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

The Hampton Review included a specific recommendation that regulators should be more accountable for the way in which they undertake their delivery functions. Rather than providing the funding directly, Defra proposes to introduce a charging mechanism for DWI to recover the costs of its regulatory functions from the water industry, which will help achieve this recommendation.

### What are the policy objectives and the intended effects?

Defra considers that providing a mechanism for the Drinking Water Inspectorate (DWI) to recover the costs of its delivery functions from the water industry will be more consistent with cost recovery mechanisms for other water regulators (Ofwat, Consumer Council for Water and the Environment Agency). It will also:

- Assist in making the funding of DWI more transparent;
- Enable DWI to be more accountable for the way it delivers its inspection and enforcement functions;
- Incentivise desirable water quality risk management behaviour among water companies and suppliers.

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

**Option 1)** Do Nothing - Defra considered continuing to subsidise the full costs of DWI but this is not compliant with the Hampton Review and is not consistent with charging mechanisms of related water regulators.

**Option 2)** Consideration was given to whether the regulatory service should be provided through the private sector. This option was rejected for two reasons:

- the service provided by DWI is so specialised and of low margin that it is not likely to be economically viable and
- the service provided by DWI is so important as the provision of a safe water supply is fundamental to public health protection.

**Option 3)** Defra’s preferred option is to enable DWI to impose a charging scheme which will enable it to recover the cost of its regulatory functions from water companies.

- This option is justified under the Defra Charging Handbook 2005 which provides guidance to facilitate consistent, coherent, transparent and predictable charging for regulatory services across Defra.
- The overall rationale for charging is that if an industry undertakes an activity that causes an adverse effect on others (such as pollution or risk of disease) which requires regulation, it should face the cost of enforcing and implementing the regulation. In this respect the water supply industry is regarded as managing a risk of disease due to the fundamental link between safe water supplies and public health.
- A significant proportion of DWI activity relates to monitoring the way water companies meet their regulatory requirements through technical audit and associated enforcement activity. As the water industry benefits from these regulatory services, it should bear the cost of providing that service and related enforcement activity.
- By apportioning the costs Defra are adhering to better regulation principles.

### When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

A year following implementation and periodically in line with charging reviews.

---

**Ministerial Sign-off**  
For Consultation Stage Impact Assessment:

*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:** Enable DWI to impose a charging scheme

#### ANNUAL COSTS

<table>
<thead>
<tr>
<th>Description:</th>
<th>Enable DWI to impose a charging scheme</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>COSTS</strong></td>
<td></td>
</tr>
<tr>
<td>One-off (Transition) Yrs</td>
<td></td>
</tr>
<tr>
<td>£200,000</td>
<td></td>
</tr>
<tr>
<td>Average Annual Cost (excluding one-off)</td>
<td></td>
</tr>
<tr>
<td>£2m</td>
<td></td>
</tr>
</tbody>
</table>

**Other key non-monetised costs by ‘main affected groups’**

Ofwat advise that the cost to water companies and suppliers of reviewing and processing one new annual invoice from DWI are negligible and not monetised.

#### ANNUAL BENEFITS

<table>
<thead>
<tr>
<th>Description:</th>
<th>Enable DWI to impose a charging scheme</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BENEFITS</strong></td>
<td></td>
</tr>
<tr>
<td>One-off Yrs</td>
<td></td>
</tr>
<tr>
<td>£</td>
<td></td>
</tr>
<tr>
<td>Average Annual Benefit (excluding one-off)</td>
<td></td>
</tr>
<tr>
<td>£1.9m</td>
<td></td>
</tr>
</tbody>
</table>

**Other key non-monetised benefits by ‘main affected groups’**

1. Improved transparency (for consumers and water industry) of charging in line with Hampton recommendations, with additional information provided to the public by DWI on how well individual water companies and licensed suppliers have progressed with their risk management systems;
2. Improved independence of DWI in relation to its regulatory budget;
3. Improved accountability of DWI in relation to the water industry and consumers – through approval mechanism on proposed charges;
4. The proposed system will incentivise water companies to help deliver lighter regulation, as water companies will be charged in proportion to their own regulatory burden on DWI.

