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Flood and Water Management Bill

Impact Assessment - amendments to the special administration regime for the water industry

Last updated: 25 September 2009

Summary: Intervention & Options

Department /Agency:		Title: Impact Assessment of amendments to the special administration regime for the water industry	
Stage: Bill	Version: 7	Date: September 7	
Related Publications: Draft Flood and Water Management Bill			

Available to view or download at:

<http://www.defra.gov.uk/environment/water/flooding/flow/index.htm>

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

The current special administration for water and sewerage companies in England and Wales is not in line with modern insolvency practice. Currently the only option given in primary legislation is for a special administrator to transfer the entire business to one or more new owners. This does not enable a special administrator to rescue the business as a going concern (e.g., by business stabilisation, financial restructuring and refinancing, operational turnaround, etc). If the business cannot be rescued there are barriers to transfer in that existing undertakers can veto a transfer and the standard insolvency practice of 'hive down' is not allowed at present.

What are the policy objectives and the intended effects?

The main policy objective is to improve the special administration regime for water by increasing the options open to the special administrator to bring about a better result for creditors, shareholders or members and, ultimately, customers. The effect of the proposals will be that viable water companies that experience short-term financial difficulties will be given a breathing space to enable them to return to profitability rather than be sold to one or more new owners. Another effect will be that the regime will become more flexible, streamlined and consistent with general insolvency cases and best practice adopted in other sectors.

What policy options have been considered? Please justify any preferred option.

Option 1) The reference case: no intervention which retains the current legislation.

Option 2) The preferred option: to amend the existing regime so that a special administrator has a 'rescue objective', or if a transfer of the business is necessary, to remove the incumbent licence holders' veto and implement well-established insolvency practices when it comes to a transfer (i.e., hive-down). This will maximise the value of the company, through rescue or transfer, for creditors, shareholders and members and reduce the likelihood of negative impacts on the regulated business and on customers' bills.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? The policy will be reviewed whenever there are further changes made to the Insolvency Act 1986 or other relevant legislation.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:

.....Date:

Summary: Analysis & Evidence

Policy Option: **2**

Description: Introduce changes to primary legislation on

COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' No monetised costs.	
	One-off (Transition)	Yrs		
	£ N/A			
	Average Annual Cost (excluding one-off)			
	£ N/A		Total Cost (PV)	£ N/A
Other key non-monetised costs by 'main affected groups'				

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups' No monetised benefits. Preferred option may result in lower costs in special administration cases but this may be dependent on the availability of finance, negotiations with creditors, or the presence (or absence) of willing buyers ready to step in.	
	One-off	Yrs		
	£ N/A			
	Average Annual Benefit (excluding one-off)			
	£ N/A		Total Benefit (PV)	£ N/A
Other key non-monetised benefits by 'main affected groups' Preferred option results in a wider range of options available to the special administrator to bring about the best possible result for creditors, members, shareholders and customers. Use of hive-down will make some transfers more tax efficient.				

Key Assumptions/Sensitivities/Risks

In some circumstances there is a risk of the loss of Exchequer funds if the hive-down mechanism is used.

Price Base Year	Time Period Years	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £
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What is the geographic coverage of the policy/option?			England and Wales		
On what date will the policy be implemented?			2010		
Which organisation(s) will enforce the policy?			N/A		
What is the total annual cost of enforcement for these organisations?			N/A		
Does enforcement comply with Hampton principles?			Yes		
Will implementation go beyond minimum EU requirements?			No		
What is the value of the proposed offsetting measure per year?			N/A		
What is the value of changes in greenhouse gas emissions?			N/A		
Will the proposal have a significant impact on competition?			No		
Annual cost (£-£) per organisation (excluding one-off)		Micro 0	Small 0	Medium 0	Large 0
Are any of these organisations exempt?		No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)		
Increase of	£ N/A	Decrease of	£ N/A	Net Impact	£ N/A

Key:

Annual costs and benefits: Constant Prices

(Net) Present Value

Evidence Base (for summary sheets)

INTRODUCTION

This impact assessment sets out the case for introducing amendments to the special administration scheme for the water industry in England and Wales. It is published alongside the Flood and Water Management Bill at its introduction into Parliament.

BACKGROUND

In England and Wales, water and sewerage services are supplied almost exclusively by water undertakers and sewerage undertakers which are required to supply water and sewerage services to a specific geographical region known as their area of appointment. The Secretary of State and the Welsh Ministers must ensure that at all times there is a water undertaker and sewerage undertaker for every part of England and Wales. New-entrant licensed water suppliers are also able to provide water supply services to large non-household premises.

As the economic regulator for the water industry, Ofwat works closely with relevant undertakers to ensure that they are able to properly carry out and finance their statutory functions, and with licensed water suppliers to ensure that they are able to properly carry out their statutory functions. This working relationship helps to reduce the risk that water companies will run into severe financial difficulties or will fail to meet key statutory or regulatory requirements. However, it neither eliminates, nor intends to eliminate, all risks of these outcomes. Undertakers and licensed water suppliers are private-sector companies that do not receive any subsidies from the taxpayer. As such they are no different from other private companies in that they have to compete for private-sector finance alongside other companies and sectors.

