EXPLANATORY DOCUMENT TO

THE PUBLIC BODIES (WATER SUPPLY AND WATER QUALITY FEES) ORDER 2012

2012 No. [XXXX]

1. This explanatory document has been prepared by the Department of Environment, Food and Rural Affairs and is laid before Parliament under section 11(1) of the Public Bodies Act 2011.

2. Purpose of the instrument

2.1 The purpose of this instrument is to enable inspectors appointed under the Water Industry Act 1991 (WIA 1991) "the Drinking Water Inspectorate" (DWI) to recover from relevant water suppliers the cost of regulatory work undertaken in relation to the quality of drinking water supplies in England and some parts of Wales by way of a fee charging regime.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None

4. Legislative Context

4.1 The Public Bodies Act 2011 confers powers on Ministers in relation to certain public bodies and offices. Section 4 of the Act enables Ministers to make an order modifying the funding arrangements of bodies or office holders specified in Schedule 4, and this includes conferring power on the office holder to charge fees for the exercise of a function and to determine their amount. Inspectors appointed by the Secretary of State under section 86 of the WIA 1991 are included in Schedule 4.

4.2 The Order provides for a fee to be payable by water undertakers appointed, or water suppliers licensed, under the WIA 1991 ("relevant water suppliers[1]") where the water undertaker's area is wholly or mainly in England. These relevant water suppliers have a duty to comply with the Water Supply (Water Quality) Regulations 2000 (S.I. 2000/3184) ("the 2000 Regulations"). The 2000 Regulations set out EU and national standards for public drinking water supplies and include requirements for relevant water suppliers to ensure that water is wholesome and clean, to take and analyse samples to check for compliance, to investigate failures and to carry out remedial action where water is unwholesome, along with certain reporting requirements. The fee charging regime in the Order will allow the DWI to recover the costs of its regulatory activity under the 2000 Regulations and the WIA.

4.3 Water policy is generally a devolved matter. The Water Supply (Water Quality) Regulations 2010 apply to relevant water suppliers where the water undertaker's area is wholly or mainly in Wales. The 2000 Regulations apply where the water undertaker's area is wholly or mainly in England.

4.4 National Assembly for Wales competence does not extend to the regulation of licensed activities of water suppliers whose supply area is wholly or mainly in England. Welsh Ministers have been consulted and agreed that the order does not require the consent of the National Assembly of Wales.

[1] Updated details of the relevant water suppliers are provided in the annual report of the Chief Inspector for Drinking Water

4.5 This order enables inspectors appointed under the WIA 1991"the Drinking Water Inspectorate" to introduce a charging regime that will apply to relevant water suppliers whose areas of supply are wholly in England or mainly in England but partly in Wales. The charging regime will enable the recovery from the relevant water suppliers the cost of regulatory work undertaken in relation to the quality of drinking water supplies.

4.6 The requirement, in section 9(1)(a) and 9(3)(a) of the act to consult the Scottish Parliament and Northern Ireland Assembly does not apply.

5. Territorial Extent and Application

5.1 This instrument extends to England and Wales.

5.2 This instrument applies primarily in England but also applies to relevant water suppliers where the water undertaker's area is mainly in England but partly in Wales (see paragraph 4.5).

5.3 A corresponding order was laid in Wales on 17 October. That order was identical in terms of effect but applied to relevant water suppliers whose supply area is wholly in Wales or mainly in Wales but partly in England.

6. European Convention on Human Rights

6.1 Richard Benyon, Parliamentary Under-Secretary of State for Natural Environment and Fisheries Department for Environment, Food and Rural Affairs has made the following statement regarding Human Rights:

"In my view the provisions of the Public Bodies (Water Supply Water Quality Fees) Order 2012 are compatible with the Convention rights."

7. Background

- What is being done and why

7.1 The DWI is not an organisation or body; it is a lay term used to describe the Chief Inspector of Drinking Water (and inspectors) appointed under the Water Industry Act 1991 (WIA) by the Secretary of State and the Welsh ministers.

7.2 The DWI is the regulator for drinking water quality and safety. It was formed in 1990 to provide independent assurance that water supplies in England and Wales are safe and drinking water quality is acceptable to consumers. The Inspectorate provides independent scrutiny of relevant water suppliers' activities in relation to supplying water to consumers in England and Wales; works with other stakeholders such as local authorities and the Health Protection Agency for the improvement of both public and private drinking water supplies and the protection of public health respectively; commissions research to build a sound evidence base on drinking water quality regulation; and publishes data on drinking water quality in England and Wales including reporting to EU Commission on compliance with the EU Drinking Water Directive by the UK member state.

7.3 The DWI is entirely funded by Defra, and sits within Defra but differs from other parts of the department in that the role of inspectors and the Chief Inspector is recognised in statute, and they exercise powers delegated directly to them by the Secretary of State through their appointment under the WIA (save where the function has been transferred to the National Assembly for Wales when the same powers are delegated directly by welsh ministers). The Chief Inspector and inspectors act for and on behalf of the Secretary of State in relation to the functions

set out in the WIA to ensure the safety and quality of drinking water. The DWI does this by professional expert assessment of technical data and audits of relevant water supplier assets and operational procedures, taking enforcement action where appropriate including prosecution for offences as set out in the WIA and Water Supply (Water Quality) Regulations 2000.

7.4 The work of DWI can be divided into two areas: regulatory and technical advice to policy functions. The regulatory functions relate to the DWI's statutory role in ensuring relevant water suppliers meet their statutory requirements, and in the discharge of the statutory duties of the Secretary of State and Welsh Government, as set out in the WIA. The policy functions relate to the general powers and duties set out in section 86 of the WIA.

Regulatory functions:
- Technical audits involving the inspection and assessment of relevant water suppliers' water supply arrangements.
- Investigation of water quality events, incidents and other matters.
- Checking compliance with statutory requirements, and legal instruments.
- Technical evaluation of relevant water suppliers' water quality data.
- Investigations of consumer complaints relating to drinking water quality as notified by members of the public, local authorities or businesses.
- Statutory reporting on drinking water quality by relevant water suppliers.

Policy functions:
- Commissioning and management of research programme on drinking water quality and health as evidence base for technical advice roles listed below.
- Providing scientific and technical advice to Ministers, officials in Defra and Welsh Government and local authorities on drinking water issues, policies and standards.
- Assisting with Parliamentary questions on drinking water quality issues.
- Involvement with national, European and international issues and organisations in the development of guidelines and standards for drinking water quality, and measures to improve drinking water safety.

7.5 The recent Water White Paper, drawing on the Cave Review[2], proposes increased competition in the water industry and if this occurs it will add to the complexity of the water supply arrangements nationally, increasing the number of water suppliers that the DWI will be required to regulate.

7.6 Defra proposes to enable the DWI to recover the cost of their regulatory activities directly from relevant water suppliers . This will provide a fair system that ensures that regulatory costs are recovered in proportion to their individual relative regulatory burden.

7.7 The Defra Charging Handbook 2005 provides guidance to facilitate consistent, coherent, transparent and predictable charging for regulatory services across Defra. The overall rationale for charging is that if an industry undertakes an activity that causes (or could potentially cause) an adverse effect on others (such as pollution or risk to public health) which requires regulation, it should face the regulatory cost. This is underpinned by the 'polluter pays' principle set out in the EU Water Framework Directive (2000/60/EC). The role of the water supply industry in supplying safe water supplies is regarded as a fundamental part of public health management.

7.8 The Order will enable the Chief Inspector and inspectors appointed by him or her to recover costs of DWI regulatory activities from relevant water suppliers by way of a charging scheme. A corresponding Order will also be made in Wales.

[2] Independent Review of Competition and Innovation in Water Markets by Prof. Martin Cave, Apr 2009.

