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Trust in water

Water 2020: Regulatory framework for wholesale markets and the 2019 price review

Appendix 5 Enabling direct procurement for customers - further evidence and analysis

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1. Introduction

This appendix provides further detailed evidence in support of our regulatory approach to direct procurement for customers ('direct procurement') set out in our [decision document](#).

In Chapter 6 of our decision document, we summarise our decisions on our approach to direct procurement. We set out our policy decision to encourage companies to use direct procurement for suitable projects, incentivising this through the risk-based review (RBR) of business plans at the next price review (PR19).

This appendix sets out additional evidence on the scope for direct procurement. We set out the alternative options we considered for direct procurement and our reasoning behind choosing the approach set out in our decision document over the other options considered.

2. Scope for direct procurement

To understand the potential benefits of introducing a direct procurement approach, we have investigated the potential scale and number of projects that it could be applied to.

To assess the potential scale of direct procurement opportunities in the provision of water and wastewater services, we looked at the number, size and type of schemes included in business plans at previous price reviews.

Table 1 below lists the past investment projects which would have qualified for direct procurement under the regulatory approach set out in Chapter 6 of our [decision document](#). We carried out this assessment based on the information available to us, which covered capex costs associated with particular schemes. However, under our approach the guideline threshold will be set as whole-life totex, rather than capex. As totex includes both capital and operating expenditure, the scope for direct procurement will be greater than demonstrated by the examples shown below. More schemes will qualify above the £100 million guideline threshold when using whole-life totex.

Table 1: Schemes with capex exceeding £100 million in previous price reviews

| Water company | Scheme | Claim Value | Notes |
|--|--------------------------------------|--|------------------------------|
| Large enhancement projects in the 2014 price review | | | |
| Severn Trent Water | Birmingham resilience main scheme | £265m | |
| United Utilities | Thirlmere and West Cumbria | £215m | |
| Thames Water | Thames Tideway Tunnel | £404m | |
| Thames Water | Counters Creek sewer flooding scheme | £257m | |
| | | Total: (2012-13 prices) £1,141m (£1,210m in 2015-16 prices) | |
| Large enhancement projects in the 2009 price review / commenced in AMP5 | | | |
| Thames Water | Lee Tunnel | £555m | |
| Thames Water | Deephams STW | £264m | An AMP5-AMP6 overlap project |
| Southern Water | Brighton & Hove STW | £192m | |
| Wessex Water | Integrated supply grid | £271m | An AMP5-AMP6 overlap project |
| United Utilities | Vyrnwy LDTM cleaning | £172m | An AMP5-AMP6 overlap project |

| Water company | Scheme | Claim Value | Notes |
|--|-------------------------|--|------------------------------|
| | | Total: (2007-08 prices) £1,454m (£1,808m in 2015/16 prices) | |
| Large enhancement projects in the 2004 price review / commenced in AMP4 | | | |
| Thames Water | Beckton STW upgrade | £201m | An AMP4-AMP5 overlap project |
| Thames Water | Crossness STW | £246m | An AMP4-AMP5 overlap project |
| Thames Water | Mogden STW | £168m | An AMP4-AMP5 overlap project |
| United Utilities | Shell Green Incinerator | £102m | |
| United Utilities | West to East Link Main | £123m | An AMP4-AMP5 overlap project |
| | | Total: (2007-08 prices) £840m (£1,045m in 2015/16 prices) | |

Based on these past projects, we have used figures of £1,045 million and £1,808 million in 2015-16 prices as the assumed minimum and maximum value of projects in any five year price review period that could be subject to direct procurement. This is likely to produce a narrower range than could occur in practice given:

- previous price review expenditure is not necessarily an accurate basis for prediction of future expenditure; and
- as noted above, this range is based on capex only whereas whole-life totex will be used in practice.

Despite these limitations, this range does provide a reasonable and evidence-based view of the potential scale of projects across the industry that direct procurement could apply to.

This evidence suggests that direct procurement could be used for around 2% of the total value of the water and wastewater value chain. As there are a number of potential benefits from direct procurement, including for wider expenditure (as described in Chapter 6 of our [decision document](#)), the overall scale of the enhancement projects that could benefit from such an approach provides a strong rationale for direct procurement.

