



The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

INFRASTRUCTURE AND CAPITAL INVESTMENT COMMITTEE

Wednesday 17 December 2014

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INFRASTRUCTURE AND CAPITAL INVESTMENT COMMITTEE
29th Meeting 2014, Session 4

CONVENER

*Jim Eadie (Edinburgh Southern) (SNP)

DEPUTY CONVENER

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

COMMITTEE MEMBERS

James Dornan (Glasgow Cathcart) (SNP)

*Mary Fee (West Scotland) (Lab)

*Mark Griffin (Central Scotland) (Lab)

*Alex Johnstone (North East Scotland) (Con)

*Mike MacKenzie (Highlands and Islands) (SNP)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Johanna Dow (Scottish Water)

Peter Farrer (Scottish Water)

Ronnie Mercer (Scottish Water)

Douglas Millican (Scottish Water)

CLERK TO THE COMMITTEE

Steve Farrell

LOCATION

The Adam Smith Room (CR5)

Scottish Parliament

Infrastructure and Capital Investment Committee

Wednesday 17 December 2014

[The Convener opened the meeting at 10:00]

Scottish Water “Annual Report and Accounts 2013/14”

The Convener (Jim Eadie): Good morning everyone, and welcome to the 29th meeting in 2014 of the Infrastructure and Capital Investment Committee. Everyone present is reminded to switch off mobile phones, as they affect the broadcasting system. Some committee members may consult tablets during the meeting, as meeting papers are provided in digital format.

We have received apologies from James Dornan, who will not be joining us this morning.

The only item on today’s agenda is evidence from representatives of Scottish Water, focusing on its performance over the 12 months covered in its “Annual Report and Accounts 2013/14”, as well as looking ahead to the 2015 to 2021 regulatory period.

I welcome Ronnie Mercer, the chair of Scottish Water; Douglas Millican, the chief executive; Peter Farrer, Scottish Water’s chief operating officer; and Johanna Dow, the chief executive of Scottish Water Business Stream. I invite Mr Mercer to make an opening statement.

Ronnie Mercer (Scottish Water): Thank you for inviting us along to give evidence. We had another quite strong year, with continued investment in Scotland’s water and waste water infrastructure. In the year that we are discussing, we recorded our best-ever drinking quality and environmental performance. We achieved record levels of customer satisfaction during the year, and the average household charge was held to £54 lower than the average bill in England and Wales.

We introduced a customer awareness campaign to help prevent what we call costly blockages in the sewer network. It is not always pretty to watch what we are putting out, but the aim is to get people to help us to avoid spending a lot of money cleaning up.

We were delighted that the First Minister, Nicola Sturgeon, officially opened our new premises at the Bridge in Stepps, Glasgow. Not only does that involve an investment in staff; it is an investment in customers. The premises house our intelligent

control centre, which uses telemetry to drive the business forward. That enables us to be a bit more predictive and proactive in our day-to-day issues. Technology helped to play a positive role this year when we had peak demand in local areas for the Commonwealth games and the Ryder cup, for example.

We also had some challenges during the year. Not everything goes perfectly well. We had some large water main bursts in Glasgow, which affected our service to customers. Hopefully, however, we recovered them quite quickly. The incidents were not related.

I am delighted to say that, since we last appeared before the committee a year ago, we have reached a final agreement with our regulator on prices and priorities for the period 2015 to 2021. That has come after extensive engagement with customers. One of their top priorities is stable prices—that is what customers spoke about, and I am delighted to say that we have committed to delivering it. We have agreed that, for four years, price increases will be pegged at 1.6 per cent per annum. Prices have fallen by more than 10 per cent in real terms between 2010 and 2015, so we have been quite successful at managing that during the period.

Other key priorities that the regulator has told us we need to have are continued water and waste water improvements, building resilience in the network and security of supply, which is a big issue. We do not have a record of having many droughts and so on, but we need to build in more resilience. We will probably answer questions on that today. We would like again to reduce to next to none the number of homes that are at risk of internal sewer flooding.

Our investment periods involve planning and evaluating operations more strategically over the longer term. During my time at Scottish Water I have noticed that there has been a maturing asset management journey. I was looking back on that before we came here this morning. It has gone from being a compliance-driven approach to sustainable performance—from tactical investment to real strategy-led investment. It has gone from being a reactive approach to long-term, risk-based predictive outcomes. Everything moves on in life, and that is one of the things that has moved on—for the better, in my opinion.

We will be investing about £500 million a year. We will be meeting new growth demand. We support the economy and employment. We create job opportunities for young people. We currently have 78 apprentices and 33 graduates. We “encourage”—I put that in inverted commas—our supply chain to take on graduates and apprentices, and there are a lot more of them there, too.

Some of our new talent will be working on big projects that we have planned. For example, there is £100 million for a Glasgow waste water tunnel, for improvements on the River Clyde and to reduce flooding in Mount Florida and Giffnock. Some of those young people—graduates and apprentices—will work on that.

I mention briefly Scottish Water's work and relationship with WaterAid, a big charity working in Africa and Asia that helps to provide safe drinking water and better sanitation, whose activities we support all over the place. Peter Farrer has been to Zambia to see some of the work that we support there.

Business Stream is the retail arm, of which Jo Dow is the interim chief executive. It has achieved increased customer satisfaction over its six years of existence, and has delivered benefits such as discounts and savings, in particular energy efficiency savings through water saved—20 billion litres, we think.

We have an engineering solutions group, which goes to customers and helps them to get their bills down. That is perhaps ironic, but the idea is to help them to be more efficient.

During the past year, Business Stream had a successful partnership with the public and third sectors, which was extended for another 12 months. That ends in March 2015. That has added exceptional value for public sector customers, and quite big savings were made for them.

Scotland's retail market has been open to competition since 2008; England's does not open until 2017. Competitors have mobilised in Scotland ahead of the English market opening. There are now 17 competitors for Business Stream in the Scottish market. Two years ago, there were three or four. Those people are here, and they are competing in Scotland. They do not compete with each other in England yet, because that market is not open. Business Stream's objective is to hang in there until the market in England opens in 2017, when it might regain some market share.

I make a little warning: if some questions are commercially sensitive, Jo Dow will need to answer them afterwards, outside the committee room. This meeting is being filmed and all 17 competitors might be watching, and we wouldn't want to give them any advantage through what we say. I ask you to bear with me, and we will tell you what you want to know.

That was a brief update on our activities since we last appeared before the committee. We are delighted to answer any questions that you have on any part of our business.

The Convener: Thank you, Mr Mercer. We will crack on with some questions from Adam Ingram,

who will ask about water and sewerage charges and Scottish Water International.

Adam Ingram (Carrick, Cumnock and Doon Valley) (SNP): Good morning, everyone. Mr Mercer, you mentioned previous sessions or meetings in the Parliament. It is fair to say that, over the past couple of years, you were proud to announce the lowest water charges in the United Kingdom, but that situation has changed a little. Can you explain why we no longer have the lowest water charges in the UK?

Ronnie Mercer: Sure. In effect, we drive ourselves to have among the lowest bills in the United Kingdom, with the highest level of customer service. At any given moment, we might be not in that pole position but close to it. I would not want to make any incorrect decisions just for the sake of it, but we have the huge objective of being at that level.

I ask Douglas Millican to elaborate on that.

Douglas Millican (Scottish Water): There are several parts to this. First, over the past two or three years, one of the water companies in England whose charges were very similar to ours was required by the regulator to have significant below-inflation price adjustments, and that brought its charges slightly below ours. However, looking at our relative position compared with that of England as a whole, our average charges in Scotland have been consistently about £54 a year below the average in England and Wales throughout the past few years.

Secondly, looking to the future, we have been very much guided by asking what our customers want. We did a huge amount of customer research and engagement in setting the plans and priorities for the period from 2015 to 2021. A number of things came out loud and clear from customers. First, they did not want us to go back on any aspect of service or performance. Secondly, they wanted us to improve service in certain particular areas, subject to prices rising by less than inflation. In setting our plans and priorities for the next few years, we have tried to respond to what customers want. Therefore, over the next few years, prices will reflect what customers are looking for in the balance between prices and service priorities.

Now that the English price determinations for the next five years are out, we can be pretty confident that our competitive pricing proposition will carry on through to 2020 and that average charges in Scotland will continue to be at least £50 a year below the average charge in England and Wales.

Adam Ingram: How are you able to hold down your charges below the average in England and Wales?

Douglas Millican: A number of factors affect companies' relative charge levels. Geography plays a part and can place an upward cost pressure on us, because we cover a third of the United Kingdom land mass.

We have some favourable factors going for us. Our public ownership works in our favour, because we get access to low-cost finance relative to that which private companies can access. Our system for billing and collecting household charges is very efficient; charging is done in conjunction with local authorities, so there is one bill that covers council tax and water charges. That gives a big saving to customers.

