

Department for Environment, Food and Rural Affairs

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Summary of responses to the consultation on regime for special water and sewerage infrastructure projects in England

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1. Introduction and Background

1.1 In 2010 a new part 2A of the Water Industry Act 1991 (WIA91) was enacted to give powers to the Secretary of State and Welsh ministers to make regulations regarding the provision of infrastructure for the use of undertakers. A consultation published in April 2011 set out proposals for regulations under section 36A of the WIA91 that would enable the Secretary of State or Ofwat to require water and sewerage infrastructure projects that met certain criteria to be put out to competitive tender on a project-financed basis by water and sewerage companies (“undertakers”). The regulations would enable a new regime to be created in which specified water and sewerage infrastructure projects could be financed and designed, built, operated and maintained by third parties (Infrastructure Providers -IP), rather than undertakers, under contractual arrangements between the relevant undertaker and Project Company. The regulations would also provide for, but not necessarily require, the project company to be regulated by the Water Services Regulation Authority (Ofwat).

1.2 The consultation explained that the new regime – the Special Infrastructure Projects Regime (SIPR) – would be limited to “high risk” water and sewerage infrastructure projects, namely infrastructure projects that are of a size or complexity that threaten the ability of an undertaker to provide services to its customers, but the overall aim of the SIPR was to ensure that high risk infrastructure projects would only be put out to tender by undertakers on a project-financed basis where this would provide value for money

1.3 The consultation sought views on the proposed regulations for special projects including definition, designation, licence changes, the role of Ofwat and the management of risk.

2. Analysis of responses

2.1 13 responses were received. Ten were from water companies (Anglian Water, Business Stream, Northumbrian Water, Portsmouth Water, Sembcorp Bournemouth Water, Severn Trent Water, South West Water, Sutton and East Surrey Water, Thames Water and Wessex Water). The remaining three were from WaterUK, the Institute of Civil Engineers (ICE) and the Consumer Council for Water.

2.2 The consultation included seven questions focusing on the definition of a Special Infrastructure Project, the process for specifying a project as one that must be put out for tender, the process for designating a project company as one that must be regulated and managing the risk of financial distress or failure of a project company.

2.3 The majority of respondents recognised that these regulations are only intended to capture projects of a size and complexity that threaten an undertaker’s ability to provide services for its customers and that projects would therefore only be designated in few cases. Most water companies and Water UK sought assurance that the criteria would be clearly defined and that the criteria would be evaluated transparently and objectively. Otherwise, there would be uncertainty about the projects that might be required to be put out to tender under the regulations. Some water companies thought that guidance from Ofwat would provide the necessary clarification.

2.4 The consultation document proposed two criteria that would require a project to be put out to tender, namely 1) that the project is of a size or complexity that threatens the responsible undertaker’s ability to provide services for its customers and 2) that specification of the project as a special infrastructure project and the consequent application of the regulations in relation to the project, is likely to result in better value for customers than would otherwise be the case.

The majority of respondents broadly supported both criteria, but stressed the need for clarity and certainty on how the criteria would be applied. Several respondents called for a quantitative threshold to be set to assess the 'size and complexity' criteria, with some suggesting that an assessment of the project costs as a percentage of the companies RCV or turnover would be more appropriate than a fixed threshold. Thames Water thought that the value for money criterion was inappropriate and that specification should be solely based on whether the project meet the size and complexity test. Water UK supported the aim of ensuring that projects are only put out to tender under the regulations where this would provide value for money on the basis that it would be undesirable to conduct detailed tendering processes if these were unlikely to deliver a cost saving. CC Water welcomed the inclusion of the value for money criterion, but thought that how this would be assessed would need to be set out clearly and would need to involve a benchmarking process. It was concerned, however, that customers should be adequately protected from wasted tendering costs. Several respondents requested clarity on the relationship between the size and complexity test and on the value for money test and asked whether they were considered of equal importance.

