



Scottish Council for  
Development and Industry

## POLICY SUBMISSION

## BUILDING A HYDRO NATION

**March 2011**

SCDI is an independent and inclusive economic development network which seeks to influence and inspire government and key stakeholders with our ambitious vision to create shared sustainable economic prosperity for Scotland.

For more information on this response please contact the SCDI Policy Team at

Campsie House  
17 Park Circus Place  
Glasgow  
G3 6AH

**e** [gareth.williams@scdi.org.uk](mailto:gareth.williams@scdi.org.uk)

**t** 0141 332 9119

## Building a Hydro Nation

1. SCDI is an independent membership network that strengthens Scotland's competitiveness by influencing Government policies to encourage sustainable economic prosperity. SCDI's membership includes businesses, trades unions, local authorities, educational institutions, the voluntary sector and faith groups.

### Introduction

2. The Scottish Government has defined its purpose as "to focus government and public services on creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth." SCDI strongly believes that investment in water infrastructure creates economic, social and environmental benefits, and that sustaining high-levels of investment will be needed to enable economic growth and meet rising environmental standards.
3. This will be a significant challenge as water companies are capital hungry. Scottish Water's investment programme for the period 2010 to 2015 will cost around £500 million per year, funded through a combination of customer charges and borrowings drawn down from the Scottish Government. The Scottish Government had committed to new lending to Scottish Water of £140 million per year until 2014-15, equivalent to about 5 per cent of the Government's projected annual Capital DEL budget over the next four years. With the capital budget falling by a quarter in the Scottish Budget 2011-12, the Scottish Government has decided that, rather than allow this borrowing for the year, Scottish Water will use its surplus cash to fund its water capital investment programme for 2011-12.
4. SCDI believes that, under the existing public ownership model, investment in water infrastructure should continue to be a high priority for the public purse. There is an understanding that the Scottish Government is committed to allowing new lending to Scottish Water of £140 million per year for the rest of the regulatory period, which is welcome, however SCDI notes that this would still leave Scottish Water with less of a cash buffer to help it meet any unexpected future capital cost increases and that this commitment would not be binding on any new Scottish administration. Reducing the size of or re-profiling the capital programme would not only reduce its direct benefits for the economy, society and environment, but have a negative impact on businesses and jobs in the under-pressure civil engineering industry. This underlines that the Scottish Government and Parliament must ensure that sustainable, long-term funding arrangements, which provide Scottish Water with access to sufficient capital, are in place.
5. The Scottish Government commissioned Independent Budget Review recommended that the Scottish Government and Parliament, in liaison with HM Treasury should urgently review the status of Scottish Water and that alternative models should be considered. It pointed out that "there is at least one alternative route; that of a public interest company (similar to Welsh Water), which should

permit the release of significant capital to the Scottish Government for other projects while allowing the attraction of private investment and the return of any surplus to the public benefit.” The Independent Budget Review has suggested that this option could release £140 million annually for alternative public investments while the refinancing of Scottish Water’s existing debt built-up post Devolution would generate a capital receipt of approximately £1.2 billion, representing a significant contribution to meeting the Scottish Government’s capital shortfall towards the end of spending review period, and at the same time provide a huge boost to economic development by supporting capital investment.

6. SCDI considers that should the existing model prove unsustainable in funding the Scottish Government’s objectives for economic growth and environmental standards, within tightening public expenditure limits and economically and socially acceptable charges, other external funding streams should be explored.
7. The public spending context in Scotland is the most challenging for at least a generation. The status and financing of Scottish Water impact not only on its own essential investment programme, but on the funding available for the Scottish Government’s wider capital programme to support increasing sustainable economic growth. Scottish Water’s structure and regulatory framework have proved successful, but the issue is whether, in a completely different economic and financial context, the model is the right one to achieve priority social and economic outcomes for water services and Scottish public spending going forward. This is related to the value Scottish Water can deliver and merits proper consideration. The Scottish Government should - as the Independent Budget Review recommended - at least be exploring and seeking evidence on whether a public interest model might better meet the three priorities (*Foreword*) and four Principles (*Chapter 3*) that the Scottish Government identifies for Scottish Water.
8. The Scottish Government has established the Commission on the Future Delivery of Public Services in Scotland to produce a ‘road map’ for the future reform of public service delivery in Scotland over the coming 5 to 10 years. The Commission will report this summer and it would be useful to consider the options following its recommendations, as among the issues it is considering are:
  - the extent to which public services are successful in achieving outcomes for and with individuals and communities;
  - the extent to which public services are efficient and financially sustainable;
  - the relationship between public, third sector and private sector delivery.