3. Options for direct procurement

In our December consultation, we discussed how direct procurement could be used to procure services on behalf of customers. We considered that direct procurement could deliver benefits by including financing of projects. We discussed how this approach can promote efficiency and provide the best value for customers.

We have since explored in further detail how the different models of direct procurement could work in the water and wastewater industry. We considered five options in detail as outlined below in Figure 1.

Figure 1: Options for direct procurement

| | 1 No change | 2 Direct procurement 'encouraged' | 3 Direct procurement 'prescribed' | 4 Thames Tideway-type model | 5 Ofgem model |
|---------------------------|--|---|--|---|---|
| | No change from current use of competitive tendering | Direct procurement encouraged through risk based review | Direct procurement required for all qualifying projects | Water companies run tenders for separately licensed infrastructure providers | Ofwat runs tenders for separately licensed infrastructure provide |
| Legislation | No legislation required | | | Legislation could be required | |
| Financing costs | By water company | Competitive tender | Competitive tender – financing costs for project specified separately in price control. | | |
| Procurement | By water company | By water company | By water company subject to Ofwat rules | By water company | By Ofwat |
| Extent of competition | Market testing of design and build | Direct procurement of design, build, finance and operation | Direct procurement of design, build, finance and operation | Direct procurement but bidders limited by exclusion of water company | Direct procurement of design, build, finance and operation |
| Timing and price controls | Funding for projects decided in 5 year business plan cycle | Open to possibility of separate price control for companies that propose it | Funding set outside of 5-year price control cycle; price control set for water company for the project | Funding set outside of 5-year price control cycle; separate price control given to separate licensed entity | |
| Threshold | No threshold | Soft guideline threshold | Hard threshold | Criteria set out in Specified Infrastructure Projects Regulations | Threshold could be set out in legislation |

Our analysis examined the costs and benefits of options ranging from no change – not promoting direct procurement further – to implementing a model similar to Ofgem’s offshore transmission owner model – which could require primary legislation and would involve a significant role for Ofwat in running a tendering process. We describe the options considered in turn below.

Option 1 would present no change to current processes. There would be no impact on costs or benefits from Option 1 as we would not introduce changes to the current arrangements.

Option 2 presents a model where we would take a proportionate approach to strongly encourage the use of direct procurement. Option 2 would encourage water companies to use direct procurement for suitable high value projects in their business plans. This would include competitively tendering for the financing of projects. This approach is consistent with our principles-based approach to regulation. It puts the emphasis on water companies owning their business plans and identifying the projects appropriate to deliver through direct procurement. Under this option, we would use our risk-based review (RBR) process at PR19 to assess the extent to which direct procurement has been considered. Companies would need to justify why they have not used direct procurement for any projects above the guideline threshold.

Options 3-5 present more prescriptive and costly options. This is balanced by the fact that these options may result in greater use of direct procurement, as it would be required under these options under certain circumstances. These options all include separate price controls for the financing of the projects and the funding would be set outside of the usual five-year price control period.

Option 3 would require direct procurement to be used for some projects. Specifically, where projects are above the threshold value, companies would be required to run a tender process for the project. Other criteria could also be set for identifying projects, for example direct procurement may only be required for projects that are sufficiently separable from other operations. We would set rules for the tender process, which would be run by the water company. There are two sub-options, where either the water company can bid into its own process or not. If the water company could bid into its own process, this may reduce the confidence of other bidders in the bidding process. This could be addressed by Ofwat prescribing an approach to running fair tenders. If the water company could not bid in, then a potential provider would be excluded, which could remove a potentially efficient solution from the market. This issues arises with Option 3 but not Option 2 as the latter does not require us to prescribe the approach to running tenders, and so leaves it open for the water company to include or exclude themselves from the tender (with the possibility of them still being a provider of last resort) as is most appropriate for each tender.

Option 4 would follow a similar approach to the Thames Tideway Tunnel model but on a smaller scale and without government assurance or guarantees around the financing of the project. This approach would allow the successful bidder to operate the project as a new licensed entity. This option could require changes to primary

legislation in order for the specified infrastructure projects (SIP) regulations to apply to a wider range of projects.

Finally, Option 5 is based on the model Ofgem uses for direct procurement in the energy industry. The tender process would be run by Ofwat, with the water company being able to bid into the process, therefore promoting the widest extent of competition. The successful bidder would then be granted a licence for the project. This option could also require primary legislation to create the new licence. A significant additional role would be created for us to run the tender process.

