EXPLANATORY MEMORANDUM TO

THE WATER INDUSTRY (SPECIFIED INFRASTRUCTURE PROJECTS) (ENGLISH UNDERTAKERS) REGULATIONS 2013

2013 No. [DRAFT]

1. This explanatory memorandum has been prepared by the Department for Environment, Food, and Rural Affairs and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 The Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 ("the Regulations") enable the creation of Infrastructure Providers (IPs) regulated by the Water Services Regulation Authority (Ofwat) to finance and deliver large or complex high-risk water or sewerage infrastructure projects.

2.2 They provide for the procuring, licensing and regulating of an IP that is separate from a water or sewerage company (an undertaker). They also lay out how the Secretary of State and/or Ofwat 'specify' which projects should be subject to these rules and how they 'designate' the company which is to become an IP licensed by Ofwat.

2.3 The Regulations are generic and apply to all water and sewerage undertakers and large infrastructure projects that meet the criteria.

2.4 Within the next ten years the Regulations are currently expected to affect the proposed Thames Tideway Tunnel, a Top 40 Priority Infrastructure Investment in the National Infrastructure Plan 2011. They would enable the undertaker, Thames Water Utilities Ltd, to tender competitively an Ofwat-regulated IP to finance and deliver the project.

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

3.1 None

4. Background & Legislative Context

4.1 These Regulations implement Part 2A of the Water Industry Act 1991 (as inserted by the Flood and Water Management Act 2010) in relation to water and sewerage undertakers whose appointment areas are wholly or mainly in England.

4.2 Under ordinary procurement law, water and sewerage undertakers have to tender infrastructure construction contracts competitively. In a process regulated by Ofwat they charge customers the cost of financing projects based on their normal cost of capital. But if they are faced with an unusually large or complex infrastructure project of a different

risk profile then the real cost of capital for that project may be higher or lower than is typical.

4.3 Currently, there is no requirement to tender the financing for infrastructure projects and so in these circumstances it is difficult for Ofwat to judge the correct cost and customers' risk of being over or under charged. For this reason the Flood and Water Management Act 2010 amended the Water Industry Act 1991 and provided a power to make Regulations to compel an undertaker in certain circumstances to tender not just the construction but also the finance of unusually large and complex projects and so help deliver better value for money for customers.

5. Territorial Extent and Application

5.1 This instrument applies to the provision of infrastructure for use by any undertaker whose area is wholly or mainly in England, and forms part of the law of England and Wales.

6. European Convention on Human Rights

Richard Benyon MP, Parliamentary Under Secretary of State for Environment, Food and Rural Affairs has made the following statement regarding Human Rights:

In my view the provisions of the Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 are compatible with the Convention rights.

7. Policy background

- What is being done and why

7.1 The objective is to help deliver necessary large or complex high-risk infrastructures such as the Thames Tideway Tunnel whilst helping isolate, contain and minimise risks to undertakers, customers and UK taxpayers to provide overall better value for money so helping keep customers' bills as low as possible.

7.2 The effect of the policy is to create a parallel regulatory regime for delivering large or complex high-risk water or sewerage infrastructure which provides value for money for customers and safeguards the ability of undertakers to continue delivering their required level of existing services. Another intended effect is to help promote innovation in the financing and delivery of future water and sewerage infrastructure projects.

7.3 Two other options to achieve these objectives were also considered.

7.4 First, the existing baseline whereby water or sewerage undertakers continue to finance and deliver all water and sewerage infrastructure projects under the existing regulatory regime. This provides undertakers with a *de facto* monopoly in their appointed service areas, including the delivery of infrastructure. The regime has enabled undertakers

to attract enough capital to fund almost £108 billion of infrastructure (in today's prices) since privatisation in 1989. For the vast majority of future infrastructure projects, the existing regime will suffice.

7.4.1 However this was rejected for two reasons.

7.4.2 Firstly, Ofwat would not have an objective means of testing whether the financing costs of a proposed large or complex high-risk infrastructure are appropriate or reasonable.

7.4.3 Secondly, the existing level and cost of services which customers receive could be detrimentally affected by undertakers having to include the financing and delivery of a large or complex high-risk project, for example by increasing the cost of capital for all of an undertaker's agreed projects which is subsequently passed onto customers, which could in turn also threaten or overwhelm an undertaker's ability to deliver their existing required level of service and already-agreed improvements to current infrastructure.

7.5 In the second considered option, Ofwat would make changes to an undertaker's appointment conditions (operating licence) to require the financing and delivery of a large or complex high risk project be put out to tender. This would allow for competition in the provision of some infrastructure and give Ofwat an objective means of assessing whether the costs of the project are appropriate and reasonable.