#### Price Base Summary

<table>
<thead>
<tr>
<th>Price Base Year</th>
<th>Time Period Years</th>
<th>Net Benefit Range (NPV)</th>
<th>NET BENEFIT (NPV Best estimate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008/9</td>
<td>12</td>
<td>-£0.6 m to -£1.4 m</td>
<td>£-1m</td>
</tr>
</tbody>
</table>

**Key Assumptions/Sensitivities/Risks**

Key – that DWI can quantify relative regulatory burden of water companies.

<table>
<thead>
<tr>
<th>What is the geographic coverage of the policy/option?</th>
<th>England and Wales</th>
</tr>
</thead>
<tbody>
<tr>
<td>On what date will the policy be implemented?</td>
<td>2010/11</td>
</tr>
<tr>
<td>Which organisation(s) will enforce the policy?</td>
<td>Defra (incl. Review)</td>
</tr>
<tr>
<td>What is the total annual cost of enforcement for these organisations?</td>
<td>£</td>
</tr>
<tr>
<td>Does enforcement comply with Hampton principles?</td>
<td>Yes</td>
</tr>
<tr>
<td>Will implementation go beyond minimum EU requirements?</td>
<td>N/A</td>
</tr>
<tr>
<td>What is the value of the proposed offsetting measure per year?</td>
<td>£ N/A</td>
</tr>
<tr>
<td>What is the value of changes in greenhouse gas emissions?</td>
<td>£ N/A</td>
</tr>
<tr>
<td>Will the proposal have a significant impact on competition?</td>
<td>No</td>
</tr>
</tbody>
</table>

**Annual cost (£-£) per organisation (excluding one-off)**

<table>
<thead>
<tr>
<th>Micro 10p per water bill</th>
<th>Small 10 p per water bill</th>
<th>Medium 10 per water bill</th>
<th>Large 10 per water bill</th>
</tr>
</thead>
<tbody>
<tr>
<td>£</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Impact on Admin Burdens Baseline (2005 Prices)**

<table>
<thead>
<tr>
<th>Increase of £</th>
<th>Decrease of £</th>
<th>Net Impact £</th>
</tr>
</thead>
<tbody>
<tr>
<td>None</td>
<td>None</td>
<td>(Increase - Decrease)</td>
</tr>
</tbody>
</table>

**Key:**

- Annual costs and benefits: Constant Prices
- (Net) Present Value
Evidence Base (for summary sheets)

Introduction

The Drinking Water Inspectorate (DWI) was established in 1990 as the drinking water quality regulator for the privatised water industry. The Secretary of State for Environment, Food and Rural Affairs and Welsh Ministers have responsibility under the Water Industry Act 1991 (as amended by the Water Act 2003) for regulating the quality of public drinking water supplies in England and Wales respectively. The Act allows the Secretary of State and Welsh Ministers to appoint persons to act on their behalf as technical assessors.

DWI undertakes a range of statutory and non-statutory roles. The work of DWI can be divided into activities that stem from its statutory role in ensuring water companies meet their statutory requirements and those that support policy functions.

Regulatory functions

- Technical audits involving the inspection and assessment of water companies’ water supply arrangements (s86 of WIA)
- Investigation of water quality events and incidents (s86 of WIA)
- Providing guidance on the Drinking Water Quality Regulations and Standards
- Technical evaluation of water companies' water quality data
- Investigations of complaints relating to drinking water quality as notified by members of the public, local authorities or businesses to establish whether any regulatory breach has occurred (S86 and S18 of WIA)
- Statutory reporting on drinking water quality (S86 of WIA)
- Commissioning and management of research as evidence base for regulatory action including the requirements to maintain a wholesome water supply.