7.9 By introducing a charging scheme, DWI will come into line with other related water regulators such as Ofwat and the Environment Agency. DWI will identify the costs of its regulatory services in relation to each of the individual relevant water suppliers for each calendar year. Ofwat, who are aware of the proposed charging scheme, have confirmed to the Chief Inspector that the cost recovery arrangements for the DWI would have little consequence for their price setting processes.

7.10 In practice, the costs borne by the relevant water suppliers may be passed on to consumers as ultimate beneficiaries, subject to application by water suppliers and approval by the economic regulator Ofwat. The benefit to consumers of independent scrutiny by DWI of the drinking water quality they receive will be enhanced public confidence through greater transparency of the differing time (cost) spent by DWI on checking the performance of each of the relevant water suppliers which directly reflects the safety and effectiveness of each of the water suppliers assets and water supply management arrangements.

7.11 DWI have consulted with the water industry on the principles of the scheme to ensure that the needs of the industry are met, in particular the industry's express wish that the process is efficient and does not involve either them or inspectors in any additional administration burdens. Once approval for the scheme is received, DWI will consult the water industry on the details of the scheme and then provide each water supplier with details of when and how the charges will be made, the unit charge for each of the services, and the water supplier's own data that DWI will use to calculate the supplier's invoice. DWI will also publish the details of the scheme on its website.

7.12 Section 8 of the PBA 2011 states that a Minister may make an order under the PBA 2011 only where they consider the order serves the purpose of improving the exercise of public functions, having regard to efficiency, effectiveness, economy and securing appropriate accountability to Ministers.

. <u>Compliance with Section 8 of the Public Bodies Act 2011</u>

7.13 Section 8(1) of the Public Bodies Act 2011 provides that a Minister may make an order under sections 1 to 5 only if the Minister considers that the order serves the purpose of improving the exercise of public functions, having regard to -
(a) efficiency,
(b) effectiveness,
(c) economy, and
(d) securing appropriate accountability to Ministers.

Efficiency
7.14 The charges will directly reflect the work of inspectors in carrying out checks, audits and investigations with the larger or least efficient water suppliers attracting higher charges than the smaller or most efficient water suppliers. Under the current taxpayer funding of inspectors activities no distinction in cost is made in relation to size or the performance of each of the water supplier. Under the new charging scheme the costs of inspectors in relation to each of the water suppliers will be transparent and this will encourage each water supplier to adopt more efficient arrangements for monitoring and managing drinking water quality. This incentive has the potential to reduce the amount of independent checking and auditing required to be carried out inspectors and provide a more cost effective regime.

Effectiveness
7.15 Each water supplier is required by law to monitor the quality of drinking water and make these test results available to DWI together with full technical details of the water suppliers' actions in relation to any adverse result. Water suppliers must also provide consumers with a summary of the test results to consumers and other stakeholders such as local authorities. The

number of tests carried out by each water supplier is directly proportionate to the risk to public health and varies according to the population served and the volume of water supplied. The work of inspectors in scrutinising the results is therefore directly related to the effectiveness of each supplier in carrying out the monitoring and taking action to secure that water quality is satisfactory at all times and that water supply management arrangements are safe.

Economy

7.16 It is vital in the current economic climate that financial savings are made across Government. The Drinking Water Inspectorate is currently funded entirely by Defra, and its costs of operation therefore fall to the taxpayer. Allowing the DWI to charge the industry for its regulatory work will result in a saving to the taxpayer of around £1.9m per year (see Impact Assessment for costings) and will contribute towards Defra's planned saving in the current spending review. On the introduction of the charging scheme the relevant water suppliers may be able to pass the costs onto customers, subject to individual water suppliers decisions as to whether to meet the costs directly or seek approval to pass on the costs to consumers from the economic regulator Ofwat. If all costs were included in water bills then this would increase the average annual water bill by around 15 pence. Subject to parliamentary scrutiny, the charging regime will be introduced in January 2013 and water suppliers will be invoiced bi-annually.

Securing appropriate accountability to Ministers

7.17 The introduction of a charging regime will not result in any lack of accountability to Ministers The Chief Inspector is appointed by ministers and is directly accountable to ministers for the exercise of various functions relating to drinking water quality set out in the Water Industry Act 1991. Accountability is currently achieved through the publication of an annual report on the activities of both water suppliers and inspectors in relation to drinking water quality together with other reports to ministers on water quality incidents, prosecutions and enforcement actions. The introduction of a charging scheme will provide ministers with new information about the cost of drinking water regulation. The charges for regulatory services will serve as an indicator of the relative efficiency and effectiveness of each of the water suppliers whereas the non chargeable costs of DWI will provide ministers with new information about the cost of enforcement and compliance with EU reporting requirements.

7.18 Section 8(2) of the Public Bodies Act 2011 provides that a Minister may make an order under those sections only if the Minister considers that –

(a) the order does not remove any necessary protection, and
(b) the order does not prevent any person from continuing to exercise any right or freedom which that person might reasonably expect to continue to exercise

7.19 The Minister considers that the conditions in section 8(2) are met. The power to modify funding arrangements which will enable DWI to charge for their regulatory activities will not remove any necessary protection nor prevent any person from continuing to exercise any right or freedom which that person might reasonably expect to continue to exercise.

Discussions in Parliament during passage of the Public Bodies Bill

7.20 The inclusion of the DWI in the Public Bodies Bill was debated in the House of Lords Committee on 7th March 2011 (the relevant text from Hansard can be found at **http://www.publications.parliament.uk/pa/ld201011/ldhansrd/text/110307-0004.htm** columns 1503 - 1508). An amendment had been tabled to remove a group of bodies from the Bill, including the DWI. The House wanted to know why these bodies, who had very significant responsibilities in terms of sustaining and protecting the environment, had been included in the Bill.

7.21 In relation to the DWI, the House was informed that the changes were very minor and removed financial burden from the taxpayer. In light of this the amendment was withdrawn. However, in order to comply with the wishes of the Welsh Government, a Government amendment was tabled which restricted the order-making power of Ministers to the Drinking Water Inspectorate in England. This amendment was agreed.

8. Consultation outcome

8.1 The proposal to enable DWI to recover the cost of its regulatory functions from relevant water suppliers was originally raised in the consultation on the Flood and Water Management Bill in 2009. The questions asked were:

> Do you agree that DWI should introduce charging to recover the cost of their regulatory activities from water companies and licensed water suppliers in line with other water regulators?
> Do you agree with the principle that charges to individual water companies and licensed water suppliers should be proportional to the relative regulatory burden they represent?

The consultation received 642 responses, of which the main respondents were stakeholders such as water suppliers, local authorities, NGOs, consultants, trade associations, private individuals and community groups. Of the 642 responses received, only 50 were in relation to the proposed charging scheme and of those a majority agreed with the proposal. A copy of the summary of responses can be found at http://webarchive.nationalarchives.gov.uk/20100111085541/http://www.defra.gov.uk/corporate/consult/flood-water-bill/responses-summary.pdf
A copy of the page relating to the DWI proposal from the summary document is attached at Annex A.

8.2 The main themes and issues that arose from the consultation responses were:

- Customers would still end up footing the bill and be unlikely to see any reduction in tax burden.
- The charging scheme should be based on the five principles of better regulation; proportionate, transparent, consistent, targeted and accountable
- DWI should ensure it operates in the most efficient and cost effective manner to limit the regulatory burden on companies and customers.
- Ensure these proposed ‘pay as you use’ changes could not perversely encourage water suppliers to hide their potential problems and failures in any effort to reduce costs.

8.3 The provisions however were removed from the draft Bill to reduce its size and was not discussed in Parliament, but the DWI continued to consult and work with the water industry to address the issues raised in the consultation. The provisions were subsequently included in the Public Bodies Bill.

