The Committee will meet at 2.00 pm in Committee Room 2 to consider the following agenda items:

1. **Water Inquiry (in private):** The Committee will consider possible lines of questioning for witnesses on its inquiry into water and the water industry.

   *Not before 2.15 pm*

2. **Executive Undertaking on Northern Isles Ferries:** The Committee will consider the following draft undertaking—

   Draft Undertaking by the Scottish Ministers and NorthLink Orkney and Shetland Ferries Ltd.

3. **Water Inquiry:** The Committee will take evidence as part of its inquiry into water and the water industry from—

   - Dr Jon Hargreaves, Chief Executive, East of Scotland Water Authority
   - Councillor Robert Cairns, Chairman, East of Scotland Water Authority
   - Katherine Bryan, Chief Executive, North of Scotland Water Authority
   - Colin Rennie, Chairman, North of Scotland Water Authority
   - Ernest Chambers, Chief Executive, West of Scotland Water Authority
   - Professor Alan Alexander, Chairman, West of Scotland Water Authority
   - Graeme Millar, Chairman, Scottish Consumer Council
   - Trisha McAuley, Head of Corporate Resources, Scottish Consumer Council

4. **Genetically Modified Organisms (in private):** The Committee will consider a second draft report on the issue of genetically modified organisms.
5. **Water Inquiry (in private):** The Committee will consider further practical arrangements for its inquiry into water and the water industry.

Shelagh McKinlay  
Clerk to the Transport and Environment Committee  
Room 2.02, Committee Chambers  
0131 348 (8)5208  
e-mail Shelagh.McKinlay@scottish.parliament.uk

The following papers are relevant for this meeting:

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TRANSPORT AND THE ENVIRONMENT COMMITTEE

Scottish Statutory Instrument

The Draft Undertaking by the Scottish Ministers under Section 2 (1) of the Highlands and Islands Shipping Services Act 1960

1. The Draft Undertaking by the Scottish Ministers under Section 2 (1) of the Highlands and Islands Shipping Services Act 1960 was laid on 30 November 2000. The Parliament has designated the Transport and the Environment Committee as the lead committee for the consideration of this instrument. An Executive note accompanies the draft undertaking.

2. The draft undertaking was laid under "affirmative procedure" which means that the Parliament must approve the order before it may come into force. The sponsoring Minister (Sarah Boyack, Minister for Transport) has therefore lodged a motion, S1M-1423 "That the Transport and the Environment Committee recommends that the draft Undertaking by the Scottish Ministers under section 2(1) of the Highlands and Islands Shipping Services Act 1960 be approved".

3. The draft Undertaking is required under the Highland and Islands Shipping Services Act 1960 to set out the terms and conditions under which the Executive awards shipping subsidies above a certain level. The draft Undertaking arises following the tendering exercise for the Executive’s contract for a subsidy to a ferry operator to run passenger ferries to Orkney and Shetland from 2002. The Minister for Transport announced on 6 October that a preferred bidder, NorthLink Orkney and Shetland Ferries Limited, had been appointed.

4. The Subordinate Legislation Committee considered this instrument at its 35th meeting on 5 December 2000. In its 45th report (2000) the Committee reported that the attention of the Parliament need not be drawn to the instrument.

Alastair Macfie
Assistant Clerk
Transport and Environment Committee
December 2000
NORTHERN ISLES PASSENGER FERRY SERVICES – DRAFT UNDERTAKING

BRIEFING NOTE

1. Financial assistance for shipping services within Scotland is a devolved matter. The Scottish Ministers have powers to subsidise shipping services in the Highlands and Islands under the Highlands and Islands Shipping Services Act 1960 (“the Act”). These powers are used to support shipping services to Orkney and Shetland on the Pentland Firth route between Scrabster and Stromness and Aberdeen/Orkney/Shetland.

2. The present subsidy is a 5-year block subsidy award for the period 1997-2002 payable to P&O Scottish Ferries following a tendering exercise. Tendering is required under the EC State Aid rules for a Public Service Obligation. A tendering exercise commenced in October 1998 for the future subsidy payable for the period 2002-2007.

3. The Scottish Ministers may award subsidy under section 2(1) of the Act only after receiving Parliament's approval of an Undertaking "including the terms and conditions upon which the Undertaking is proposed to be made".

