is happening in respect of fisheries and I know that a number of members are focused on the issue. Maureen Macmillan has an opening question.

Maureen Macmillan: I hope to ask more than one question.

I was in Shetland during the summer and spent quite a bit of time with the white-fish fishermen and with the pelagic fishermen. I am aware that they were keen for the haddock permit vessels to have extra days at sea and I notice the proposal to increase those from 15 to 17. Perhaps you can comment on that.

The fishermen were also interested in maintaining or improving the Shetland box. What are the possibilities for that? Can you comment on other such access arrangements that have a socioeconomic dimension in other parts of Scotland? If I may continue, I am also interested in how we are progressing with the establishment of the regional advisory councils.

The Convener: That should be enough to be going on with. Can the minister remember the first question?

Ross Finnie: I visit Shetland frequently and I, too, meet representatives of those fishermen's many and several bodies. I am fully apprised of the serious difficulties that they face.

I remain firmly of the view that our policy must be based on science and that it must have at its core a wish to conserve the marine biological resource. That creates a particular difficulty for the northern isles, given that cod is currently below its biological safe limits and the most prolific of the cod fisheries are closest geographically to Shetland. That imposes on those fishermen a very real difficulty. We should understand that, although we should also understand that the overarching policy objectives must remain.

That means that in any spatial management agreement, such as the box systems that are currently in place, those fishermen—the problem is perhaps more acute for them, although others have the same difficulty—have to seek alternative fishing grounds. Therefore, the number of days that they have available to them is more critical. We have been arguing for the extra days for a substantial length of time. We have laid before the European Commission evidence to argue for a quid pro quo—if we can demonstrate de minimis cod bycatch levels, the quid pro quo should be that the Commission allows more effort in those areas where the fishery is being controlled. I am disappointed at the time that it has taken to deal

with the days-at-sea issue, although I gather that the matter may now be put before almost any meeting of the Council of the European Union as an A point.

13:00

Lachlan Stuart (Scottish Executive Environment and Rural Affairs Department): It will be considered as an A point at the next available council meeting.

Ross Finnie: Instead of being required to be considered by a meeting of the fisheries council, the issue will now go to any council meeting for passing as an A point. The decision must then be published in the *Official Journal of the European Union*. I am deeply depressed at the length of time that it has taken, as the matter should have been before a council in June. However, progress has been made. Almost as important, the fact that the matter will be agreed in that way means that the principle of giving some reward for de minimis levels will be established. As we go forward to December, we should be able to build on that important principle.

On regional advisory councils, I have always said that such bodies should be a first step rather than the end-product of the process. I very much wish the regional advisory councils to have more powers and to have slightly more geographical focus. However, I regard the establishment of the North sea RAC as crucial in demonstrating to the wider political and engaged public that the regional advisory councils can work. The North sea RAC is the most advanced of any of the ones that have been recommended. Its preliminary meeting will take place on a date in November—

Lachlan Stuart: It will be on 4 November.

Ross Finnie: The meeting will be held in Edinburgh. That provides us with the opportunity to demonstrate not only that we are wholly engaged in making the regional advisory councils work but that the involvement of the Scottish fishing industry will be crucial to the operation of that RAC. My officials and others who are engaged in assisting with the establishment of the North sea RAC are certainly putting a great deal of time and effort into ensuring that that happens.

Finally, on the Shetland box, although the definition of that was enshrined in the common fisheries policy agreement two years ago, the fact that it is defended on conservation or socioeconomic grounds means that it is one of a number of areas that comes up for review. At a council meeting in either November or December this year, there will be a policy debate on the Shetland box, although no decision will be taken then. The Commission has already invited us to submit evidence, in which we have repeated both

the strong conservation argument and the equally strong socioeconomic argument for the Shetland box. We expect the preliminary report that will be the focus of that debate to be available perhaps in October.

Maureen Macmillan: I thank the minister for his detailed answer.

Mr Morrison: Before I come to inshore fishing matters, let me say that I was delighted to hear the minister say that the animal transport issue is permanently stalled under the Dutch presidency. On the LFA review, I am sure that the committee will work closely with the minister in following that important matter.

My primary concern is with inshore fisheries. I was delighted to hear the minister's report on the progress that is being made in establishing regional advisory councils. I certainly agree that the powers and role of the councils should be greatly enhanced. The fact that the first meeting will be held in Edinburgh in a few months' time is a welcome development.

I will focus on conservation and sustainability. As the minister will recall, some parties represented on the committee were involved in a shameful betrayal 10 months ago when the needs of scallop fishermen and processors were sadly ignored. Given that the Dutch presidency is now a few months old, has there been any indication that there will be any deviation from the sensible strategy for inshore fishery protection that was outlined by the Scottish Executive and UK Government?

Ross Finnie: I think that there is no appetite to make any changes there—quite the reverse. The clear steer that all of us with responsibility for fisheries management take from the current presidency is that we should develop our inshore fisheries management and that any such development should be based on the same overarching principle of having regard to the marine biological resource.

