FINANCE COMMITTEE

AGENDA

20th Meeting, 2004 (Session 2)

Tuesday 22 June 2004

The Committee will meet at 9.30 am in Committee Room 1 to consider the following agenda items:

1. Declaration of Interests: The Committee substitute will be invited to declare any relevant interests.

2. Scottish Parliament Building Project: The Committee will consider the latest monthly report from the Presiding Officer and take evidence from—
   
   Paul Grice, Clerk and Chief Executive, Scottish Parliament

   Robert Brown, MSP, Member, Scottish Parliamentary Corporate Body

   John Home Robertson, MSP, Convener, Holyrood Progress Group

   Sarah Davidson, Project Director, Holyrood Project Team

3. Scottish Water: The Committee will take evidence on the Scottish Executive’s response to the Committee’s report on Scottish Water from —

   Ross Finnie, MSP, Minister for Environment and Rural Development

   Andrew Scott, Head of Division, Water Services Unit; Janet Egdell, Operational and Institutional Governance Team Leader; William Fleming, Strategic Review of Charges Team Leader; Andrew Fleming, Capital, Regulatory Protocols, Off-Network Supplies Team Leader; and Clare Morley, Water Services (Scotland) Bill Team Leader, Scottish Executive

4. Prohibition of Smoking in Regulated Areas (Scotland) Bill (in private): The Committee will consider its draft report on the Bill’s Financial Memorandum.

Susan Duffy
Clerk to the Committee
The papers for this meeting are:

**Agenda Item 2**

Correspondence from the Presiding Officer, dated 9 June 2004.

Further correspondence from the Presiding Officer - to follow

**Agenda Item 3**

Correspondence from the Minister for Environment and Rural Affairs, dated 14 June 2004 and 23 April 2004

**Agenda Item 4**

PRIVATE PAPER
Dear Des

HOLYROOD PROJECT – OUTSTANDING ISSUES FROM MAY REPORT

Thank you for your letter of 26 May. I will deal with the points raised by the Committee in turn.

Fire damage – Reids Close

The fire which took place a few weeks ago within the boundaries of the site hoarding was in itself relatively minor and the damage caused appears to be cosmetic rather than structural. The fire, which was extinguished by BLL site staff, affected the surface finish of nine precast concrete panels on Reids Close. Options for a surface repair are currently being explored. Replacement is likely to be an option which would only be considered for the longer term, given the disruption associated with moving these huge panels.

There is no evidence to suggest negligence on the part of Bovis or Chubb Security over this incident. There is currently a joint names insurance policy in place that should cover the cost of making good the damage. This policy carries an excess of £5,000 which would be met by the Parliament under the terms of the agreement. It is intended that a claim will be lodged against this policy. This insurance arrangement will remain in place until practical completion of the building when the SPCB assumes responsibility.

Performance of Bovis Lend Lease (BLL)

It is a matter for the Holyrood Project Team to ensure that BLL complies with the terms of its contract and our Project Managers routinely monitor performance through written reports, meetings, site visits and inspections.
As I have explained to the Committee before, the logistics of working on a project of this scale are incredibly challenging. In many areas of the building, due to the complexity of the design and construction only one activity can take place at any one time and every activity depends on the successful completion of the previous one. This imposed sequential method of working means that there have been occasions when workmen have been delayed from completing their specific task or have had to do it in a way which is inefficient from their individual point of view.

This way of completing the Project has given rise to the notion that workers on site are somehow, “doing little or nothing”. Not only is this not the case, but each and every claim by a contractor for additional payment is stringently examined for due entitlement. Settlement of final accounts requires the contractor to prove beyond any doubt that he is fully entitled to the additional sum, in other words, that his presence was required on site at any given time.

**Equipment hire.**

Equipment for use on the project is purposely kept on hand, stored in the garage area and is the responsibility of individual trade package contractors. A large proportion of equipment is owned by those contractors and its storage on site is entirely to the benefit of the project and does not pose any additional cost. Obviously equipment has to be available when it is required and it would be neither practical nor cost effective for contractors involved in essential works to have to wait for hire machinery to be delivered. It is normal and practically unavoidable in large construction projects to have routinely-used hire machinery immediately available and the resultant costs are in no way unique to the Holyrood Project.

I will of course be writing to you again with my next routine report before the end of June.

Yours sincerely

GEORGE REID
Dear Des

HOLYROOD REPORT, JUNE 2004

This is my tenth monthly report on Holyrood, providing the Finance Committee with the latest information on the Project cost and programme. This report deals with progress since the previous report on May 24th.

Progress on site this month has been intensive and impressive. The attached illustrated annex shows a Parliament building which is almost ready for occupation and as you know, arrangements are well in hand for the move in August. Recent press comment from architectural writers has been extremely positive and encouraging. By the time the Committee meets after the summer recess, it will be at Holyrood. This is therefore the last of the monthly progress reports in this style and my letter includes details of how the SPCB intends to report to the Committee on financial matters in the future.

Key points this month:

1. There is no change to the overall cost reported in May.

2. Since the May report, £4.8m has been moved from the risk and programme reserve into construction commitment. £1.8m has also moved from the landscaping reserve. These movements were all in fulfilment of anticipated commitments. Details of this are given in the attached cost breakdown at annex A.

3. There is no change in the overall programme. Occupation of the building will take place this summer.
Progress on site in June includes:

- Laying of the carpet in the Chamber is well advanced;
- 45 MSP desks are installed in the Chamber;
- Hard landscaping has started around the north lightwell and the formal entrance;
- The pavement has been completed along the length of the Canongate Wall;
- Landscaping of the Internal Gardens is underway;
- TV monitors are installed within the Chamber;
- Fit-out in Towers 1 and 2 is largely complete;
- The lower concrete pergola is fully glazed and the upper level of timber screening is well advanced;
- the last Caithness cladding panels are being installed on the media tower;
- The majority of the Bovis site accommodation has been dismantled to allow the landscaping to progress south towards the Crags.

Migration and Occupation:

Members will be well aware of the advanced plans for their own moves and similar arrangements are in place for staff. During July, the construction fit-out of the Towers and other areas will be completed and the remaining furniture will start to be delivered w\c 5\textsuperscript{th} July.

Members move

Members have so far had two packages of information regarding pacing and arrangements for the move A final note will be issued towards the end of June.

Staff move

SPCB staff move into the building from 2\textsuperscript{nd} August, although security and facilities management staff will have been present at the building for some time before this. Moving from the five existing locations presents its own problems from a Health & Safety perspective and this is why the move is phased over a 7 day period. The major parts of the move also avoid the beginning of the Edinburgh Festival.
Testing the building
A great deal of testing of the building services will be complete by the time staff move into the building. Plans are also in place to ensure that Parliamentary business and visitor management works smoothly. Staff and contractors will require training on voting, sound and broadcasting systems in the Debating Chamber and the Committee Rooms and this will include simulations of Parliamentary business in these areas. Management of an estimated 700,000 visitors a year requires significant preparation and setup of the public facilities including the reception, security, shop and education facilities. This work will be carried out by Parliament staff from the date of occupation on 2nd August right up till the first day of business on 8th September.

