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A consultation on the regime for special water and sewerage infrastructure projects in England

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Introduction

What this consultation concerns

1.1 This consultation paper seeks your views on the proposals for new regulations under section 36A of the Water Industry Act 1991 (the WIA91) that will enable the Secretary of State or Ofwat to require water and sewerage infrastructure projects that meet certain criteria to be put out to competitive tender on a project-financed basis by water and sewerage companies ("undertakers"). The regulations will enable a new regime to be created in which specified water and sewerage infrastructure projects are financed and designed, built, operated and maintained by third parties rather than undertakers, under contractual arrangements between the relevant undertaker and project company[1]. The regulations will also provide for, but not necessarily require, the project company to be regulated by the Water Services Regulation Authority (Ofwat).

1.2 The new regime – the Special Infrastructure Projects Regime (SIPR) – will 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. However, the overall aim of the SIPR is to ensure that high risk infrastructure projects are only put out to tender by undertakers on a project-financed basis where this would provide value for money.

How to respond

1.3 We would like to receive responses to the boxed questions that commence on Page 8. A list of the organisations that we have approached directly for views is on the Defra web site, but we welcome views from all interested parties or individuals.

1.4 We need to receive your responses by 17 May 2011 . Please send them:

by email (in Word, Rich Text or pdf format) to
Specialinfrastructureconsultations@defra.gsi.gov.uk

or

- by post to

  Nick Jenkins
  Competition & Consumer Protection Team
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In your responses, please:

[1] "Project company" means the company or other entity which has contracted to carry out the project under the project agreement

- include your name and address;
- explain who you are and, where relevant, whom you represent ;
- order your comments under the relevant question; and
- Include a summary of your comments if they are more than three pages long.

1.5 In line with Defra's policy of openness, copies of the responses that we receive will be made publicly available, at the end of the consultation period, through the Defra Information Resource Centre, Ergon House Lower Ground Floor, Horseferry Road, London SW1P 2AL. If you do not consent to this, you must clearly request that your response be treated confidentially. Any confidentiality disclaimer generated by your IT system in e-mail responses will not be treated as such a request. You should also be aware that there may be circumstances in which Defra will be required to comply with their obligations under the Freedom of Information Act and the Environmental Information Regulations.

Next steps

1.6 All the responses received by the deadline will be analysed, and a summary will be placed on the Defra web site.

1.7 After consideration of the responses, the draft regulations will be laid before Parliament in draft. Once laid, the Regulations will be subject to the affirmative-resolution procedure. This means that the regulations require Parliament's approval before they can be commenced. If Parliament grants its approval, then the regulations will be commenced as soon as is practical thereafter.

Code of practice on written consultation

1.8 This consultation paper has been produced in accordance with the Better Regulation Executive guidance on written consultations, as set out at *www.bis.gov.uk/files/file47158.pdf*

.Background

2.1 Section 35 of the Flood and Water Management Act 2010 created a new Part 2A of the WIA91 that gives the Secretary of State and Welsh Ministers the power to make regulations regarding the provision of infrastructure for the use of undertakers. Section 36G(2) of the WIA91 provides that before laying draft regulations under section 36A of the WIA91 before Parliament, the relevant minister must consult persons who in the Minister's opinion represent interests likely to be affected by the regulations. This consultation describes our proposals for regulations under section 36A of the WIA91 in relation to undertakers whose areas are wholly or mainly in England, as well as our proposals for the SIPR more generally.

The existing regime

2.2 Incumbent water and sewerage undertakers or water-only undertakers currently deliver infrastructure under an existing regulatory regime under the supervision of Ofwat. Under the existing regulatory regime, the "regulatory capital value" (RCV) represents the capital value of each undertaker for the purposes of setting price limits.

In simple terms, RCV is the regulatory value of the undertaker which is adjusted to take account of new capital expenditure after allowing for current cost depreciation.

