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Trust in water

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

Appendix 4: Direct procurement for customers

Contents

Contents	1
What is direct procurement for customers?	2
Responses to our July discussion document	4
Current use of direct procurement in the sector	5
Experience in other sectors with direct procurement for customers	10
Future development of direct procurement	14

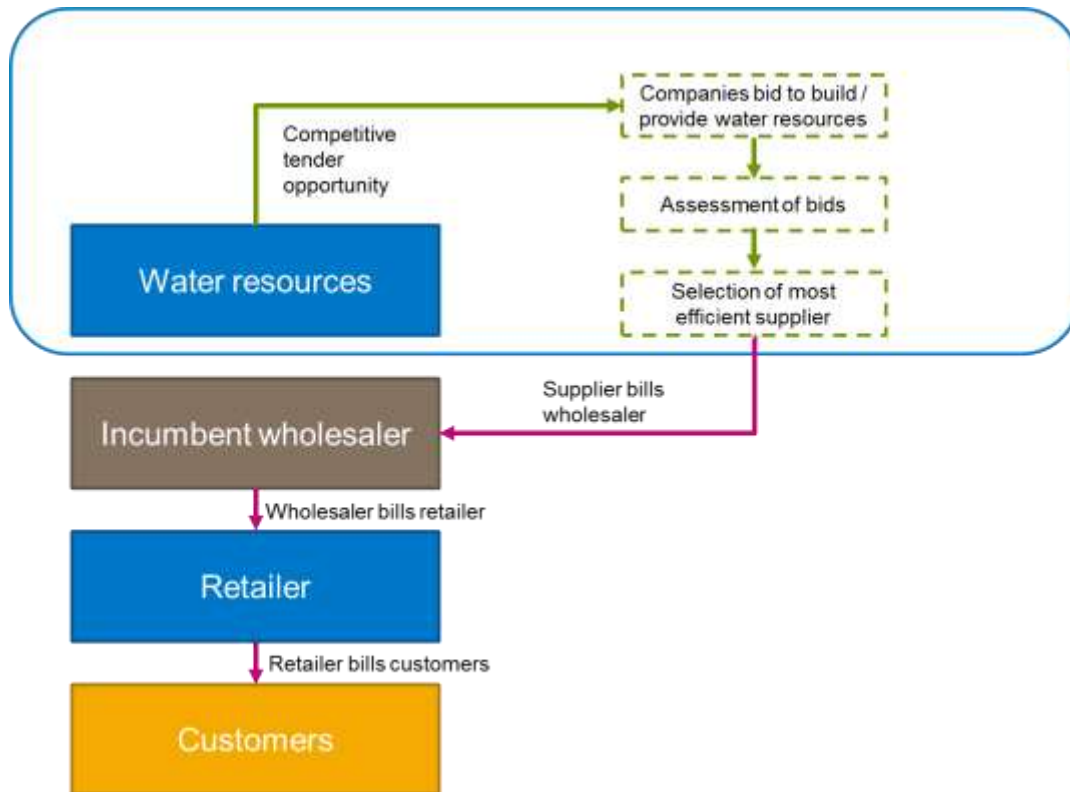
What is direct procurement for customers?

In this appendix, we discuss how direct procurement for customers and market testing can help to promote efficiency. Appointees currently use a wide variety of arrangements to provide services, including self-provision and procuring services from third parties. We use the term 'direct procurement for customers' to describe arrangements whereby an appointee procures services on behalf of customers – such as when Thames Water procured the delivery of the Thames Tideway Tunnel from an independent service provider, including the financing of the project. While the Thames Tideway Tunnel has a number of unique characteristics – including the scale and risk of the project and a Government support package – the principle of a water company acting to procure major projects or enhancements on behalf of customers can be applied elsewhere.

Under a 'direct procurement' framework, the appointee does not provide or finance the service, but instead seeks bids from third parties and selects the best value offer on behalf of its customers. Market testing is the use of evidence from competitive procurement processes to demonstrate efficiency of services as part of a company's business plan. A key difference between direct procurement and market testing is that under a direct procurement arrangement, the service provider is competing to provide finance as well as construction and potentially operation of the project. This provides market evidence on the cost of finance as well as the construction cost.

Figure 1 below illustrates, using water resources as an example, how we could use direct procurement for the customer in the sector.

Figure 1: Example – the application of direct procurement for customers



Source: Ofwat.