Contract mobilisation
Major contracts, including that for maintenance, have already commenced on site with others now making preparations for the move. This is a complex operation given the ongoing site activity. Major activities include setup of new catering, printing, webcast and crèche contracts as well as public information displays, the shop, mail services and numerous other contracted services that support our organisation. Many of these contractors require considerable support from the Parliament’s IT team who are also involved in setting up the new telephone and network services.

Occupation Certificate and Health and Safety
Moving into the building requires the granting of a building occupation certificate by the Parliament’s building control consultants. This is a rigorous process which began some time ago and ensures compliance with building control standards and Fire regulations in order that the Parliament fulfils its duty of care to all those who use the building. Arrangements are already well advanced for making sure that the requirements of both building control and the fire inspector are met by the required dates.

As you would expect, the number one priority during migration, early operation and opening is the health and safety of the public, staff and members. Getting an Occupation Certificate in itself means that the major identifiable risks have been removed. Systems will of course be put in place to ensure that any risks posed by snagging and related ongoing works are carefully managed.

Snagging, defects and completion of works
It is normal practice for a building completion certificate to identify any aspects of work which have not been completed exactly as they should be. This could be either because they have not yet been finished off or because they have not been finished correctly. The process of resolving these is what is known as ‘snagging’. While most snagging activity will be undertaken in August before the building is occupied by MSPs, a strategy is also in place to manage and rectify any outstanding problems during the first few months of occupation.
During September and October any such works will be carried out as far as possible outwith business hours, but during the August recess weeks it is expected that a considerable number of people will be working on snagging and defects throughout the building during normal working hours. Based on previous experience of projects of a similar scale, snagging and commissioning works are likely to continue in some form through until the end of the year and possibly beyond.

It is planned that hard landscaping work around all the entrances to the building will be complete by early September and the final landscaping work will continue into the autumn with tree planting planned for November, (the right time of year for this activity). The current programme was planned on the basis of post-fixing some timber louvered screens at lower levels at the rear of the Chamber and on Tower 4. This will probably be carried out either in the October or December recess and should have no impact on building users.

This full programme of work is illustrated on the attached programme in summary format at Annex C.

**Future reporting arrangements:**

I hope that the Members have found my monthly site progress reports useful this year. The time for these is evidently coming to an end and the SPCB has discussed how best to continue our reporting to the Committee until ‘commercial completion’ is reached. It is to be hoped that this stage will occur not long after the end of the defects liability period, (one year after practical completion of the building), at which point a definitive total project cost will be known.

We intend to submit to the Committee a financial monitoring report. This will set out clearly the total capital costs of the project and provide details of final accounts and claims as these are settled with the Trade Package Contractors. I anticipate that the Committee will receive the first of these reports to coincide with your initial meeting after the recess and thereafter every two months until the end of the year. At that point I suggest that we might review the frequency and if a significant number of accounts have already been settled, it might be appropriate for reporting to move onto a quarterly basis thereafter.

As members of the Committee will appreciate, we cannot tell at this stage what disputes may arise in the process of settling accounts or during the defects period. However, the SPCB will routinely be receiving reports on such matters and we would expect to report progress in resolving any financial disputes to the Committee in the context of the financial monitoring report.

In order to keep Members, staff and others in touch over the summer months, the SPCB will be producing a monthly ‘migration bulletin’ with up-to-date information about fit-out completion and move arrangements.
Other post-completion matters

I recently received a letter from John Home Robertson MSP in his capacity as Convener of the Holyrood Progress Group. He indicated that the HPG will continue to meet at regular intervals during the recess in order to maintain the necessary momentum and liaison with the principal consultants and with HPT during this final stage of completion and migration. The Group envisages holding its last meeting on 29th September and will formally be wound up on the date of the official opening.

In replying, I thanked the Progress Group and said that SPCB was extremely grateful to each member for having made and sustained such a level of commitment to the project.

One of the unique strengths of the HPG was the professional expertise and experience within its membership. The SPCB is therefore pleased that David Manson, Andrew Wright and John Gibbons have agreed to remain available to us and to the HPT in an advisory capacity after the building is complete. I anticipate that they will be consulted on such matters as the processes for the review, pursuit and defence of potential claims; our strategic approach in relation to specific disputes which may arise and any proposals for significant alterations or modifications to the building fabric which may arise. Of course, final decisions on all these matters will remain for the SPCB.

Yours sincerely

GEORGE REID

Encl: financial summary annex.
### MAIN PROJECT

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### LANDSCAPING

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<td><strong>17.6</strong></td>
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**SUBTOTAL**                                    417.4 420.9

Programme contingency (incl. VAT) 6.8 9.6

### Materialisation of risk sums:

**Risk drawn down from 'Construction Reserve':**
- Q H Scaffolding 750,000
- Specialist Glazing 2,000,000
- MSP Mullions, Louvres & Gargoyles 100,000
- QH Partitions / Ceilings 25,000
- Mechanical & Plumbing East 600,000
- Fire Alarm & Protection 400,000
- Building Management System 100,000
- Structured cabling 340,000
- Security 550,000
- East Electrical 400,000
- Utilities (package transfer to above) (400,000)

**Net Total** 4,865,000

**VAT** 851,375

**Total** 5,716,375

**Risk drawn down from 'Landscaping Reserve':**
- Hard Landscaping 1,872,154
- VAT 327,627

**Total** 2,199,781
Progress on Site

Good progress has been made across the site since last month’s report on Holyrood, and Parliament is on course to begin migration at the end of July. As final work on the project proceeds apace, more and more of the routes through the building are becoming available. As well as the route from the MSP building through the garden lobby towards the Chamber, the public stair which links the public entrance to the gallery and Committee Rooms is now accessible.

The Chamber

The installation of desks and carpet in the Chamber has begun, and all desks will be in place by the end of June. The timber linings and monitor screens around the Chamber have now also been installed.
**Committee Rooms**

All six committee rooms in Towers 1 and 2 are now nearly complete, as are the associated office spaces for clerks and other Parliament staff. The distinctive desks are now in place in all but one of the committee rooms.

*The large committee room on the top floor of Tower 2, awaiting the last committee desk*

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**Landscaping**

Site huts have been removed from much of the site, allowing work on the landscaping to move out towards the Crags. Completion of the glazed section of the pergola has also allowed scaffolding to be removed and work to progress around the public entrance. Soil is being laid in the garden between the MSP building and Reid’s Close, and hard landscaping has now begun around the formal entrance and the north lightwell.

*The lower pergola outside the public entrance, now fully glazed.*

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**Other Progress**

- The pavement has been completed along the length of the Canongate Wall;
- The last Caithness stone feature panels are being installed on the media tower;
- Oak and sycamore panels are now in place around the chamber conference room;
- Furniture continues to be installed in office spaces across the east end of the site.

*The garden lobby features Kemnay granite flooring beneath its leaf-shaped skylights*

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*Furniture in place in staff offices below the public entrance.*
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14 June 2004

To:
Des McNulty
Convener, Finance Committee

Inquiry into the Water Industry

Following my letter of 23 April 2004, I now attach my response to the conclusions and recommendations of your Committee’s Report on Scottish Water (Annex A). As requested, my response takes into account the Committee’s further questions as raised in your letter of 30 April.