You will be aware that we have set up a group that represents many of our inshore fisheries organisations across Scotland. Given the organisations' disparate interests, the group is not easy to chair or manage. However, the members of the group, too, are coming together under proposals and plans that have conservation at their heart. Because of different geographical interests and conflicts over different fishing methods and the different use of gear, managing the respective inshore fisheries is not easy. That said, we are making progress and are much better engaged with the industry. That inshore fisheries group, which now meets regularly, is very much helping to inform the debate.

Mr Morrison: I certainly welcome the minister's comment that conservation and sustainability are

at the forefront of that important group's deliberations.

The Convener: I believe that Rob Gibson has a question about local offices.

Rob Gibson: I thank the minister for providing an annex to the papers detailing the process for North sea haddock arrangements. The annex is interesting in itself. However, when I raised the matter in February, I also had agricultural policy in mind. At the time, I asked about the arrangements involving Pentland House, local offices and producer organisations. Would it be possible to receive in writing a worked-out example of how a scheme such as the suckler cow premium scheme is developed? I find it most interesting to see the process at work and such a paper will spur future questions.

Ross Finnie: To be absolutely blunt, I hope that we are not going to bring back the suckler cow premium scheme. Having just abolished it, I think that that would be a retrograde move.

As far as policy development is concerned, I do not want to suggest for a minute that my department or I have got these matters right. However, we have genuinely been trying very hard to do so. We have set up numerous steering and working groups on sea fisheries, inshore fisheries, the environment and agriculture, which I should point out do not go on for ever—they are time limited and restricted to policy development.

We welcome feedback on whether the groups have or have not worked, but I must claim that I have made a genuine attempt to engage others in finalising the shape of an instrument or in implementing an instrument. After all, I can make announcements and lay regulations before Parliament for its approval and the committee can scrutinise them and make constructive comments but, at the end of the day, the people on the ground have to deliver them. My personal view—which I am sure is shared by the rest of the Executive and the committee—is that the more constructive engagement we have in formulating or implementing regulations, the better. However, people must understand that that does not mean that the process will be quicker.

Alex Johnstone: I want briefly to cover a couple of subjects, the first of which relates to discussions that are taking place on the rural development regulation. The minister and his department almost had to jump through hoops to establish a less favoured area support scheme. Is there any threat to the nature or the existence of the scheme as a result of the current process?

Ross Finnie: I think that there will be a less favoured area scheme, although we should be in no doubt that there could be serious discussions about its nature. The LFA scheme, which is called

other things in other member states, was the subject of a rigorous examination by the EU audit committees and auditors and received an unfavourable report. Whether we agree with that is not relevant; the point is that it has prompted the Commission to call for a pretty thoroughgoing review. We have modified our initial fears; we had thought that the Commission was going to start almost with a blank sheet of paper. However, there are concerns. We in Scotland enjoy the fact that 85 per cent of our agricultural land is deemed less favoured. It is clear from the discussion papers emerging from Europe that it would be difficult for one to justify that figure unless the land met rigorous criteria relating to a permanent state of disadvantage.

There are other issues for us in Scotland surrounding the fact that some of the initial discussion papers, which have been issued recently, focus on the fact that disadvantage might arise only when land is on high hill ground. Our view is that that is a criterion, but that land being on an island is an equal disadvantage in relation to sustainable agriculture. There is a lot for us to contribute to the debate. We are alive to its importance to Scotland and members can be assured that that is one of the reasons why we have read thoroughly the preliminary initial stuff, which was issued only recently. We will be engaged fully in the process.

Alex Johnstone: The other subject that I want to raise with you briefly is progress on what I describe as the normalisation of the beef industry. There have been promises of progress, but there also seems to have been delays. To what extent are the current delays in the progress centred in the European Commission and other European organisations and to what extent are they based in the UK?

Ross Finnie: As Alex Johnstone and other members of the committee will be well aware, there have been reviews of the risk attached to the over-30-months scheme for beef, but, unfortunately, two separate views have emerged, because the methodology adopted by the two parties were different. The Food Standards Agency applied criteria that invited a risk-reward ratio in terms of the cost of the scheme, but the public health authorities applied a much more prescriptive rule. It is simply not for me to adjudicate on that.

Ministers for health have therefore received differing, although not entirely different, advice. The issue is about public health and ministers for health throughout the United Kingdom are, quite properly, seeking unanimity about the risk. The matter lies there, because it is the job of health ministers to ensure that they are satisfied—as they are entitled to be—about the risk of allowing OTMS beef back into the food chain.

From the agricultural perspective, we are queueing in a chain. I do not necessarily discern any particular difficulties in Europe. However, if you were a commissioner sitting in Brussels and you did not have a clear direction from UK health ministers, you would be asking yourself questions as well. We are at a bit of an impasse. If the health issue is resolved satisfactorily, subject only to the fact that we have a change of commissioners and cabinets, we could quickly bring back on to the agenda the issue of the OTMS and the unwinding of the date-based export scheme.

The Convener: Thank you very much, minister, for giving us a paper in advance and for coming to talk to us and answer questions. I remind members that next week we will be kicking off with a briefing at 9.30 am, before the committee meeting starts.

Meeting closed at 13:15.

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