8.4 As initial consultation on the principle of charging had already taken place, it was decided that further consultation on proposals for a charging scheme would be aimed at key stakeholders (such as relevant water suppliers, Ofwat, CCWater and Water UK who represents the water industry).

8.5 The further consultation ran for 6 weeks and was published on both the Defra and DWI websites and was emailed directly to 33 key stakeholders in the water industry. A copy of the consultation document is at Annex B and is also available at http://www.defra.gov.uk/consult/files/dwi-consult-doc-111024.pdf.

8.6 A total of 21 responses to the published consultation letter were received. Twenty respondents supported the proposal for charging in principle, and the approach proposed. Comments received focussed on process matters. Recurring themes included: the importance of a simple, fair to all, transparent and stable system, which minimises the administrative burden on all parties concerned, which encourages appropriate behaviours on the part of the relevant water suppliers, and which provides incentives for relevant water suppliers for efficiency improvements. The respondent who did not support the proposal challenged the general principles of cost recovery policy, specifically disagreeing with the idea that charging improves accountability and did not accept the "polluter pays" principle. The points made were not specific to the DWI scheme. A copy of the summary of response is attached at Annex C and is also available at http://www.defra.gov.uk/consult/files/dwi-consult-summary-120228.pdf

8.7 As the proposals affected a small number of regulated businesses (29) it was considered that as part of this consultation process, in addition to the published consultation document, face to face discussion with representatives of those businesses would provide more focussed responses. For this reason DWI met with the Chief Executive Officers of the regulated businesses and the trade association to discuss the proposals for the scheme and obtain their direct feedback. During this part of the consultation proposals on how the charging scheme could identify and allocate costs across water suppliers were developed including the principle of charging for regulatory activities by reference to a daily rate and for checking sample results by reference to a fee fixed for a standard number of sample results.

8.8 The Welsh Government has undertaken their own consultation.

9. Guidance

9.1 DWI will provide guidance to the water industry in the form of an Information Letter to Board Level Contacts in each business in line with established ways of working with the water industry.

10. Impact

10.1 The impact on business.
The charging system will be designed to be broadly cost reflective at the level of the individual, site or firm. A business that requires only light regulation (and therefore gives rise to few costs for the regulator) should generally pay lower charges than a business that needs frequent or more detailed interventions by the regulator.

10.2 The impact on the public sector.
In practice, the costs borne by water companies may be passed on to consumers as ultimate beneficiaries, subject to water companies decisions and approval by the economic regulator Ofwat. Consumers will continue to derive benefit from the independent validation and verification by DWI of the drinking water quality they receive from water companies. Ultimately therefore there will be a transfer of funding from taxpayers to water bill payers. Whilst this involves a switch from a progressive fundraising system (i.e. one which is scaled by ability to pay) to one which is more regressive, because the aggregate costs to be recovered are relatively small compared with other chargeable costs, the impact on individual consumers' bills will be less than a 0.1% increase (around 15 pence per annum). Given this, and the fact that water companies will soon be able to consider social tariff schemes to assist those with the most significant affordability issues, we judge the equity impacts arising from the proposal to be negligible.

10.3 A copy of the Impact Assessment is attached to this memorandum at Annex D.

11. Regulating small business

11.1 The legislation will apply to all relevant water suppliers (none of these are classified as micro businesses) and does not apply to small businesses

12. Monitoring & review

12.1 The operation of the charging scheme will be assessed in June 2015 by Defra and Welsh Government. Although it has not yet been decided how the scheme will be assessed, its aim will be to ensure that it is achieving its desired outcomes that it was designed to achieve and if necessary make any required adjustments.

13. HM Treasury

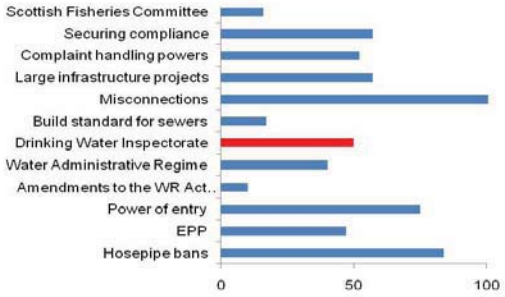
13.1 HM Treasury have been involved with this proposal and the drafting of the order from a very early stage and have provided written confirmation that they are content with both the proposal and the draft order.

14. Contact

14.1 Jeni Colbourne at the Drinking Water Inspectorate, Department of Environment, Food and Rural Affairs. (Tel: 0300 068 6424 or email: jeni.colbourne@defra.gsi.gov.uk) or Peter Jiggins at Department of Environment, Food and Rural Affairs (Tel: 0207 238 5897 or email: peter.jiggins@defra.gsi.gov.uk) can answer any queries regarding the instrument.

3.23 Drinking Water Inspectorate recovery of charges

Fifty responses commented on this section. The majority agreed with the proposals.



Question 151: Do you agree that DWI should introduce charging to recover the cost of their regulatory activities from water companies and licensed water suppliers in line with other water regulators?; and

Question 152: Do you agree with the principle that charges to individual water companies and licensed water suppliers should be proportional to the relative regulatory burden they represent?

Key issues raised by stakeholders included concerns that customers would still end up footing the bill and are unlikely to see any reduction in their tax burden.

Others suggested that the charging scheme should be based on the five principles of better regulation; i.e. it should be proportionate, transparent, consistent, targeted and accountable; and that the DWI should ensure it operates in the most efficient and cost effective manner to limit the regulatory burden on companies and customers.

Respondents looked for formal confirmation that these proposed 'pay as you use' charges could not perversely encourage water companies to hide their potential problems and failures in an effort to reduce costs.

Annex B

Department for Environment, Food and Rural Affairs

October 2011

Proposal for the recovery of costs by the Drinking Water Inspectorate

Contents

The proposal.....1

Background.....1

Reasons for the proposal.....2

The Costs involved (including administrative burden).....3

The benefits of the proposal.....3

Implementation matters.....4

Questions.....5

The proposal

To update details on the implementation of a cost recovery scheme by DWI that will enable it to recover the cost of its regulatory functions from water companies.
The scheme will provide the Secretary of State and Welsh Ministers (and therefore the Chief Inspector appointed to act on their behalf) with the power to recover costs of DWI regulatory activities by way of a charging scheme. It is proposed that the Welsh Order will enable Welsh Ministers to make Regulations to allow charging in relation to water companies whose supply area is wholly or mainly in Wales and the English Order provides the same power for the Secretary of State in respect of water companies whose supply area is wholly or mainly in England. Following an informal consultation in the Autumn,

It is proposed that the Orders will come into force on 1st January 2013.

Publication of this consultation paper initiates a 6 week period during which the DWI will be seeking the views of the water industry and any organisation or individual who may have a personal or professional interest in the charging scheme. The consultation will run from 24th October 2011 to 5th December 2011.

Please send your responses to this consultation to dwi.consultation@defra.gsi.gov.uk by **5th December 2011.**

Background

The Drinking Water Inspectorate (DWI) was established in 1990 as the drinking water quality regulator for the privatised water industry. All inspectors, including the Chief Inspector, are appointed under section 86 of the Water Industry Act 1991.

The Chief Inspector of Drinking Water exercises the powers of the Secretary of State and Welsh ministers as set out in the Water Industry Act 1991 (as amended by the Water Act 2003) in relation to the safety and quality of drinking water. DWI does this by means of technical audit of

water company assets and operational procedures, taking enforcement action where appropriate including prosecution for offences as set out in the Act and Water Supply (Water Quality) Regulations.