2.5 Several water companies were concerned about the financial risks to the undertaker if the undertaker was required to step-in to rescue a special infrastructure project following the failure of the IP. CC Water was concerned that if the IP became insolvent, this could lead to higher costs for consumers. Many respondents stressed the importance of a clear assessment and allocation of risks and liability between an undertaker and an IP to reduce the risk and impact of the failure of a project. Several respondents called for consideration of a Special Administration scheme or a liability bond to mitigate against the risk of project failure. There was strong support for Ofwat having the power to bring enforcement proceedings against an IP where a project is in breach of an economic or environmental regulation.

2.6 Thames Water called for the impact on the credit rating and credit worthiness of an undertaker to be considered as part of the assessment of whether to specify a project as one that must be put out to tender. They also proposed that liability and financial risk of a special project should be transferred from the undertaker to an IP in order to protect the undertaker, and customers, from the financial risk of project failure.

3. Summary by Question

3.1 Question 1: Does any other infrastructure need to be captured other than dams, reservoirs, sewerage and water transportation tunnels and conduits, and sewerage and water treatment plants and other associated infrastructure assets? Should any of these be excluded and, if so, why?

3.2 Respondents agreed with the types of infrastructure listed in the consultation. Suggested additions were desalination plants, water and sewerage pumping stations, water transportation schemes and service reservoirs. It was also recommended that canals and channels built or adapted for transportation of water should be included under the definition of transportation tunnels and conduits. There was agreement that offices and non essential items should be excluded.

3.3 Thames Water requested a broad 'catch all' definition of infrastructure stressing that the key criteria was whether any type of infrastructure was of 'a size and complexity that threatens the undertaker's ability to provide services for its customers.'

3.4 Question 2: Do you have any comments about the proposed process for the specification by the Secretary of State or Ofwat of infrastructure projects which must be put out for tender as special infrastructure projects (SIP)?

3.5 Generally respondents didn't provide specific comments on the process for specification outlined in the consultation. There was consensus that there should be consultation with undertakers before a project is specified as one that must be put out for tender. Thames Water thought that an undertaker should have the right to apply for a project to be specified as an SIP.

3.6 CCWater called for a benchmarking exercise to be carried out by the undertaker, along with Ofwat, to provide a framework for the expected cost of the project, and for Ofwat to be required to consult key stakeholders, such as the Drinking Water Inspectorate, Environment Agency and CCWater to ensure that the implications for customers of putting a project out to tender, would be fully considered. They were also concerned that tendering costs should not be passed on to customers.

3.7 Question 3: Do you have any comments on the proposed criteria to be used by the Secretary of State or Ofwat in determining whether to require an undertaker to put an infrastructure project out to tender as a special infrastructure project in accordance with the regulations?

3.8 See paragraph 2.4 above. There was general agreement that Ofwat guidance on specification should be consulted on.

3.9 ICE considered that an accurate appraisal and allocation of risk between an IP and an undertaker should be a key criterion in considering whether a project should be specified as one that must be put out to tender. They also called for Ofwat to determine which risks should be borne by customers and which by shareholders.

3.10 Thames Water thought that that a value for money assessment was not appropriate as it was not envisaged by the primary legislation and its inclusion in secondary legislation or guidance had the potential to set up a conflict between the 'size and complexity' test and the value for money test. They queried whether the value for money assessment was necessary as the Secretary of State and Ofwat already have a duty to further the consumer objective.

3.11 Question 4: Have we included all necessary preparatory work that would be required to be carried out by the undertaker to facilitate and promote the tender process in relation to a special infrastructure project?

3.12 In addition to the preparatory work listed in the consultation, environmental consents, environmental impact assessments, scoping of the contractual arrangements, feasibility studies, limits of risks and benchmarking costs were suggested. Thames Water thought that the extent of the preparatory work to be done by the undertaker should be determined on a case by case basis. Water UK recommended a non-exhaustive definition.

3.13 The general consensus of water companies was that Ofwat's role should be limited to providing guidance and being an observer in the tendering process. Some were concerned that the proposed degree of intervention by Ofwat was inconsistent with the use of the Utilities Contract Regulations. There was general support for the proposal for associated companies to be eligible to tender.