The third dimension is the work that we have done and will continue to do to drive efficiency and innovation into how we deliver services. Our relentless drive comes from our belief that our customers should not pay a pound more than they need to for the vital services that they depend on. We have used that belief to engage with people and to drive further efficiency into the future service.

Adam Ingram: It is interesting that the first point you mentioned was public ownership. The fact that a public body can outperform the private sector is encouraging. Perhaps that is a pointer to other services.

Ronnie Mercer: The fact is that the regulator in England has looked up here and said, "That's a pretty good working model." He is maybe trying to prevent the dividend flow from leaving the UK through some of the companies down south, but there we are.

Douglas Millican: We have tried to make that dimension work for us, particularly in the way that we engage our people in the challenge, which is inspiring and encouraging. All the benefits of delivery flow back to customers. Whether that is enhanced service or greater efficiency, it all flows back to more affordable charges for our customers.

Adam Ingram: I move on to one of your subsidiaries, if that is the right expression; I refer to Scottish Water International, which you made some play of in previous evidence sessions. Scottish Water International posted a loss of some £200,000 before tax, on revenue of £1.2 million in 2013-14. What was the loss after tax? It was not set out in the annual reports.

Douglas Millican: It will be down in the roundings, but it will be slightly less than £200,000, because in effect Scottish Water International gets a tax credit back.

I will place that in a broader context. We set up Scottish Water International about three years ago. We have invested much in the growth and

development of the business and we have been learning what works and where the demand is for our services. We have landed in a place where we know that we offer a unique proposition. How can we help other publicly owned water companies or water authorities become efficient or commercially successful through public ownership? That is our unique proposition.

One of our aims was to try to get to the position of having three baseload contracts—three contracts through which we might be involved in territories on a multiyear basis. When we met the committee a year ago, we had just one contract, in Qatar. At that time I hoped that a second contract was in the offing, and I am delighted to advise the committee that we now have three baseload contracts. We continue to work in Qatar, and we are working in the Republic of Ireland, supporting the set-up of Irish Water, which is a publicly owned organisation that needs to deliver significant efficiencies and commercial change. We are also working to improve the efficiency of water services in Calgary.

That is the foundation of the business, although there are various other contracts on top of that. It is too early to predict precisely what the results will be, but I am pretty hopeful that there will be a more positive financial report for the current year.

Adam Ingram: How do you see the business developing?

Douglas Millican: We have recognised that there are two types of skill that we can sell to and deploy in the target market, which is other publicly owned businesses that are looking for real expertise. The most significant area of value is where we take senior people in Scottish Water who have experience of the transformation and send them out for periods as short as a week or two weeks at a time. The insights and experiences that they share can really add value for other public authorities.

The second dimension involves experienced members of staff in middle levels of management and technical expertise. Those people might go out for a number of months or, in the case of Qatar, for a number of years. Over the past year, we have had 68 employees working on assignments, ranging from people who are full time in Qatar for many years to those who are out for a couple of weeks.

10:15

Adam Ingram: So it is a mixture of consultancy and technical advice.

Douglas Millican: It is very much about advisory and consultancy work, looking at where we can bring to bear the skills and expertise to

help other public bodies. There is also a direct benefit back into Scottish Water, because the system provides good development opportunities for our staff, who work in different cultures and different commercial contexts. We are trying to deliver a win-win situation in which we deliver benefits to clients and get development value for Scottish Water.

Ronnie Mercer: We are not going to build, own and operate anything anywhere else. It is about expertise and people. We are not risking our customers' money in that way; that is definitely not what we are doing. It is about people and expertise, not digging holes.

Adam Ingram: Ronnie Mercer mentioned that Peter Farrer had been out in Malawi. Was he there as part of such a scheme?

Ronnie Mercer: It was Zambia, and he was there for Water Aid.

To elaborate on what Douglas Millican said, the Republic of Ireland Government people phoned me last week to chat about what they are trying to do, because the model for them is Scotland or Wales, not England. The model is interesting and people quite like it, and Irish Water will be owned by the Government anyway. Our model allows us to sell our expertise and that is a good thing to do. It also makes Scottish Water a slightly more interesting company to join if employees think that they can go and do things like that. I was going to use the word "sexy" there, but the job has a wee bit of glitter about it if a student thinks that they might get the chance to go abroad to work for a bit.

The Convener: Mr Farrer, did you want to come in on that?

Peter Farrer (Scottish Water): No.

The Convener: I thought that you were champing at the bit.

Alex Johnstone has some questions on Scottish Water Horizons.

Alex Johnstone (North East Scotland) (Con): I note that Scottish Water Horizons has turned around in the 12 months to the date of the report that we are considering, and it has reported a profit of £700,000 before tax. Relating that back to Adam Ingram's question, how much tax did you pay on that £700,000? Perhaps the right thing to ask is how tax and profit are treated within the company. Do you pool together your profits or losses before tax is calculated?

Douglas Millican: Scottish Water is subject to corporation tax. The position of Scottish Water as a whole is that we have never yet been in a taxpaying position for our main activities, and that is absolutely to the benefit of our customers. That

reflects the fact that we get capital allowances on new investment and infrastructure that we put into the ground, so although something might appear as an accounting profit it is not a taxable profit. To the extent that we can, we may utilise that to benefit other parts of the group, but we are fully compliant with all the requirements of UK tax legislation.

Alex Johnstone: Would it be fair to say that a profit in one part of the group will ultimately be set against losses in other parts?

Douglas Millican: Absolutely. We optimise our tax position across the group, but customers get the benefit of that through bills being lower than would otherwise be the case.

Alex Johnstone: Will you provide an overview of the strategic review of Scottish Water Horizons and the contents of the business recovery plan?

Douglas Millican: We have undertaken quite a review of the key areas of focus for Horizons, and we will continue to develop that as we see how the economy and the market recover.

Horizons has probably two principal activities, the first of which is supporting developers who want to do studies, who want to connect to the infrastructure or who need to lay infrastructure of their own to connect to the system. Scottish Water Horizons provides a market-competitive service in that arena and, in the past year, turnover in that area of activity was nearly £5 million.

The other major area of activity for Horizons is waste management, which falls into two categories. First, we have turned an old, disused waste water treatment plant in Cumbernauld into a food waste recycling plant that disposes of food waste from across the central belt and creates energy as a by-product.

Secondly, we are taking waste, particularly liquid waste, at our range of waste water treatment plants around the country. We tanker in waste and, to an extent, bleed it into the waste water treatment plants in a manner that fully complies with Scottish Environment Protection Agency licences for the operation of those plants. In the Shetland Islands, for example, we have, on the back of the growth that is taking place at Sullom Voe, been doing a lot of work on taking waste off site and then bleeding that into our waste treatment plants. It is a good example of a market-led opportunity. We were not doing this a couple of years ago, but it is now providing a material income stream in the current year.

Alex Johnstone: As you have pointed out, commercial operators work in the sectors covered by Scottish Water Horizons. Is it appropriate for you to continue with those activities when a

number of private companies are already competing for that business?

Douglas Millican: It is a case of our providing an opportunity against some key conditions. First, an opportunity must be absolutely consistent with the running of our core waste water activities. Secondly, it must be absolutely profit enhancing—in other words, it must give clear value to the Scottish Water group and, as a result of that, to customers. The third—and very important—dimension is that the activities are not cross-subsidised. We compete against the private sector on a fully costed service.

Alex Johnstone: Although Ronnie Mercer has already touched on the other area that I want to ask about, which concerns Business Stream, I will ask the questions anyway and if the witnesses tell me that the information is commercially sensitive—

Ronnie Mercer: I will tell you outside. *[Laughter.]*

Alex Johnstone: The annual report highlights growing competition in the non-domestic market. What impact is that having on Scottish Water and Business Stream?

Ronnie Mercer: We knew that we would eventually get competition, which we do not mind as long as it eventually becomes universal throughout the United Kingdom. However, there is a bit of a time lag in that respect. Business Stream has been running since 2008 and although the Scottish market has been open since that time, it will be another two and a bit years before the market is open in England. As a result, our market share is being eroded by companies in Scotland that are tuning up for the market in England opening up as well. Some companies are just taking licences and seeing how things go.

I will ask Jo Dow to elaborate a wee bit on how life has changed in the past year or so, because what has happened has been quite dramatic and we are spending a lot more time on the matter.

Johanna Dow (Scottish Water): When the market opened up in 2008, we fully expected to lose customers. The whole point of a competitive market is to drive advantage for customers, and the natural consequence of that is that customers switch. They choose either to move to a different service provider or, indeed, to stay with Business Stream if they feel that they can get the enhanced level of service that they are looking for.