As your Committee will understand there are a number of developments we are proposing for the water industry in Scotland, and my response to your investigation is set within that context. First, the Water Services Bill, which is published by the Parliament today, proposes a number of changes to the way in which the industry is regulated and charges are set. Furthermore, it sets out our proposals for prohibiting common carriage on Scottish Water’s water and sewerage networks, prohibiting competition in the domestic sector, and for licensing retail competition in the non-household sector.

Second, I expect to launch, in July, two consultations: one on the Quality and Standards III and the other on the Principles of Charging. Together these consultations will consider the need for investment from 2006 to 2014 and how customers should pay for the services provided. Third, I recently wrote to Scottish Water and the Water Industry Commissioner commissioning the next Strategic Review of Charges 2006-10. I would like to take this opportunity to put this in the public domain, so that the process and timetable for setting water prices for the coming years will be clear to all. My commissioning letter is appended at Annex B. It will be followed in January 2005 by the publication of detailed guidance from Ministers on aims and objectives for the industry in the next review period.

Since my last letter to you, there has been a good deal of speculation about how the position of the present Water Industry Commissioner will be affected if Parliament approves the changes set out in the Water Services Bill. You will see that the Bill requires that Ministers must consult the Chair of the Water Industry Commission prior to appointing the first Chief Executive of the new Commission (Schedule 1 paragraph 7(3)). I attach considerable importance to this provision because it is important that Members of the Commission and its Chief Executive can work together well in delivering sound decisions on behalf of water customers. The new Water Industry Commission, subject to Parliamentary Approval, will be responsible for determining water charges as a result of the forthcoming Strategic Review of Charges on the basis of statutory guidance from Ministers.

Notwithstanding the significance of these proposed changes, I am clear, however, that the current discipline of economic regulation is helping to deliver significant benefits for customers. In response to the disciplines of the current Strategic Review
of Charges, the public water service in Scotland now costs customers over £1m less every week in operating costs alone than it did prior to our reform of the industry. If the Commissioner’s targets are achieved by 2006, the comparative savings in operating costs to customers will be approximately £2m every week.

It is important for customers that this emphasis upon efficiency continues and there is no slackening in the pace of their delivery. For this reason I have decided that Alan Sutherland should continue to serve beyond the expiry of his current term (in November 2004) in accordance with the rules governing public appointments. In arriving at this decision I have been obliged to take account of the circumstances in which Alan Sutherland last year exceeded the allowance agreed with Ministers as regards the costs of running his office by £140,000. I have made clear to Mr Sutherland my deep displeasure at this expenditure which he accepts was the result of inadequate financial controls within his Office and have taken steps to ensure that this cost is not passed on to water customers. He has now put adequate controls in place. I have decided that on balance the benefits of maintaining continuity in the approach to regulation for the time being outweigh those of change. The revised structure of corporate governance proposed in the Water Services Bill will provide firmer accountability for water customers in future. Further, I intend that Mr Sutherland’s suitability to act as the first Chief Executive of the new Commission will be a matter for early discussion with the Chair of the Commission when he or she is appointed next year.

I believe that the proposals in the Water Services Bill, combined with the forthcoming public consultations on investment and paying for water services, and the process we have now set in train for the next Strategic Review of Charges will improve the accountability and transparency within the water industry in Scotland.

Finally, Members of the Committee have expressed a particular interest in the progress of the Quality and Standards 2 capital programme and Scottish Water’s borrowing from the Executive. For 2003-04 Scottish Water borrowed £42m of the £249.7m made available to it. This was due to slower than expected delivery of the capital programme, increase revenues and greater than expected cost savings. That means that, against the approved budget, it has generated an end year flexibility of some £200m, but, as you know, Scottish Water is allowed flexibility in its funding requirements between years. A fuller explanation of the current position on the capital programme and borrowing is provided at paragraph 16 of the Memorandum and I intend to continue to monitor closely the continuing delivery of the capital programme.

I am most grateful to your Committee for the stimulus that they have provided in helping us to develop our thinking over the past year.

A copy of this letter goes to Sarah Boyack, Convenor of the Environment & Rural Development Committee.

ROSS FINNIE
Executive’s Response to the Recommendations on the Finance Committee’s Report on Scottish Water

**Harmonisation**

1. **There were higher than expected increases in water charges for the West and the East, and harmonisation is certainly a very significant factor in the price rises which caused such widespread concern (paragraph 25).**

   I am very aware of the concerns raised over increases in water charges, and particularly that many customers felt they were neither warned nor consulted. The rises arose from the combination of harmonisation and a move to more cost reflective charging. Changes to water prices in the future, including the rate of such changes, will depend on decisions which the Executive will take as part of the Strategic Review process, informed by the very wide-ranging consultation processes due to take place this summer.

2. **The Committee is not convinced of the WIC’s estimate and explanation of the impact of harmonisation on customers in the East and West (paragraph 28).**

   I understand that the Commissioner will be responding on this point.

**Efficiency savings**

3. **The Committee is concerned that there does not appear to be agreement between the WIC and Scottish Water on how much progress is being made with regard to efficiency savings and operating costs and is also concerned over what the impact could be if the necessary savings are not met (paragraph 35).**

   Some degree of disagreement between a regulator and the corporation it regulates is to be expected. One issue is that Scottish Water is measuring its progress on the basis of their statutory audited accounts, whilst the Commissioner adjusts these to take account of factors such as inflation, new operating costs arising from the addition of new plant, changes in accounting practice etc. The Commissioner is currently exploring the possibility of introducing a separate set of regulatory accounts as used in other regulated industries. These would be used for the assessment of efficiencies.

   The overall revenues for the period to March 2006 have already been set. This means that any shortfalls in the delivery of the efficiencies, as set out in the Strategic Review of Charges 2002-06, will be met through additional borrowing and therefore greater servicing charges in the future. As we said in our evidence, Scottish Water
and the Water Industry Commissioner agreed, in July 2003, a level of £265m for controllable operating costs for 2005-06.

4. There is a clear requirement to improve relationships with local government and other stakeholders to deliver both better value for Scottish Water’s capital spend, and alleviate current barriers presented by Scotland’s water and sewerage networks to development in urban and rural areas and radically increase the rate of infrastructure renewal and investment (paragraph 48).

In order to improve these relationships, I established the Quality and Standards III project some 12 months ago. This project involves a range of stakeholders, including local government, and is tasked with advising me on the type and scale of investment required to meet public health standards for drinking water, meet environmental standards (legislative) for wastewater, and maintain and extend the existing network. This project involves a thorough and systematic review of capital requirements for the industry and will be used to inform the content and shape of proposals for an overall investment programme for the water industry. It will be the subject of a full public consultation due to be launched next month, and will inform my decisions on the investment required from 2006.

In the meantime, the current investment programme (2002-06) also addresses development constraints to some extent. Around £200 million of the investment under Quality and Standards II will help to alleviate development constraints, and a further £41 million was specifically targeted for improving the infrastructure in rural areas, including first time connections.