## CONSULTATION QUESTIONS

**Q1 (Principles):** Are the principles set out above the most appropriate to guide the development of Scottish Water into a wider role?

9. SCDI generally supports these Principles. It would be seriously concerned if Scottish Water lost focus on its core functions of the delivery of clean fresh

drinking water and the collection and treatment of sewerage (Principle 1) due to the development of new activities and taking on new functions (Principle 3). SCDI welcomes the Scottish Government's statement that essential services must not be compromised, but SCDI believes that it would be worth reinforcing in Principle 3 that Scottish Water should develop new activities and take on new functions where these do not compromise and at a pace which does not compromise its core functions and do not duplicate the activities and functions of others which are already delivering them well, and that it should seek to form partnerships too.

10. SCDI recommends that the first guiding principle for Scottish Water should incorporate Scottish Water's role in enabling the delivery of outcomes sought by customers, especially competitive prices, value for money, supply and service.

**Q2 (Developing Non-core):** Does the proposed revision to Section 25 of the 2002 Act deliver the Government's aim of making it certain that Scottish Water is able to utilise its assets and expertise in any way it sees fit for commercial and/or social benefit?

**Q3 (Developing Non-Core):** Should Scottish Water be under an obligation to seek to develop commercially attractive opportunities?

11. SCDI strongly supports the Scottish Government's view that Scottish Water's asset base can be used to generate significantly higher renewable electricity. SCDI welcomes the progress that Scottish Water has already made in this area and any clarity and certainty which it considers necessary to develop its capacity.
12. SCDI supports the further development by Scottish Water of non-core commercially attractive opportunities aligned with its core functions, with the clear proviso that these activities must not compromise its focus on core services. SCDI is content with the proposed revision to the 2002 Act and agrees with the Scottish Government that a statutory obligation on Scottish Water to seek these opportunities would be unnecessary and potentially distracting, and that Scottish Water's Board should be allowed to identify and assess potential opportunities.
13. Scottish Water will only be able to maximise its potential for renewable energy and revenue generation over a long period. SCDI believes that it will need to continue to work with renewable energy developers, accepting an appropriate degree of shared risks and shared benefits. While clarity and certainty over its powers to operate beyond its core functions may be helpful, developments may be hamstrung by the years which projects can languish in the planning system and the regulatory framework, for example around anaerobic digestion, and these need to be addressed if Scottish Water is to be able to pick up the pace.

**Q4 (New Functions):**

**(a).** Do you support the proposal that Scottish Water should work with the Scottish Government to identify areas where they may contribute to water-related international development activities?

**(b).** Should Scottish Water be asked to use part of their own resources to support the proposed water-related international development activities?

**(c).** If yes, should Scottish Water be given a statutory obligation to do so or should they take responsibility for deciding how best they can contribute resource and expertise?

14. SCDI would support the proposal that Scottish Water should identify areas where it may contribute to water-related international development activities. This would also bolster Scotland's reputation as an outward-looking 'Hydro Nation'.

15. There may be opportunities for Scottish Water to capitalise on interest in replicating the model of public sector ownership and economic regulation in countries such as India and New Zealand. Scottish Water may also be able to partner with Scottish-based engineering and consultancy businesses to earn additional revenues from commercial opportunities in international markets.

16. In relation to water-related international development activities, there is a distinction to be made between commercial and non-commercial activities. The Scottish Government has an international development budget and SCDI would question whether non-commercial international development activities would more appropriately be funded from Scottish Water's own resources or from it.

17. SCDI does not believe that Scottish Water should be given a statutory obligation.

**Q5 (New Functions):**

**(a).** Which areas of water science and innovation in Scotland could contribute to assist in the initiative, and how could this input best be achieved and organised?

**(b).** What role should Scottish Water play in any such Centre?

18. Consultation with national and global water policy experts will clarify which areas of water science and innovation can contribute and how, and the role of Scottish Water in supporting the creation of a Scottish Centre of Water Expertise.