Policy functions

- Commissioning and management of research programme on drinking water quality and health (as evidence base for technical advice roles listed below)
- Providing scientific and technical advice to Ministers and officials in Defra and the Welsh Assembly Government on drinking water issues, policies and standards
- Statutory reports as required by Ministers (s86 WIA 1991)
- Assisting with Parliamentary and Welsh Assembly Government questions on drinking water quality issues
- Involvement with national, European and international organisations in the development of guidelines and standards for drinking water quality and measures to improve drinking water safety.
- Co-ordinating role with other UK Drinking Water Regulators

The Water, Floods, Environmental Risk and Regulation Directorate (WaFERR), has responsibility within Defra for the policy on drinking water quality in England, also holds the sponsorship role in relation to the DWI. DWI differs from ordinary divisions in Defra in that its role is recognised in statute, and it exercises powers delegated directly to it by the Secretary of State. However it is similar to other divisions in that it sits in organisational terms alongside other divisions within WaFERR, is accountable to the Director on HR and financial management matters and its staff are civil servants employed by the Crown. The relationship between the DWI and the Welsh Assembly is identical in respect of powers and duties under section 86 of the 1991 Water Industry Act but the Welsh Assembly has no direct day to day role in managing the Inspectorate.

DWI’s budget falls within the WaFERR Directorates’s total programme allocation and the Secretary of State is ultimately responsible for allocating resources to DWI and is accountable to Parliament for that expenditure. Therefore, currently, tax payers fund both DWI regulatory and policy functions.

Policy Aims - Reasons for the Proposed Changes

The Hampton Review of 2005 identified ways in which Government Departments could reduce the administrative burden of regulation on businesses, namely the cost in time or money of regulators’ inspection and enforcement activities, but while maintaining or improving regulatory outcomes and increasing operational efficiency. Among the recommendations was the consolidation of regulators into a number of thematic bodies. In light of reassessment of the business case, further consideration is being given to whether DWI should merge with another body or whether it should remain within Defra and the Government will consult separately on this matter before the end of the first quarter next year. Hampton also included a specific recommendation that regulators should be more accountable for the way in which they undertake their delivery functions. Defra and the Welsh Assembly Government consider that providing a mechanism for DWI to recover the costs of its delivery functions from the
water industry will assist in making the funding of DWI more transparent and enable DWI to be more directly accountable for the way it delivers its regulatory functions.

Enabling DWI to impose a charging scheme to recover the cost of its regulatory functions from water companies will add to the increased independence of DWI within Defra. DWI already has its own budget within the Water, Floods, Environmental Risk and Regulation Directorate of Defra; it has separate accommodation from the Defra policy division; produces an independent annual report and the Chief Inspector of Drinking Water, appointed by the Secretary of State and Welsh Ministers, has specific independent powers on enforcement and prosecution.

Policy Options

Defra considered several options including:

1. Do Nothing and continue to subsidise the full costs of DWI. However, no justification has been found to warrant this as a workable option. Defra will however continue to fund the policy service DWI provides to both Defra and the Welsh Assembly.

2. Provision of the regulatory service should be through the private sector. There are two main reasons why it was felt that the service would not be suitable for delivery by the private sector. Firstly the service is so specialised and of low margin that it is not likely to be economically viable and secondly the service is so important as the provision of a safe water supply is fundamental to public health protection.

3. To introduce a new power within the Water Industry Act 1991 to enable DWI to impose a charging scheme which will enable DWI to recover the cost of its regulatory functions from water companies. This is the preferred option.

The remainder of this IA deals with the preferred option only.

Justification for preferred option

The Defra Charging Handbook 2005 provides guidance to facilitate consistent, coherent, transparent and predictable charging for regulatory services across Defra. The overall rationale for charging is that if an industry undertakes an activity that causes an adverse effect on others (such as pollution or risk of disease) which requires regulation, it should face the cost of enforcing and implementing the regulation. In this respect the water supply industry is regarded as managing a risk of disease due to the fundamental link between safe water supplies and public health.

The water industry already meets the cost of the statutory direct monitoring (water sampling and analysis) that is required by the Water Supply (Water Quality) Regulations 2000 and 2001. However, a significant proportion of DWI activity relates to monitoring the way water companies meet their regulatory requirements through technical audit and associated activities. As it is the water industry who benefits from these regulatory services, they should bear the cost of providing that service.

By introducing a charging scheme DWI will be in line with the related water regulators Ofwat, the Consumer Council for Water (CCW) and the Environment Agency who charge for their regulatory activities.