The Chief Inspector also acts for Ministers in relation to enforcing that local authorities take action as set out in the Private Water Supply Regulations in relation to private water supplies. The Chief Inspector is responsible for publishing drinking water reports and providing the European Commission with data demonstrating compliance by the UK with the EC Drinking Water Directive. Similar arrangements exist in Scotland and Northern Ireland and the Chief Inspector discharges these duties for the member state through a Memorandum of Understanding with her equivalents in Scotland and Northern Ireland. The Chief Inspector (and inspectors) exercises these powers independently of Ministers.

DWI operates a risk based approach to technical audits of water companies and their drinking water supply arrangements. The regulatory activity applicable to each water company and each licensed water supplier is governed by the potential risk of its activities to public health. Regulatory monitoring for compliance with EU law is already risk based with the number of tests required varying according to the volume of water supplied/population served. The activity levels applicable to each company/licensed supplier will therefore vary, and will also change over time relative to the risks, and by the outcome of regulatory monitoring. The number and type of licensed water suppliers may also change according to competitive market forces and Government policy.

Reasons for the proposal

The Hampton Review of 2005 on good regulatory practice included a specific recommendation that regulators should be more accountable for the way in which they undertake their delivery functions. Defra and the Welsh Government consider that providing a mechanism for DWI to recover the costs of its delivery functions from the water industry will assist in achieving this recommendation.

A significant proportion of DWI activity relates to monitoring the way water companies meet their regulatory requirements through technical audit and associated activities. As it is the water industry who benefits from these regulatory services, they should bear the cost of providing that service.

The proposed charging scheme would also apply the following strategic principals:

- **The polluter, risk owner or beneficiary pays -** The polluter or risk owner should bear the costs of any measures to prevent harm that they might otherwise cause by their actions or non-actions, including the cost of monitoring regimes. This provides incentives for the development and adoption of less damaging methods and practices.

- Charges paid by the individual or firm should broadly reflect the cost incurred by the regulator in regulating that firm or individual - The charging system will be broadly cost reflective at the level of the individual, site or firm. A business that requires only light regulation hence gives rise to few costs for the regulator should generally pay lower charges than a business that needs frequent or more detailed interventions by the regulator.

By introducing a charging scheme, DWI will come into line with other related water regulators such as Ofwat and the Environment Agency and also the Consumer Council for Water (a consumer body), all of which charge for their regulatory activities. This proposal also brings the arrangements for DWI in line with general policy on charging, which is that businesses which benefit from regulation, not the taxpayer, should bear the cost of regulation.

The charging scheme will result in proportionate charges on water companies based on the level of technical audits and inspections involved. This will create a financial incentive for water companies to improve their water safety management.

The Costs involved (including administrative burden)

The estimated annual cost of the regulatory functions undertaken by DWI on behalf of the water industry is estimated at around £1.9m per annum.

Water companies may pass the charges onto their water customers, who are the main beneficiaries of the regulatory work (wholesome drinking water). It is estimated that if water companies did pass this cost on to customers, the average annual water bill could increase by around 15 pence.

The administrative burden on industry arising from this proposal are negligible.

The benefits of the proposal

The benefits of this option are that it:

- will assist DWI in achieving one of the Hampton Review's recommendation that regulators should be more accountable for the way in which they undertake their delivery functions.

- will create a financial incentive for water companies to improve their water safety management.

- brings the arrangements for DWI in line with general policy on charging.

Implementation matters

A significant proportion of DWI activity relates to scrutinising the way water companies (including licensed water suppliers and inset appointees) meet their regulatory requirements through technical audits and inspections. As it is the water industry which benefits from these regulatory services, the proposal to introduce a charging scheme would bring the arrangements for DWI in line with general policy on charging, which is that businesses which benefit from regulation, not the taxpayer, should bear the cost of regulation.

The charging scheme would provide a financial incentive for water companies to improve their procedures for water safety management. As companies will be paying for the technical audit services and inspections they receive, they will balance these costs against management measures which would lead to fewer technical audits and inspections and so potentially reduce the overall cost.

By introducing a charging scheme, DWI will come into line with other related water regulators such as Ofwat and the Environment Agency (EA) and also the Consumer Council for Water (CCWater) which is a consumer body, who all charge for their regulatory activities. All three regulators recover their costs through the licensing regime (which is statutory). It is proposed that DWI will develop a system to identify the costs of their regulatory services in relation to each of the individual water companies and licensed suppliers which will allow cost recovery to be apportioned fairly to individual water companies and licensed suppliers.

Proposals to enable DWI to recover the cost of its regulatory functions from water companies were raised previously in the consultation on the Flood and Water Management Bill in 2009. However, the provisions were removed from the final session of the Bill to reduce its size. This consultation advises that the proposals have now been included in the Public Bodies Bill, and addresses the implementation of those proposals.

The implementation of the proposal is dependent on the outcome of parliamentary scrutiny of the Public Bodies Bill, and it receiving Royal Assent. If enacted, the Public Bodies Bill will provide the required primary legislation that provide powers for DWI to introduce a charging scheme. The scheme itself would be introduced by way of an Order made under this general charging power.

The proposed charging scheme will apply to all water companies and licensed suppliers. Each company/supplier will pay for the technical audit services and inspections they receive, therefore it is not considered to impose a discriminatory burden on small firms.

As explained in the previous consultation, those regulatory functions for which it is proposed to recover costs include:

- Technical audits involving the inspection and assessment of water companies' water supply arrangements.
- Investigation of water quality events and incidents.
- Checking compliance with statutory requirements, and legal instruments.
- Technical evaluation of water companies' water quality data.
- Investigations of consumer complaints relating to drinking water quality as notified by members of the public, local authorities or businesses.
- Statutory public reporting on drinking water quality.

Questions

1. **Do you have any comments on the proposals for implementation of a cost recovery scheme by DWI that will enable it to recover the cost of its regulatory functions from water companies?**

© Crown copyright 2011

You may re-use this information (not including logos) free of charge in any format or medium, under the terms of the Open Government Licence. To view this licence, visit www.nationalarchives.gov.uk/doc/open-government-licence/ or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or e-mail: psi@nationalarchives.gsi.gov.uk

Annex C

www.defra.gov.uk www.dwi.gov.uk

Summary of responses to the consultation on proposals for the recovery of costs by the Drinking Water Inspectorate

February 2012





Contents

Background 2
Analysis of responses 2
The way ahead 4
Appendix 1 5

Background

The Drinking Water Inspectorate (DWI) was established in 1990 as the drinking water quality regulator for the privatised water industry.

Proposals to enable DWI to recover the cost of its regulatory functions from water companies were raised in the consultation on the Flood and Water Management Bill in 2009. However, the provisions were removed from the final session of the Bill to reduce its size. The proposals were subsequently included in the Public Bodies Bill, and addressed the implementation of those proposals.

Consequently, a further non-formal consultation was undertaken from 24th October 2011 to 5th December 2011 to seek views on the proposal for DWI to develop a system to identify the costs of their regulatory services in relation to each of the individual water companies and licensed suppliers that would allow cost recovery to be apportioned fairly to individual water companies and licensed suppliers.

The question posed in this consultation was:

1. **Do you have any comments on the proposals for implementation of a cost recovery scheme by DWI that will enable it to recover the cost of its regulatory functions from water companies?**

Analysis of responses

Number and detail of those that responded

The consultation was available on both the Defra and DWI websites. In addition, 33 key stakeholders in the water industry were emailed directly notifying them of the consultation. A total of 21 responses were received. A list of the organisations who responded can be found below in Appendix 1.