2.3 RCV is related to, but not directly linked with, infrastructure-delivery cost. The price limits that are set by Ofwat provide each undertaker with the capital expenditure Ofwat considers necessary to deliver the outputs set down in price limits. Once price limits are set undertakers are legally bound to deliver the outputs within the price setting package, although they do have the opportunity to appeal their price limits to the Competition Commission. It is then for undertakers to manage the risks associated with delivery of the capital programme, including cost overruns

2.4 To date, this regulatory regime has facilitated the industry's investment of approximately £90 billion (inflation-adjusted) in water and sewerage infrastructure since privatisation in 1989. However, the significant majority of investment projects have been on a relatively small-scale and there have been relatively few major long-term projects. The challenges of climate change and population growth are expected to increase the stress on water resources and on water and sewerage infrastructure. This increased stress is likely to necessitate investments in larger and/or more complex infrastructure projects than the industry has delivered in recent decades. These projects may raise issues of planning, financing and construction risk that are greater than those normally associated with undertakers' capital investment and are likely to require construction over two or more planning periods. Untested on such projects, the existing regulatory regime may not have the capacity to facilitate the efficient or effective delivery of such projects as it does not permit competition for the right to finance infrastructure projects in the water and sewerage sector. It probably also, without further change, has limited ability to reduce the risks to the undertaker's ability to provide its other services to customers that may result from a large high-risk infrastructure project.

What the regulations will achieve

2.5 The regulations will supplement the existing regulatory regime by enabling the Secretary of State or Ofwat to require undertakers to put certain infrastructure projects out to competitive tender and procure the delivery of the relevant infrastructure on a project-financed basis. By virtue of section 36A(4) of the WIA91, the regulations must be limited to infrastructure projects that are of a size or complexity that threaten the undertaker's ability to provide services for its customers.

2.6 Requiring undertakers to put high-risk projects out to tender and procure the relevant infrastructure on a project financed basis may offer greater benefits through:

- Ring-fencing the delivery and financing of an individual project and its risks from the delivery and funding of other capital projects and thereby reducing the risk that the project may affect the undertaker's ability to provide other services to customers;

- increasing competition in relation to the delivery of the infrastructure by enabling new entrants (i.e. project companies that are not water companies) to participate in the delivery of water and sewerage infrastructure;

- revealing the level of risk the investors are willing to bear;

- incentivising a market- tested project cost of finance and the single project focus thereby potentially offering greater certainty of outturn cost and project timetable, which will reduce the risk of major cost overruns;

- potentially introducing strategic and innovative approaches to the delivery of improvement schemes in the water industry.

2.7 The regulations will also provide for (but will not necessarily require) the project company to be directly regulated by Ofwat under an amended WIA91. A project company that is to be directly regulated by Ofwat will be designated an Infrastructure Provider (IP).

2.8 The undertaker would continue to be regulated by Ofwat in line with the duties imposed on it, including the duty [in section 2(2A) of the WIA91] that Ofwat exercise its functions in a manner it considers best calculated to ensure that undertakers are able to finance the proper carrying out of their functions.

Utilities Contracts Regulations 2006

3.1 Much utility sector procurement is regulated by EU procurement rules. Directive 2004/17/EC, implemented in the UK by the Utilities Contracts Regulations 2006[2] (as amended) is the legal framework for procurement by utility companies. The purpose of the EU procurement rules is to open up the public procurement market and to ensure the free movement of supplies, services and works within the EU. In most cases they require competition. The Utilities Contract Regulations set out the procedures to be followed at each stage of the procurement process leading to the award of contracts above certain thresholds when utilities seek to acquire supplies, services, or works (e.g. civil engineering or building) as defined in the EC Directive.

3.2 In most cases, the procedures, as set out in the Utilities Contract Regulations (UCRs), will apply to those projects that an undertaker has been required under the proposed regulations to put out to tender. However, there may be certain circumstances where a project which is required to be put out to tender under the proposed regulations is exempt from the competitive tendering requirements of the UCRs. A particular circumstance might be where the contract could be awarded to an undertaker's associate company or joint ventures with which it is associated.

3.3 In cases such as these, for the sake of consistency and in keeping with the aim of the primary legislation to ensure that projects are put out to competitive tender, we are proposing through the regulations to require undertakers to apply the competitive tendering requirements of the UCRs to cases in which EU competitive tendering requirements would not automatically apply.