4. Our assessment of options for direct procurement

We assessed the alternative options for direct procurement against our Water 2020 assessment criteria. Our decision to pursue Option 2 is explored further in Chapter 6 of our [decision document](#). Our assessment of the alternative options is summarised below in Figure 2.

We consider that Option 2 aligns best with our strategy and would deliver the greatest benefits compared to costs. Our risk-based review of the extent to which companies have used direct procurement in their business plans will provide incentives for companies to use direct procurement without being prescriptive. This is in line with our strategy and our risk-based approach to regulation. Below we summarise why we chose not to progress the other options considered for direct procurement.

Figure 2: Preferred option for direct procurement

| | 1 Do nothing | 2 Direct procurement 'encouraged' | 3 Direct procurement 'prescribed' | 4 Thames Tideway-type model | 5 Ofgem model |
|----------------------------------|--|--|--|---|---|
| Achieving our objectives | Transparent and predictable but risks missing opportunity to promote efficiency through effective competition. | Targeted at projects with appropriate economic characteristics; consumer objective met through effective competition. ✓ | Risk of compromising company ownership of their business plans; risk of efficient options being excluded if incumbent cannot bid. | Equally as compliant with objectives as Thames Tideway. ✓ | Consumer objective furthered by the promotion of effective competition, but removes ownership and accountability from company. |
| Addressing known problems | Does not address problems identified. ✗ | Encourages water companies to consider alternative financing solutions, but does not require their use. | Requires use of alternative financing where available. Moves procurement decision outside of 5-year process and opens possibility of setting longer-term price control to enhance longer-term focus. ✓ | | |
| Practicality | No additional cost. ✓ | Can be encouraged through RBR; possible under current legislation; voluntary licence change needed if separate price controls set. ✓ | Exclusion of water company from bidding process could require licence change; allowing water companies to bid could reduce confidence in process. ✗ | Additional costs if extended to more projects; could require primary legislation to allow SIP Regulations to apply to broader range of schemes. ✗ | Additional costs of regulator-led bidding process; could require primary legislation to introduce new forms of licence and to allow Ofwat to run tenders. ✗ |

Option 1 would not have any costs, but would not realise any additional benefits from direct procurement. Respondents to our December consultation were largely receptive and positive towards the potential benefits from direct procurement. As the alternative options are also cost beneficial, we rule out this option.

Option 3 could provide significant competitive opportunities for direct procurement, but would also present challenges with the implementation, robustness and monitoring of the tender process. For example, if water companies are not excluded from the bidding process, 'Chinese walls' within the water company would need to be sufficiently robust to give other bidders confidence in the impartiality of the tender process. If water companies were not allowed to bid, this would remove one potentially efficient bidder from the process. We therefore consider that the practical issues around this option make it less preferable than Option 2.

Options 4 and 5 could both require primary legislation. For Option 4, legislative change would be required to allow the current legal architecture to apply to smaller projects that would not threaten the ability of the water company to fulfil its statutory duties. The model used for the Thames Tideway Tunnel has effectively delivered benefits to customers – see [our website](#) for further information on the Thames Tideway Tunnel. However, it may be less appropriate for smaller projects. Depending on exactly how this option was put into practice, any additional involvement by us and Defra in the tender process could add complexity to the tender process relative to other approaches. While this involvement has been beneficial for the Thames Tideway Tunnel, it may not be appropriate for smaller schemes. We therefore think that Option 4 is less practical than Option 2.

Option 5 could require primary legislation to create a new type of licence and to allow us to run tenders to award these licences for the delivery of large projects. This approach would mitigate concerns that arise under Option 3 surrounding the robustness of the tender process but would create significant additional costs for us. However, the practical issues with this option are significant. The additional costs we would face in running this process may be more significant than they are in energy, as there are likely to be fewer projects than in energy, and so the fixed costs of establishing the necessary expertise within Ofwat would not be spread across so many projects. The practical implications of this option mean that, for PR19, we do not think that this is an appropriate option.

In conclusion, considering the costs and benefits of each option, we have decided to take forward Option 2. We describe this option and our rationale behind this choice in more detail in Chapter 6 of our [decision document](#). However, for future price reviews, we will revisit the evidence base around direct procurement and may consider moving to a more prescriptive approach if the potential benefits of direct procurement are not realised in PR19.