4. The draft Undertaking now submitted comprises the terms and conditions under which it is proposed to award a 5-year block subsidy to NorthLink Orkney and Shetland Ferries Limited (NorthLink) following conclusion of negotiations after their appointment as preferred bidder in October 2000.

5. The Scottish Ministers propose to undertake to make advances by way of grant under the Act in accordance with:-

   (a) the draft Undertaking;

   (b) a draft Minute of Agreement between the Scottish Ministers and NorthLink Orkney and Shetland Ferries; and

   (c) Tripartite Agreements between the Scottish Ministers, NorthLink Orkney and Shetland Ferries Limited and Lombard Lessor (who will be a wholly owned subsidiary of Royal Bank of Scotland) who own the vessels to be used in the new service and will lease them to NorthLink.

6. Attached to this note, as Annex A, is a detailed summary of the main clauses in the Minute of Agreement. A summary of the main clauses of the Tripartite agreements is attached as Annex B.

7. The Executive policy is to support lifeline ferry services to the Highlands and Islands for economic and social reasons. The proposed Undertaking and related Agreements provide for this to be effective for the period 2002-2007 in relation to the Northern Isles and in accordance with the terms of the Act.

8. The agreement provides a number of benefits and improvements in service. They include 3 new vessels, shorter journey times and cheaper fares. The undertaking demonstrates the Executive’s commitment to maintaining lifeline services to the islands and their communities.

Scottish Executive Development Department
December 2000
ANNEX A

AGREEMENT BETWEEN THE SCOTTISH MINISTERS AND NORTHLINK ORKNEY & SHETLAND FERRIES LTD

Briefing Note

Clause 1 - Definitions and Interpretation

This is standard wording. The detailed definitions and interpretation clause are in the Schedule Part 1.

Clause 2 - Conditions Precedent

This sets out the key issues which have to be in place before the contract can take effect. In negotiation the list of potential conditions precedent have been minimised as shown in 2.1.

Clause 3 - Grant

This clause sets out Scottish Ministers’ obligation to pay grant for the Approved Services. It divides the payment periods into accounting periods of a year. This allows the accounting period to start at the commencement of the grant period which is now likely to be 1 October 2002.

It states the Base Annual Grant i.e. the amount of grant bid at April 2000 prices. and clarifies how the grant will be indexed by inflation. The intention is that there shall be an estimate of a “provisional Annual Grant” for the 12 month period made (based on the Bank of England forecasts for RPI) and then paid in equal instalments throughout the year. It shall then be adjusted on the basis of the actual inflation rate applying.

Apart from the detailed calculations of Grant Clause 3 also contains important elements of control, such as the requirement that the Grant be used for nothing other than the Approved Services (3.4) and that the absence of any service for a more than one month leads to a complete suspension of Grant payment (3.9).

Clause 4 Grant Clawback

This clause enables Scottish Ministers to reclaim a proportion of the grant if, at the end of the grant period, NorthLink’s profits over the entire grant period exceed the agreed Rate of Return on Capital Employed (i.e. 7.5%). This mechanism provides for the possibility of a positive return on the grant monies paid.

Clause 5 Material Change

Bidders for the 2002 contract were invited to take on the main business risks associated with providing the ferry service. This included the demand for volume usage, operational risk, errors in the time or cost estimates in providing the vessels on services and so on.
Since the subsidy is a 5 year block subsidy arrangement, and the bid information is constructed well in advance of the start of the contract, bidders expect some limited protection against any material change in circumstances where they might not have expected to have any control and which has an impact on the costs of providing the Approved Services. The sort of key assumptions where a material change was envisaged included major shifts in costs of fuel, or major changes in policy affecting either ferry services or Government transport policy. This section, therefore, identifies the main circumstances under which a material change would have been expected to occur.

The clause, however, does apply a threshold to the material change events where the Company would be expected to absorb the risk. Although the clause and calculation are fairly technical their purpose is to ensure that only where the return on capital employed has dropped under a given threshold and one or more of the defined material changes has taken place will a material change calculation be triggered.

Clause 6 - Compliance with Law

This clause provides that, in carrying out the Approved Services, Northlink shall ensure that it, or in the case of anyone acting on its behalf shall use all reasonable endeavours to ensure that they, comply with applicable law and all other binding rules and regulations relating to maritime vessel, crew and passenger safety legislation and regulatory requirements.