The Water Industry Act 1991 (WIA91) contains a special administration regime with provisions to ensure that essential services will continue to be delivered to customers if one of the following becomes insolvent:

- water undertakers;
- sewerage undertakers; and
- licensed water suppliers that own a designated strategic supply.

The special administration regime for water differs from other sectoral regimes in that it can also be used as an enforcement tool if one of the above water companies is failing to such an extent that transfer to a new owner is seen as the only option to protect the interests of customers.

Licensed water suppliers that provide retail services only and that do not own strategic services or supplies are not covered by the special administration regime. They would instead be covered by the regime for non-regulated companies under the Insolvency Act 1986.

In view of the importance of maintaining water and sewerage services at all times, the special administration regime in the WIA91 aims to ensure that water supply and sewerage services will not be adversely affected if a water company runs into severe financial difficulties or if it becomes appropriate on regulatory grounds to replace the company concerned.

The special administration regime achieves this broadly by:

- replacing ordinary insolvency proceedings with special administration proceedings;
- requiring the special administrator to carry out the company's statutory functions or licensed activities and to run the regulated business pending the transfer of the regulated business to one or more new owners; and

- using transfer schemes to transfer ownership of the licence and assets of the company to one or more new owners.

This proposal forms part of the Government's ongoing strategy for modernising the court's role in dealing with insolvency. In July 2001, the Government published its White Paper, 'Productivity and Enterprise: Insolvency - A Second Chance'. The Enterprise Act 2002 made substantial amendments to the administration procedures for failing companies that were originally introduced in the Insolvency Act 1986. The purpose was to enhance the policy of creating a 'rescue culture', so that insolvent companies so far as possible should be saved before either their assets are stripped and distributed to creditors; or, as is the case with special administration, they are sold to one or more new owners. The first regulated sector to adopt a special administration regime with company rescue as an objective was the energy sector. The energy administration regime also includes a hive-down provision and a more streamlined transfer scheme than that currently provided for in the WIA91.

POLICY OPTIONS

Option 1) Reference Case

The Government is confident that the special administration regime, as it currently stands in the WIA91, is able to ensure that the interests of customers of water and sewerage customers are protected in terms of continuity of service (although there has never been a water-company failure in which to fully test this). However, the legislation provides only one option for the special administrator to resolve a special administration case: to sell the business to one or more new owners. There is thus no scope for the special administrator to work with creditors, investors and the directors to examine other options that might retain value in the business and therefore bring about a better result for:

- creditors, because there may be better ways to make more funds available to pay off debts than a straightforward sale of the business might generate;
- shareholders and members, because they would retain ownership of the business; and ultimately
- customers, if the outcome is a more efficient water company with lower costs.

Transferring the business would still be preferred if the company in question was inefficient, suffered from poor management or was otherwise unviable. It is also the only option if the company is failing to such an extent that it is unlikely to be able to carry out its statutory functions. (The special administration regime for water is unique in that it is used as an ultimate enforcement tool.) However, there may be circumstances where the transfer of a viable water company that is experiencing short-term financial difficulties (e.g., problems with re-financing debt) may not be sold for its full market value, which may significantly reduce the amount of money available to creditors, and may have an adverse impact on customers' bills. Because water companies have to raise money through private-sector finance just like the companies that are covered by the general insolvency regime, it is appropriate to consider whether the legislation should address issues around short-term financing problems, particularly in cases where the business is otherwise viable.

The current legislation does not permit the special administrator to sell part of a water company to a wholly-owned subsidiary in order for new owners to buy the company assets and shares with minimal liabilities (*i.e.*, "hive-down"). This makes straightforward sales of water companies less attractive to potential buyers and may expose the transfer to certain tax liabilities that would otherwise be avoidable if hive-down were permitted.

Another feature of the water administration regime is the ability for property, rights, assets and liabilities of the water company to be passed to a new owner through the use of statutory transfer schemes. An undertaker with an interest in the failing business (e.g., one that receives a bulk supply) currently has to give its consent to the transfer. This interest gives it the ability to veto or delay a potential sale to new owners if it thinks its interests could be significantly affected.

The Government therefore does not consider “do nothing” as being in the best interests of water customers or the industry generally.

Option 2) Preferred Option - change

We intend to amend the WIA91 so that the special administration regime for water companies experiencing financial difficulties will be brought into line with the general insolvency regime (with appropriate modifications to take account of the special administration objective) and the regimes for other sectors, especially that for energy. This will include:

- introducing a rescue objective for viable water companies;
- allowing for hive-down;
- applying changes introduced by the Enterprise Act 2002 to the special administration regime; and
- removing a requirement for an undertaker’s consent to be given before a transfer can take place.

No other options regarding this proposal have been considered.