Although in the first few years of competition, switching was an incredibly slow process, we have definitely seen a step change in the past 12 months. As Ronnie Mercer has said, we now have 17 competitors in the market, many of whom are active; in fact, most of them are English water

companies that are using the fact that the English market is not fully open to competition while the Scottish market is. They are coming to Scotland to test their wares, see how the market works and get experience of it. Although we are definitely living with that every day, I see it as an opportunity. We always expected a level of churn in the market—that is what the market is there for—so it is a positive for us.

As Ronnie Mercer has said, our big challenge just now is the lack of a level playing field, and the fact that we can lose customers in Scotland but cannot win back an equal number of customers in the English market is definitely a source of frustration.

Ronnie Mercer: We look forward to a level playing field in two years' time.

Alex Johnstone: I am tempted to ask about the switching that has taken place. Is there churn in the market, or are a few big customers making big savings by switching?

Johanna Dow: Until approximately six months ago, switching was taking place more at the larger end of the market, typically because the larger customers were a bit more commercially savvy and knew that the market existed. We differentiate between and segment our customers, and we found that, prior to the past six months, there was not a huge amount of switching among the small to medium-sized enterprises that we categorise as our smaller customers. That situation has changed in the past six months, and a couple of major players have come into the market to target solely those SME customers. Again, that is a good thing, because we want all customers in the market to benefit from competition.

Alex Johnstone: A moment ago, you touched on the quid pro quo of opening up the market, which is that the English market will open up in just over two years' time. What are you doing to prepare for that? Do you see that as an opportunity?

Ronnie Mercer: Because, having been in competition for a while now, we have already gathered more scars, we will have a first-mover advantage. To some degree that is why, as Johanna Dow has described, there has been more activity in the past year. Since the legislation in question was passed in England, it has become obvious that the market will open up. It is real, it is going to happen, and we have been—and still are—preparing for that.

Ultimately, the market share that we record will be the market share for the whole UK—minus Wales, which is not in the system—rather than the market share in Scotland. That will be what counts. We have a targeted strategy for that; I will not tell you what that is on camera, but, if you

want, I can tell you after the meeting. We have people working on nothing but that, and—

The Convener: You are among friends.

Ronnie Mercer: Indeed. If you switch the cameras off, I will go for it, but I will not tell the people who are watching what we are doing.

The targeted strategy is part of Johanna Dow's element of the business. There is quite a long hang-on, and we have a while to wait yet. Although both elements are fully legally separated, we are carrying all the costs at present, but we will just have to live with that.

Alex Johnstone: I understand that this is a big opportunity, and I can see the potential for substantial success. However, with such an opportunity comes risk. How will Scottish domestic customers be protected from any risk that you might take in order to succeed in the marketplace?

Douglas Millican: First, as Ronnie Mercer said a minute ago, Business Stream is completely separate, legally and financially, from Scottish Water, and all of its activities need to stand or fall within the financial resources that are available to it. There is no cross-subsidy mechanism between Business Stream and Scottish Water and the regulated business that it supplies to household customers. With the legal arrangements and the scrutiny—dare I say it—of the Water Industry Commission for Scotland, customers can feel totally assured that there is no risk of cross-subsidy in that area.

Mike MacKenzie (Highlands and Islands) (SNP): I represent the Highlands and Islands, and it will come as no surprise to you that I am greatly concerned by the number of areas in which my constituents suffer from and are victims of market failure. I am sorry, but I must take this opportunity to tell you that I have received what seems to be a disproportionately high number of complaints about Business Stream in the Highlands and Islands, and those complaints relate to various problems such as a disproportionately long wait in dealing with billing inquiries and other matters.

10:30

A story that illustrates the nature of the problem concerns a new connection that, had it been for a domestic rather than a business supply, would have been of little consequence and easily accomplished. However, the surveyor from Business Stream came on a four-hour journey from Glasgow, took a look across the water at the island that he was supposed to visit and, despite the fact that the ferry was running as normal, thought that he might suffer from seasickness. He went back to Glasgow and came out some months

later, which resulted in a simple business connection being delayed for six months or so.

You will therefore understand why I am heavily in favour of the principle of the universal service obligation. We have talked about competitiveness and so on. Are my constituents going to suffer from market failure? Given that competition can sometimes be healthy, will the change improve Business Stream services to my constituents in the Highlands and Islands?

Ronnie Mercer: Yes. Quite frankly, I think that there should be no difference between the service in your constituency and that in anybody else's. I accept that an island is an island and it might well be a bit harder to reach. Two months ago, I went on a little tour of three islands—Orkney, Shetland and Lewis—and at the public meetings that I held along the way, we heard about a number of issues that I have been following up. One of those issues relates to developers; after all, the islands are a wee bit more remote.

I point out that customers, if they so wish, can change to any of the other 17 suppliers tomorrow; there is no need for them to stay with Business Stream. To be fair to Business Stream, I should also say that when we formed it there were a lot of data issues. In the past, we charged people on rateable value; now, there are meters everywhere that all have to be read. By far the majority of businesses—not all of them, as problems can occasionally arise—are metered, and over the past two or three years we have put in 40,000 meters. That is how the business is developing.

Only this morning, we received a report from the Scottish Public Services Ombudsman. Given that the committee will not have seen it yet, I will ask Johanna Dow to read the paragraph on what the SPSO said about complaints, just as a matter of interest. *[Interruption.]* I have just been told that the report is embargoed until lunchtime. Damn! That has scuppered my plan. *[Laughter.]* We will see you at 12 o'clock, and we can show it to you then. It is quite complimentary about the progress that is being made.

The fact is that when customers start switching data problems show up; suddenly we find out that supermarket X has more sites than we thought or has shut some that we did not know about. For a long time now—I do not know how long—we have been clearing out data. It has been a huge job, and England has that pleasure to come. It will have the same issues; they have just not shown up yet because there is no competition. We have had to clear a number of things, so I am sure that the examples that you have given us are correct. That said, there has been a huge step change, and we will tell you at 12 o'clock what the SPSO's report says. In any case, as I have said, customers can switch if they do not like Business

Stream; I hope that they do not, but they can if they wish.

I should also point out that the issues are not all to do with Business Stream. In fact, one of the complaints that I heard when I was up on one of the islands came from someone who, it turned out, had switched. They were not with Business Stream at all; they had signed up with someone else, but they did not seem to know that.

Peter Farrer: To be fair to Business Stream, I should say that the connection process in retail spaces includes a Scottish Water element. We have talked about the complexities of the market, and Douglas Millican is absolutely right about that. Johanna Dow runs the retail business, and there is a complete barrier between her business and the wholesale business for which I run the connections part.

Approximately 12 months ago, we realised that certain complexities in the processes were making things difficult for customers; the processes were set up to suit our businesses rather than our customers. Over the past 12 months, we have taken a long hard look at that issue, have worked closely with retailers and have significantly improved the processes. For example, approximately 12 months ago, the average time between the point at which an application came in to the retailer and the point at which the customer got a quotation for a connection was around 100 days. Working primarily with Business Stream, through which, because of its market share, most of the connections come, and with retailers, we have completely changed the processes, and the timescale has been reduced to 15 days. In other words, all applications to the point of quotation are now being dealt with within 15 days.

Mike MacKenzie: Thank you for that. You have articulated perfectly the nature of some of the problems that my constituents have experienced, and I am glad to hear that those issues are being dealt with.

I am sure that you accept the principle that it is possible to have a set of results that look very good overall, only for people to find when they drill down—particularly in areas such as the Highlands and Islands, which I readily accept present problems for any business—that performance across sparsely populated areas is pretty poor. I would be very interested in any information that you can share with us after lunch—or after dinner or whenever—that demonstrates the principle of universal service.

Douglas Millican: Responding to that from a Scottish Water angle, I think that you are correct. Although we can look at our customer satisfaction scores and show that last year they rose by a couple of percentage points on the previous year,

and although we can look at where we are in the current year and see that we are continuing to make really good progress, it is clear that, even with a very good set of results overall, some customers will still not be getting the level of service that they deserve. We investigate every single source of dissatisfaction that we hear about, and we drive down into the root causes to analyse the issues and work out what we need to change—it might be the processes, or there might be a geographical issue—to ensure that we endeavour to give every customer, irrespective of where they are in Scotland, the same very high level of service.

Mike MacKenzie: That is reassuring, and I would be delighted if you could use that data to prove to me that I am completely wrong.

Ronnie Mercer: I will give Johanna Dow an opportunity to respond to the points that have been raised.

Johanna Dow: First of all, coming from Shetland, I am incredibly sympathetic to the Highlands and Islands situation, and Mike MacKenzie should rest assured that it is high on my agenda.