Responses to our July discussion document

In its response to our July discussion document, Affinity Water stated:

“While we welcome the debate about how to incentivise innovation we wonder whether it has been couched too narrowly, for example, we can see a case for companies exploring the potential for paying third parties to collect and use raw water as alternatives to other demand reduction approaches.”

Sembcorp Bournemouth Water also expressed support for the concept of direct procurement:

“We believe that there could be innovative ways for new entrants to contract with the existing monopolies for the use and management of existing infrastructures for distribution and treatment. For example, competition in wholesale would be facilitated by the introduction of separation of asset ownership and service provision. Competition could be introduced by the retendering of service provider contracts on a periodic basis – but these contracts would need to be let on a long term basis, a minimum of every 10 years. As an alternative, service provider responsibilities could be divided through a series of contracts which interface with one another.”

Current use of direct procurement in the sector

Under the existing regulatory framework, there is scope for direct procurement in relation to:

- new large infrastructure projects; and
- providing water and wastewater services to new developments as ‘new appointments’ (includes variations of existing appointments).

Specified infrastructure projects

The Flood and Water Management Act 2010 inserted an enabling power into the Water Industry Act 1991, as amended (WIA91) to provide a framework under which English water companies can be required to put out to competitive tender the finance and delivery of:

“[...] projects or works that in the Minister’s opinion are of a size or complexity that threatens the undertaker’s ability to provide services for its customers” – section 36A(4) WIA91.

Under this enabling power, the only Regulations to have been made to date are The Water Industry (Specified Infrastructure Projects) (English undertakers) Regulations 2013 (the ‘SIP Regulations’). Under the regulations, large infrastructure projects can be required to be delivered by independent providers that are:

- appointed by the incumbent undertaker following a competitive procurement; and
- regulated by Ofwat under a project licence.

This approach has been used to provide the Thames Tideway Tunnel (TTT), which is a large, complex investment project to improve the capacity of London’s sewerage system and reduce overflows of untreated sewage into the River Thames. Under the Regulations, the Secretary of State made the Thames Tideway Tunnel a ‘specified project’. Thames Water was required to put the procurement of an Infrastructure Provider (IP) out to competitive tender. Amendments were made to Thames Water’s licence, and conditions introduced to the IP’s licence, to allow the IP to charge Thames Water for its services under a revenue agreement. Thames Water will, in turn, recover such charges from its wastewater customers.

Thames Water concluded – and we and the UK Government agreed – that the competition should be both for the:

- IP (which would own and finance the tunnel); and
- three main construction packages to physically build the tunnel.

The normal process would have been for the winning IP to put the construction out to tender. However, it was considered that this would not only extend delivery of the tunnel but also result in a higher cost of capital as the IP would be taking greater risk on the construction cost. By running the two procurements alongside each other, it enabled the IP bidders to have a known set of construction costs with known contractors and for the project to achieve a fast start after the licence was awarded.

The IP procurement evaluation process was focused primarily, although not exclusively, on the cost of capital as we (and the Government) were also interested in whether the winner had a financing plan that was deliverable. Bazalgette won the tender to be the IP, bidding a cost of capital of 2.497% – well below the allowed wholesale cost of capital for the 2014 price review (PR14) of 3.60%. While care must be taken in this comparison, as the financing cost for PR14 includes allowance for embedded costs from financing in earlier periods and the IP benefits from a Government support package covering some high value/very low probability risks, it does suggest that opening competition for the finance and delivery of projects can deliver benefits to customers as well as reveal useful information about cost of finance for the sector.

The SIP Regulations are limited in their use to where the size or complexity of the project to be undertaken threatens an incumbent's ability to provide services for its customers. The test is therefore proportionate. So, whereas a large-scale project would need to be considered for a large water and sewerage company, for a small water only company the size of the project could be very much smaller.

New appointments and variations

There is some parallel between direct procurement for customers and providing water and wastewater services to **new developments**. Under these arrangements, independent providers can provide water and/or wastewater services for a defined area in place of an incumbent appointed water company. This is permissible where:

- there is a large user¹;
- the area is unserved; or
- the existing appointed company consents.

These arrangements are known as ‘new appointment and variations’ (NAV²s). Under a NAV, any new appointee has the same duties and responsibilities as other appointed water companies. Ultimately, these appointees can serve customers either with their own resources, or by requesting the use of the incumbent appointed water company’s assets under a bulk supply or bulk discharge agreement. The NAV is also responsible for billing the end user (to recover the costs associated with providing the services and the infrastructure). Once the non-household retail market opens in 2017, NAVs will continue to be solely responsible for billing end household customers, but non-household customers of English NAVs will be able to choose their retailer.