Definition of Infrastructure and Special Infrastructure Projects

4.1 Section 36A3(b) of the WIA91 enables the regulations to define "infrastructure" for the purposes of the new regime. The definition of infrastructure for the purposes of the proposed regulations will include all fixed assets (whether above or below the ground) which are required in order for an undertaker to fulfil its statutory obligations under the WIA91 and other relevant legislation connected with the delivery of water and sewerage services to customers. This will therefore include dams, reservoirs, sewage and water transportation tunnels and conduits, and sewage and water treatment plants. This definition is largely based on the definition of infrastructure that is included in an undertaker's conditions of appointment (or licence as it is more

[2] http://www.legislation.gov.uk/uksi/2006/6/contents/made

commonly known). The definition will not cover office or other accommodation that happens to be built by an undertaker or other non-essential assets.

4.2 The proposed regulations will enable the Secretary of State or Ofwat to require undertakers to put certain infrastructure projects out to tender as "special infrastructure projects". A special infrastructure project will comprise (a) the design and construction of the infrastructure in question, (b) the maintenance and operation of the infrastructure or just the maintenance or operation of the infrastructure and (c) the financing of the project. In most cases, the principal assets – the infrastructure and the land to which it is annexed – are likely to be owned by the undertaker and licensed to the project company. However, the proposed regulations will also enable the Secretary of State to specify at any time prior to or during the tender process whether the infrastructure must be owned by the undertaker or the project company responsible for delivery of the project if this is necessary to facilitate any given project.

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

Power to specify special infrastructure projects

5.1 As explained above, we propose to grant the Secretary of State and Ofwat the power to specify an infrastructure project as a special infrastructure project which the undertaker must then put out to tender in accordance with the regulations. However, it is expected that the Secretary of State will only use her powers in exceptional cases and that Ofwat, as the independent economic regulator for the water sector, will exercise this power in practice. Ofwat will be required under the proposed regulations to produce guidance on how it would exercise its power to specify an infrastructure project as a special infrastructure project.

5.2 Where the Secretary of State is the designating authority she will consult Ofwat and the relevant undertaker before specifying a project as a special infrastructure project. Ofwat will similarly consult the Secretary of State and the relevant undertaker. Both the Secretary of State and Ofwat will also consult the Welsh Ministers if the infrastructure in question is to be located in Wales (i.e. if the infrastructure is built in the Welsh part of the Severn Trent appointed area) as provided for in section 37F of the WIA91, and any other person that they consider appropriate. The designating authority may then issue a project specification notice (see paragraph 6.9)

Primary and Secondary duties under WIA 91

5.3 Sections 2 and 2A of WIA91 impose general duties on Ofwat and the Secretary of State which provide when and how it should exercise and perform those duties in relation to the water and sewerage industry. We are proposing to extend these duties to Ofwat's functions (and the Secretary of State) under the SIPR to the extent that they are relevant to particular functions.

5.4 In exercising those duties Ofwat (and the Secretary of State) will also be required to have regard to the principles of better regulation when carrying out their regulatory functions (i.e. regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed).

Requirement for special infrastructure projects to go out to tender

6.1 Section 36B of the WIA91 enables the Secretary of State or Ofwat to specify infrastructure projects that must go out to tender and to prohibit an undertaker from undertaking an infrastructure project which is required to be put out to tender in accordance with the regulations. Section 36C of the WIA91 also requires regulations under section 36A of the WIA to specify the criteria to be used by the Secretary of State or Ofwat in determining whether to exercise this power.

6.2 The proposed regulations will give the Secretary of State and Ofwat the power to require an undertaker to put a special infrastructure project out to tender if certain criteria are met. We propose to include the following criteria in regulations:

- the Secretary of State or Ofwat thinks that the project is of a size or complexity that threatens the responsible undertaker's ability to provide services for its customers;

- the Secretary of State or Ofwat thinks 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.

6.3 The first criteria reflects the provisions in section 36A (4) of the WIA91. This sub-section was introduced to allay concerns that all infrastructure projects would be subject to the new regime. This was never the policy intention behind the primary legislation which was always to limit regulations under 36A to high-risk construction projects of the kind never before delivered by undertakers. The first criteria will mean that the designating authority (whether that is the Secretary of State or Ofwat) will have to be satisfied that the infrastructure project is of such a size or complexity that if the undertaker were to finance and carry out the infrastructure project itself, rather than put the project out to tender as a special infrastructure project, the undertakers ability to provide services to its customers might be threatened.