As Douglas Millican has said, we in Business Stream try to ensure a consistent level of great service across the country, but there are times when that service is not as good as we would like it to be. We are focusing on tackling that problem and ensuring that we address the issues. I am more than happy to pick up the issue that Mike MacKenzie's constituent raised offline, if that is helpful, and I reiterate the points that Peter Farrer made. As an industry, we recognise that new connections have been a bit of a problem area because of the multiple interfaces between retailers and wholesalers, but we have worked jointly to address that and to improve things from a customer perspective.

Mike MacKenzie: Thank you very much. I have to say that I am perplexed at why you would ever want to leave Shetland. *[Laughter.]*

The Convener: Mary Fee has some questions about measuring Scottish Water's performance.

Mary Fee (West Scotland) (Lab): The Water Industry Commission uses a scoring system to measure Scottish Water's performance against the overall performance assessment. Your target was 380, and you scored 397. How does that compare with the performance of water companies in England? Are there any specific areas in which you need to make additional improvements?

Douglas Millican: Perhaps I can provide a bit of context. The overall performance assessment is a methodology that was established in England back in the 1990s to drive up performance in the

companies in England and Wales. By 2007 or so, performance was pretty stable, and it was pretty clear that the leading companies in England were delivering an OPA score in the 380 or 380-plus territory. Because of that, the Water Industry Commission set us the target of getting our performance up to a score of 380 or higher by last year. We could then say that customers in Scotland were getting the same level of service as that provided by the leading companies in England and Wales. However, the OPA mechanism as such was disbanded in 2011 in England, and the companies moved to a different mechanism, which I can talk about if you are interested.

We have endeavoured not only to look at the scores and say, "Good—we have beaten the 380 target", but to look at the components of OPA performance to the extent that we can still benchmark them against the equivalent performance metrics in England. When we look across the basket of measures for last year, we see that the scores range from those that show us to be the clear leader to others that show our performance to be at the lower end of the spectrum. Looking across those measures, one can say objectively that our performance is very much at the same level as that of the leading three or four companies in England.

Mary Fee: Thank you. I was going to ask whether you could still compare if England has changed the way that it measures, but you have answered that.

Do you need to make additional efforts in certain areas? You said that some of your scores are above average and that, in some, there is further improvement. Do you need to take additional measures to match the top performers?

Douglas Millican: There are a couple of dimensions to that. On the OPA side, we are carrying the approach on to the next period. Although our scores are at a very high level, our first challenge is to sustain them at a very high level, as points can be lost very easily. The first challenge is to sustain the high performance.

The further improvements to make on drinking water quality are probably the specific issue that stands out most. It is worth putting that in a longer-term context. In Scottish Water's very early days, our water quality performance was at 99.3 per cent compliance. Last year, we were up to 99.91 per cent compliance. That is a dramatic transformation in water quality. All the English companies begin at 99.9 per cent, but the final decimal point might be a wee bit higher than ours. There is more that we can and will do to further improve drinking water quality and, crucially, to manage the risks to it.

From a customer angle, the most significant area that we will focus on in the next period is all-round customer experience. We have done a lot of work on that over the past few years to drive up customer satisfaction, but we are broadening that. I give credit to the customer forum for its work. It worked with us in agreeing our plan for the next period. We will focus on household customer experience and, crucially, link that to the previous subject matter, business customer experience.

There is a set of quantitative and qualitative measures. The quantitative measures include how we are doing in reducing the need for customers to contact us and how we are getting on in reducing complaints. The qualitative measures are all about the experience of customers, whether they have contacted us or they have had a service experience but have chosen not to contact us. We will set stretching targets to drive at how the experience feels for customers across Scotland.

Mary Fee: You raised the issue of customer satisfaction. Before I ask you about ministerial targets, could you tell me how many complaints were received in 2013-14? How many were satisfactorily resolved?

Peter Farrer: I will take that question.

We have seen a further improvement in the number of complaints. There was a further reduction of 12 per cent in complaints over the year. I am glad that the number is improving. Even from the first six months of this year, we are on track for a further 25 per cent reduction in complaints this year. We have been on that journey for quite a while. Complaints have reduced by 50 per cent in this regulatory period from the starting point. We are getting down to a particularly good level.

On your second question, once we have finished dealing with a complaint, the customer can go to the Scottish Public Services Ombudsman to deal with a second-tier complaint. Again, we have seen significant improvements on that over this regulatory period. There was the significant reduction of 85 per cent in the number of referrals to the SPSO in 2013-14. The figure went down from 24 referrals in the year before to 11 in 2013-14. Of those 11 referrals, only three of the complaints were upheld.

Mary Fee: Your report talks about the 12 per cent reduction in the number of complaints, but 12 per cent of how many? Twelve per cent of 100 is a small number, but was it 12 per cent of 10,000? How many complaints do you get?

Peter Farrer: The absolute number for 2013-14 was 2,114. That amounts to 0.1 per cent of the connected domestic properties that we have in Scotland.

Mary Fee: What work are you doing to reduce the number of complaints further?

10:45

Peter Farrer: Probably the key measure, and the reason why we have got to such a low level of complaints from where we were, was that we significantly upskilled our complaints management team and changed all the processes for dealing with complaints, with the primary objective of giving customers the best possible service so that they do not have to go to the ombudsman when we fail to resolve their complaints. That was stage 1.

Another change that has had a significant impact is that, as Douglas Millican mentioned, we now measure customer experience for every transaction when a customer phones up, whether that is about a burst water main causing an interruption to supply, a water quality issue or a blockage to a sewer. With anything that requires work to be done by Scottish Water, we immediately send out a customer experience survey to the customer.

Over the past 12 months, we have implemented a real-time system so that we get information back from customers from the survey in real time. We get a huge amount of information from that, not just from the satisfaction score that customers give us but from the reasons why they give us that score. As Douglas Millican mentioned, we do root-cause analysis on that quickly. We go back to the customers to find out what we could have done better and we fix that. That quick response is helping to drive down the number of complaints. We are getting on top of experience issues quickly and before customers feel frustrated enough to write a complaint letter to us.

Ronnie Mercer: It is interesting that Business Stream is moving to that system, too, as it happens.

Mary Fee: Can you provide the committee with a summary of progress that you are making towards meeting the ministerial targets that you have been set?

Douglas Millican: The ministers set targets for each regulatory period. We are nearly at the end of the 2010 to 2015 period, but ministers have now also set us objectives for the 2015 to 2021 period, so we are almost sitting on two sets of objectives. I will deal with each in turn.

For the 2010 to 2015 period, overall, we are very much on track. There are some areas of investment where we ran ahead of expectations and there are one or two areas in which we are running slightly behind. Importantly, the Water Industry Commission for Scotland has put in place

a mechanism called the overall measure of delivery, which is the capital equivalent of the OPA score. The aim is to give stakeholders and Government confidence and to show whether we are on track with investment delivery overall. That OMD score is very much on track.

On the 2015 to 2021 period, for which the First Minister announced the objectives a couple of months ago, we are well on with the planning and preparatory work. A lot of study work is going on and we have new investment alliances being put in place so that, when we get to April next year, we can hit the ground running in the delivery of the new investment programme.

Mary Fee: I have specific questions about the two objectives that are probably the most onerous and the ones on which members probably get more complaints than anything else. Those are the objectives on unsatisfactory intermittent discharges to rivers, lochs and coastal waters and on reducing odour issues for waste water treatment works. As someone who lives quite near a waste water treatment works, I know how difficult odour issues are to cope with and how difficult they are to solve. Can you update us on that?

Douglas Millican: I will take each in turn. On intermittent discharges from the sewerage system, to give a wee bit of context, we have done a huge amount of work over the first 10 or 12 years of Scottish Water on upgrading waste water treatment plans. The focus now has very much moved to ensuring that the points of intermittent discharge from the sewerage system—basically, where storm water overflows at times of high storm events—are to a satisfactory standard. The upgrades usually fall into one of two categories. We may need to ensure that all the sewage-related debris stays inside the system, which is therefore about having appropriate screening in place. Alternatively, for water quality reasons, we might need to hold the storm water in the sewer until it can be taken down the system to a point where it can be appropriately treated, for example, at a waste water treatment plant.

Most of that work in this period is focused on the Glasgow area. It has been a very complex programme of work, in which we have worked closely with SEPA, Glasgow City Council and other agencies in the area to understand the nature of the challenges and the right solutions to be put in place, not just by Scottish Water but by other agencies. A huge amount of study work has been done to come up with the right solutions. We are part of the way through delivery. There are some parts of the Glasgow system where those unsatisfactory intermittent discharges have now been made satisfactory—they are now satisfactory points of intermittent discharge.