Ofwat recovers all of its £18M annual costs from the water industry through provisions in the water company licences. CCW recovers all of its £6M annual costs from the water industry through provisions in their licence fee and the Environment Agency recovers the cost of its regulatory services through statutory charging schemes such as abstraction and environmental licenses, which account for some 34% of its annual total operating costs of £1,025M.

How the Recovery/Charging Powers will work

DWI operates a risk based approach to technical audits. The regulatory activity applicable to each water company/supplier/relevant person is governed by the potential risk of its activities to public health. The activity levels applicable to each company/supplier will therefore vary between companies/suppliers and will also change over time relative to the risks as determined by DWI. The number of licensed water suppliers will also change according to competitive market forces and Government policy (e.g. Cave review).

It is proposed that DWI will develop a system to identify the costs of their regulatory services in relation to individual water companies and licensed suppliers which will allow cost recovery to be apportioned to individual water companies. Water companies and water suppliers will then include these charges in customer’s water bills.

Charging schemes should be clearly understandable, require a minimum of bureaucracy and the prediction of future charges should be simple. DWI will produce a document to introduce the cost recovery mechanism explaining the basis of charging and how future charges will be notified.

The development of a charging system of this type is dependent on DWI establishing a system of financial management that can separately identify both the costs of regulatory functions such as inspections and technical
audits for each water company and the costs of policy functions, such as advice to Ministers, which will not be subject to cost recovery.

**Presentation of figures in the IA**

Figures are shown in 2008/09 prices. It is assumed that the policy will be implemented in 2010/11, and that the functions and associated costs will transfer in that year and be removed from the Defra funded budget received by DWI, and all new ongoing costs will arise from that year onwards. The DWI system development cost is assumed to be incurred in the year before that. The timeframe chosen is 12 years from today, to span 10 years from the time of implementation. Annual average costs for the IA timeframe have been reached by dividing by 12, therefore. Figures are discounted to today using a 3.5% discount rate in line with Treasury Green Book guidance.

Although the NPV shown is negative this is only because many of the benefits of the preferred option are not capable of being monetised, since they relate to improved regulatory practice, transparency, and the provision of incentives to the water industry.

The NPV range illustrates the impact of the DWI system development and operational costs being 40% higher or lower than the central estimate.

**Benefits of DWI Developing a Charging Scheme**

Charging schemes should aim to incentivise desirable behaviour. Under the preferred option, the contribution that each water company has to contribute to finance the DWI regulatory functions will depend in part on the amount of technical audits and associated activities required. The main desirable behaviour sought from the water industry is the adoption of a risk assessment and management approach so that in the long term improved protection of water safety is achieved and lighter regulation is possible. If lighter regulation is required technical audits and investigative work can be decreased and charges reduced.

The transparency of charges will provide additional information to the public on how well individual water companies and licensed suppliers have progressed with their risk management systems. If a water company/water supplier is progressive and has developed robust and effective risk management they will have a reduced inspection programme compared to a water company that has limited systems.

Other benefits include improved independence of DWI in relation to its regulatory budget, and improved accountability of DWI in relation to the water industry and consumers – through approval mechanism on proposed charges. It is not possible to monetise these benefits.

It is hoped that in the medium term the incentives provided to water companies will improve water safety management, enabling fewer inspections and so reducing the overall spending of the DWI on regulatory functions. This financial benefit has not been monetised.

**Disadvantages of DWI Developing a Charging Scheme**

The major financial impact of the preferred option is the transfer of funding of DWI regulatory functions from Defra (tax payers) to water companies and water suppliers. It is assumed that this cost will transfer from the year of implementation, 2010/11. The preliminary estimate of costs indicates that regulatory functions account for about 69% of DWI’s costs, in the region of around £2.312M, using figures provided by DWI for 2008/09. The cost of these DWI functions has not altered by more than 10% in the last 3 years.

The preferred option will result in a charging scheme that will ultimately be funded by a small increase in customers’ water bills. Based on 2007/08 bill levels, recovery of £2.3m (the annual average is £2m) across all water bills in England and Wales will add on average 9.6 pence per bill per year. Each water company or supplier will pay a different amount, in part reflecting the number of inspections and associated activities that its behaviour requires. The range of bill impact is expected to be from 5 pence per year to 20 pence per year, around the average 10p. This increase will be the same for all water customers (domestic and business).