5. Ambitious targets have been set for Scottish Water Solutions Limited and it is not yet clear whether the framework which has been established will deliver these targets within the financial parameters which have been set (paragraph 51).

I agree that it is too early judge whether Scottish Water Solutions will be able to deliver the full level of efficiencies with which they have been tasked. In a capital intensive industry such as water, and with a long-term, complex investment programme, we should allow both Scottish Water and Scottish Water Solutions the four year period before making any assessment on their performance.

**Environmental requirements**

6. The Executive has recently published a draft Water Services Bill which contains provisions to update the framework to ensure that public health, environment protection and social policy objectives can continue to be met if competition develops in the Scottish Water industry. The subject committee will have an interest in the policy issues but the Finance Committee will undoubtedly take a close interest in the Financial Memorandum associated with this Bill as this may have implications for Scottish Water as well as for the Scottish Executive’s budget (paragraph 54).
As mentioned in my covering letter, the Water Services Bill is published today and I look forward to the debates on the issues it raises.

**Charging Scheme and Consultation**

7. The failure to openly debate and consult on harmonisation and the specific harmonisation methodology that was implemented for business users, as well as the failure to introduce such a significant change on a phased basis, has caused a great deal of distress to small businesses (paragraph 59).

As I mentioned above, I am very aware of the concerns raised from many quarters about the impact of the harmonisation of water charges and the large increases that many customers faced. Considerable investment is still required in the water industry in the coming years, and this will need to be funded. How the costs of that investment should be shared between different groups of customers is one of the key issues for consideration in our forthcoming consultation on the principles of charging.

8. The Committee had been minded to recommend that there be a fundamental review of the principles of charging. However it notes that during the course of the Committee’s investigation, the Deputy Minister for Environment and Rural Development announced the Scottish Executive intends to consult on the underlying principles of charging. The Committee welcomes this consultation and its progress will be monitored. The Committee believes that it is vital that the consultation is thorough and inclusive so that consumers’ views are taken into account (paragraph 64).

We expect to launch the consultation on how customers should pay for water services during July, alongside the consultation on the investment required in the water industry for the period from 2006 to 2014. We aim to make the consultations as inclusive as possible by providing the public with a range of opportunities for discussion including public meetings and encouraging written consultation responses from groups or individuals.

9. The Committee is disappointed that it took so long for Scottish Water to introduce a consultation code which applies to large capital projects rather than across Scottish Water’s operations. The Committee believes that consultation is not simply making presentations and asking for views of decisions already taken but that the public should have a real opportunity to contribute to decision making (paragraph 78).

Scottish Water’s consultation code has now been finalised in accordance with section 28 of the Water Industry (Scotland) Act 2002. It is available on Scottish Water’s website. It does not just apply to large capital projects, and is intended to give the public effective and appropriate routes to contribute to Scottish Water’s decision making.
Accountability

10. The Committee recommends that to give the public greater confidence in the quality of the consultation carried out, both Scottish Water and the WIC should operate under clear consultation codes with consistent approaches to publication of responses. In particular, all consultation submissions made to the WIC should be made public before any of his statutory reports are released and the WIC should address the relevant issues raised by consultees within the reports themselves. In this way, the public can be reassured about the conduct of the relationship between the WIC, Scottish Water, its customers and the Scottish Ministers (paragraph 80).

Scottish Water now has a consultation code in place, and the Water Industry Commissioner is considering introducing such a code. Both organisations will, of course, also be subject to the Freedom of Information Act, and will produce publication schemes for their office later in the year. As set out in the commissioning letter at Annex B, Consultation on the next Strategic Review of Charges will be considerably more wide-ranging than previously. We hope this will alleviate concerns you and the public more generally have raised over the quality of consultation on the major decisions being made within the water industry.

The Executive is consulting in the coming months on both the level of investment required from 2006 to 2014 and on how customers should pay for water services and the Commissioner will consult on the methodology he will use for the Strategic Review of Charges, and on his proposed charge levels for the years 2006 to 2010.

11. The Committee believes that it would aid the accountability and transparency of the WIC in the view of many customers if he had to give a formal response to submissions from the Water Customer Consultation Panels which could also be lodged with the Parliament (paragraph 83).

The Executive will give further consideration to this suggestion and the way in which it may be given effect in future.

12. The Committee is concerned that there is a lack of transparency in the way in which the roles of the WIC as regulator and customer champion are combined and that there is a perception in the minds of at least some stakeholders that there may be a conflict of interest between the WIC's stated role as a champion of current consumers and being a vital element in the drive for the water industry's long-term efficiency (paragraph 85).

The Executive will give further thought to this point. However, it is important to note that the delivery of the efficiencies as required by the WIC will benefit all customers both in the short and long terms.

13. The Committee believes that an improved structure and support for the WIC is needed to ensure independent regulation and transparency across the industry. Modelled on some of the English and UK regulators, an Office of the Water Industry Commissioner, including a non executive membership, could provide greater accountability and continuity for the Scottish water industry.
Consideration should be given to whether certain decisions should be taken by the WIC in the context of advice from the Minister rather than the reverse (paragraph 88).

The Executive agrees with the Committee that robust, transparent and economic regulation has a crucial role to play in ensuring that Scottish Water becomes more efficient. We recognise that this requires a number of changes to the current regulatory regime and these are set out in the Water Services Bill which is being published today. I believe these changes will provide for greater continuity and consistency in economic regulation. They make a clear distinction between Ministers’ responsibility for setting Scottish Water’s objectives and the economic regulator’s duty to ensure that the objectives are delivered as efficiently as possible. This greater clarity of roles will help Parliament to hold Ministers and regulators to account for their respective decisions and contribute to the operation of a more transparent process.

I believe that the functions and structure of the new Water Industry Commission meet the Committee’s call for economic regulation to be modelled on the other UK regulators. Consistent with that approach, and subject to the Parliament approving the changes, we will seek an order under the Scotland Act to balance the Commission’s new powers by making its decisions on charges subject to review by the Competition Commission in the same way as happens, for example, with OFWAT and the decisions that it takes in respect of the water industry in England and Wales.

The Financial Framework

14. The Committee recommends that the Executive investigates how it can ensure transparency over decisions regarding borrowing provision in the future (paragraph 95).

To improve transparency in the allocation of Executive funds to Scottish Water, the arrangements for notifying borrowing provision for the next Strategic Review period have been set out in paragraph 8.3 of the Commissioning letter attached at Annex B. Borrowing provision will continue, as at present, to be set out in the documents accompanying the Budget Bills for Parliament’s approval. Currently, as the Committee will appreciate, details on the levels of borrowing, repayments of capital and interest for a given year are shown together with a high level breakdown of the investment that it will fund. We propose to expand the information provided to include additional material regarding the progress in the delivery of the capital programme.