6.4 Requiring undertakers to put projects out to tender as special infrastructure projects will lead to greater transparency and may lead to innovation in design, financing, construction, maintenance or operation of such projects, such that they deliver better value for money than under the current regime. Moreover, competition may lead to bidders being willing to assume risks that would otherwise be borne by customers. For these reasons, we see the SIPR as creating the potential for greater efficiency and effectiveness in the delivery of specified water and sewerage infrastructure projects.

6.5 However, it is not certain that procuring infrastructure projects in this manner will actually foster greater efficiency and effectiveness in every case, even for very large or complex projects. Therefore, in determining whether to require an undertaker to put an infrastructure project out to tender as a special infrastructure project, the designating authority will need to consider whether procuring the infrastructure project as a special infrastructure project would result in better value for money for the undertaker's

customers than if the project were to be financed and carried out by the undertaker under the current regime.

6.6 In the event that procuring a very large or complex project does not appear to provide value for money, the infrastructure project would not be specified as a special infrastructure project and the undertaker would not be required to put the project out to tender as a special infrastructure project. The infrastructure project may then need to be reconsidered or financed and carried out by the undertaker under the existing regime. Any threat to the undertaker's ability to provide services (which may be minimal) would need to be appropriately managed through existing mechanisms under Ofwat's regulatory duties under the WIA91, including the duty to exercise its functions in a manner Ofwat considers best calculated to ensure that undertakers are able to finance the proper carrying out of their functions.

6.7 The consultation process mentioned in paragraph 5.2 will allow the undertaker to make representations about the threat to its ability to provide services to its customers if it were to finance and deliver the project, discuss with the designating authority whether going out to tender will provide better value for money for customers than would otherwise be the case, and discuss the proposed scope of the infrastructure project that it might be required to put out to tender as a special infrastructure project. For example, a special infrastructure project might include the design and construction of a particularly large or complex water transportation tunnel, but not include new pipework to connect it to a treatment plant which could instead be delivered in-house by the undertaker or under an existing framework agreement.

6.8 The undertaker will be required to provide the designating authority with whatever information it needs to make a decision about whether an infrastructure project should be specified as a special infrastructure project.

6.9 Once the relevant authority has consulted and decided that an infrastructure project should be specified as a special infrastructure project, the relevant undertaker will be issued with a "project designation notice" by the designating authority. The notice will identify the special infrastructure project in question, specify that it must go out to tender, set out the scope of the project – for instance, whether the project is to cover either the maintenance and operation of the infrastructure or both as well as the design and construction of the infrastructure and its financing - and set out the reasons why the project has been specified as a special infrastructure project.

6.10 It was the last Government's intention to enable the Thames tunnel phase of the Thames Tideway project to be put out to tender under regulations made under 36A of the WIA91, if appropriate, and this proposal is also supported by the current Government and Ofwat. We propose to implement the SIPR as soon as is possible in order that consideration can be given as to whether to require the Thames Tunnel phase of the Tideway project to be put out to tender under the regulations as a special infrastructure project.

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 to tender as special infrastructure projects?

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?

Terms relating to the tender process

7.1 The proposed regulations will require the undertaker to consult the Secretary of State and Ofwat about the terms on which a special infrastructure project is to go out to tender. Where any part of the special infrastructure project is in Wales the undertaker must also consult Welsh Ministers.

7.2 Ofwat would also expect to approve the terms on which a special infrastructure project is to be put out to tender by the undertaker. The undertaker would therefore need to obtain Ofwat's approval to:

- the nature, structure and timing of the tender process;
- the notice(s) required for publication in the Official Journal of the EU[3] (e.g. the Prior Information Notice before it is published);
- the pre-qualification documentation, criteria and evaluation methodology (e.g. questionnaires, preliminary pass/fail criteria, weighting/scoring procedures);
- the tender commercial terms (e.g. details on scope, intended risk allocation, payment allocation, payment mechanism and ownership of the infrastructure, etc);
- the procedure, evaluation criteria and evaluation methodology for any debt or equity funding competition; and
- the final commercial package at award, including the construction and operating budgets, approach to and cost of financing and any changes in scope and risk allocation arrived at through the negotiation process.