COSTS OF PREFERRED OPTION

Rescue objective

In certain cases the special administrator would work with the water company on the feasibility of producing a rescue plan in order to turn the business around and return it to a state of profitability (e.g., restructuring its capital structure through business stabilisation, financial restructuring, refinancing, operational turnaround, etc). It might also include selling part of the business to help pay off debts, but this would be considered only if it did not affect the delivery of essential water and sewerage services. The costs of the rescue objective could therefore be considered in the context of maximising value in the business and producing a better outcome for creditors by potentially making more funds available to pay off debts.

However, there could be greater costs associated with pursuing the rescue objective if there are already one or more willing buyers prepared to take over the business as a going concern at the full market value. In such circumstances the special administrator will consider which option will bring about the best result for creditors. The courts will also ensure that the objectives of the special administration are met quickly and efficiently.

Hive-down

Where the transfer objective is the only viable way forward, there would be cost savings associated with facilitating a transfer using a hive-down mechanism. A hive-down is a way of obtaining the market value of a company without passing on most of the liabilities to the new owners. As above, costs would need to be looked at in terms of maximising value in the business in order to generate more funds to pay off debts. However, a straightforward transfer

without using hive-down could expose the transaction to certain tax liabilities, which could greatly add to overall costs and could affect the value of the business. There would, however, be a potential loss to the Exchequer as a result of introducing hive-down.

Application of Enterprise Act 2002 provisions

In the unlikely event that a water company were to go into special administration, the insolvency practitioner would need to familiarise himself with the requirements of the special administration regime. However, this should not significantly increase costs as the provisions will be broadly based on those for other companies.

Transfer scheme provisions

Removing the right of a relevant water company to veto a transfer will remove what could be a significant barrier to taking forward the sale of a failing water company, particularly if it took the form of a legal challenge. Removal of the right of veto reduces the risk of escalating costs that could arise while due process is followed.

BENEFITS OF PREFERRED OPTION

Generally it is important that the special administration regime for water keeps up-to-date with the regimes for other sectors, particularly as some water companies (*i.e.*, water and sewerage retailers) are covered by general insolvency legislation and may benefit from the wider range of insolvency mechanisms that are open to them. A major benefit of the preferred option would therefore be a narrower gap between the treatment of different water companies that find themselves in financial difficulties.

Rescue objective

The main benefit of pursuing the rescue objective will be that viable water companies will not necessarily be sold to new owners if their financial difficulties are only short-term in nature and not of their own making. It will maximise the value of the company and will give the special administrator more options to secure a better result for creditors by potentially making more funds available to pay off debts (the principal objective of ordinary insolvencies), and a better outcome for shareholders because they will retain ownership of the business. A better outcome for creditors, shareholders and investors could also bring about benefits for the wider economy.

Bringing in the rescue objective could also potentially reduce the cost of borrowing for water companies because there is a reduced risk of the business being sold if it gets into difficulties, but there are a large number of other factors to be taken into account by investors in capital markets so the reduced risk may not have much of an impact on actual costs.

Hive-down

Providing a hive-down mechanism in the special administration regime would make it easier to transfer the business to new owners because the liabilities associated with the original owner will not be included as part of the sale. This will make the business a much more attractive proposition for potential buyers and will help the special administrator to obtain the best possible price for the business, which will be of direct benefit to the creditors because there will be more funds available to pay off debts (the proceeds of the sale will be used by the special administrator to pay off the debts).

Acquiring a company by a hive-down mechanism is of benefit to the new owners as it allows them to acquire ownership of the licence and assets by purchasing shares. This means that it allows the purchaser to acquire a 'clean' company which does not come with the liabilities that led the original owner into insolvency. There are some special tax reliefs which can be

available under the hive-down mechanism to ensure that the transfer can be made free of tax, which makes it much easier to find buyers for the business.

Application of Enterprise Act 2002 provisions

The main benefit of adopting the changes made to the Insolvency Act 1986 by the Enterprise Act will be that the special administration regime will be aligned with the regime for non-regulated companies (including water and sewerage retailers). The insolvency practitioners that are appointed as special administrators will find themselves in familiar territory when handling a special administration case and will not have to refer back to the old insolvency procedures. This will help ensure that any special administration case will run smoothly.

Transfer scheme provisions

The benefit of removing the undertaker's right of veto from the transfer scheme will be that one particular interested party will not prevent a transfer taking place. The costs of special administration fall to the failing water company and, ultimately, to customers; these costs could be considerable if a transfer is delayed or if no buyers can be found. The potential delays associated with obtaining another undertaker's consent could also cause potential buyers to withdraw offers or deter others from pursuing a purchase if they thought consent might be difficult to obtain.

SPECIFIC IMPACT TESTS

Defra has not conducted any specific impact tests. The policy proposals recommend changes that are applicable only to water and sewerage undertakers and qualifying licensed water suppliers and do not in any way have an impact on market participation or put incumbents at a competitive advantage. The proposals come into play only if one of these companies falls into financial difficulties; they therefore have no significant effect on small firms, and do not raise any issues related to the environment, health, equality, human rights, or rural areas. The proposals make changes to court procedures but will not have an impact on Legal Aid.

The Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	No	No
Small Firms Impact Test	No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

Annexes