Summary of responses

Overall views

- Nearly all respondents supported the proposal for charging in principle, and the approach proposed.
- There was recognition by many respondents of some common themes: the importance of a simple, fair to all, transparent and stable system, which minimises the administrative burden on all parties concerned, but which did not encourage inappropriate behaviours on the part of the water companies, and which provided incentives for water companies for efficiency improvements .
- It was pointed out by one respondent that DWI accountability did not require an extension to cost recovery, although they were supportive of the principles for better regulation outlined in the Hampton review

Points made by respondents

1) Principle of cost recovery

- The point was made that the link between accountability and cost recovery was not clear, and that it was not immediately apparent how this particular recommendation from the Hampton review would be achieved.
- One respondent did not agree that Regulator accountability extended to cost recovery or that the 'polluter pays' principle applies to water companies in this particular context

2) Cost recovery process

- The point was made that impact /effectiveness studies involving stakeholders would be welcomed, and the proposal to facilitate further stakeholder audits was welcomed to facilitate transparency and accountability for both the charging process and for the overall costs.
- It was suggested that a list of included and excluded activities for charging should be available
- A respondent pointed out that DWI activity relating to private supplies should not be included.
- It was suggested that statutory public reporting should not be included in any charging mechanism as this is a duty undertaken on behalf of the Secretary of State.
- A number of respondents made the point that costs for dealing with events and audits should reflect the severity of the issue under investigation. A respondent stated that costs relating to Inspector training should not be included.
- A number of companies commented on the timing of the proposals, noting that this would be an unfunded cost for water companies, as it sat outside the funding provisions for the current price review cycle. In addition, there may be internal funding issues associated with the timing of charging in the last quarter of 2012/2013 where budgets have already been set.
- It was suggested there should be an appeals process in place as part of any charging mechanism.
- Some inset appointees and smaller water companies noted the potential for them to incur what they considered might be disproportionately high charges.
- Some respondents noted to need to clarify with Ofwat how funding provision might be included in business plans.

3) Mechanism for charging

- Several respondents were of the view that consideration should be given to operating on a fixed cost basis only to minimise administrative burden, and that if a variable cost element is to be included it should relate only to those activities arising from water quality events and/or compliance failures. There were a number of refinements suggested on this theme. One respondent suggested that all costs be treated as variable.
- It was noted that using the number of compliance samples as a basis for the fixed element of the charge would better reflects the level of DWI activity, and also that the data is readily available.
- A respondent suggested the use of financial turnover as a basis for the fixed element of the charge as it reflects company efficiency.
- Several respondents noted the need to ensure stability in DWI revenues.

The way ahead

Defra proposes to make enabling regulations based on the technical content in the consultation draft. The points made by respondents will be considered further to refine the processes and mechanisms for charging.

Appendix 1

List of respondents to the consultation

Water UK
OFWAT
CCWater
Dee Valley Water
South West Water
Northumbrian Water
Albion Water
Sembcorp Bournemouth Water
Severn Trent Water
SSE
Albion Water
United Utilities
Anglian Water
Portsmouth Water
Veolia Water East
Veolia Water South East
Veolia Water projects
South Staffordshire Water
Thames Water
Yorkshire Water
Dwr Cymru Welsh Water

© Crown copyright 2012

You may re-use this information (not including logos) free of charge in any format or medium, under the terms of the Open Government Licence. To view this licence, visit www.nationalarchives.gov.uk/doc/open-government-licence/ or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or e-mail: psi@nationalarchives.gsi.gov.uk

This document/publication is also available on our website at:
http://www.defra.gov.uk/consult/2011/10/24/dwi/
Any enquiries regarding this document/publication should be sent to us at:
dwi.consultation@defra.gsi.gov.uk

Annex D

Title:
Drinking Water Inspectorate Charging Scheme for England
IA No: Defra 1382

Lead department or agency:
Defra

Other departments or agencies:

Impact Assessment (IA)

Date: 23/02/2012

Stage: Final

Source of intervention: Domestic

Type of measure: Secondary legislation

Contact for enquiries:
Tracy Westell/Milo Purcell

Summary: Intervention and Options

RPC Opinion: GREEN

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
-£1.021m	-£12.834m	£1.407m	No	NA

What is the problem under consideration? Why is government intervention necessary?

Defra currently funds the Drinking Water Inspectorate (DWI) for both its regulatory and policy functions; it now proposes to enable DWI to recover the costs of its existing regulatory functions from the water industry. This proposal brings the funding arrangements for the DWI in line with general government policy on charging, which states that businesses which benefit from regulation should bear the cost of regulation, not the taxpayer. Also, the Hampton Review 2005 included a specific recommendation that regulators should be more accountable to those who benefit from their delivery functions.

What are the policy objectives and the intended effects?

The proposal will:
- make DWI more accountable to those who benefit from its regulatory functions;
- make DWI funding more transparent;
- contribute around £2.0m per annum saving in the current spending review and reduce future pressures.

The proposal will also bring DWI in line with the cost recovery mechanisms for other water regulators (Ofwat, Consumer Council for Water and the Environment Agency).

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Option 0: Do nothing
Option1: Enable cost recovery for existing services using basic methodology.
Option 2: Provide the regulatory service through the private sector.
Defra's preferred option is Option 1 which will enable DWI to recover the cost of its existing regulatory functions from water companies. It is also consistent with the views of water companies that the scheme should be as simple as possible. Although the option involves a modest net cost of around £1m, this is judged to be more than outweighed by the non-monetised benefits of aligning the charging of DWI services to those who benefit.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 06 2015

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** **No**	**< 20** No	**Small** **Yes**	**Medium** **Yes**	**Large** **Yes**
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible SELECT SIGNATORY: ..... Date: .....

Summary: Analysis & Evidence

Policy Option 1

Description: Option 1: Introduce a charging scheme using basic methodology

FULL ECONOMIC ASSESSMENT

Price Base Year 2011	PV Base Year 2010	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: n/a	**High:** n/a	**Best Estimate:** -1.02

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	n/a		n/a	**n/a**
High	n/a		n/a	**n/a**
Best Estimate	0		1.7	**13.86**

Description and scale of key monetised costs by 'main affected groups'

Average annual costs are £1.7m. This is made up of additional administrative costs of £200K in the first two years, then £100K thereafter, as well as £2.0m in charges raised from the water industry (from year 3 onwards). Over 10 years, the total cost has a net present value of £13.9m. The majority of this is the cost of the charges raised on industry (a cost to business with a net present value of £12.8m or £1.5m as an annualised cost (£1.4m as an EANCB at 2009 prices).

Other key non-monetised costs by 'main affected groups'

The cost to water companies and licensed water suppliers of reviewing and processing a bi-annual invoice from the DWI are negligible and not monetised. No additional data/administrative costs are incurred.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	n/a		n/a	**n/a**
High	n/a		n/a	**n/a**
Best Estimate	0		1.5	**12.83**

Description and scale of key monetised benefits by 'main affected groups'

Benefits are the reduced cost to government arising from transferring the annual funding of DWI operations to the industry. This exactly offsets the increased cost to the industry (£12.8m in total PV terms, or £1.5m as an annualised cost).

Other key non-monetised benefits by 'main affected groups'

The DWI will be able to inform the public on how well water companies have progressed with their drinking water safety management. Improved independence of DWI in relation to its regulatory budget & improved accountability of DWI in relation to the water industry and consumers – through approval mechanism on proposed charges.The proposed system will encourage water companies to help deliver lighter touch regulation as charges will reflect their respective regulatory burden.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

- changes to DWI governance and support arrangements might affect the charging regime but none are planned presently
- uncertainties regarding future market reform – plans unknown, but the proposal is sufficiently flexible to adapt to expansion of competition in the sector
- DWI future efficiency [see evidence base for safeguards]

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 1.41	**Benefits:** 0	**Net:** 1.41	No	NA

Summary: Analysis & Evidence

Policy Option 2

Description: Option 2: Provision of the regulatory service through the private sector

FULL ECONOMIC ASSESSMENT

Price Base Year n/a	PV Base Year n/a	Time Period Years n/a	Net Benefit (Present Value (PV)) (£m)		
			Low: n/a	**High:** n/a	**Best Estimate:** n/a

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	n/a		n/a	**n/a**
High	n/a		n/a	**n/a**
Best Estimate	n/a		n/a	**n/a**

Description and scale of key monetised costs by 'main affected groups'

The costs of this option have not been monetised (see below).