In summary, NAVs allow for competition with respect to the supply of new developments, or large commercial users with infrastructure. They have been designed to encourage innovative solutions and environmental benefits; and additionally, to deliver price discounts and enhanced services to customers. They also allow for existing suppliers to expand their service areas, effectively putting competitive pressure on regional suppliers. Ultimately, NAVs have succeeded in delivering against a number of these original objectives and play a valuable role in the sector.

And yet, we recognise that the overall impact of NAVs to date has been limited (there are currently 13 providers serving 58 NAVs, representing more than 50,000 customers). Eight of those providers are existing incumbents providing water and wastewater services to sites that were originally within another incumbent’s area of appointment. There are a number of factors that may be contributing to the slow success of NAVs – in particular:

¹ A large user is a customer that uses (or is likely to use) at least 50 million litres of water a year in England or 250 million litres of water a year in Wales.

² A new appointment occurs when we appoint a company for the first time; and a variation is when an existing appointed company seeks to extend the area to which it provides services.

- the process is long – it takes roughly 100 days for NAV applications to be processed;
- there is detailed scrutiny of applications – this is problematic and costly for companies wishing to supply a number of sites as they are subject to in-depth site-by-site scrutiny;
- it may not be economically worthwhile for new entrants; and
- there is a lack of transparency around negotiations.

We note that while the current approach allows NAVs to compete for the market (generating a range of benefits), it tends to result in the associated gains directly going to developers and only indirectly to customers in terms of the cost of new housing.

We can compare the NAV framework in the water sector with the provision of gas connections in Great Britain. Here, companies are able to develop and operate small, local gas networks. Ultimately, this allows **firms to compete for the provision of ‘connections’ to the broader gas distribution network** – as we describe in more detail below.

Case study: Competition for gas connections, Great Britain

In the GB gas sector, small, local networks are owned and operated by Independent Gas Transporters (IGTs), and their networks directly connect to the Gas Distribution Network (GDN), which is the regional monopoly supplier, through a connected system exit point (or indirectly through another IGT’s local network).

Implemented in 1997, Ofgem’s IGT framework offers customers a greater choice of gas transporter providers, which allows all customers’ household, industrial and commercial premises, to connect to IGT networks. In effect, **IGTs compete with GDNs to provide connections to the distribution network**.

Currently, six IGTs operate local networks, and more than half of new and modified connections are carried out by IGTs, with new housing and commercial developments forming the largest share of the IGT market. Ofgem estimates the number of customers connected to the IGT networks to be about one million.

Early criticisms of the regime focused on the wide variance in observed IGT transportation charges, with some IGTs having charges at about the same level as the National Grid (Tansco), while other IGTs charged significantly more. Transportation is a monopoly activity, and for household customers, these charges represented 35% to 40% (at the time of consultation) of the final gas bill. Consequently, to ensure customers were protected, Ofgem introduced a relative price control (RPC) capping IGT transportation charges at a level consistent with the National Grid gas distribution networks.

In 2007, a number of further refinements were implemented. These reflected concerns about large observed variations in the processes and procedures across the IGTs, which

were considered to be contributing to higher costs for shippers of gas operating on the network (particularly during customer switching). To improve efficiencies and reduce costs, Ofgem implemented the Independent Gas Transporter Network Code, to streamline and standardise network codes applied by IGTs. This resulted in a more consistent approach to processes and procedures across the transporters.

Source: [Ofgem](#).

Of relevance to our thinking, Ofgem's IGT approach highlights the following.

- **Competition for new connections can be feasible.** However, it can be slow to develop and deliver benefits. Of relevance to us, we note that the IGT framework is relatively mature compared with our NAV framework, and as such this might imply that NAVs could develop further over time.
- **The appropriate regulatory approach may need to evolve over time.** As described above, the IGT framework faced some early criticism and required a number of subsequent refinements. When considering the scope for direct procurement for customers in water and wastewater services, therefore, we need to take into account the need for flexibility – so that we can correct elements of any approach that do not work well and, similarly, build on those that do.
- **Standardisation and streamlining of processes can be beneficial.** The IGT framework illustrates how inconsistencies in processes, or the application of processes, can result in unnecessary costs that impede competition. Consequently, we would need to consider how any approaches we adopt might help encourage standardisation where appropriate.

