

## **Explanatory Memorandum to The Construction Contracts (Exclusion) (Wales) Order 2023**

This Explanatory Memorandum has been prepared by the Department of Climate Change & Rural Affairs and is laid before Senedd Cymru in conjunction with the above subordinate legislation and in accordance with Standing Order 27.1

### **Minister's Declaration**

In my view, this Explanatory Memorandum gives a fair and reasonable view of the expected impact of The Construction Contracts (Exclusion) (Wales) Order 2023. I am satisfied that the benefits justify the likely costs.

**Julie James MS**  
**Minister for Climate Change**  
14 March 2023

## **1. Description**

1.1. This instrument excludes two types of construction contract from the provisions of the Housing Grants, Construction and Regeneration Act 1996 ("the Act"):

- Direct Procurement for Customers (DPC) Competitively Appointed Provider (CAP) Contracts - excluded from all requirements of Part 2 of the Act; and
- Direct Procurement for Customers (DPC) First Tier Sub-Contracts - excluded from section 110(1A) of the Act.

1.2. Both contract types form part of a new procurement model, known as Direct Procurement for Customers (DPC) for the finance, design, building, operation and maintenance of high value water and sewerage infrastructure.

1.3 Part 2 of the Act makes provision as regards the terms of construction contracts and related matters. The Order excludes from the entirety of Part 2 of the Act certain large infrastructure project contracts where a party to the contract is a sewerage or water undertaker, subject to the following requirements.

1.4 The contract must relate to a project designated by the Water Services Regulation Authority (Ofwat) as a direct procurement for customers project in accordance with the conditions of the relevant undertaker's appointment. Such contracts must also involve the making of regular payments by reference to actual costs incurred and which become due after one or more parts of the construction operations are completed and are capable of performing a sewerage or water service.

1.5 The Order also excludes section 110(1A) of the Act from applying where a party to such a contract enters into a subcontract. Section 110(1A) of the Act provides that the requirement that contracts provide an adequate mechanism for establishing what payments become due and when under the contract is not met if payment is conditional on obligations being performed under another contract.

## **2. Matters of special interest to the Legislation, Justice and Constitution Committee**

None.

## **3. Legislative background**

3.1 Powers are conferred on The Welsh Ministers to make the Order by sections 106A(2) and 146 of the Act.

3.2 In accordance with section 106A(4)(a) of the Act, a draft of this Order must be laid before Senedd Cymru and approved by a resolution of the Senedd Cymru (the affirmative procedure).

## **4. Purpose and intended effect of the legislation**

4.1. Direct Procurement for Customers (DPC) is a procurement framework designed and regulated by Ofwat for water and sewerage companies to competitively tender for third parties to design, build, finance, operate and maintain large-scale infrastructure assets where Ofwat believe this offers better value for money for

customers. Its objective is to efficiently deliver large water or sewerage infrastructure projects

4.2 A DPC CAP agreement is a contract between a water or sewerage company appointed by Ofwat and a CAP, successful in a competitive procurement process. The CAP is likely to be a special purpose vehicle, owned by a private consortium likely to include a construction company, funder and service provider.

4.3 A DPC First Tier Sub-Contract is a contract between the CAP to a DPC agreement and a third party (the main construction contractor) in which the former sub-contracts construction obligations in the DPC CAP agreement to the latter.

4.4 There is 1 proposed DPC CAP agreement in Wales in respect of the Dŵr Cymru Welsh Water Cwm Taf water treatment works ("Cwm Taf"). This is a new, large, and enhanced water treatment works serving much of southeast Wales to replace three existing treatment works where there are issues of deteriorating raw water quality and maintenance of existing assets is no longer feasible.

4.5. The operation and maintenance of this works will be kept in-house by the water company – the design, finance and build will fall within the scope of the DPC CAP.

4.6. Ofwat established a general principle for DPC projects that customers would not start paying for the asset until it is operational, which is consistent with other project finance models. A risk of legal challenge around this approach under the Act has been identified.

4.7. The Act creates a framework for key aspects of construction contracts including:

- an adequate mechanism for determining what payments become due under the contract, and when. This requirement is not met when any contractual term makes payment conditional on the performance of obligations under another contract, or a decision by any person as to whether obligations under another contract have been performed (referred to as 'pay-when- paid' clauses); and
- a statutory right for parties to a construction contract to refer a dispute to adjudication.