Other key non-monetised costs by 'main affected groups'

Much water monitoring activity is already delivered in conjunction with water and other private sector companies and the elements of the regulatory process which remain with DWI are judged to be too specialised to be economically viable for the private sector. Even if viable, the delivery of these functions privately would compromise the residual DWI's ability to deliver policy advice and may impact on public confidence (see risks). Monopoly providers may still need some regulation.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	n/a		n/a	**n/a**
High	n/a		n/a	**n/a**
Best Estimate	n/a		n/a	**n/a**

Description and scale of key monetised benefits by 'main affected groups'

This benefits of this option have not been monetised.

Other key non-monetised benefits by 'main affected groups'

This option might, if viable, deliver small further efficiency benefits and savings compared with Option 1 - but overall is not felt to viable for the reasons given above.

Key assumptions/sensitivities/risks — **Discount rate (%)** n/a

See Option 1. In addition, a key risk of this option is that the transfer of remaining public responsibilities within the drinking water regulatory regime to the private sector would compromise the independence of operations and impact on public confidence and health.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: n/a	**Benefits:** n/a	**Net:** n/a	No	NA

Evidence Base (for summary sheets)

Background

The DWI was established in 1990 as the drinking water quality regulator for the privatised water industry. All inspectors, including the Chief Inspector of Drinking Water, are appointed under section 86 of the Water Industry Act 1991 ("the WIA").

The DWI differs from ordinary divisions in Defra in that the role of inspectors and the Chief Inspector is recognised in statute, and they exercise powers delegated directly to them by the Secretary of State. The Chief Inspector exercises the powers of the Secretary of State and Welsh ministers as set out in the WIA (as amended by the Water Act 2003) in relation to the safety and quality of drinking water. The DWI does this by means of technical audit of water company assets and operational procedures, taking enforcement action where appropriate including prosecution for offences as set out in the WIA and Water Supply (Water Quality) Regulations 2000 (as amended).

The Chief Inspector also acts for the Secretary of State in relation to enforcing that local authorities take action as set out in the Private Water Supply Regulations 2009 in relation to private water supplies. The Chief Inspector is responsible for publishing drinking water reports and providing the European Commission with data demonstrating compliance by the UK with the EC Drinking Water Directive 98/83/EC. Similar arrangements exist in Scotland and Northern Ireland and the Chief Inspector discharges Secretary of State duties as member state through a Memorandum of Understanding with her equivalents in Scotland and Northern Ireland. The Chief Inspector (and Inspectors) exercises these powers independently of Ministers.

DWI undertakes a range of statutory and non-statutory roles. The work of DWI can be divided into activities that stem from its statutory role in ensuring water companies meet their statutory requirements, and in the discharge of the statutory duties of the Secretary of State and Welsh Government, as set out in the WIA, and those that support policy functions.

Regulatory functions:

- Technical audits involving the inspection and assessment of water companies' water supply arrangements.
- Investigation of water quality events and incidents.
- Checking compliance with statutory requirements, and legal instruments.
- Technical evaluation of water companies' water quality data.
- Investigations of consumer complaints relating to drinking water quality as notified by members of the public, local authorities or businesses.
- Statutory public reporting on drinking water quality.

Policy functions:

- Commissioning and management of research programme on drinking water quality and health as evidence base for technical advice roles listed below
- Providing scientific and technical advice to Ministers and officials in Defra and Welsh Government on drinking water issues, policies and standards
- Assisting with Parliamentary questions on drinking water quality issues
- Involvement with national, European and international issues and organisations in the development of guidelines and standards for drinking water quality, and measures to improve drinking water safety

Although DWI's budget falls within the Water, Floods, Environmental Risk and Regulation Directorate's total programme allocation, the Secretary of State is ultimately responsible for allocating resources to DWI, and is accountable to Parliament for that expenditure. Therefore, currently, tax payers fund both DWI's regulatory functions and policy functions.

Problem under consideration

When DWI was set up it was funded by the taxpayer. Although administratively simple, it is not the solution that most appropriately reflects the principles of a market for drinking water quality. It does not reflect the polluter or risk owner or beneficiary pays principle, and creates moral hazard in the industry to the extent that water companies do not have as full a stake as they might in the costs of regulating drinking water quality.

Also, the Hampton Review of 2005 included a specific recommendation that regulators should be more accountable to those who benefit from their delivery functions. Defra considers that providing a mechanism for the DWI to recover the costs of its existing regulatory functions from the water industry will assist in achieving this recommendation by linking directly the costs incurred by the regulator to the activities associated with individual water companies. This will improve transparency on funding arrangements. DWI has a good record in respect of other Hampton recommendations and demonstrates very good compliance with the expectations of the Regulators' Compliance Code, as recorded by the BIS/BRE report of its review of DWI dated March 2010. This review focussed on an assessment of regulatory performance against Hampton principles and Macrory characteristics of effective inspection and enforcement.

Furthermore, the Cave Review into competition in the water industry is expected to lead, over time, to an increase in the number of water suppliers, and therefore an increase in the work faced by DWI. It is anticipated that this, along with increased numbers of inset appointees throughout England and Wales, will increase the extent of DWI regulation in these sectors. Enabling DWI to recover the cost of their regulatory activities directly from water undertakers (including inset appointees) and licensed water suppliers will provide a fair system that ensures that regulatory costs are recovered in proportion to their individual relative regulatory burden.

Rationale for intervention

Water customers suffer from the problem of asymmetric information. They cannot obtain information themselves on the quality of drinking water supplied to them as many aspects of drinking water quality are unobservable at the point of use. Health effects may take hours, weeks or even decades to have an impact and may be difficult to attribute to water consumption. This is compounded by the fact that (with the exception of some business customers) they receive supplies from monopoly providers and they are therefore unable to signal their preferences regarding drinking water quality by switching suppliers. Government intervention is required to police drinking water quality and this is effectively the rationale for DWI itself and the rationale for extensive statutory monitoring.

However, a significant proportion of the DWI's activities relates to monitoring the way water companies meet their regulatory requirements through technical audit and associated activities. As it is the water industry and their customers that benefit from these regulatory services, they should bear the cost of the service they receive.

Enabling DWI to change the way its regulatory functions are funded [from water companies rather than the Exchequer] will add to the increased independence of DWI within government which is important for industry and consumer confidence. DWI already has its own budget; it has separate accommodation from the Defra policy division; produces an independent annual report; and the Chief Inspector of Drinking Water, appointed by the Secretary of State and Welsh Ministers, has specific independent powers on enforcement and prosecution.

By introducing a charging system, DWI's position will be consistent with that of other water industry regulators, Ofwat and the Environment Agency, and with the Consumer Council for Water.

Policy objective

The Defra Charging Handbook 2005 provides guidance to facilitate consistent, coherent, transparent and predictable charging for regulatory services across Defra. The overall rationale for charging is that if an industry undertakes an activity that causes (or could potentially cause) an adverse effect on others (such as pollution or risk to public health) which requires regulation, it should face the regulatory cost. The role of the water supply industry in supplying safe water supplies is regarded as a fundamental part of public health management.