In your letter of 30 April you asked me to clarify when the decision was taken to allow a further £200 million of borrowing to Scottish Water. In November 2001, prior to the creation of Scottish Water, we considered the potential risk that the new public corporation might not achieve the full efficiencies set out in the Strategic Review of Charges 2002 to 2006. Given that revenues across the period are fixed and that we were not prepared to allow the capital programme to be compromised, we agreed that it would be prudent to make available an additional £200m to Scottish Water should it be required. This is entirely consistent with our role as “owner” of the
business. Consistent with this position, in July 2003, Scottish Water and the Water Industry Commissioner concluded that Scottish Water’s total debt at the end of the Strategic Review period may rise to a maximum of £2.71bn. This level of debt included provision of up to £112m reflecting the effects of higher projected rates of inflation in the cost of capital goods.

Claim that there had been an accounting error

15. The Committee concluded on the basis of evidence received that the hypothesis put forward by Analytical Consulting Ltd that there had been double-counting and their interpretation of Treasury advice were wrong. Fergus Ewing and Jim Mather dissented (paragraphs 116 and 117).

I welcome this conclusion. As I said in my initial response to your report, you have confirmed what we have always maintained: the Executive applied the Resource Accounting and Budgeting rules correctly and did not wrongly double count depreciation. All parties understood the rules and water charges were in no way affected.

Underspend and End year Flexibility

16. The Committee is very concerned about the persistent slippage in Scottish Water’s capital investment programme and recommends that the Executive investigate the reasons for this as a matter of urgency and take the appropriate steps to ensure that Scottish Water meets its required capital investment targets (paragraph 118).

I share the Committee’s concern about the pace of the capital programme. I am therefore meeting members of the Board of Scottish Water regularly to discuss progress on the delivery of the capital investment programme. However, there is a sensitive trade-off to be made between rushing investment and delaying investment in order to maximise value for money for customers. Scottish Water’s current assessment is that they will be able to deliver the vast majority of the capital programme (around 95%) within the four year period. The shortfall in delivery is due to a combination of factors including: the time taken to set up Scottish Water Solutions Ltd; the time taken to collate and agree a single Scottish Water investment programme with the regulators; and the delays arising from planning considerations for some of the projects (eg the Katrine Water Project). Together, we and Scottish Water will continue to monitor the delivery of the investment very closely.

For 2003-04, your Committee will be interested to learn that:

- the capital invested was £408m, that is 15% below the target of £480m. Furthermore of the £408m delivered approximately £350m was paid for in 2003-04 and £60m will be paid for in 2004-05; and
- higher than anticipated revenue and lower operating and interest costs reduced Scottish Water’s borrowing requirement by £45m.

As a result of these factors, in comparison to the original public provision of £249.7m in 2003-04, Scottish Water only borrowed £42m.
Looking forward to the current financial year, I understand that based on the latest forecasts of capital spend this year (around £505m), Scottish Water will not require in EYF any of the underspend that was generated in 2003-04. I will be reviewing with Scottish Water, in the light of revised financial plans and the delivery of the capital programme, their borrowing needs for 2005-06. As the committee is aware, we have an agreement for 100% End Year Flexibility (EYF) for water. This means that the necessary borrowing will be made available to Scottish Water to ensure that the capital programme is delivered.

17. The lack of transparency, particularly the failure to report EYF transfers accurately to the Committee in 2003, is unacceptable (paragraph 124).

I am concerned that the Committee found the Executive’s presentation of the numbers unhelpful, and I will consider how best this can best be improved in future. In particular, I will make clear in future EYF statements how much of the underspend relates to Scottish Water and of this how much is due to shortfalls in the delivery of the capital programme.

18. The Committee recommends that monitoring reports should be routinely sought from Scottish Water on its spending performance to ensure further slippage is identified and dealt with earlier (paragraph 125).

We receive regular monitoring reports, and I have regular updates from Scottish Water’s board on the delivery of the investment programme, the risks of slippage and the actions being taken to mitigate any such slippage.

19. The Scottish Executive should re-examine the way in which efficiency gains are built into budgetary assumptions prior to delivery, creating unnecessary uncertainty. The Committee recommends that urgent consideration be given to whether such a margin is a sensible way to provide a buffer in case efficiency targets are not met. The question is whether efficiency gains should be excluded from the budget figures until they are delivered and then made available to supplement capital expenditure from profits (paragraph 126).

The Executive will consider the handling of efficiency in its provision of detailed guidance for the next review. We will strive to achieve a solution that balances the need to preserve the stability in public finances, customers’ concerns with prices, and clear forward planning of the investment programme.

For this review period, it is clear that Scottish Water is continuing to make greater efficiency gains than it anticipated in its business plans. I will ensure that public expenditure, released as the result of improvements, is made available to fund other priorities.

20. Whilst broad financial ratio analyses can add clarity in making comparisons, they can be misleading where non comparable bases are used to assess performance. The Committee found unacceptable the WIC’s use of comparisons between Scotland and England and Wales without making clear
the impact of different bases of calculation. Where different bases are used this should be fully explained to ensure transparency (paragraph 129).

This is for the Water Industry Commissioner to answer. However, we believe that the process set out for the forthcoming Strategic Review of Charges will ensure that the bases of calculations and comparisons being used will be transparent.

21. The Committee recommends that understanding of these processes [the financial regime] be opened up to stakeholders through a more wide-ranging consultation process so that stakeholders have a better grasp of both the decisions made and the process through which decisions are made (paragraph 130).

Our intention is that the process as detailed out in Annex B will be robust and transparent and will set future water prices following full consultation with stakeholders.

22. The Committee recommends that there is an urgent need for a much more detailed examination of the appropriate amount of investment and borrowing by the water industry in Scotland, alongside the already announced review of the principles of charging (paragraph 131).

This will form part of the Strategic Review of Charges, as outlined in the Commissioning letter at Annex B.

Conclusion

23. The Committee has conducted a thorough investigation into Scottish Water but during its deliberations has found it extremely difficult to obtain reliable information and has discovered that much of the information it has sought has not been readily available. The Committee believes that the water industry is crucially important to Scotland. To ensure proper parliamentary scrutiny of a public corporation and an understanding of the industry by all those who are reliant upon it, the Committee recommends i) that appropriate steps are taken to ensure the reliability of financial information that underpins decision making and ii) that the decision making process itself is fully transparent. (paragraph 132).

I note your concerns about the difficulty in obtaining reliable information on the water industry. Much of this is due to the complex nature of the industry and the pace of change in recent years. I hope that you will accept that we have now taken a range of important steps to improve this situation and make the decision making process much more transparent. In particular I would refer you to the changes proposed in the Bill to strengthen the regulatory framework, our forthcoming consultations on investment and how to pay for water services, and the process put in train for the Strategic Review of Charges. Together I think these will ensure that the major decisions to be made in the coming 18 months will be based on wide-ranging public consultation and a much clearer understanding of the issues and the respective roles of all those involved.
May 2004

To:
Alan Sutherland
Water Industry Commissioner for Scotland

Alan Alexander
Chairman, Scottish Water

STRATEGIC REVIEW OF WATER CHARGES: 2006-10

Introduction

1. I am writing to inform you of:

   1.1. the broad arrangements that the Executive wishes to be followed in the next Strategic Review of Water Charges (SRC); and

   1.2. the Executive’s initial views on the public policy considerations that it requires to be taken into account in the SRC.