**Q6 (New Functions):**

**(a).** What opportunities are there for creating additional public benefit from Scotland's water infrastructure, both inland and maritime?

**(b).** What role could Scottish Water play?

19. SCDI agrees that there are potential opportunities for partnership working, joint ventures and sharing expertise between Scottish Water, British Waterways Scotland and Caledonian Maritime Assets Ltd (CMAL) which would create additional public benefit. This includes working together on renewable energy generation, biodiversity, freight transport on water, heritage and regeneration programmes, to promote Scotland's inland and maritime waters for tourism and leisure and to capitalise on their complementary strengths internationally. Scotland's canals could assist in flood risk management and urban drainage.

20. While British Waterways Scotland and CMAL have important roles to play in delivering the hydro nation vision, their core activities differ from Scottish Water's. British Waterways Scotland stewards, protects the heritage, regenerates and develops Scotland's 137-mile canal network, maximising their benefits for the

economy, society and environment. CMAL maintains and develops transport infrastructure, with challenging responsibilities for a £600 million investment programme for vessels and a £200 million investment programme for port modernisation and development, not only to support lifeline ferry services but for other areas including Operation and Maintenance Bases for proposed offshore wind farms and growing non ferry revenues from cruise traffic, commercial shipping leisure and fishing boats. Both British Waterways Scotland and CMAL have small teams with specialist expertise. Neither organisation is an obvious 'strategic fit' with Scottish Water. SCDI also understands that any change to CMAL's trading status could trigger significant section 75 pension liabilities of up to £100 million. SCDI would be concerned that integration of them into Scottish Water would risk the focus and delivery programmes of all of these businesses, and considers that partnership working, joint 'Hydro Nation' ventures and sharing expertise between these organisations is likely to be the best way forward.

**Q7 (New Functions):** Should Scottish Water and Local Authorities be given powers to establish Partnership Boards to address the issues of surface water flooding and implement solutions?

**Q8 (New Functions):** Could Scottish Water fulfil a proactive role in promoting the use of more sustainable urban drainage techniques for flood management?

**Q9 (New Functions):** Is there a role for Scottish Water to be required to undertake urban surface water flooding studies that examine above and below ground drainage?

**Q10 (New Functions):** Are there further steps Scottish Water can take with respect to SUDS that provide flood management benefits?

**Q11 (New Functions):** Would a greater role for Scottish Water in surface water flooding detract from the important role that planning authorities play in this area?

**Q12 (New Functions):** Should Scottish water be given a stronger role in planning decisions that could affect surface water flooding?

**Q13 (New Functions):** Should Scottish Water be given a formal role to support Local Authorities in relation to flood defence projects?

21. SCDI argued in its response to the consultation on the Flood Risk Management (Scotland) Bill that there is a pressing need for a single body to take a strategic overview and have overall responsibility for coordinating and developing national flood risk assessments and Flood Management Plans, looking well beyond three-year spending cycles. SCDI highlighted that, in its opinion, there is a need for a national body to promote the skills necessary for the design and specification of flood alleviation schemes, and in exploring innovative methods of procurement.

22. Scottish Water has expertise in construction and maintenance engineering and economics which would support a more proactive role in flood management.

SCDI does not consider that giving Scottish Water a stronger role in surface water flooding would detract from the regulatory function of planning authorities.

23. While considering the establishment of Partnership Boards and closer working to be steps forward, SCDI continues to believe that a single body with lead responsibility and accountability - and offering one point of contact - for flooding and surface water drainage would be clearer for the public and suggests that the Scottish Government should consider these questions from their perspective.

**Q14 (New Functions):** Do you think Scottish Water should be given additional functions? Please give details.

**Q15 (New Functions):** What would be the most appropriate way to confer such functions on Scottish Water? For example it could be done on a statutory basis or through Ministers' powers of directions. If it were done on a statutory basis, is it appropriate to extend Scottish Water's core functions to include the additional functions or is it more appropriate to have separate legislative frameworks for the functions for water and sewerage (core functions) and any other functions?

24. SCDI believes that Scottish Water should be given a limited number of additional functions (as previously described). The Scottish Government should assess which organisations carry out functions in the water sector, where there are gaps and whether Scottish Water (or others) would be best-placed to take them on.