In addition, the proposed scheme to recover actual costs incurred will assist in meeting three of the Handbooks strategic principles:

The polluter, risk owner or beneficiary pays - The polluter or risk owner or beneficiary should bear the costs of any measures to prevent harm that they might otherwise cause by their actions or non-actions, including the cost of monitoring regimes. For drinking water supplies, the actions necessary to mitigate pollution and protect consumers are undertaken by water companies, and regulated by DWI. The risks are owned and managed by water companies, who are required by legislation to act proactively to mitigate risks to public health and levels of service relating to the quality of water supplies. It is also in the interests of water companies to engage in the process to minimise the impact of significant failures on their reputations and on consumer confidence. The effectiveness of active management of residual risks that impact on water quality as introduced by DWI are well established within the water industry and are known to be cost effective. Furthermore, water companies benefit from the regulatory activities of DWI [examples set out below]. Transparent allocation to individual water companies, rather than to the taxpayer, of DWI's costs for regulating these functions better aligns funding arrangements with this principle.

Aim for full cost recovery - This is the Government's broad policy for services. If policymakers do not plan to recover the full cost of the service they provide, and hence the service is being intentionally subsidised, they will need to justify this decision. This proposal enables DWI to fully recover the costs for its existing regulatory functions, as listed above.

Charges paid by the individual or firm should broadly reflect the cost incurred by the regulator in regulating that firm or individual - The charging system should be designed to be broadly cost reflective at the level of the individual, site or firm. A business that requires only light regulation (and therefore gives rise to few costs for the regulator) should generally pay lower charges than a business that needs frequent or more detailed interventions by the regulator.

This proposal brings the arrangements for the DWI in line with Defra general policy on charging, which is that businesses that benefit from regulation, not the taxpayer, should bear the cost of regulation.

In practice, the costs borne by water companies may be passed on to consumers as ultimate beneficiaries, subject to water companies decisions and approval by the economic regulator OfWAT. Consumers will continue to derive benefit from the independent validation and verification by DWI of the drinking water quality they receive from water companies. Ultimately therefore there will be a transfer of funding from taxpayers to water bill payers. Whilst this involves a switch from a progressive fundraising system (i.e. one which is scaled by ability to pay) to one which is more regressive, because the aggregate costs to be recovered are relatively small compared with other chargeable costs, the impact on individual consumers' bills will be less than a 0.1% increase. Given this, and the fact that water companies will soon be able to consider social tariff schemes to assist those with the most significant affordability issues, we judge the equity impacts arising from the proposal to be negligible.

As the proposal comprises charges for existing regulatory activities, and does not entail a change in regulatory functions, it does not come within the scope of policy on one-in, one-out. This has been confirmed by BRE.

Description of options considered

Option 0 - Do nothing and continue to subsidise the full costs of DWI. This is not compliant with the Hampton Review recommendations, or with the Defra Charging Handbook strategic aims, nor is it consistent with other charging mechanisms of related water regulators. (Note however that under any option, Defra will continue to fund the "policy service" part of DWI which provides advice to Ministers and officials).

Option 1 - Introduce a charging scheme using basic methodology – this is Defra's preferred option. This option will enable DWI to recover the cost of its regulatory functions from water companies. It is also consistent with the views of water companies that the scheme should be as simple as possible, whilst still retaining some basic incentives to reduce the regulatory burden by maintaining performance with statutory obligations.

Consideration was also given to introduce a charging scheme using more detailed methodology. However, when consulted, the clear view of water companies was that the sums to be raised through this charging process were very small (at around £2m over the whole industry per annum) in relation to wider industry costs, and that the charging regime burden should reflect this. Thus, minimising data submissions and administrative costs would be of greater benefit for both them and customers than the potential financial incentives to be gained from a more complex incentivisation mechanism. Some companies noted that the reputational impact of regulatory underperformance would be of far greater significance than the direct financial costs involved.

In summary, whilst a very complex charging method could be designed, the preference is for a simpler one, with some incentives but which gives water companies and DWI necessary certainty. It is also noted that other water industry regulatory charging options (e.g. for Ofwat and CC Water) are simply defined.

Cost recovery will recover costs incurred based on a two part charge: a charge using the number of tests for compliance purposes reported by each water company, which directly relates to DWI workload for each company on routine checking and monitoring; and a charge based on water company performance – reflecting directly the allocation of DWI's resources to deal with underperformance using a risked based approach, principally in investigating and reporting on compliance failure, incident management and technical audit.

Option 2 - Provision of the regulatory service through the private sector. This option was considered, but was not assessed quantitatively for the following reasons. The current regulatory model for drinking water quality has in place substantial private sector involvement. For example, delivery of the statutory monitoring (water sampling and analysis) that is required by the Water Supply (Water Quality) Regulations 2000 (as amended) has already been vested in water companies as a recoverable cost that is passed on to consumers through their water bills. It is integrated with process control and operational management requirements, and the estimated cost of these combined functions across all water companies in England and Wales is £500m pa.

Also, the quality assurance arrangements necessary to ensure the integrity of this substantial monitoring and control programme are conducted by co-regulation, involving bodies such as the United Kingdom Accreditation Service [the sole national accreditation service recognised by Government]; the analytical service industry; and water companies, using an agreed specification put in place by DWI. The remaining elements of regulation retained by DWI provide the minimal oversight necessary to deal with non-compliance by independent enforcement [or prosecution, where necessary], and with public reporting to maintain public confidence. These elements of the regulatory process are so specialised and of low margin that it is not likely to be economically viable for the private sector to deliver.

Finally, the service is critically important for public accountability in the provision of safe clean drinking water, and is fundamental to the protection of public health and maintenance of public confidence in public water supplies. This means that delivery of remaining regulatory functions through the private sector is still likely to need to include at least some oversight, especially if the provider has a high degree of monopoly power. This would impose costs and therefore reduce the already modest financial savings possible from this option. The provision of the regulatory service through the private sector would also inhibit DWI policy support functions as it would not benefit from the wider knowledge and information obtained in the course of regulatory activities undertaken by a separate private organisation. Industry satisfaction with these arrangements appears high, as reported by a recent BRE Hampton Implementation audit of DWI.

Monetised and non-monetised costs and benefits of each option (including administrative burden)

Option 1 - The monetised cost of the regulatory functions undertaken by the DWI on behalf of the water industry is estimated to be £2.0m per annum [Source: DWI; see list of function above]. This would represent a cost transfer to the industry [net economic impact=0] and in practice would be implemented from the third year onwards.

However, net costs arise from provision for transitional set-up costs, estimated by DWI at £200k in FY 11/12 and FY12/13 [to provide administrative and IT arrangements to support charging], and for ongoing

management costs of £100k per annum [for data collation; administrative support; and financial management].

The cost to water companies and licensed water suppliers of reviewing and processing a bi-annual invoice from the DWI are negligible and are therefore not monetised. There are no additional costs relating to data gathering or submissions. The profile of the monetised costs is summarised in the table below.

Summary of monetised costs (undiscounted £,000s)

Year	***1***	***2***	***3***	***4***	***5***	***6***	***7***	***8***	***9***	***10***	***Total***
Admin costs	200	200	100	100	100	100	100	100	100	100	1200
Industry charges*			2000	2000	2000	2000	2000	2000	2000	2000	16000
Total	200	200	2100	2100	2100	2100	2100	2100	2100	2100	17200

* = A transfer and fully offset by savings to government (which comprise the monetised benefits of Option 1)

In line with best practice the monetised impacts have been discounted at an annual rate of 3.5%. This calculation is intended to convert all impacts into a consistent basis on which they can be compared according to social time preference. More information on discounting is available from www.hm-treasury.gov.uk/d/green_book_complete.pdf.

The charging scheme will place proportionate costs on water companies and licensed water suppliers based on the level of regulatory activity involved. Water companies may pass the charges onto water customers, which could result in an increase to the average annual water bill of up to 15 pence.