At the other end of the spectrum is the project that Ronnie Mercer called out, which is the big tunnel that we are building on the south side of Glasgow. In financial terms, it will cost more than £100 million. To give you a sense of the scale, the tunnel will run for 5km and is 4.5m in diameter, which is broadly equivalent to the diameter of this room. There is a water quality reason for the tunnel, which is to store storm water and convey it down to the treatment plant when the storm has abated. Although the contract has been awarded for that project, there is a year's worth of preparatory work to be done before the tunnel boring machine can go in the ground. We expect that the machine will go in in early 2016 and will run for 14 months.

That is by way of illustration and to give you a sense of the complexity of the programme. We expect that this phase of the overall programme will be complete in 2018.

The second dimension is odour from waste water treatment works. I will take that in two parts. We were set targets in the current period to make upgrades at four waste water treatment works. Those had all been made by the end of last year. What has been identified for the objectives for the next period is a couple of sites where we need to make further enhancements. That has been built into the ministerial objectives for 2015 to 2021.

The reality with odour is that most of the challenge comes down to operational vigilance. There are times when what is required is something additional to the capability of the assets to ensure that they minimise odour, but the real challenge is to ensure that the plants are operated completely vigilantly to minimise odour nuisance. Responsibility is split between us and our private finance initiative companies. Some of our largest waste water treatment works are run under PFI contract. From a customer angle, that makes no difference—it is our responsibility—but what it means in some quite significant areas is that we need to work through our PFI contractors to ensure that they are being vigilant in the control of odour nuisance.

Mary Fee: I move on to sustainable development. How do you intend to reduce greenhouse gas emissions further in the coming years?

Douglas Millican: I am happy to answer that. That is an area where we have made significant process in recent years. Most of the greenhouse gas emissions associated with our activity are to do with electricity consumption. It is the nature of a water company to be a large electricity user. If I take the water system for example, there are places where water needs to be pumped, but the treating of water to very high standards requires the use of electricity.

The really good news for Scotland is that we have the lowest carbon footprint of any water company in the UK when it comes to the water service. That is largely down to the great foresight of our predecessors in having gravity-fed water treatment systems, where generally water comes from upland sources down to more lowland communities.

On the waste water side, one of the consequences of all the work that we have done to improve waste water discharges to meet all the European Union standards is that we have now put in place treatment where previously there was not treatment. That in itself has driven up significantly the amount of energy that we need to consume as a business. That is the historical context.

To try to mitigate that, we have a four-strand approach to energy. First, we are trying to reduce the amount of energy that we need to consume in the operation of our assets. Peter Farrer's team has done a huge amount of work in that area. I might hand over to Peter in a minute to talk about some of the things that we have done operationally to drive down energy use.

We are also planning to drive up the amount of energy that we generate, both directly through hydroelectricity and solar power, and through wind power. We are in a position where Scottish Water either provides directly or enables the provision of more renewable power than we consume in our activities.

My final point before Peter talks about some of the specific measures is that it is important to place this issue in context. First, we have had a good-news story that—notwithstanding the upward pressures on energy demand—our operational carbon footprint has fallen by 18 per cent over the past seven years. The amount of energy that is consumed per customer in providing water and waste water to every home in Scotland is less than is consumed by an A-rated fridge freezer.

Peter Farrer: Pumps are among our biggest users of electricity. We have many thousands of pumps across our assets all over the country. We are doing audits to find out which pumps are efficient. In a number of cases, it makes sense on a spend-to-save basis to upgrade pumps with more energy-efficient pumps. The savings that we get back from the reduced consumption of energy pay for that initial spend in a very short period. We are doing quite a bit of that.

A lot of our waste water treatment works have aeration systems, which are part of the biological process to treat sewage—we put oxygen into the sewage. That oxygen has to be generated through large compressors and blowers and it is quite an energy-intensive process. If we put in simple

things such as timers and variable speed gearboxes and add more controls so that we reduce the amount of oxygen that we put in at times when it is not needed, that will reduce energy consumption.

We are also working with the operational teams. We can put in a lot of control equipment and new pumps, but we also need to educate the operational staff on what they need to do to maintain good energy management practices on the sites. We are doing quite a lot of development work to bring our people up to the right standards to run the sites more efficiently.

Also, there are seasonal time-of-day tariffs—it is far more expensive to purchase energy at particular points in the day. We have looked at changing our automatic control systems so that we can shut down the high energy-using equipment during peak periods and have it start up again afterwards, which will cost less and use less energy. We are doing a number of different things to reduce energy consumption.

Mary Fee: I know that you have plans to increase in-house electricity generation. Can you give us an overview of that and what impact that will have on customers' bills?

Douglas Millican: The impact on customers' bills has been baked into our plans for the next six years. In agreeing our business plan with the customer forum and then ultimately with the Water Industry Commission, we put in the operational savings that we would make based on having more renewable power in place. We now have to go and work hard to deliver against that promise that we have made.

To give you a bit of context, we currently use 450GWh a year. At the moment, we are generating about 23GWh a year; that will go up to about 55GWh a year by the end of this year and it will go up to well over 60GWh a year in the next regulatory period.

What is crucial is what we host in wind generation on our sites. We already produce 350GWh of energy on our land. There are further schemes that have received Scottish Government consent, which will produce a further 558GWh. We have over 300GWh at various stages of planning and development. When we add all that up, it is a significant multiple of the energy that we consume ourselves.

Mary Fee: Thank you.

Mike MacKenzie: At the risk of appearing a bit pedantic, and so that members can envisage this Glasgow tunnel that you are talking about, I should say that this room, at its widest point, is about 7m and this table, at its widest point, is about 4.5m.

We all support your efforts to improve environmental quality. Could you indicate with data, in outcomes terms, the effect of improvements to our waterways, particularly with regard to waste water and sewage discharges in our coastal and inland waters?

11:00

Douglas Millican: I suspect that the issue that is at the heart of your question is something that I would need to pass over to the Scottish Environment Protection Agency. Our discharge standards for our waste water treatment plants are set with regard to the capacity of the receiving waters—whether it is a highland burn or the North Sea—to take treated effluent. SEPA examines that and, based on the environmental sensitivity of the receiving water, it back-solves the licence standard that needs to be achieved. In simple terms, if we are meeting our licence standard, SEPA is in effect providing an assurance to the country that the receiving water is operating to the requisite environmental standard.

Mike MacKenzie: You will therefore understand my disappointment when I have spoken to SEPA about such issues. I am concerned about things such as E coli concentrations, but it is unable to tell me whether there has been an improvement. That strikes me as peculiar. If we think in an outcomes-based way, surely that is what matters. It is not having lots of shiny new-painted sewage-water discharge plants that is important, but the outcomes.

Douglas Millican: Absolutely. To set the minister's objectives for the next period, a huge amount of work was done by the Scottish Government, Scottish Water and SEPA to consider the environmental improvements that need to be delivered in the next period, very much working back the way from the outcome that is required in relation to the receiving watercourse. For example, all the improvements to points of unsatisfactory intermittent discharge in the sewage system are very much geared to the creation of a satisfactory burn or river to where the discharges may come out. That is absolutely the focus. From a Scottish Water angle, I cannot give you the science in relation to the receiving waters. That is a matter for SEPA's expertise. However, our standards are designed to achieve that.

Ronnie Mercer: You could say that the idea is to have many fewer unplanned discharges. It is quite numerical to say, "We used to have so many a year and now we will have a lot less, because we are holding the water to treat it instead of discharging it untreated." There will be some numbers around that, eventually.

Peter Farrer: Douglas Millican is right to say that SEPA has to determine what the outcomes are. What we know, based on the consents that SEPA has set us for discharging, is that we have had some significant improvements in that regard. For example, in the current regulatory period, there has been a 44 per cent reduction in the number of category 1 and category 2—the serious categories—waste water pollution incidents from our assets, and there has been a 20 per cent reduction in the lower-priority pollution incidents. Compliance on the part of waste water treatment works has been improving year on year. At the start of this regulatory period, 39 of our waste water treatment works were failing to meet their consent standards; we now forecast that only two will.

Mike MacKenzie: I appreciate that catastrophic events are problematic. However, I am more interested in what we might call the baseline levels.

It seems to me that there have been a number of instances in which Scottish Water has got into difficulties with partners—often local authorities—with people on both sides saying that flood water run-off, for example, is a responsibility of the other side. It seems to me that the way forward in such a situation is to recognise that the situation is a problem for both parties to deal with. Are you making progress in your relationships with local authorities in finding solutions in a spirit of joint responsibility and co-operation?

Douglas Millican: The short answer is yes, but I will add a bit of colour. This is an inherently complex area, because there can be many sources of flooding. Often, a fair bit of investigation is required to understand the root cause and whose responsibility it is to address it. One of the really good things about the Flood Risk Management (Scotland) Act 2009 is that it places an onus on public bodies such as Scottish Water to work collaboratively with SEPA and local authorities in dealing with flood risk.