7.3 The proposed regulations may also place an obligation on the undertaker to do this in which case the regulations would require Ofwat to produce guidance setting out how it would expect the tender process to be run and the terms it would expect to see in any of the above documentation.

7.4 More generally, Ofwat is likely to have a pro-active role throughout the tender process. This is consistent with Ofwat's approach to some larger undertaker projects it has been involved with, most notably the building of the Lee tunnel by Thames Water. In some cases, Ofwat (or the Secretary of State) may also expect to be represented on the undertaker's procurement steering group or attend briefings or meetings with bidders. However, the regulations must ultimately provide for the undertaker responsible for the tender process to determine which bid to accept.

Associated companies

8.1 Section 36B (4) of the WIA91 requires the regulations to make provision about the extent to which companies associated with the undertaker can participate in a tender process.

8.2 For the purposes of this document and the proposed regulations we are defining "associated companies" as either:

[3] http://eur-lex.europa.eu/JOIndex.do

- a group company – this means, in relation to the relevant undertaker, any holding company or subsidiary of that undertaker, or any subsidiary of any holding company of that undertaker ("subsidiary and "holding company" have the meanings given in section 1159 of the Companies Act 2006(a) as supplemented by Schedule 6 to that Act);

- a related company – this means, in relation to the relevant undertaker, any undertaking in which that undertaker has a participating interest ("undertaking" has the meaning given in section 1161 of the Companies Act 2006 and "participating interest" has the meaning given in paragraph 8 of schedule 8 to the Small Companies and Groups Regulations 2008(b)).

8.3 The extent to which an associated company can participate in the tender process is a particularly important issue because the undertaker will be the tendering authority. Potential bidders might be deterred from participating in the tender process if they thought a company associated with the undertaker was going to bid, thus defeating the objective of requiring the undertaker to put the infrastructure project out to tender as a special infrastructure project.

8.4 However, the UCRs take precedence here and the Government considers that a prohibition on all or some types of associated companies may be disproportionate and discriminatory and as such, may result in a breach of EU law. Therefore we are proposing to include a requirement in the regulations that where an associated company is proposing to participate in a tender process, the undertaker must demonstrate to Secretary of State's/Ofwat's satisfaction that the associated company's participation in the tender process will not compromise its fairness and transparency.

Preparatory work carried out by an undertaker

9.1 Whilst the regulations will prohibit the undertaker from carrying out any activities within the scope of the special infrastructure project, section 36B (3) of the WIA91 does enable the regulations to permit or require an undertaker to carry out certain preparatory work, to be funded under existing regulatory mechanisms.

9.2 It will be particularly important for the undertaker to prepare for and promote the forthcoming tendering exercise to generate interest from potential bidders, both domestic and international. The undertaker must also be able to prepare certain documents and strategies for the tendering exercise and obtain and prepare the land needed for the project. The proposed regulations will therefore allow the undertaker to carry out specified preparatory work. The preparatory work we propose to include in the regulations would cover:

- Preparation for and promotion of the tender process;

- the development of asset management plans;

- the creation of a system performance specifications;

- initial designs of works;

- site investigations and surveys;

- planning applications;

- compulsory land purchases/acquisition of land;

- applying for compulsory work orders (in case of the construction of reservoirs in Wales); and
- ground preparation, demolition and enabling works.

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?

Designation of Infrastructure Providers

10.1 Section 36D of the WIA91 allows regulations under 36A of that Act to provide for the designation of any person who appears to the Secretary of State or Ofwat to be wholly or partly responsible for an infrastructure project that was put out to tender in accordance with the regulations as an "infrastructure provider".

10.2 The proposed regulations will enable the Secretary of State or Ofwat to designate the project company as an infrastructure provider (IP) (and any other person who subsequently assumes responsibility for the delivery of the special infrastructure project), and then to directly regulate the IP through a licence. The regulations will also amend the WIA91 to extend various provisions of the WIA91 to IPs.