SRC arrangements: background

2. The Executive announced on 23 April that the forthcoming Water Services (Scotland) Bill will include provisions to improve the transparency, accountability and robustness of the economic regulation to which Scottish Water is subject. As these provisions will be directly relevant to the SRC, I summarise them below.

3. The main features of the provisions on the economic regulation of Scottish Water to be included in the Bill are:

   3.1. The repeal of the provisions at sections 29 to 34 of the Water Industry (Scotland) Act, under which Scottish Water’s charges for providing core services to its customers are set, and their replacement by new provisions on setting such charges, including charges for trade effluent services.

   3.2. A Water Industry Commission for Scotland to take over all of the functions of the Commissioner (whose office will be dissolved). The Commission will comprise a non-executive Chairman, a Chief Executive and between 2 and 4 other non-executive members.

   3.3. A duty on Ministers to specify the period of time to be covered by each SRC.

   3.4. A duty on Ministers to set the standards and objectives to be achieved by Scottish Water in the provision of core services during the period to be covered by a SRC.
3.5. A duty on Ministers to set out the principles to be applied by the Commission in setting charge limits for different customer groups at the conclusion of a SRC and to be applied by Scottish Water and the Commission respectively in making and approving charges schemes consistent with the charge limits.

3.6. A duty on the Commission to determine the limits on what Scottish Water can charge different customer groups for the provision to them of core services, including trade effluent services. These limits will be set for each of the years covered by a review period and must be consistent with whatever principles on charging Ministers set. (The Commission will be under a duty to publish and consult on its proposals for the limits in advance of determining what they are to be.)

3.7. A duty on the Commission to undertake interim reviews of charge limits within a SRC period, where there has been a material change in any of the factors taken into account by the Commission in a SRC, and for the Commission to consult publicly on the procedure that it will adopt, and the criteria that it will apply, in establishing the circumstances in which it will conduct an interim review.

3.8. A duty on the Commission, in determining charge limits, to ensure that the revenue from the limits, when taken with all borrowing authorised by the Executive, is sufficient to allow Scottish Water to perform its core functions and meet stated Ministerial objectives at the lowest reasonable overall cost.

3.9. A duty on the Commission to consider proposals for annual charges schemes (based on Ministers' statement on the principles of charging and the Commission's charge limits) from Scottish Water. If the Commission does not approve the scheme as proposed, it is to put in place one of its own devising and to publish its reasons for having taken this course.

4. Also, the Executive has agreed with the UK Government that these provisions will be supplemented by powers taken at Westminster under the Scotland Act 1998 that will enable Scottish Water to appeal to the Competition Commission against charge determinations made by the Water Industry Commission.

5. The statutory framework created by these provisions will establish a transparent and robust process for setting charges in which the Executive, the Water Industry Commission, Scottish Water and the Competition Commission each have clear and well-defined functions to perform. This will serve the customer interest by identifying the lowest cost at which Scottish Water can deliver the improvements in quality and standards to which we are all committed.

6. Subject to the Parliament approving the Water Services Bill, and to it securing Royal Assent, the Bill's provisions on charges and on the creation of the Water Industry Commission will be commenced by June of next year. The powers
enabling the Competition Commission to consider appeals from Scottish Water will be commenced in the autumn of that year. The closing stages of the SRC will be conducted under these new statutory arrangements. The intention is that the Water Industry Commission will be in place by August 2005 at the latest, enabling it to make the final decisions on charge limits in light of representations from the Executive, Scottish Water and others, between September and November 2005. Scottish Water will be able to appeal the Commission’s decisions to the Competition Commission.

7. If for any reason it does not prove possible to put the new arrangements in place, Ministers will take decisions on charge limits in light of advice from the Commissioner at the conclusion of the SRC. Such advice should describe any changes made by the Commissioner to his proposed charge limits as a consequence of representations made by Ministers, Scottish Water and any others in respect of the proposals, the reasons for making those changes and the reasons for resisting any changes sought in the representations. However, even in these circumstances it will be in the customer interest for the clearer and more transparent process envisaged by the Bill to have been followed as far as is possible. Therefore the arrangements for the SRC that I outline below reflect that approach and for the most part will apply whether or not the relevant provisions in the Bill are in force. (Paragraph 9 comments further on this point.)

SRC: process

8. Responsibility for taking forward the SRC and for bringing it to a timely conclusion rests with the Commissioner, until such time as the Water Industry Commission is established to replace his office. Subject to consultation, it will be for the Commissioner to determine the methodology to be used in the review and to manage the detailed process by which he gathers and tests information from Scottish Water and produces proposed and then final charge limits. The Executive expects the Commissioner and Scottish Water to take forward this work having regard to the following points:

8.1. **The evidence on Scottish Water’s investment priorities that is emerging from the Quality and Standards III process:** The Executive, Scottish Water, the Commissioner, SEPA, the Drinking Water Quality Regulator, CoSLA and other stakeholders are working, through the Quality and Standards III process (Q&SIII), to identify Scottish Water’s investment priorities for the period 2006-14. Q&SIII will be the subject of public consultation later this year and the outcome of the consultation will be a major factor for the Executive in setting the objectives that Scottish Water is to be required to achieve in its core business during the Q&S period as a whole. As work on Q&S progresses, it will provide increasingly robust information about the investment programme that Scottish Water should be delivering between 2006 and 2014. Scottish Water and the Commissioner should use this information to inform their work on the SRC.

8.2. **The SRC period to be 2006 to 2010:** The Commissioner is to proceed on the basis that the SRC will determine charge limits for the first four years
of the eight-year period covered by Q&SIII. This determination is to be based on an assessment of the cost of delivering the full Q&S programme over eight years and, in addition to the charge limits for 2006-10, should provide an indication of likely charge limits for the following four years. The indicative limits are required so as to illustrate the estimated cost of the full Q&S programme. They will not be binding. A further SRC for the period 2010-14 will determine charge limits for that period and will do so in light of the Q&S investment programme for that period having been reviewed in 2008-09.

8.3. Borrowing and the SRC: The SRC charge limits should reflect decisions on borrowing levels for 2006-08, and assumptions on borrowing levels for 2008-10, that the Executive will notify to Scottish Water and the Commission in January 2005. At that date, the Executive will also state what assumptions should be made about borrowing for the purposes of the indicative charge limits required for 2010-14. The borrowing assumptions that the Executive will notify for the period beyond 31 March 2008 will be provided for illustrative purposes and should not be taken as implying a commitment by the Executive. The Executive will announce firm borrowing levels for 2008-10 in late 2006.

8.4. Initial views from the Executive on the public policy considerations that it requires to be taken into account in the SRC: these are set out in the next section of this letter.