Offset against the net costs above are the unmonetised benefits arising from the proposed arrangements, which:

- will assist the DWI in achieving one of the Hampton Review's recommendation that regulators should be more accountable to those who benefit from their delivery functions.
- will encourage water companies to improve their drinking water safety management and therefore help to deliver lighter touch regulation as they will be charged in proportion to their own regulatory burden on DWI.
- brings the arrangements for the DWI in line with general policy on charging, and consistent with similar regulatory arrangements within the water industry.
- Contributes to the improved operational efficiency of DWI itself, arising from the greater transparency and public accountability inherent in the scheme.

The DWI operates a risk based approach to technical audits of water companies and their drinking water supply arrangements. The regulatory activity applicable to each water company and each licensed water supplier is governed by the potential risk of its activities to public health. Regulatory monitoring for compliance with EU law is already risk based with the number of tests required varying according to the volume of water supplied/population served. The activity levels applicable to each company/licensed supplier will therefore vary, and will also change over time relative to the risks, and by the outcome of regulatory monitoring. The number and type of licensed water suppliers may also change according to competitive market forces and Government policy.

Risks and assumptions

Risks include:

- changes to DWI governance and support arrangements may impact on the charging regime – but none are planned presently
- uncertainties regarding future market reform – plans are currently unknown, but the proposal is sufficiently flexible to adapt to expansion of competition in the sector
- potential inefficiency in DWI operations leading to increased costs. Safeguards to ensure DWI's on-going efficiency include
    - Public reporting of water company and DWI performance in the annual Chief Inspector's report
    - Defra governance oversight, as per existing arrangements
    - Defra internal audit, as per existing arrangements
    - BRE audit and the Regulators Compliance Code, regular assessment and public reporting arrangements
    - Stakeholder audit by invitation, continuing current practice of inviting water companies to carry out their own audit of DWI activities and performance

Assumptions include:

- That DWI remains within Defra for accommodation and administration/services support.
- Although a sunset clause does not apply to this scheme, it is proposed that the effectiveness of the arrangements will be reviewed in June 2015.

Wider impacts

Economic/Financial

The proposed charging scheme will apply to all water companies and licensed suppliers (none of these are classified as micro businesses). Each company/supplier will pay the costs incurred for the checking and monitoring, and technical audit services and inspections they receive, therefore not imposing a discriminatory burden on small firms/businesses.

Water companies and licensed water suppliers may pass the charges onto their water customers, who are the main beneficiaries of the regulatory work (wholesome drinking water). It is estimated that if water companies did pass this cost on to customers, the average annual water bill could increase by around 15 pence.

Social

There are no social impacts or additional impacts on rural areas.

Environmental

The overall rationale for charging is that if an industry undertakes an activity that causes an adverse effect on others (such as pollution or risk to public health) which requires regulation, it should face the regulatory cost. The role of the water supply industry in supplying safe water supplies is regarded as a fundamental part of public health management.

The water industry meets the cost of the statutory direct monitoring (water sampling and analysis) that is required by the Water Supply (Water Quality) Regulations 2000 (as amended). A significant proportion of the DWI's activities relates to monitoring the way water companies meet their regulatory requirements through technical audits and associated activities. As it is the water industry and its customers that benefit from these regulatory services, they should bear the cost of the regulatory services provided.

The regulatory service is fundamental to the protection of public health in the provision of safe clean drinking water and to the maintenance of public confidence in public water supplies.

Water companies benefit from:

- Consistent, authoritative interpretation of regulatory requirements that facilitates a level playing field for all participants;
- Provision of guidance on matters of good practice; and
- Public confidence in an industry vital to social and economic wellbeing that accrues from independent scrutiny of functions that are substantially self-regulated and co-regulated by private sector organisations.

Consumers benefit from:

- The contribution of regulation to the consistent delivery of statutory obligations that brings focus on outcomes;
- Timely and proportionate independent investigation and public accountability when failure occurs;
- Regular, transparent and efficient provision of information verified by an independent source; and
- Assurance that there is an independent advocate for their interests in drinking water quality matters.

This proposal is consistent with the principle of a sustainable economy.

Consultation

The DWI charging scheme proposal was originally included in the formal consultation on the Floods and Water Management Bill in 2009. Stakeholders such as water companies, local authorities, NGOs, the agriculture sector, trade associations, private individuals and community groups were the main respondents. A majority of responses agreed with the proposal (only 9% disagreed with the proposal) and there were no significant issues requiring revision in the proposed policy. The main issues identified by the consultation were:

1) The charging scheme should be based on the five principles of better regulation; proportionate, transparent, consistent, targeted and accountable
2) DWI should ensure it operates in the most efficient and cost effective manner to limit the regulatory burden on companies and customers.
3) Look for formal confirmation that these proposed incentives for lighter touch regulations would not result in perverse outcomes by encouraging water companies to hide their potential problems and failures in any effort to reduce costs.

These issues have been taken into account in the final proposal. In particular, regarding issue 3 above, DWI will continue to be vigilant through its audit and inspection processes to ensure water suppliers meet their statutory responsibilities, and it has the powers to take enforcement action to deal with underperformance, if needed.

An informal consultation, in the form of meetings and stakeholder workshops for water companies and licensed suppliers, Ofwat, CCWater and Water UK, who represents the water industry, began on 24th October and ran for 6 weeks, closing on 5th December 2011. As industry were already aware and supportive of this proposal, no specific issues were raised.

Summary and preferred option with description of implementation plan

Currently Defra funds both the regulatory functions and the policy and technical advice functions undertaken by the DWI. However, a significant proportion of the DWI's activities relate to scrutinising the way water companies (including licensed water suppliers and inset appointees) meet their regulatory requirements through technical audits and inspections. As it is the water industry that benefits from these regulatory services, option 1, introducing a charging scheme, is the preferred option as it would bring the arrangements for the DWI in line with general policy on charging, which is that businesses that benefit from regulation, not the taxpayer, should bear the cost of regulation. Ofwat, who are aware of the proposed charging scheme, have confirmed to the Chief Inspector that the cost recovery arrangements for the DWI would have little consequence for their price setting processes.

By introducing a charging scheme, DWI will come into line with other related water regulators such as Ofwat and the Environment Agency and also the Consumer Council for Water which is a consumer body, who all charge for their regulatory activities. All three regulators recover their costs through the licensing regime (which is statutory). DWI will identify the costs of its regulatory services in relation to the costs incurred by each of the individual water companies.

The Public Bodies Bill includes the required primary legislation to provide powers for DWI to introduce a charging scheme. The scheme itself would be introduced by way of an Order made under this general charging power (schedule 4, amendment 79A - 'Inspectors appointed by the Secretary of State under section 86 of the Water Industry Act 1991'). Although the bodies listed within the schedules of the Bill are subject to sunsetting, Orders made, for example in respect of charging powers, will survive the removal of the body from the Act and will remain in force.

The operation of the charging scheme will be assessed in June 2015, to ensure that it is achieving its desired outcomes that it was designed to achieve and if necessary make any required adjustments.

The proposed scheme will provide the Secretary of State and Welsh Ministers (and therefore the Chief Inspector appointed to act on their behalf) with the power to recover costs of the DWI's existing regulatory activities by way of a charging scheme. It is proposed that the Welsh Order will enable Welsh Ministers to make Regulations to allow charging in relation to water companies whose supply area is wholly or mainly in Wales and the English Order will provide the same power for the Secretary of State in respect of water companies whose supply area is wholly or mainly in England. Following the informal consultation, it is proposed that the Order will come into force 1st January 2013.

Charges will be introduced from January 1st 2013. Costs will be invoiced directly bi-annually.