10.3 The Secretary of State or Ofwat will need to decide on a case by case basis as to whether it is necessary to regulate delivery of the special infrastructure project and therefore designate the project company as an IP. However, the relevant authority may decide that designation is not necessary if the contract between the undertaker and the project company is sufficient to protect the undertaker's customers from the most significant risks associated with the delivery of the infrastructure project. An example of such a contract might be one based on those for a public private partnerships (PPPs) arrangement.[4]

10.4 We do not envisage that all project companies will need to be directly regulated by Ofwat in accordance with section 36D WIA. Where a project company is not designated as an IP, Ofwat will nevertheless be able to indirectly regulate the project through:

I. the contractual provisions of the contract between the project company and the undertaker

II. Ofwat's powers of regulation over an undertaker under its licence following amendment of that licence if necessary.

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

[4] The most common form of PPP has been the Private Finance Initiative. PFIs are subject to HM Treasury guidance known as "Standardisation of PFI Contracts"
http://www.hm-treasury.gov.uk/ppp_standardised_contracts.htm

Regulation of designated Infrastructure Providers

11.1 Designation of an IP will involve Ofwat issuing the project company with a licence and project companies will be regulated in a similar way to undertakers and licensed water suppliers. However, the SIPR will be a much lighter-touch regime as in most instances the contract between the IP and undertaker will "regulate" the delivery of the infrastructure and will make sure that the infrastructure is delivered so as to ensure that the undertaker can meet its statutory obligations as well as other environmental standards. Because of the rigorous tendering process Ofwat will not have to carry out any checks on the suitability of the successful bidder to carry out the special infrastructure project.

11.2 IPs will not be subject to the same detailed reporting requirements as an undertaker because they will not be subject to the price control regime and do not have a direct interface with customers. However, effective monitoring of the project will be key to its success and Ofwat may require monitoring information direct from the IP. In addition, undertakers will need to agree with the IP what information they will need to meet their own statutory reporting requirements.

11.3 For the most part, the undertaker will remain responsible for meeting water quality and environmental standards regardless of whether or not the IP is the owner and/or operator of the infrastructure - as is the case with contractors and sub-contractors of an undertaker. However, depending on the licence issued there may be circumstances in which Ofwat will need to be able to pursue an IP if it is in serious breach of its licence conditions which cause the undertaker to be in breach of its statutory obligations.

11.4 An IP will also be subject to same rights, duties and responsibilities as an undertaker where it needs to carry out necessary works on public and private land in its own right – these are set out in Part VI Chapter 1 of WIA91.

Licences

12.1 The licence issued by Ofwat to an IP may consist of standard licence conditions common to all IPs and also some conditions relevant to its role in the delivery of the specific infrastructure project – either as an owner or operator or both. It will complement rather than override the contract between the undertaker and IP and is likely to include conditions to help Ofwat regulate the IP and set out the licence fees provisions.

12.2 The proposed regulations will enable Ofwat and the Secretary of State to amend the undertaker's licence in consequence of the requirement on the undertaker to put an infrastructure project out to tender as a special infrastructure project and, following its award, the delivery of the special infrastructure project by the successful bidder following consultation with the undertaker.

12.3 In order to submit tenders, companies will need to understand the regulatory framework within which they might operate. We therefore envisage that the tender documents will say whether or not the Secretary of State or Ofwat is minded to designate the successful tenderer as a designated infrastructure provider and if it does, a draft of the licence that will regulate the entity will be included in the tender documents.

12.4 It is likely that the tender negotiation process will reveal critical information on whether it will be appropriate for the successful tenderer to be designated. Relevant to the decision will be the contractual safeguards proposed and whether the cost of providing the service will materially change if the entity is designated. The scale of the project and the strategic importance of the project will also be relevant in the decision (if the infrastructure project is of strategic importance it is more likely to be designated). It is envisaged that the licensing of an infrastructure provider will follow shortly after the appointment of the successful tenderer.

12.5 The designation of an infrastructure provider will be the responsibility of the Secretary of State or Ofwat, whereas the appointment of the successful tender will be the responsibility of the undertaker (see 7.4). This will require the development of an integrated process so that Ofwat's requirements for an infrastructure provider are clearly stated and met by all the shortlisted parties. The exact details of this process will be set out in guidance issued by Ofwat.