For example, in the current regulatory period, we have undertaken five flood risk studies in major urban areas including Edinburgh and Dundee in order to understand the sources of flood risk and who might need to do what in the future to minimise that risk to customers. Having done five such studies in the current period, we have signed up to do 15 in the next regulatory period. Those 15 areas have all been agreed collaboratively with the Scottish Government, SEPA and local authorities as part of a process of identifying the next 15 communities that are at the greatest risk of flooding. After the combined studies have been carried out, each party will be able to work out what it has to do to minimise the risk.

Mike MacKenzie: I want to continue on the theme of sustainable development. If we think about that in its widest sense—from the point of view not just of what Scottish Water does, but how it facilitates what happens in the country as a whole—how closely do you co-operate with local authorities when, for example, they develop their local development plans? I have certainly been aware of a few cases in which what a local authority thought was part of its effective housing-land supply turned out not to be an effective housing-land supply area from your point of view.

Douglas Millican: That is an area in which the answer today is different from what it would have been a year ago. I try to get round the country to meet all the local authority chief executives. Those discussions include quite brief meetings in which I discover that everything is going really well, but in a couple of instances earlier in the year I realised that there was a gap in how we were handling things in Scottish Water and that we were not as joined up as we needed to be.

Therefore, we have put in place a new development management team, which is operating at the interface between local authorities and developers and has a knowledge of our own asset capability. In the north-east of Scotland, where there is a lot of economic growth going on, the team is working with Aberdeen City Council and Aberdeenshire Council to understand where they have got to as enablers of development in those areas, but also as people who will be bringing forward specific plans for development. As well as working with the developers in that area, crucially the team has an understanding of what capacity and capability we have in our water treatment plants and our networks to cope with additional growth, and is working to identify how we can optimise our networks so that, to the extent that we need to enhance things, we do so as cost effectively as we can. It is a case of joining together Scottish Water's asset capability, local authorities' planning aspirations and the market-led opportunities for developers. There was a wee bit of a gap there, but we have plugged it and we are now making significant progress in that area.

Mary Fee: I want to ask briefly about leakage. I well remember the discussion that we had about leakage the last time you appeared before the committee. You told us that you had reached the economic level of leakage, but leakage is reducing by 9.5 million litres a day. Has there been a renewed focus on reducing leakage, or is that reduction a knock-on effect of other operational improvements?

Peter Farrer: You are absolutely right that when we had the discussion last year, we were proud to say that we had reached the economic level of leakage a year early. We did so in half the time

that it took some of the English and Welsh companies to get to that stage, so we were really pleased about that.

We have reduced leakage further this year. The key reason is that although we are looking at things from an economic perspective—it costs more to fix the leak than it does to waste the water—customers are saying that they find it unacceptable to see leakage from pipes. One of the key messages from our huge consultation exercise was that it was a priority to deal with visible leakage much quicker than we have been doing. We have been continuing on the drive with that.

There has also been a refresh of the calculation of the economic level of leakage. The range is now between 500 and 600 megalitres per day. We sat at 566 megalitres per day in 2013-14 and we are trying to get the level as low as possible. The regulator has also recognised that customers want to see that level going further down and has built into our 2015 to 2021 plan some incentives for us to get down to the lower end of that range as quickly as we possibly can.

Mary Fee: Thank you for that.

The Convener: Thank you. The majority of the provisions in the Water Resources (Scotland) Act 2013 are now in force. Can you update the committee on how Scottish Water is managing implementation of the legislation and how it is working with its partners to achieve the Scottish Government's hydro nation agenda?

Douglas Millican: The 2013 act has many dimensions, so let me try to rattle through a few.

On the hydro nation agenda, we are doing a lot of work in anticipation of provisions coming into force—the international business work that we have discussed already and our on-going work in renewables, which is absolutely in line with the expectations of the act.

Another area that is quite interesting is work that we are now kicking off on the back of that on what we call sustainable rural communities. We are doing quite a bit of research on how we support life in rural communities and how we can make such communities more self-sufficient and even carbon-neutral when it comes to water and waste water services. We hope that that research might bring out some innovations in the future because, historically, investment in rural communities has been relatively expensive and very energy-intensive and we might be able to come up with some smarter solutions in the future.

Another dimension of the 2013 act is about how we manage water in times of water shortage. It might be hard to believe, but there are times and places in Scotland where we can get a wee bit

tight for water, and the legislation contains some very helpful provisions. However, that also coincides with new provisions coming in on the back of the Water Environment (Controlled Activities) (Scotland) Regulations 2011. Taking the two together has given us a new way of working with SEPA to deal with issues that are related to water shortage and we have been able to manage that very quietly, without any environmental damage and without any customer impact since the act came into force.

The third dimension that I would call out is the very helpful safeguard powers that we have been given to enter land premises to protect sources of raw water. We are endeavouring to work constructively and collaboratively with landowners and land agencies to promote improved farming practices, for example, in order to reduce the incidence of contaminants getting into rivers and finding their way into water treatment plants. The fact that those provisions are in the act gives us a helpful backstop if we are not successful in the more collaborative arrangements.

The Convener: As no one has anything to add to that, we will move on to the strategic review of charges.

Mark Griffin (Central Scotland) (Lab): Are you confident that Scottish Water will be able to meet its operating and investment targets within the financial boundaries that have been set by the water industry commissioner? What contingency plans are in place for potential financial shocks?

Douglas Millican: Gosh! At this stage of the process it is hard to use the word "confident". I cannot say unequivocally that we are confident. It happens every time in this process that there are some big intakes of breath as we stand up to a whole new set of targets for stretching efficiency. We spent a long time as a board debating what we could and could not live with.

11:15

Ronnie Mercer: We agonised over it. I have to say that the board will accept a deal only if the executives tell it that they can better the deal. If they tell the board that they can just do what is in the deal, the board does not want to know. The executives have got to be able to tell it that they can do better than the deal—they really have got to beat the deal. That is my contingency. Now tell them what that is, Douglas. *[Laughter.]*

Douglas Millican: We look at the matter very much in the round. There is a whole set of objectives that need to be delivered, and there is a certain amount of money. We aim to deliver all those objectives for less than the total amount of money. What I cannot say is that we will deliver every single sub-objective for precisely the amount

of allocated money. We take a much more holistic approach.

A lot of the challenge is to get going early. One of the great benefits of having had the customer engagement programme and agreement on the business plan with the customer forum is that we got the deal agreed in February last year. It has now been endorsed for the regulator to process. That has given us a year of early planning.

We have a team of people led by Peter Farrer looking at how we try to meet our board's expectation of outperforming our plan, delivering more efficiencies and, crucially, delivering them more quickly than was envisaged. That really is at the heart of it: how do we deliver more and how do we deliver it more quickly?

There are risks. We have to work on the basis that some things will not go as planned, and therefore we have to build up contingencies so that we have financial reserves to manage shocks that might come about.

To say that we are "confident" would be too strong, but we are absolutely committed and determined not just to deliver but to outperform the settlement.

Mark Griffin: The final determination came from the commission on 20 November. Does it make any changes that have implications for delivery of your business plan? Are you able to set out any of those implications?

Douglas Millican: First, I want to commend the Water Industry Commission for Scotland. It came up with the innovative process of getting Scottish Water and its customers to agree the plan. It brought some really creative tensions into the process. I know that the committee heard evidence session on the subject back in April. To the commission's credit, it recognised and reflected that in its determination. The only change that the determination made to the agreed plan was what Peter Farrer referred to a few moments ago—the new leakage incentive scheme to incentivise us to get down to a leakage level of 500 megalitres per day.

Mark Griffin: What are your key priorities for the upcoming business plan?

Douglas Millican: At the highest level, our priority is to deliver what our customers have asked us to deliver. There is some specific stuff around improving drinking water quality and improving the customer experience, which we have been talking about.

There is a big new commitment on sewer flooding. One of the worst things that can happen to a water customer anywhere in the developed world is having a sewage system overflow, not into a watercourse at a point of intermittent discharge,

but either into their open spaces or, especially, inside their property. In what I think is a first in the United Kingdom, we have made a commitment that, for any customer who is at the highest risk of that level of flooding, we are going to make upgrades to reduce the risk of such flooding. We define the highest risk of that happening on a once in 10 years basis. That is a significant commitment to about 350 customers in Scotland today. There is a wide range of other commitments, but those are the ones that I would call out.

Mark Griffin: You have previously touched on the overall performance assessment targets. With the new business plan in mind, are you confident that you will maintain those market-leading standards for customer experience and satisfaction among water companies and all other utilities?