8.5. A first draft business plan from Scottish Water: This should be submitted to the Executive and the Commissioner by 31 October 2004. In light of the evidence emerging from Q&SIII, the first draft should provide an assessment by Scottish Water of the objectives for its core business for the period 2006-10, and how these should be delivered, in light of the Executive’s initial views on public policy considerations. It should set out separate proposals for the management and the funding of the retail entity as required at paragraph 21 below. This version of the plan will have two purposes. The material on the core business will inform the early stages of the Commissioner’s work on the SRC. (For that reason its format and the information that it contains must be consistent with whatever the Commissioner specifies to Scottish Water as being required for this work. He will set out his requirements to Scottish Water in writing not later than 25 June 2004.) And, along with the outcome of the consultation on Q&SIII, it will inform the Executive’s decisions on the objectives that Scottish Water is to deliver during the SRC period.

8.6. Detail of the public policy considerations that the Executive requires to be taken into account in the SRC: In light of conclusions arising from, and the outcome of the consultation on, Q&SIII and of Scottish Water’s first draft business plan, the Executive will set out its detailed objectives for Scottish Water during the SRC period. It will also set out the public expenditure assumptions that the Commissioner and Scottish Water should take into account in taking forward the SRC and – in the case of Scottish Water – in developing a second draft business plan. The
Executive will provide this information by **end-January 2005**. In light of this information Scottish Water should prepare by **20 April 2005** a second draft business plan, whose main purpose will be to inform the Commissioner’s detailed analysis of how much it should cost Scottish Water to deliver the Executive’s objectives.

8.7. **The principles that the Executive requires the Commissioner to apply in setting charge limits:** In light of responses to the consultation on the principles of charging that the Executive will undertake this year, the Executive will set out the principles that the Commissioner must apply in setting charge limits for different customer groups. This information, which the Executive will provide by **end-January 2005**, will provide the Commissioner with the basis upon which he should share out Scottish Water revenue requirements among different customer groups.

8.8. **The proposed charge limits for the period 2006-10:** The Commissioner must publish proposed charge limits by the **end-June 2005**, with a view to the Executive, Scottish Water and others commenting on them by **end-August**. In working between September and November to determine final charge limits, the Commission might have to re-work the Commissioner’s proposals if, in light of the implications of the proposals for customer charges, the Executive decides that there should be any adjustment to its objectives for Scottish Water during the review period.

8.9. **The final charge limits:** These should take account of any change in the Executive’s objectives for Scottish Water and of any comments on the analysis underpinning them from Scottish Water or others. The Commission must publish them by **end-November 2005**. They will apply to the scheme of charges that is to come into effect on **1 April 2006**. In the event that Scottish Water decides to appeal to the Competition Commission against the limits, the limits will continue in effect until the Competition Commission comes to a decision on the appeal.

8.10. **The scheme of charges for 2006-07:** Scottish Water will propose to the Commission a scheme of charges for 2006-07 and the Commission will either approve it or replace it with one of its own devising in time for **1 April 2006**.

9. If the provisions on charge setting by the Water Industry Commission proposed for the Water Services (Scotland) Bill, and on appeal powers for the Competition Commission, are not commenced in time for them to apply to the final charge limits, the intention is that the process as described at sub-paragraphs 8.1 to 8.8 above will apply. Thereafter, instead of determining final charge limits, the Commissioner would submit his proposed charge limits to Ministers in the form of advice under the provisions at section 33 of the Water Industry (Scotland) Act 2002. Once Ministers had come to a decision on the advice and this had been published, the provisions for making a scheme of charges under sections 31, 32 and 34 of the 2002 Act would have effect.
10. The Commissioner and Scottish Water should be mindful throughout the SRC of the possibility of the Competition Commission considering an appeal by Scottish Water against charge limits set by the Commission. Accordingly, both parties should maintain full and accessible records of their respective actions during the course of the SRC. These should include a record of all exchanges between the two parties and of all analysis undertaken by them in support of the SRC. The Executive expects Scottish Water to provide the Commissioner with whatever information he requires to conduct the SRC. If Scottish Water is unable to comply with any such requirement, it should advise the Commissioner in writing of the reasons for this.

Initial views from the Executive on the public policy considerations that it requires to be taken into account in the SRC

11. I set out below the Executive’s initial view on the public policy considerations that Scottish Water and the Commissioner must take into account in taking forward work on the SRC. These relate mainly to the Executive’s objectives for Scottish Water and they should be addressed in Scottish Water’s first draft business plan. The Executive will provide a fuller description of its objectives for Scottish Water at the conclusion of Q&SIII and in light of Scottish Water’s first draft business plan.

The Executive’s objectives for Scottish Water

12. The Executive’s broad objectives for Scottish Water for 2006-14 are that it should:

12.1. Ensure, as a minimum, that the levels of the core services provided to customers through Scottish Water’s assets do not deteriorate during the period.

12.2. Plan to comply with the full range of statutory obligations that it expects its regulators to place on it during the period.

13. Q&SIII will consider in detail the manner in which these objectives should be secured in the period 2006-14 as a whole. The Commissioner and Scottish Water should take forward work on the SRC on the basis that the Executive will not require Scottish Water to deliver any objectives in the 2006-10 period that have not been considered in Q&S discussions. Meantime, in its first draft business plan Scottish Water should set out a programme of work for the period 2006-10 that it judges to be a practical and achievable means of addressing the two broad objectives described above. In doing so it should identify those areas where it considers that its regulators have discretion in placing or enforcing statutory obligations on Scottish Water and what it considers to be the appropriate standards to be set in such cases. It should identify too the arrangements that it will need to make to enable it to provide water and sewerage services to licensed providers of these services as described at paragraphs 16 to 21 below. On these bases, it should set out the levels of borrowing from the Executive that it considers would be appropriate to support the programme; and the impact on the level of current charges of...
implementing such a programme at the level of borrowing envisaged by Scottish Water.

14. In addition, the first draft business plan should set out any other objectives that Scottish Water judges it appropriate for it to be pursuing during the 2006-10 period. In doing so, it should set out the levels of borrowing from the Executive that it considers would be appropriate to support the achievement of such additional objectives, and the impact on future charge levels of meeting such objectives, at the level of borrowing that it envisages. (For both illustrations the impact on charge level should be expressed in terms of the current tariff structure and should not make any assumptions about changes in the structure that might be required once the Executive has set out its principles on charging.) In the second draft business plan Scottish Water should set out the programme of work necessary for it to deliver the outputs specified by the Executive in January 2005 (paragraph 8.6 refers).

Scottish Water’s core functions

15. In preparing its first draft business plan, Scottish Water should take account of the changes to its core business that will be a consequence of the Water Services (Scotland) Bill.

16. Scottish Water’s core functions are defined at subsection 70(2) of the Water Industry (Scotland) Act 2002. As matters stand, these functions include the provision of retail water and sewerage services to non-household customers. In light of provisions to be included in the Water Services (Scotland) Bill, these services will cease to be core functions with effect from 1 April 2006.

17. The Bill will prohibit both common carriage on the infrastructure vested in Scottish Water and the provision by anyone other than Scottish Water of retail water and sewerage services to households; and it will enable third parties under licence to provide retail services to non-household customers. It will confer powers on Ministers to direct Scottish Water to establish a separate legal entity for the purposes of acquiring a licence to provide all retail water and sewerage services, including trade effluent services, to non-household premises and subsequently of performing the functions of a licensed provider to non-household premises.