12.6 The procedure for making changes to licences will be broadly the same as that for licensed water suppliers under sections 17G to 17R of the WIA91, which will mean that any disputes around proposed licence changes may be subject to appeal to the Competition Commission. However, we do not propose to grant Ofwat powers to change all IP licences where a certain percentage of IPs agree to a change as provided for water supply licences under sections 17J of the WIA91. This is because we do not think that there will be many holders of IP licences to make such a provision workable and because we want to give potential bidders and investors some certainty that changes will not be imposed without some negotiation with the IP in question.

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

Enforcement

13.1 The WIA91 enforcement regime consists of a number of provisions:

- **enforcement orders (section 18) -** If the relevant authority (Secretary of State, Drinking Water Inspectorate or Ofwat) is satisfied that an undertaker or licensed water supplier (a water company) is contravening or is likely to contravene any condition of its appointment or licence or any statutory or other requirement that is enforceable under section 18 WIA91, the enforcement authority is under a duty to impose an enforcement order. This duty is subject to certain exceptions set out in section 19 WIA91. For example, the duty to make an enforcement order does not apply if the contravention is of a trivial nature; or the company has given and is complying with an undertaking to take appropriate steps to remedy the contravention under section 19.

- **financial penalties (section 22A)** - If the enforcement authority is satisfied that a company has contravened or is contravening a condition of its appointment or licence or any statutory or other requirement that can be enforced under section 18 WIA91, the enforcement authority can impose a financial penalty on the company.

- **special administration orders (sections 23-25)** – unlike in other sectors, the special administration regime for undertakers and some licensed water suppliers[5] is also used as an ultimate enforcement tool where a company is failing to such an extent that the only way to protect customers' interests is to transfer the business and licence to a new owner.

13.2 As said above, we envisage that the undertaker will continue to remain responsible for meeting relevant statutory obligations and other environmental standards. However, where specific contractual obligations are placed on the project company to enable the undertaker to meet its own obligations, Ofwat may require the project company to comply with these obligations as a condition of its licence and ensure compliance using its existing enforcement powers. Depending on the circumstances, the IP, rather than the undertaker, may also need to obtain relevant regulatory consents and approvals directly from the relevant regulatory authority, in which case the regulatory authority may be able to take enforcement action against the IP.

13.3 We do not intend to modify the WIA91 to allow a special administrator to be appointed if the IP is in serious breach of an obligation as can currently be done when an undertaker:

- is in serious breach of its principal duties;
- has been or is likely to be in serious contravention of an enforcement order issued under section 18 of WIA91
- cannot or will not participate in arrangements for an inset appointment under section 7 of WIA 91.

Managing the insolvency of a project company

14.1 In common with other regulated utility sectors, there is a special administration regime provided for in legislation that the Secretary of State or Ofwat may invoke when an undertaker cannot, or is unlikely to be able to, pay its debts.

14.2 The primary objective of the special administration regime for water and sewerage is to ensure that essential water supply and sewerage services to customers are maintained even if an undertaker runs into severe financial difficulties. In broad terms, this is achieved by:

- enabling the Secretary of State or Ofwat, in the event of an undertaker's insolvency, to appoint a special administrator;

- requiring the special administrator to transfer, as a going concern, as much of the insolvent undertaker's business to a new company or companies as is necessary to ensure that the undertaker's statutory functions may properly be carried out and, pending the transfer or transfers, to carry out those functions or licensed activities;[6]

[5] Only licensed water suppliers that hold a combined licence and own a strategic supply are subject to the special administration regime under the WIA91.

[6] Schedule 5 to the Floods and Water Management Act 2010 amended the special administration regime in the WIA91. In particular, it amended the purposes of special administration orders in relation to insolvent undertakers so as to first require the special administrator to seek to rescue the company as a

- modifying the rights of third party creditors under general insolvency law (sections 24 and 25 of, and Schedule 3 to, the WIA91).

14.3 Each undertaker is also required by the ring-fencing condition in its licence to ensure, so far as reasonably practicable, that it would have sufficient rights and assets to enable a special administrator to manage its affairs, business and property so that the purposes of a special administration order could be achieved if a special administration order were made in respect of the undertaker.

14.4 In practice, special administration would only be invoked as a last resort when all other avenues to resolve the undertaker's financial difficulties – including both regulatory interventions, and action by the undertaker's lenders – had been exhausted.