25. SCDI would prefer a clear distinction between Scottish Water's core functions and its additional functions, and would suggest that the most appropriate way for the Scottish Government to confer such functions would buttress this distinction.

**Q16 (Financing):** What is an appropriate balance for surpluses generated by Scottish Water and its subsidiaries between building up a financial buffer, developing Scottish Water's commercial activities, financing social initiatives and being returned to Government to fund other priorities?

26. If the First Minister's ambition for Scottish Water to generate additional revenue to become financially neutral to the Scottish Government is attainable, it will only be realised over a long period. In the meantime, the priorities for surpluses generated by Scottish Water's subsidiaries should be to support its core functions, replenish its cash surplus reduced by the Scottish Government's decision to use it to fund the water capital investment programme for 2011-12 and build up its financial buffer, and develop its commercial activities, while minimising any increase in charges. If and when Scottish Water is generating any surpluses, decisions should be taken on re-balancing how these are spent.

**Q17 (Financing):** Is it appropriate to ask water and sewerage customers to fund the costs arising from other activities such as flood defences?

27. SCDI believes that charging based on usage is the fairest way for customers and can stimulate positive changes in water use. SCDI therefore supports metering.

28. Asking all water and sewerage customers to contribute to the costs arising from activities such as flood defence projects does run contrary to this principle. However, if the high costs of these projects are borne only by those in areas which are directly affected and are not socialised to an extent across the wide customer base, it would have a far more serious impact on their water charges.

29. Under the existing model, SCDI believes, that, on balance, it would be more appropriate to spread at least part of these costs. However, the Scottish Government should carefully consider all the options, including whether alternative models which may allow for the attraction of private investment could fund such a flood defence network without raising charges for water customers.

**Q18 (Financing):** Is it appropriate for customers to have part of their charges invested in commercial opportunities if they could receive the profits which flow from this investment in the form of lower bills in the future?

30. The economic regulatory framework has provided greater certainty and stability for customers about their charges over an extended period. This has been particularly appreciated at a time of economic turbulence, and volatile and sharply rising prices across other utility services. Within the Scottish Water group, subsidiaries have been able to identify commercial opportunities and reach decisions about appropriate risks, but, the overall group has had a guaranteed annual return determined by the regulator which provides stability.

31. The proposals to invest part of customers' charges in commercial opportunities, which may generate or losses, would increase the risks to the wider group and to customers. While SCDI agrees that, given the range of commercial opportunities, a degree of additional commercial risk would be appropriate, but this should be in Scottish Water's commercially-minded business units rather than its core functions, and great care should be taken to minimise the risks to price stability. Customers must be able to influence the level of risks taken on their behalf and there must be transparency about when they will realise the projected benefits.

**Q19 (Governance):** In the light of the Government's proposals to make best use of Scottish Water's assets and expertise, would putting in place a more standard corporate structure, consisting of a holding entity controlling distinct and separate business units, enhance the governance of Scottish Water?

32. SCDI believes that the separation of Scottish Water and Business Stream and the introduction of competition into the non-domestic market are serving businesses and public sector bodies well. As a dedicated retail company, Business Stream is able to focus on service delivery and costs for customers, representing their interests with Scottish Water and driving product innovation.

33. A more standard corporate structure, with separate business units, could simplify governance arrangements and reinforce the separation of Scottish Water and Business Stream. To ensure efficient use of assets and expertise while enabling

Scottish Water to develop new activities and take on new functions, each of Scottish Water's business units would need distinct and focused strategic aims.

**Q20 (Governance):** In the light of the Government's proposals to make best use of Scottish Water's assets and expertise does the economic regulatory framework in the Scottish Water industry remain fit for purpose to or could it be strengthened?

34. SCDI agrees that the introduction of independent economic regulation has been a key to driving improved efficiency and service levels at Scottish Water.

35. The Water Industry Commission for Scotland has been consulting on putting customers at the centre of the price review process. In view of the Scottish Government's proposals to ask water and sewerage customers to fund the costs arising from other activities such as flood defences and have part of their charges invest in commercial opportunities, it is important that customers' views on the associated risks are afforded a greater weight within the regulatory framework.

36. SCDI broadly supports a risk based approach to regulation, which incentivises good performance, while ensuring robust regulatory and enforcement powers.