18. As foreshadowed in its consultation paper on the draft Bill, the Executive intends to exercise these powers of direction so as to require Scottish Water to establish a retail entity, licensed under the provisions of the Bill, which will come into existence on 1 April 2006. As a consequence of this, Scottish Water will cease to provide water and sewerage services, including trade effluent services, to non-household premises from that date. Instead it will sell such services to the retail entity, which in turn will sell the services to non-household customers. Limits on the amounts that Scottish Water can charge for selling such services to licensed retailers, including the retail entity, will be covered in the SRC and will form part of the charge limits that the Commission will set for Scottish Water.
19. In the first instance the retail entity will provide all such services to all non-household customers served by Scottish Water’s infrastructure. During that time, the retail entity’s licence will regulate the relationships between the entity and Scottish Water and between the entity and its customers. The licence will extend to the amounts that the entity can charge its customers. These charges will not form part of the charges scheme in respect of core services.

20. The intention is that this state of affairs should continue for two years (i.e. until 1 April 2008), so that the Commission can develop plans for licensing third parties, while avoiding disruption in the retail market, which could undermine the Executive’s wider policy objectives for Scottish Water. During this interim period, the Commission will put in place preparations to license other providers to compete with the retail entity in providing retail services to non-household customers. When these arrangements become operative on 1 April 2008, the charges levied by Scottish Water to the retail entity and all other providers will continue to be regulated within the SRC and by the charges scheme. However, subject to the Commission judging that the retail market is being contested, the charges levied by providers, including the retail entity, will be unregulated and will be a matter of contract between the provider and its customers. (In the event that the Commission concludes that the market is not contested, it will continue to regulate the charge to customers beyond April 2008.)

21. Scottish Water’s first draft business plan should take account of these planned changes and should distinguish between those of its functions that will continue to be core and those that will cease to be so after 1 April 2006. The plan should set out Scottish Water’s proposals for the objectives that the re-defined core business should be delivering in the period 2006-10. It should also identify those functions that Scottish Water considers should become part of the retail entity and should contain separate proposals for their management and funding after 1 April 2006. It should do so on the basis that the Executive will wish any borrowing by the entity, including working capital, to be kept to a minimum, and to be clearly justified in terms of the effective performance by Scottish Water of its core functions.

Conclusion

22. I will write to you again in January 2005 with detailed information on the objectives and standards that the Executive requires SW to achieve during the review period, on the Executive’s assumptions about Scottish Water’s borrowing limits in the period, and about the principles that the Executive will require the Commission to apply in setting charge limits at the conclusion of the review.

23. I am sending copies of this letter to the Chairman of the Competition Commission, the Chairman of SEPA and the Drinking Water Quality Regulator for Scotland.

ROSS FINNIE
23 April 2004

To:
Des McNulty
Convener, Finance Committee

I am writing to thank your Committee for its report on Scottish Water, and to welcome your main conclusions and give you my initial reaction to your recommendations. I will, of course, respond more fully to your report in due course.

We have been following with interest your deliberations and the evidence that you have gathered, and have also been considering in parallel how we could respond to the concerns raised about transparency and accountability within the water industry. Below I outline the conclusions we have reached that we propose to take forward through the Water Services Bill. The Executive will also make these decisions public by means of the attached press release.

I am pleased to see that the Committee has finally lain to rest the misleading allegations made by Analytical Consulting Ltd. Your report confirms what we have always maintained: the Executive applied the Resource Accounting and Budgeting rules correctly and did not wrongly double count depreciation, all parties understood the rules and water charges were in no way affected.

We want a public sector organisation delivering efficient water and sewerage services throughout Scotland. I welcome the endorsement from stakeholders of this policy, and agree with your statement that rather than challenging the current public sector model we must concentrate on making Scottish Water work and putting it on a sustainable footing. The Executive considers that improving the efficiency of Scottish Water is the only sustainable means of raising standards and keeping charges for customers as low as possible. This is why we set up Scottish Water as a public sector corporation on April 1 2002, and why we have set Scottish Water challenging objectives for its first four years: delivering a substantial capital investment programme which is improving drinking water quality and enhancing our environment, at the same time as becoming much more efficient by reducing its operating costs by around one-third and procuring its capital for one-fifth less than originally estimated.

The Executive agrees with the Committee that robust, transparent and economic regulation has a crucial role to play in ensuring that Scottish Water becomes more efficient. We recognise that this requires a number of changes to the current regulatory regime and propose to make these through the forthcoming Water Services Bill. In broad terms, the changes that we have in mind are

To give Ministers clear statutory duties to set publicly the standards and objectives that Scottish Water should achieve and the principles to be applied in setting charges for customers.
To transfer the functions of the Water Industry Commissioner from an individual to a small board of non executive experts and a chief executive, to be known as the Water Industry Commission for Scotland.

To empower the new Commission to set limits on Scottish Water’s charges, rather than advise Ministers on them as happens at present, and to do so on the basis of Scottish Water being funded to deliver Ministers’ objectives at the lowest overall efficient cost to the customer.

To set out in statute a transparent process by which the new Commission, working within a policy framework established by Ministers, will consult publicly on proposed charge limits before setting these limits.

These changes will provide for greater continuity and consistency in economic regulation. They make a clear distinction between Ministers’ responsibility for setting Scottish Water’s objectives and the economic regulator’s duty to ensure that the objectives are delivered as efficiently as possible. This greater clarity of roles will help Parliament to hold Ministers and regulators to account for their respective decisions and contribute to the operation of a more transparent process.

I believe that the new functions and structure of the Water Industry Commission meet the Committee’s call for economic regulation to modelled on the other UK regulators. Consistent with that approach, and subject to the Parliament approving the changes, we will seek an order under the Scotland Act to balance the Commission’s new powers by making its decisions on charges subject to review by the Competition Commission in the same way as happens, for example, with OFWAT and the decisions that it takes in respect of the water industry in England and Wales.

I welcome your view that we need a more detailed examination of the investment needs for the industry. Identifying and providing for future investment needs is crucial to the success of the industry. In order to address this requirement, I established the Quality and Standards III project some 12 months ago. This project which involves a range of stakeholders, will advise me on the type and scale of investment required to meet public health standards for drinking water, meet environmental standards (legislative) for wastewater, and maintain and extend the existing network. This work, which is probably the most systematic review of capital requirements for the industry, will be used to develop the content and shape of proposals for an overall investment programme for the water industry. It will be the subject of a full public consultation planned for the summer.

I also welcome your support for the consultation on the principles of charging that we are undertaking later this year. We will, of course, make this as inclusive as possible, and I am sure many of the concerns you raise over the impact of harmonisation of charges will be addressed within that consultation process.

The outcome of the consultations on Q&S and on charging will inform Ministers’ decisions in setting the policy framework within which the Water Industry Commission will conduct the next strategic review of water charges.
I am copying this letter to Sarah Boyack as the convener of the Environment and Rural Development Committee, to the Clerks of both Committees and to SPICe.

ROSS FINNIE