Douglas Millican: We are absolutely determined to do that, and we are gearing the whole way in which we run the business to achieve that.

Ronnie Mercer referenced the fact that we had been up in three of the islands. That was as part of a tour of Scotland to meet all our employees face to face. We were in 13 venues across Scotland, from Glasgow to Lerwick, engaging all our employees in the challenges and opportunities that lie ahead.

When I read the feedback forms from our employees, I was encouraged by the fact that they recognise that we have been really successful but that there is more that we can do to continue to deliver further improvements to our customers. If there is anything that gives me confidence, it is the fact that our workforce of 3,500 believe that there is more that we can do.

Mark Griffin: On maintenance investment, your plan shows an annual spend of £280 million on capital maintenance and improving infrastructure. Do you think that that is sufficient to see a reduction in some of the pollution that has been caused, for example, by the Glenfarg water treatment works? Is that planned maintenance investment sum enough to see a real reduction in such incidents?

Douglas Millican: Let us take that question in two parts. I shall deal with the first part and I shall ask Peter Farrer to deal with the specifics of how we plan our maintenance.

At the highest level, the £280 million is an increase on what we have had in the past. It reflects the fact that, over time, we have a more extensive asset stock. If we think about some of the new waste water treatment plants that we have built over the past 15 or 20 years, we can see that we now have bits of plant and equipment that need to be replaced. Previously there was

nothing that needed to be replaced, and the change is driving an increased maintenance requirement.

In accepting £280 million, we are taking on board a significant efficiency challenge, because we need to get quite a bit more efficient at how we deliver our capital maintenance to ensure that we can maintain service against the bigger asset stock for the amount of money that we have available. To come back to your question about confidence, we are absolutely determined to get every pound of value out of the £280 million, and we will be working hard to ensure that we can manage our service risk for that money.

It might be useful for Peter Farrer to talk about what we do in practice from a maintenance angle, and to link that into the type of situation that has arisen in Glenfarg.

Peter Farrer: The Glenfarg incident was partly to do with asset control and partly to do with human error. In cases of human error, we have to upgrade our people and development to get them to deal with the incidents better than they have done in the past. From a maintenance point of view, keeping the performance of assets is first about capital maintenance expenditure and keeping the stock of assets up to the right standard; secondly, it is about operational maintenance and what we call preventative maintenance of assets, which is something that we are putting a lot of effort into now.

We have a complete programme of works in place under which every one of our critical assets has a maintenance plan. We carry out preventative operational maintenance tasks to look at pieces of pumps and equipment controls, change bearings, check temperature and check for oil contamination, and we fix any problems proactively before they lead to an incident that may cause the pollution of a local watercourse, as happened in the Glenfarg incident. A number of things are done, from both a capital maintenance and an operational maintenance point of view, to prevent our assets from failing.

Adam Ingram: It would be remiss of us not to question you about the 1.6 per cent increase that you are proposing over the next three years. We live in austere times and household bills are a struggle for a lot of people in the current circumstances.

The 1.6 per cent rise in each of the next three years is slightly ahead of the rate of inflation. I think that the consumer prices index was 1.3 per cent in October this year. Can you explain why that level of increase is necessary?

Douglas Millican: Let me consider that in the context of the whole six-year period. We have made a commitment that, over that six-year

period, prices will fall by 1.8 per cent relative to CPI. From a customer angle, prices will keep falling in real terms over the six years.

When we were going through the point about landing on CPI minus 1.8 with the customer forum, that was all very much in the context of what customers were looking for, with a balance between maintaining high service and the areas of service that people wanted to be improved and what they were looking for by way of below-inflation price increases. We clearly could have come up with a settlement where prices went up by even less or were reduced by even more relative to inflation, but that would not have given customers what they were asking for by way of service improvement. That is the context.

On the specific point about the 1.6 per cent rise, one thing that came out of our customer engagement was that customers were looking for certainty, as well as a below-inflation price rise. What would it mean for customers' pockets? What we have come up with is a real first, I think, in the utilities sector. Every customer can know from a household budgeting angle what their bills will be not just this year and next year but right out to 2018. That gives customers that certainty.

You are absolutely right about how inflation has come out: it is sitting at 1.3 per cent at the moment. It therefore looks as though 1.6 per cent may run a wee bit ahead. All that does is increase the prospect that, in the back years from 2018 to 2021, we can keep the price rises limited to 1.6 per cent. If we continue with a very benign inflation environment over the next few years, price rises in 2018 to 2021 might be much less than 1.6 per cent.

That approach has been very much rooted in listening to our customers and engaging with them through the customer forum to land in a place that they want.

Adam Ingram: Have you reviewed the matter of relief for customers who are struggling?

Douglas Millican: There are two parts to that. One concerns the way in which the charging structure operates in Scotland—and the committee should bear in mind that we are starting with average charges that are £54 a year less than they are in England and Wales. The charging structure is linked to the council tax band structure. Within that, single-person occupants or people who are in full receipt of council tax benefit can get a further 25 per cent discount. That means that somebody in a band A house who is in receipt of a full discount is paying a quarter of what somebody in a band H house pays. Therefore, the charging structure inherently provides huge affordability protection, certainly relative to anything else that exists in the rest of the UK.

The second part is that the charging structure is kept under review, which, crucially, is primarily a matter for the Scottish Government. It is the Scottish Government that sets the principles of charging. It has committed to reviewing further the whole area of affordability protection over the next few years.

The Convener: I wish to ask about the cost to Scottish Water of the private finance initiative. I return to something that you said earlier, Mr Millican, in response to a question from Mr Ingram: that the low cost of finance compared with private companies was one of the advantages of public ownership.

One of the issues that you have had since 2002, when Scottish Water was established, is that you have to finance and service the costs of the PFI contracts that you inherited from the three predecessor water authorities. At page 17 of your annual report and accounts, you indicate that the cost of PFI in the financial year 2013-14 is running at £150 million. That is a significant figure, particularly when we compare it with the expenditure on capital investment, which is at £475 million.

First, I want to understand what the difference is between the £150 million figure on page 17 of the annual report and the figure quoted on page 69, of PFI operating costs of £109.3 million. In asking that, I am conscious that I am not an accountant.

11:30

Douglas Millican: I will first set the context, and I will try to answer all the questions on the way through.

You are absolutely right to say that we inherited nine PFI contracts. Eight of them cover waste water treatment for around 45 per cent of the waste water across Scotland. One specifically covers sludge treatment and disposal for around half of Scotland's sludge. Sewage sludge is a by-product from the waste water process.

Across all nine contracts, we are dealing with 45 per cent of our waste water and a total of about 80 per cent of our sludge disposal. A huge part of our waste water activities is done through those contracts. That is why we are talking about those big sums of money.

All nine of the PFI contracts are unique, and they are all structured quite differently. They all probably represented quite good deals in their day. We continually keep each of the contracts under review, first from an operational angle—referring back to the previous conversation about odour—and also to ensure that they are providing the best financial deal possible to our customers.

We keep under review the question whether it would be better to adopt some other arrangement. Typically, the contracts are structured such that, if we were to terminate them voluntarily, we would have to pay very significant sums by way of termination compensation. To date, it has never represented good value to our customers to bring any of those contracts to a premature close.

The Convener: Perhaps you can interpret something in the annual report for me, relating to that point about the high costs of unilateral termination of contract. You use an interesting phrase:

“Other than each party's unilateral right to propose an amendment to a contract, the most likely circumstance which would give rise to the re-negotiation of a contract is as a result of a change in law which requires the manner in which the treatment and disposal service is delivered to be changed, in order to ensure it meets the requirements of such legislative changes.”

Are you hinting that you want some legislative change to occur that would assist in that regard?

Douglas Millican: No—we are more hinting at the reality that the requirements on us can change over time. For example, some years ago, the Parliament passed an odour code of practice. As a result of that code of practice being passed, we were required to adhere to higher standards of odour control. In Edinburgh, one example was the Seafield waste water treatment plant. We had to agree a plan of action with the City of Edinburgh Council and to get the PFI company to deal with the matter. Because that was effectively a legislative change, we had to bear the cost.

The Convener: So you are not calling on the Government to make a change in legislation.

Ronnie Mercer: No.

Douglas Millican: No.

You also asked me about the difference between the figures. It comes down—dare I say it?—to the way in which things can be accounted for in different contexts. The figure of £150 million a year is the total payment that we made in the year for those contracts, reflecting the operation and maintenance activities and all the financing obligations. The figure of £109 million on page 69 is very much for the operating and maintenance component. The financing obligations, under international accounting standards, are dealt with separately.

The Convener: I think that is clear.