Clause 7 - Consultation with Users

This provides for Northlink to have quarterly consultation meetings with users. This will apply from the date of the Agreement i.e. including period of the build up to the start of the contract.

Clause 8 - Approved Services Obligations

Clause 8 implements a deduction regime if Northlink fail to meet agreed standards of performance for reliability and punctuality. The details of the deduction calculations are given in the Schedule, Part 5. Essentially it provides for subsidy to be deducted by increasing levels if there is poor performance of punctuality and reliability.

The clause does provide, however, for certain situations which are essentially outwith NorthLink’s control to be taken into account and for the deduction regime not to apply. These “relief events” are set out in Clause 8.1. This clause, therefore, seeks to achieve the proper balance of providing sufficient incentive for measuring performance and output which we are buying with penalties deployed in proportion to the degree of any bad performance involved. It also, however, gives the company reassurance that any problems outwith their control are taken into account and it in no way prejudices the final decisions of the Company or the Master of the vessel about whether it or not it is safe for a vessel to sail. All of these developments will be monitored as part of the monitoring regime for the contract.

Clause 9 - Variation or Discontinuation of Services or Changes in Tariffs

This clause provides that there can be no amendment to the routes, times and schedules of the services involved without the agreement of Ministers. It also requires the Company to seek Scottish Ministers’ agreement to any increases in fares above the initial index linked levels.
Clause 10 - Reserve Funding

Northlink has access to certain reserve funds and, as part of our business monitoring of the Company, this Clause requires them to give us notice any time these funds are used.

Clause 11 - Expenditure and Accountability

This clause requires Northlink to ensure that it has adequate internal expenditure, financial monitoring and financial reporting place. It also requires Northlink to ensure that there is no cross subsidisation between the services we support and any others e.g. freight services which are not subsidised.

Clause 12 - Termination

This clause provides for termination of the contract by Scottish Ministers (12.1), by agreement between Scottish Ministers and Northlink (12.2), and where either party may terminate because of either’s failure to perform their obligations under the contract (12.3). Further, to take account of the interaction between the Grant Agreement and the Tripartite Agreement (dealing with the Scottish Ministers’ options on termination), a clause has been added to ensure that a termination of the charter of the vessels (between NorthLink and Lombard Lessor) terminates the Grant Agreement (12.4) The clause also provides for recompense where one party is in breach.

Clause 13 - Force Majeure

This clause provides for force majeure events to be taken into account in considering whether a delay in performance or a non-performance is a breach of the Agreement. The definition of Force Majeure is contained in Schedule Part 1 and is deliberately narrow to ensure that only matters of near catastrophe qualify. In the event of a force majeure continuing for 6 months either party may terminate the agreement.

Clause 14 - Transfer of Staff to Incoming Operator

This clause provides for an adjustment to the grant if certain additional costs arise. Looking forward the assumption is that the Transfer of Undertakings (Protection of Employment) Regulations 1981 (as amended) would apply in relation to staff/crew for any future tendering exercise. If that proved not to be the case, however, the costs arising would be taken into account by an adjustment to the subsidy grant calculation. This is a contingent liability and is being reported separated to Parliament as part of the contingent liability reporting arrangement. If provision for this were not made in the contract bidders would build the cost of this risk into their bids thereby pushing up the subsidy requirement. In effect this would mean additional subsidy throughout the term of the contract to cover costs for an event which the Executive considers unlikely to arise.

Clause 15 - Transfer or Assignation

This is a standard clause.
Clause 16 - Late Payment

This is a standard clause on interest on late payment.

Clause 17 - Confidentiality

This is a standard clause, but has been extended to include the provision by Northlink of information needed for the next 2007 contract award exercise to be conducted with all the relevant information e.g. staff costs etc (Clause 18.2(g) refers).

Clause 18 - Entire Agreement

This is a standard clause.

Clause 19 - Amendments to Agreement

This is a standard clause.

Clause 20 - Disputes

This is a standard clause.

Clause 21 - Notices

This is a standard clause.

Clause 22 - Waiver

This is a standard clause.

Clause 23 - Severability

This is a standard clause.

Clause 24 – Just Quaesitum Tertio

This is a standard clause.