7.5.1 However this was rejected for three reasons.

7.5.2 Firstly, because Ofwat would either have to agree or impose changes to an undertaker's operating licence. Agreeing amendments could potentially give rise to a lengthy negotiation period, whereas imposing changes would be a lengthy process with no guarantee of a successful outcome as the changes would have to be approved by the Competition Commission.

7.5.3 Secondly, it is not possible to establish a directly regulated separate IP with this option. If a separate vehicle were used, regulation would be indirect via the undertaker. If the project were delivered within an undertaker and it would not be possible to ring-fence the project to the extent which would occur under new Regulations from the rest of the undertaker's activities.

7.5.4 Finally, as it is not possible to ring-fence the activities (and the associated risks) of the IP from the activities of the undertaker, the existing level and cost of services which customers receive could be detrimentally affected by an undertaker having to include the financing and delivery of one large or complex high-risk project. This could also threaten or overwhelm their ability to maintain at a reasonable cost their existing required level of service and already-agreed improvements to current infrastructure.

- Consolidation

7.6 There is no consolidation associated with this instrument.

8. Consultation outcome

8.1 There have been two public consultations on the Regulations.

8.2 An initial 12-week public consultation was carried out between February and May 2011 seeking initial views on proposals for new regulations. 13 replies were received and a summary published on Defra's website in September 2011. (http://www.defra.gov.uk/consult/2011/02/22/water-sewerage-infrastructure-england-1102/)

8.3 The second consultation ran for 4 weeks between 5 November and 4 December 2012. Its purpose was to inform stakeholders who represented interests likely to be affected about taking the proposals forward and included draft regulations and a corresponding Impact Assessment. It was issued by email to 73 contact addresses previously contacted for the 2011 consultation, including:

- Mayor of London;
- London MPs with a known interest;
- EFRA Committee MPs;
- Water and Sewerage companies;
- Ofwat;
- Consumer Council for Water.

8.4 Seven responses were received and a summary published on Defra's website in March 2013 (http://www.defra.gov.uk/consult/2012/11/05/water-sewerage-infrastructure-england-phase2/). There has also been an on-going dialogue between Defra, Ofwat and Thames Water Utilities Ltd as the key stakeholders immediately affected by the proposals.

8.5 In light of consultation, Government has decided to proceed with laying the draft Regulations before Parliament in spring 2013. This is because they would allow for Ofwat-regulated IPs to be created which would:

- enable the risks and costs associated with large or complex high-risk projects to be more transparently captured;
- ring-fence and contain the risks and likely higher costs of financing a large complex high-risk project and so help prevent those costs being transferred to all other "typical" and less risky projects for which an undertaker is responsible;
- help to minimise total final project costs and benefit customers of undertakers, by requiring undertakers to competitively tender IPs;
- provide the most clarity to all undertakers and other companies on the delivery of any future large or complex high-risk water and sewerage infrastructure projects;

- enable any Government financial support given under, for example, section 154B of the Water Industry Act 1991 (as inserted by the Water Industry (Financial Assistance) Act 2012) to be better targeted to a sole large or complex high-risk project, rather than directed at a specific undertaker with its range of services.

9. Guidance

9.1 Defra will announce the Regulations coming into effect in the following ways:

- by a Press Release;
- through the Twitter social network;
- an email to all the original consultees; and
- on the Defra/GovUK website.

9.2 As the instrument largely applies the Water Industry Act 1991, as amended, presenting a net annual benefit to business with neither a net cost nor a requirement for enforcement, there is no need for specific guidance.

10. Impact

10.1 The impact on business (based on an assessment relating to the Thames Tideway Tunnel and summing the costs and benefits to Ofwat, Thames Water Utilities Ltd and an IP) is for an overall net benefit estimated at **£237m** (Present Value over 30 years, best estimate). The low-high range is £53-547m.

10.2 An Impact Assessment is attached to this memorandum and will be published alongside the Explanatory Memorandum on www.legislation.gov.uk.

11. Regulating small business

11.1 The legislation does not affect small business.

12. Monitoring & review

12.1 The instrument gives the Secretary of State a duty to carry out a review of the Regulations and publish a report setting out its conclusions at the end of a period of five years beginning with the day on which the Regulations come into force.

13. Contact

John Manning (020 7238 2019) or email thamestunnelteam@defra.gsi.gov.uk at the Department for Environment, Food, and Rural Affairs to answer any queries regarding the instrument.