There will be a few additional costs arising from the preferred option.

DWI estimates its one off cost of setting up the new financial management and charging system at £200k in 2009/2010, to procure and develop the necessary IT systems, with an ongoing maintenance cost equivalent to one full time person, with overheads and any associated expenses for system maintenance, totalling £100k a year from 2010/11 onwards. This estimate is considered sufficient to include any additional days that are spent by DWI staff for recording regulatory activity against individual water companies, and invoicing. This raises the bill impact to around 10 pence per year.
A mechanism of independent scrutiny will be required to ensure that the costs DWI charge for their regulatory service are justifiable and apportioned in a fair manner. The scrutiny will be provided by initial consultation with water companies on proposals, with provision for representations to the Secretaries of State and for Secretaries of State to approve the proposed charging scheme before adoption. No significant costs will be involved, and an estimate of 5 days per year for Defra policy staff handling representations to the Secretary of State has been included, totalling around £1,000 per year.

This brings total bill impacts to 10 pence per year on average, with a range between 5 and 20 pence. The bill increase will be at the same rate for all customers in a given water company area, hence the Summary Sheet shows the annual impact on businesses of all size at the average cost of 10 pence gross. (For companies that are tax payers, the net impact of transferring DWI funding from tax to water bills will be less than this gross effect.)

There will negligible or zero other costs or savings to Defra and Ofwat. Water companies and suppliers will be required to review and process one new invoice per year from the DWI, and make one new payment against that invoice. Ofwat have advised that there will be negligible or zero additional costs associated with this. For this reason the Summary Sheet indicates no change to administrative burden on industry arising from the preferred option.

**Specific Impact Tests**

**Competition Assessment**
The proposed charging scheme will not have an impact on competition.

**Small Firms Impact Test**
The proposed charging scheme will have a small impact on all water bills – within a given water company area, the charge will be the same, whether you are a commercial user or domestic user, it is not dependant on the amount of water used. The additional charge on water bills will be in the order of between 5 pence to 20 pence per year, around an average increase for England and Wales of 10 pence per year. This is not considered to impose a discriminatory burden for small businesses.

**Legal Aid**
The proposed charging scheme will not introduce new criminal sanctions or civil penalties.

**Sustainable Development**
The overall rationale for charging is that if an industry undertakes an activity that causes an adverse effect on others (such as pollution or risk of disease) which requires regulation, it should face the cost of meeting the regulation. In this respect the water supply industry is regarded as managing a risk of disease due to the fundamental link between safe water supplies and public health. The water industry already meets the cost of the statutory direct monitoring (water sampling and analysis) that is required by the Water Supply (Water Quality) Regulations 2000 and 2001. However, a significant proportion of DWI activity relates to monitoring the way water companies meet their regulatory requirements through technical audits and associated activities. As it is the water industry who benefits from these regulatory services, they should bear the cost of providing that service. This proposal is consistent with the principle of a sustainable economy.

**Carbon Assessment**
The proposed charging scheme will not lead to a change in the emission of Greenhouse Gases.

**Other Environment**
The proposed charging scheme will not affect other environmental issues.

**Health Impact Assessment**
The proposed charging scheme will not have an impact on health, well-being or health inequalities.

**Race Equality**
The proposed charging scheme will not have an impact on race equality.

**Disability Equality**
The proposed charging scheme will not have an impact on disability equality.

**Gender Equality**
The proposed charging scheme will not have an impact on gender equality.

**Human Rights**
The proposed charging scheme will not have an impact on human rights.

**Rural Proofing**
The proposed charging scheme will not have a different impact on rural areas.
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.

<table>
<thead>
<tr>
<th>Type of testing undertaken</th>
<th>Results in Evidence Base?</th>
<th>Results annexed?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competition Assessment</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Small Firms Impact Test</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Legal Aid</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Sustainable Development</td>
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</tr>
<tr>
<td>Carbon Assessment</td>
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<td>Other Environment</td>
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<td>Race Equality</td>
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<td>Human Rights</td>
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</tr>
<tr>
<td>Rural Proofing</td>
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</table>
Annexes

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