Clause 25 - Law of Contract and Jurisdiction

This is a standard clause.

Schedule Part 1 - Definitions

Explains the key definitions and interpretations.

Schedule Part 2 – Approved Services

Sets out the Approved Services timetable.
Schedule Part 3 – The Vessels

The vessel descriptions – dimensions, speed, and passenger and freight capacity.

Schedule Part 4 - Monitoring Procedures

This sets out the Executive’s requirements in relation to the specific monitoring required to deal with punctuality and reliability; expenditure and accountability; and finance and efficiency information.

Schedule Part 5 – Deduction Regimes

This sets out the detail of the deduction regimes.
TRIPARTITE AGREEMENT BETWEEN LOMBARD LESSOR, NORTHLINK ORKNEY AND SHETLAND FERRIES LIMITED AND THE SCOTTISH MINISTERS

Briefing Note

Clause 1 - Definitions and Interpretation

This sets out the detailed definitions used in the Agreement.

Clause 2 - Grant of New Charter to an Incoming Operator or the Scottish Ministers

Clause 2.1 applies at the natural expiry of the Grant Agreement (i.e. 1 October 2007 or such extended period as the Scottish Ministers may require up to a maximum of an additional 12 months).

Under this clause the Scottish Ministers are entitled to require the Bank to enter into a new Charter of the vessels for a further five year period either to the Scottish Ministers or to a new Operator of the services (an “Incoming Operator”). The Incoming Operator has to be acceptable to the Bank, acting reasonably, as the Incoming Operator is responsible for paying the Bank under the new Charter and for maintaining the vessels.

Clause 2.2 sets out the procedure which is to be followed if the Scottish Ministers wish to exercise this option. They are required to notify the Bank not less than three months in advance to allow time for the appropriate financial checks etc. and completion of documents.

Clause 2.3 deals with termination of the Grant Agreement prior to its natural expiry. The principal circumstances in which this could apply are default by either party under the Grant Agreement. In that event the Scottish Ministers have the option of either taking over the Charter themselves for its remaining period or alternatively granting a new Charter for the unexpired portion of the original charter to an Incoming Operator acceptable to the Bank.

Clause 2.4 provides for the Bank to give advance notice to the Scottish Ministers if it intends to terminate the Charter for default by NorthLink.

The likelihood of termination of the Grant Agreement is judged to be low, but provision has to be made and the basis on which this would happen agreed.

Clause 3 Termination Payments where no Incoming Operator

Clause 3 explains the situation where there was no incoming operator. It separates the termination arrangements into 2 situations. First, under Clause 3.1, if the Scottish Ministers have given reasonable notice of a 2 year period then the calculation would be applied in a set method called the ‘Reduced Charter Termination Payment’. If, however, Scottish Ministers have not given notice of 2 years and are not either pursuing subsidies for the routes or finding another operator or taking the lease on themselves, the calculation would be made in an alternative way called the ‘Full Charter Termination Payment’. The calculation arrangements are set out in Schedule 3.
Clause 3.6 provides that these termination payments will be adjusted in a ‘Material Change’
takes place after the Tri-Partite Agreement is signed. These are changes in law, changes in
certain assumptions regarding capital allowances and actions by Government etc.

Clause 4 Sale of a Vessel where no Incoming Operator

This clause deals with the procedures for selling the vessel in the unlikely event of the
termination of the lease being required. Under the first method of giving 2 years notice the
lessor would take responsibility for selling the vessel and Scottish Ministers would pay an
agreed sum at the end of the 5-year period. Under the alternative method Scottish Ministers
would be responsible for selling the vessel since they have most interest in maximising the
sale proceeds.

Clause 5 Post Termination Tax Payments

The Charters provide for certain assumptions to be made regarding tax payments - this clause
provides for an adjusting payment if these assumptions are not met.

Clause 6 Consequential Provisions on Provision of Approved Services by Incoming
Operator or the Scottish Ministers

This deals with detailed arrangements prior to handover to an Incoming Operator e.g.
inspection rights with respect to vessels.

Clause 7 Further Acts

This is a standard clause in such agreements.

Clause 8 Assignations

This clause restricts assignation rights. It ensures that the consent of both NorthLink and
Scottish Ministers are required before the Lessor can assign rights on the lease.