**Q21 (Governance):** Are there lessons from the economic regulation of Scottish Water that could be applied successfully elsewhere in the public sector in Scotland?

37. Yes, lessons from the way in which focus on core functions, partnerships, and independent regulation of outputs and outcomes aligned with appropriate incentives, have delivered productivity gains in Scottish Water are potentially applicable elsewhere in the public sector. Between 2002 and 2010, operating costs fell by more than 40% in real terms, customer service improvements almost doubled and household charges rose annually in real terms by less than 0.5%. Delivering better outcomes for less in the wider public sector is particularly relevant given the planned level of public sector spending reductions. Potential lessons are identified in David Hume Occasional paper No 76 by Jo Armstrong.<sup>1</sup>

**Q22 (Governance):** What barriers might there be to Scottish based firms competing in an English retail market and what steps can be taken to minimise these? In particular, should the aim be to have a single retail market covering the non-domestic sector in Scotland and England?

38. A range of barriers to entry have been identified in reviews of the English retail market, including lack of a common contract which all wholesalers and new entrants can use, operational and market codes, and transparent separation between incumbent companies' whole and retail functions. SCDI believes that the Scottish Government should reinforce with the UK Government the benefits

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[http://www.davidhumeinstitute.com/images/stories/publications/HOP/HOP\\_76\\_Improving\\_Productivity\\_in\\_Scotlands\\_Public\\_Services\\_Policy\\_Lessons.pdf](http://www.davidhumeinstitute.com/images/stories/publications/HOP/HOP_76_Improving_Productivity_in_Scotlands_Public_Services_Policy_Lessons.pdf)

for businesses and public bodies which competition has created in the Scottish retail market, and urge it to publish proposals in its forthcoming White Paper which would create a level playing field in the English retail market and strong economic regulatory framework in order that customers may likewise benefit and Business Stream can compete successfully and generate revenues in England.

39. The aim should be to have a single retail market covering the non-domestic sector in Scotland and England. This would enable businesses and public organisations with sites around the UK to choose a single supplier, increasing competition, encouraging innovation and generating efficiencies in the market.

**Q23 (Areas to Modernise):** Do respondents have any comments about the areas identified, or any others relating to the water environment, and the best way to modernise them?

40. Scottish Water should consult full with SEPA in developing best practice.

**Q24 (Building a Hydro Nation):** How could Scotland best develop itself as a hydro nation and take a global lead on water governance?

**Q25 (Building a Hydro Nation):** To what degree should the water centre for excellence, and our wider academic base, focus on providing educational services to the world and capacity building in the water sector?

41. SCDI welcomes the suggestions on Scotland promoting itself as a hydro nation.
42. In SCDI's *Blueprint* for the Scottish economy, we highlight that Scotland could, in the future, attract industries based on the availability of low carbon water supply. The water industry is the largest single energy user in Scotland and has a higher carbon intensity of wastewater treatment than in England. It is important that Scottish Water is financed to invest in renewable energy and energy efficiency. This year's Low Carbon Investment Conference is to cover energy efficiency in greater depth. It would be worth considering whether a future Low Carbon Investment Conference could include a focus on investment in low carbon water supply and the opportunities to attract water intensive industries to Scotland.
43. With Scotland known as a water rich country, its stewardship of its resources and focus on reducing leakage is a positive example and aspect to its reputation.
44. With water as a key concern for many Commonwealth countries, an obvious association between water and water-based sport and, generally, with sport, activity and health, and the example of the Metropolitan Glasgow Surface Drainage Partnership, if Scotland is successful in its bid to host the 2015 World Water Forum, it might be linked with the 2014 Glasgow Commonwealth Games.
45. To develop a hydro nation and further strengthen the academic base, the Scottish Government should consider how schoolchildren might become involved. Potentially this could be through Scotland's eco-schools programme. A

pipeline of young people with appropriate Science, Technology, Engineering and Maths skills will be needed if Scotland is to be a centre of excellence for water.

46. The enterprise networks and Skills Development Scotland should consider how the ambitions articulated in this consultation to develop and promote Scotland internationally as a hydro nation would be reflected their focus on priority sectors.

**Gareth Williams**  
**Head of Policy**  
**Scottish Council for Development and Industry**