4.8. Where a construction contract omits to deal with an issue or does so in a way which does not meet the requirements of the Act, the Act inserts the Scheme for Construction Contracts (England and Wales) Regulations 1998 into the DPC CAP agreement, which would then take precedence over the existing payment and dispute resolution provisions in the contract.

4.9. Ofwat have stipulated that water companies should not pay the CAP for these projects until they have been completed and become operational so water companies (funded by customer bills) will not have to pay before the work is completed and delivered. This removes the risk that water bill payers will pay for projects that are not delivered.

4.10 DPC CAP agreements fall under the Act's definition of a construction contract. The condition of payment only on completion of the asset may be subject to

challenge by the CAP or others for non-compliance with the Act unless this Order is made. While the water company can develop and enter into an agreement on this basis, there is a risk that a CAP could bring a challenge after it has entered into the agreement, for example if the relationship between the undertaker and the CAP broke down. If the CAP did successfully challenge the payment conditions and/or dispute mechanisms in the DPC CAP agreement, water company customers would be affected and they could end up paying more than otherwise might be the case through increased water bills.

4.11. Parties entering into DPC procurements will have full knowledge of the terms including that payment will only commence after construction has been completed. Importantly, alternative dispute resolution mechanisms will be included within the DPC CAP agreement. Every DPC has an independent technical advisor (ITA) role with a joint duty of care to the CAP, the Appointee and Ofwat. With respect to some issues a decision of the ITA will be final and binding. For other matters, there will be a dispute resolution process (DPC) set out in the CAP Agreement between the water company and the competitively appointed provider (CAP). Typically this will involve a process for escalating the matter in dispute to more senior levels of the Appointee and the CAP and if that does not resolve the dispute the procedure may allow for mediation and will allow for resolution of the dispute by arbitration or resolution by an expert panel.

4.12 This Order will currently only apply to the proposed Cwm Taf project in Wales. In the event there are no potential bidders for the Cwm Taf project, the water company could undertake this work in house or via other procurement mechanisms.

4.13 The UK Government has made a similar Order applicable to England - The Construction Contracts (England) Exclusion Order 2022.

## **5. Consultation**

As the Order provides a limited amendment, affecting a small number of businesses and does not reflect a change in the Welsh Government's policy, a formal public consultation did not take place. We consulted informally with Dŵr Cymru and Ofwat, who supported making this Order, and invited comments from CECA and the Electrical Contractors Association and the Civil Engineering Contractors Association and no objections were raised.

## **REGULATORY IMPACT ASSESSMENT**

### **6. Options**

Two options have been considered during policy development:

#### **i) Business as usual - Keep the status quo**

##### **Costs & Benefits**

This is the baseline option and, as such, there are no additional costs or benefits associated with the option.

Ofwat established a general principle for DPC projects that customers would not start paying for the asset until it is operational, which is consistent with other project finance models. If this Order is not made there is a risk of legal challenge around this approach in the event that a dispute arises. There is a risk water company customers could be required to pay for work before it has been completed through higher water and sewerage bills.

There are no identifiable costs or benefits to businesses from this option.

#### **ii) Make the Construction Contracts (Exclusion) (Wales) Order 2023**

### **7. Costs & Benefits**

7.1 The scope of this Order is extremely narrow. As noted in para 2.4, there is currently only one proposed project in Wales to which the Order could apply. The Order is not expected to impose any additional duties or costs on businesses or water companies, rather it will provide clarity around the timing of payments for a DPC project and the relevant dispute resolution mechanism.

7.2 Any business considering tendering for work on a DPC project would do so fully aware of the terms of this order. If all potential bidders were discouraged from bidding, with there being no satisfactory tenderers as a result (there is no evidence to suggest this would occur), the work could still be undertaken or arranged in-house by the water company outside of the DPC mechanism.

7.3 The outcome of any dispute would not necessarily be any more or less favourable to one party or the other, and there are no identifiable costs to businesses, the water company or water company customers from this option. Using the DPC provides an integrated disputes mechanism within the framework, and making this Order provides certainty that the DPC mechanism will be used.

7.4 The benefit of making this Order is the removal of the risk of water and sewerage company customers having to pay through their bills for the costs of work not completed by a contractor while a dispute is determined.

7.5 Making the Order ensures there is a consistent approach with regards to DPC projects in England and Wales.

## **8. Competition Assessment**

The Order is not expected to impact on levels of competition within Wales or the competitiveness of Welsh businesses.