Clause 9 Disclosure of Information

This clause controls disclosure of information by both parties and gives Scottish Ministers
powers to disclose relevant information. This would be necessary for any future tendering
exercise so that potential bidders were aware of the details of the lease.

Clause 10 Notices

This clause provides that, once issued, notices are irrevocable.

Clause 11 – Just Quaesitum Tertio

This is a standard clause.
Clause 12 Governing Law

Standard clause.

Schedule 1 Calculation of termination payments

This explains how the termination payments are calculated and the various assumptions that have applied to the figures quoted in the Schedule. They show the aggregate figure for all 3 vessels. Three will be one tripartite for each vessel so these figures would be adjusted accordingly.

Schedule 2 Terms of New Charter

This ensures that the transfer of any lease to a new operator is on the same terms as the original lease.

Schedule 3 Net Sale Proceeds

This explains how the termination values would be applied and for surplus proceeds to be returned to the Scottish Ministers.

Schedule 4 Terms of Sale of Vessel

This sets out standard terms for any sale of a vessel.
Transport and Environment Committee

Inquiry Into the Scottish Water Industry

Collective Submission by the Scottish Water Authorities
COLLECTIVE SUBMISSION BY THE SCOTTISH WATER AUTHORITIES

Achievements

In four years we have:
- More than doubled our pace of investment
- Cut our underlying costs to a level well below our opening position in 1996 (on a like for like basis).
- Substantially reduced sea and river pollution
- Significantly improved water quality
- Delivered higher guaranteed standards of service to our customers

Challenges

Customers

In the interests of our customers we must deliver:
- A safe, reliable and efficient service
- Cleaner coasts, lochs and rivers
- Manageable prices

The Need for Investment

- Our customers want cleaner coasts, lochs and rivers as do our regulators and the government
- Many of our treatment works, water mains and sewers are old and in poor condition. The Victorians invested for the future but we can no longer rely on their legacy.
- Our English counterparts have invested heavily in modern plant and new technologies which reduce their running costs. We cannot match their levels of efficiency unless we do the same.
- For 2002-06 our major investment will be determined through the new Quality and Standards process. This is now entering a public consultation stage and will conclude next summer.

Raising the Funds

- All our investment is ultimately paid for by our customers. We receive no subsidy from the taxpayer.
- Our investment costs have been met by a mix of borrowing, current charge income and PFI where best value has been demonstrated.
- We need to strike a balance between the pace of the investment needed and the ability of our customers to pay.

Efficiency

- Although we have made good progress, we still have a long way to go to match the efficiency levels of our English counterparts.
• We are exploring opportunities for collaboration between the three water authorities to improve our efficiency.
• We are discussing targets with the Water Industry Commissioner, aimed at reaching agreed levels of efficiency by 2005/06.

**Competition**

• Competition is already with us. Large business customers are actively reducing costs through multi-site deals and waste minimisation. Some are leaving our network entirely.
• Through metering and water conservation, income from many smaller business customers is also falling.
• Competitors are actively researching and developing propositions for our domestic and smaller business customers.
• We need to create a level playing field so that the public water authorities have the ability to undertake commercial ventures in an innovative way.
• All of the above is happening without reliance on the Competition Act or common carriage. The inception of common carriage will simply intensify competitive exposure.
• An ineffective response to competition will result in an unacceptable increase in charges to our customers.
• In a fixed cost industry the cost of the network will fall on those who remain if we lose big customers.

**The Way Ahead**

• We are determined to rise to the unique challenge these issues represent.

• This will require a scale and pace of change which is rare in the private sector and unprecedented in the public sector.

• Our aim is to deliver a modern, dynamic public sector water and sewerage industry for Scotland.

• The Authorities are working closely with the Scottish Executive to come up with solutions to the challenges facing all of us. It is likely that some of the solutions will need to be radical. If the Scottish water industry is to retain customer loyalty and serve communities via the public sector then pragmatic and innovative change will be needed. We need to establish a redefined public sector model which is stable and permanently viable.

• The circumstances of the three Authorities differ. For example, the biggest challenge for the North lies in the scale of its infrastructure and investment needs in relation to the size of its customer base. For the East, competitive pressures are more dominant. The West faces competition in its heavily urbanised area and the need to invest in some areas of sparse population elsewhere while improving collection levels from domestic customers.