Are you in a position to say what the total cost of servicing the PFI contracts has been since 2002? What are the projected costs over the lifetime of the existing contracts, bearing in mind that they will vary in length from 25 to 40 years?

Douglas Millican: Absolutely. At a high level, they will keep gently nudging up by some factor less than inflation. Typically, considering how the contract prices move, it will be by about 75 per cent of inflation, which recognises the fact that about 75 per cent of the costs of the PFI company are subject to inflationary pressures. An amount of 25 per cent, which is typically linked to the financing, is fixed.

As a ready reckoner, you can take that figure of £150 million and inflate it by about three quarters of inflation on a future basis.

The Convener: Are you happy to supply the committee with some figures on what the costs to date have been and what the projected costs will be over the lifetime of the contracts?

Douglas Millican: Absolutely. As far as the 2015 to 2021 period is concerned, those figures are absolutely all reflected in our business plan and in our agreement with customers for that period.

The Convener: Okay.

I would like you to clarify a couple of other points. Your annual report states:

“Scottish Water also has the power to levy payment deductions where the level of service falls below pre-determined standards”.

Has that happened in the past financial year? If so, what is the value of the deductions?

Douglas Millican: The short answer is yes, but we are talking about very small sums of money. We will happily supply that information to the committee after the meeting.

The Convener: I am interested because I know that, in private finance initiative contracts outwith the water industry, there are limits placed on the deductions that can be made.

Douglas Millican: Sorry—I misinterpreted your question. I thought that you were talking about the customer side.

On the PFI side, there is a complex mechanism for payment adjustments. We certainly have that information, but I will need to check whether there are any issues with commercial confidentiality. Subject to that, we can make the information available to you outside the meeting.

The Convener: Thank you—I am interested to hear what you have to say on that.

You obviously manage your business robustly to ensure that you provide best value for the customer and for the taxpayer, and that you keep those contracts under review. I would like to know a bit more about how you do that in practice. Do you work with the Scottish Futures Trust, for example, to ensure that you deliver best value?

Douglas Millican: We work with each of the PFI companies to understand the performance of the plants, understand their financial and strategic objectives, and keep the process under review. That is our primary focus, but we meet from time to time with the Scottish Futures Trust; I have a meeting planned with its chief executive early in 2015.

The Convener: That is fine.

I want to ask you about the transatlantic trade and investment partnership. What implications—if any—does it have for Scottish Water and the industry?

Douglas Millican: I am unaware of any implications that it will have for us.

The Convener: It has been suggested in the press—not that we can believe everything that we read in the press—that TTIP could have implications. I am curious about that, in the context of the discussion that we have just had on PFI.

Douglas Millican: We have seen some reference to that, and our colleagues will follow the matter up with the people who have made those particular suggestions. As I said, I am unaware of any impact that TTIP will have on us.

The Convener: Just for completeness, on another subject, can you assure the committee that you will continue to focus on improving road reinstatements by contractors, as those continue to be an issue of concern to road users?

Peter Farrer: I will take that question. You make a good point, because Scottish Water carries out 35 per cent of all road reinstatements across the country from all utilities. In 2013-14, for example, we did 33,546 reinstatements.

A few years ago, I was particularly concerned about that area. We do not do our own reinstatements—we contract out to specialist contractors whose bread-and-butter is to do reinstatements on carriageways. I was astonished to find out that the contractors could not comply with the standards.

We have worked really hard with our sub-contractors, and over the past few years in particular we have moved our compliance with road reinstatements from 52 to 92 per cent. The standard that the Scottish Road Works Commissioner has set for utilities is to get above 90 per cent, so we are delighted that we are up at 92 per cent.

We set up a reinstatements quality board with the contractors, and we meet them at regular intervals, because we realise how important it is to ensure that compliance is maintained at that high standard. We are focusing strongly on reinstatements, as we have been doing for a few

years. We are maintaining that focus as we move forward, and we are confident that we can maintain compliance at the necessary standard.

The Convener: I invite members to ask any final questions.

Mike MacKenzie: I have a couple of brief questions. I noticed that the investment that you will make from 2015 to 2021 in improvements and enhancements amounts to just above £1.3 billion. That is a significant amount of money.

I am aware that Scottish Water inherited a largely Victorian infrastructure that was past its sell-by date in many ways, and that higher standards are continually driving investment. Will there come a point at which the need for that level of investment will reduce a little, once you have largely achieved the objective of building an infrastructure that is fit for purpose, or will you still face that level of investment past 2021 and into the future?

Ronnie Mercer: I will answer that, because we have been asked the question many times before. It is a good question, because that is a lot of money, and there are a lot of aspects other than the ones that you have mentioned.

The fact is that we started higher than that: the investment was £600 million a year even when I showed up at Scottish Water. We have driven it down to about £500 million. It is much better when that figure is lower because the lower it is, the more efficient we can be at spending the money.

I was determined to get the figure down a bit so that we could control it more and gain more efficiency. We have been charged with making a 16 per cent efficiency in capital spend for the next six years; my colleagues sitting on either side of me today had to test the executives on whether they could manage that.

The fact is that more than half of the £500 million a year that I mentioned in my opening remarks is for capital maintenance. A number of new sites have been built in recent years to enable us to obey the Urban Waste Water Directive, the Shellfish Waters Directive and all the other directives that come out. That means that there is more maintenance to be done.

As we said earlier, £280 million of the £500 million is for capital maintenance, and the rest is for new things that we have to do. I cannot foresee when the figure will dip much below the current level; it will remain there for the next six years. There is never a point in the year at which we get everything done. We just have to keep going—it is a process of continuous improvement. We have to try to be totally efficient and keep the customers' bills down, despite the fact that we will, I think, need to do what you have described for the

foreseeable future. We should count on having to do that.

Mike MacKenzie: My last question is on a more general point. I was very interested to read the section in the report that deals with remuneration, although not specifically with regard to the remuneration itself. You will know that the First Minister has just appointed a gender-balanced cabinet and is encouraging every organisation to follow suit. I am sorry to say that Scottish Water does not appear to be making much progress in that direction in terms of its board or senior management. Is that part of your plan for moving forward?

Ronnie Mercer: Yes—we are totally aware of the Government's objectives. We tended in the past to appoint by competence, and the board members have the required competence, which is why the business is doing quite well. However, we are very aware of what you have just said.

We have invited someone to join us in January for a year to help us to develop future female board members. She is not from Scottish Water but is coming in from a different business entirely to join our board for a year as part of an initiative to get people involved in the board's workings. The lady, Jackie Moran, will be joining us in January.

I have spoken to our civil service colleagues about the matter, because there is always a danger that, if we just advertise for non-executive board members in the usual way, we will finish up most of the time with two middle-class white males. That is what seems to come out of the end of the process.

We talk about targets and say that it would be good for us to have a 40 per cent gender balance target, but I want to reinterpret the definition of "target". We need to target females to come in instead of hoping that they apply. They would not necessarily be appointed but they would at least be in the interview process.

Right now, not many females are applying, and we need to target them. The lady who we are getting in this year will go on a board somewhere—it could be ours eventually; you never know. We are conscious of the position: we look at the page and say, "There's not much of a female presence here."

We are trying to move towards doing more on that. When people come to the end of their terms, we should be targeting females and using the good females that we have. There is one sitting next to me: Johanna Dow. We will mix in others in the business, such as Lynne Peacock—you can see her picture in our report. Douglas Millican has an excellent human resources female employee.

They can tell us who to look for, and we should be doing that.

11:45

Mike MacKenzie: There are some empty seats, so perhaps on your next visit to the Parliament some ladies could be present.

Ronnie Mercer: One out of four certainly beats what we have in the report, so at least it is a step forward.

The Convener: Would you like to make any closing remarks?

Ronnie Mercer: I am pleased that we have had this session. We try to be as efficient as the best private companies, and a private company would turn up in front of its shareholders once or twice a year for such a session, so we are happy to do the same with you. If we cannot answer to the committee, we are doing something wrong. We enjoy doing this, in fact.

The Convener: The committee is grateful for your attendance this morning, and we thank you very much for the evidence that you have provided.

I would like to mention that this is likely to be Ronnie Mercer's final appearance before the committee. As you said earlier, Ronnie, everything moves on in life, and I understand that you will be relinquishing your role as chair of Scottish Water in the spring. On behalf of the committee, I wish you the very best for the future.

Myra Leckie, our committee assistant, is also moving on to a new post on the Parliament. I thank her for all her hard work in keeping us organised over the past two years.

The committee will next meet on Wednesday 7 January 2015, for an informal meeting with housing association representatives followed by a session with tenants' organisations. Papers for the meeting will be issued to all members on 5 January. It remains only for me to wish witnesses, the committee and the clerking team a merry Christmas and an enjoyable recess.

Meeting closed at 11:47.

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