14.5 In the case of PFI projects, the contractual arrangements between the parties will be designed to reduce the likelihood of the project company becoming insolvent and to enable the funders to rescue a project (in the first instance, through their contractual rights under the finance documents, and in the second instance, through their "step-in rights" on service of a termination notice by the procuring authority for an insolvency–related event of default under the project agreement). They will also contain:

(i) detailed provisions setting out the parties' rights on termination for an event of default (including an insolvency-related event of default) if the funders are not able to rescue or are not interested in rescuing the project;

ii) safeguards to protect the key project assets from third party claims and insolvency proceedings; and

iii) emergency step-in rights to allow the procuring authority to temporarily take over a project if it is necessary because of a serious risk to health and safety or to the environment or to discharge a statutory duty.

14.6 The contractual arrangements are therefore designed to ensure continuity of the project and service delivery if the project company experiences severe financial difficulties. If the project company/project cannot be or is not rescued, the procuring authority will be entitled to terminate the project agreement. It may then re-tender the project or may find some other way of continuing with the works or providing the service.

14.7 The possibility and consequences of the project company becoming insolvent during the lifetime of a special infrastructure project will need to be addressed comprehensively in the contractual arrangements between the undertaker and the other parties to the project, as will other serious failures by the project company, and the undertaker will need to ensure that it will be able to comply with its statutory obligations and regulatory requirements. The Government would expect the contractual arrangements between the undertaker and the other parties to a special infrastructure project to be capable of adequately managing the insolvency of the project company and maintaining service delivery if the project company became insolvent.

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going concern, unless the special administrator thinks it is not likely to be possible to rescue the company or transfer is likely to secure the more effective performance of the undertaker's functions. It also replaces Schedule 3 to the WIA 91 with Schedule B1 to Insolvency Act 1986 which the Secretary of State may modify by regulations. These amendments are expected to come into force in October 2011.

14.8 Extending the special administration regime in the WIA91 (with any necessary modifications) to enable a special administrator to be appointed in relation to an insolvent project company in order to ensure that essential services to customers are maintained would provide a further mechanism to protect customers' from potential service failures arising from the insolvency of a project company responsible for the service delivery in relation to a special infrastructure project. It would enable the Secretary of State or Ofwat to appoint a special administrator in relation to the project company, who would then be required to transfer the business of the project company to a new company or new companies and, pending the transfer(s), ensure that the project company continues to maintain service delivery.

The existence of such a regime, alongside the contractual arrangements between the parties to the special infrastructure project could have a detrimental effect on the commercial and other incentives which would otherwise underpin the contractual arrangements and could result in sub-optimal outcomes for customers. On the other hand, not extending the special administration regime could also have detrimental consequences, for example, if the project company became insolvent and was not rescued by the project company's funders, or the undertaker could not re-tender the project in "liquid market" conditions, the undertaker may have to take over the project itself. There is a risk that the undertaker could find itself in serious financial difficulties as a result.

14.10 The main purpose of a special administration regime is to protect the interests of customers through ensuring the continued provision of essential services. The risks and scenarios around the financial failure of a project company are complex. However, on balance the Government believes that the impact of the financial failure of a project company on services to customers can be adequately managed, and that it should be managed, through effective commercial, contractual and regulatory mechanisms, with customers ultimately protected through the existing special administration regime applicable to undertakers. On these grounds we are not minded to extend the special administration regime directly to the SIPR. We would nevertheless welcome views from stakeholders.

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 the interests of customers will be appropriately protected?

Impact Assessment

17.1 An Impact Assessment (IA) has been prepared for these Regulations and is attached as Annex A.

17.2 The IA reflects the fact that these Regulations are generic. Although we expect that the Thames Tunnel will be considered for obligatory competitive tender under the Regulations, there is no guarantee that the Regulations will actually be applied. The reason for this is that no value-for-money assessment has been performed to date.

17.3 The generic nature of the proposed regulations means that the quantification of costs and benefits is limited to those arising from making these Regulations. It cannot quantify the large majority of the costs and benefits arising from applying the regulations.

Annex 1 – Full list of Questions

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

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 to tender as special infrastructure projects?

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?

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?

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

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

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 the interests of customers will be appropriately protected?