3.14 Question 5: Do you agree with our proposed approach to designation of infrastructure providers?

3.15 Respondents generally agreed with the approach to designation of an IP (for an IP to be directly regulated by Ofwat, but for that regulation to be 'light-touch'). Most respondents,

including CCWater, stressed the need for a very clear allocation of risk and responsibility between a regulated IP and an undertaker to mitigate against the risk of failure. South West Water thought that a breakdown of responsibilities, risks and liabilities between an undertaker an IP within contractual provisions should be specified in guidance. Water UK stressed that regulatory certainty would be key in attracting sufficient interest in a project, and therefore designation must happen early in the process.

3.16 Severn Trent Water believed that regulation of an IP would be more efficient than relying on contractual arrangements between the two parties as a regulator was not subject to the same limitations as an undertaker. Anglian Water felt that an undertaker should be able to trigger regulatory action against an IP.

3.17 Thames Water was of the view that direct regulation of an IP would be necessary in the right circumstances. Without direct regulation, regulatory risk in relation to the project would be ring-fenced within the undertaker and this would be likely to threaten the undertaker's ability to provide services. This would also enable responsibilities and accountability for the project to be clearly allocated and make enforcement transparent, in contrast to indirect regulation of the IP, which it thought would lack the required level of clarity and certainty over responsibilities between the undertaker and the IP.

3.18 Thames Water also proposed that a regulated IP should operate under its own Regulatory Capital Value (RCV) and be economically regulated. RCV is the regulatory value of the undertaker which is adjusted to take account of new capital expenditure after allowing for current cost depreciation. If an IP operated with its own RCV it would be able to raise revenue directly from customers or the undertaker. This would be a significant advantage in procuring access to relatively low-cost and liquid capital.

3.19 Question 6: Do you agree with our proposed approach to licence changes?

3.20 Generally respondents did not comment on the proposed procedure for making licence changes, but those who answered the question were broadly supportive. Several respondents called for further clarification on Ofwat's role in this process and how regulatory sanctions would be applied. They also thought that an undertaker should be consulted on and agree any change of its licence, in line with the existing licensing regime. CCWater stressed the importance of customer and environmental protection being explicitly included within the IP licence conditions. ICE noted that IPs must also comply with regulatory requirements of the Drinking Water Inspectorate and the Environment Agency.

3.21 Question 7: What are your views on managing the risk of financial distress or failure of a project company? Do you agree that contractual mechanisms, including step-in-rights, together with the normal regulatory mechanisms, provide adequate assurance that essential water supply and sewerage services will be maintained and that interests of customers will be appropriately protected?

3.22 Several water companies expressed concern over the financial impact on the undertaker if it were required to step-in and take over the project following failure of the IP, given the scale and complexity of projects designated as Special Infrastructure Projects and suggested that special administration should be available.

3.23 Thames Water thought that the proposed measures for dealing with financial distress or project failure were inadequate for projects of the scale and complexity likely to be captured under the regulations and that it would not be possible to manage the impact of a financial

failure of an IP on the undertaker's ability to maintain services to its customers without extending the special administration regime to IPs. Should the undertaker be required to take on the project as an infrastructure provider of last resort, the undertaker would need to be protected fully from the consequences of doing so. It did not agree that a special administration regime would provide a perverse incentive for investors.

3.24 Water UK thought that if a project was of a size or complexity that could threaten an undertaker's ability to provide services to its customers then an undertaker should not be expected to assume responsibility on the failure of the project or withdrawal of the IP and that direct regulation of the IP would be more effective to ensure delivery. In any event, the undertaker should not be put in a worse position than it would have been had the IP not failed.

3.25 One suggestion for protecting customers against IP failure was the use of on-demand bonds. However, Portsmouth Water noted that typical means of risk protection, such as insurances or bonds, may be prohibitively expensive on a very large scale project and that an undertaker may not have the financial means or expertise to step-in, and thought that the best way of protecting customers if the IP failed would be to decide the most appropriate mechanism on a case by case basis

3.26 CCWater highlighted the risk that the costs of rescuing a project after the failure or withdrawal of an IP may fall on customers. They stressed the need for measures to be taken to prevent this from happening.

4. The way forward

4.1 The Government is considering the responses to the consultation and will make a decision on the way forward in due course.

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