• The Authorities welcome the opportunity to raise these issues.
The SCC recognises the need for large-scale investment in the water industry in order to meet essential environmental standards. However, domestic consumers, particularly those who are vulnerable and disadvantaged, are now being asked to meet the costs of past under-investment through steep, and geographically variable, rises in charges.

In the light of this, the current framework of the water industry requires to be changed so that the investment which is required is no longer incompatible with the ability of the most disadvantaged consumers to pay for that investment. This means ensuring:

a. An appropriate mechanism for independent and robust representation of the interests of domestic consumers in the market; and
b. In-built, legislative protection for vulnerable consumers, including clear universal service criteria.

These two points are expanded below.

In the run-up to the formation of the current regulatory structure in 1999, the SCC argued strongly that economic regulation and consumer representation should be independent of each other. The UK Government has recognised this in relation to the privatised energy utilities (where consumers at least have a choice of provider) and has set up an independent statutory consumer council. It has announced its intention to do likewise with the water industry in England and Wales. This has also just been mirrored in the public sector in relation to postal services.

Consumer representation in the water industry in Scotland currently comes under the auspices of the Water Industry Commissioner, who chairs three area consultative committees. However, there is no framework for ensuring that the interests of domestic consumers are represented outwith the regulatory system.

Effective representation of consumers' interests is a key element in making any market work. Such a market can include regulatory failure. This applies just as much in the public sector where consumers have no choice of provider and suppliers have monopoly powers. Even where they have a specific consumer protection remit regulators have to balance many different interests in making their decisions and have to operate within a legal (and impartial) framework. Consumer advocacy fulfils a quite different role to regulation, providing a counterbalance to other more vociferous and powerful interests which are seeking to shape regulatory decisions.

The consultative committees are under the auspices of the Commissioner's office and are chaired by him. They are consultative only i.e. their statutory role is confined to "the general function of advising the Commissioner." They represent the interests of all consumers, thus including large business users. What is needed is a body which will highlight issues of concern to domestic consumers and bring these to the attention of regulators, parliament and policy makers. An effective consumer
representative body needs to have a comprehensive remit, independence, freedom of speech, proper resources, expertise through access to information and a research capacity, and access to decision-makers. This would also increase public confidence in decision making itself.

- While a new statutory consumer council would be ideal, there are models of good practice in other areas where the consumer representative arrangements have all of the criteria listed above but have been established under the umbrella of the regulatory body. The Financial Services Consumer Panel is housed in and financed through the Financial Services Authority but has all the capacity, functions and degree of arms length independence needed to do its job effectively.

- Water authorities are under an obligation to show no undue preference to customer groups in providing water supplies. This has led to the dismantling of cross-subsidies and cost-reflective pricing in an essential basic service. The current structure of the industry around three geographical areas raises another issue of equity in that some consumers (particularly in the north) are paying more as a result of living within artificially constructed boundaries.

- The current Scottish Executive consultation on affordability proposes a transitional cap on charges for those on Council Tax Benefit. The equity issue will therefore remain under these proposals in the longer term. The consultation also dismisses the idea of seeking to resolve affordability via changes to the benefit system on the basis that this is a reserved matter.

- A strengthened industry framework would protect disadvantaged consumers and the opportunity exists now with the proposed Water Services Bill which has been prompted by the passage of the Competition Act.

- The framework of current legislation is weak in this respect. The Commissioner has the general function of promoting the interests of customers. This includes business users. This is in contrast with the Utilities Act where the regulator has a primary function to protect consumers and specific statutory responsibilities in respect of disadvantaged consumers including those on low incomes, the chronically sick, disabled people, pensioners, and those in rural areas. OFGEM has had to produce both a social and environmental action plan. Similar provisions exist in the new postal services framework.

- In the future companies will have to apply for licences and meet these obligations to get a license. It is very likely that business users will benefit most from the competition provided by new entrants, depriving the water authorities of revenue to meet investment costs, and leading to increased prices for domestic consumers. This an ideal time to incorporate strong universal service criteria into a new framework which would include a clear definition of what is meant by universal service, duties on regulators, duties on suppliers, and duties on the Executive.

- Strong and impartial enforcement powers will be needed and this should rest with the Water Industry Commissioner, not with Ministers as has been proposed in the consultation Managing Change in the Water Industry.