As part of the Water 2020 work programme, we are considering potential scope to improve the current NAV framework and would welcome views from stakeholders.

Experience in other sectors with direct procurement for customers

When thinking about the extent to which direct procurement for customers can be applied further to the water sector, it is helpful to examine how such models have been successfully used elsewhere. We discuss case studies of competition in relation to:

- the provision of offshore transmission assets; and
- the 'Gas to the West' pipeline in Northern Ireland.

The first case study relates to provision for offshore transmission assets, as developed by [Ofgem](#) in the energy sector.

Case study: Competition for the provision of assets, Great Britain

The significant growth in offshore wind farms, driven by the UK's commitment to renewable energy, has led to the need for significant investment in a transmission network to connect offshore generators to the Great Britain (GB) onshore transmission grid. This, in turn, has led to the need for a new licensing and regulatory framework covering the provision of these assets.

The regulatory framework adopted involves allocating offshore transmission licences, which are issued through a competitive tendering process run by Ofgem. Under this approach, offshore transmission operators (OFTOs) bid for a 20-year revenue stream, associated with operating the transmission network. Launched in 2009, the framework is flexible and has undergone refinements, where now:

- OFTOs can design, build, operate and maintain the transmission assets; or
- generators are able to build the transmission assets themselves, and then transfer them out to OFTOs once construction is completed.

The competitive tender process is organised around a series of phases. Each phase has varying requirements that the participants have to meet and accept. Ofgem then rejects/accepts applicants at each individual phase – and so the process is effectively used to 'filter down' the number of participants competing through each phase. This happens until a preferred bidder is selected and awarded an OFTO licence.

Throughout the process, tender information is managed and stored in a 'data room', which is supported by codes of conduct and requirements, as specified in a set of guidelines (which are made available to participants and developers through an online portal).

The first tender round comprised nine projects. In May 2011, Ofgem announced that all nine projects had a preferred bidder. Six groups were shortlisted (as part of the phases above) to bid for the OFTO licence, and subsequently, four were appointed as preferred bidders, none of which were existing transmission system operators.

Ofgem's round one tender was considered to be a success with a report for Ofgem estimating benefits to customers of around £200 million to £400 million on projects with a total revenue of £1.5 billion.

Source: [Ofgem](https://www.ofgem.gov.uk/sites/default/files/docs/2014/09/draft_letter_on_outcome_of_consultation_on_the_evaluation_of_ofto_tender_round_1_benefits_20140919.pdf) and University of Cambridge – Electricity Policy Research Group.
https://www.ofgem.gov.uk/sites/default/files/docs/2014/09/draft_letter_on_outcome_of_consultation_on_the_evaluation_of_ofto_tender_round_1_benefits_20140919.pdf

While the OFTO framework was in many respects a success³, it was subject to some **critiques** – specifically with regards to:

- the process itself;
- incentives to co-ordinate; and
- long-term asset incentives.

The limitations of the framework were as follows.

- **Focuses on short-term efficiency.** Long term, it is possible that some of the assets developed under this approach could be disconnected – in part, because the framework does not allow for co-ordinated offshore transmission development between OFTOs. It has been argued, for example, that over the longer term an offshore transmission grid may be more efficient.
- **Inefficient process.** OFTO licences are specific to each project, which may be inefficient if a party holds multiple licences. This is because parties may have to go through the process a number of times, creating unnecessary administration costs, but also resulting in delays to the start of projects.
- **Perverse incentives.** Incentives to develop assets beyond their original scope may be limited, given that an OFTO is only able to carry out incremental investment up to a value of 20% of initial capital costs without triggering a re-tender exercise.

³ www.eprg.group.cam.ac.uk/wp-content/uploads/2014/01/1221-Final.pdf

Of relevance to our thinking, Ofgem's use of competitive tendering demonstrates how the design of the tender process affects the identification of the preferred bidder. **It also shows how the using an online 'data room' can be a useful tool to manage, and exchange, tender information**, to ensure an efficient and transparent process. However, the criticisms of the framework mentioned above highlight several areas for consideration when implementing competition 'for the market'. In particular, **it highlights the importance of considering incentives over both the long and short term**, to ensure that the most efficient outcomes are delivered.

Ofgem recently announced that it will introduce competitive tendering to deliver new, separable and high-value onshore electricity transmission assets. In relation to this, it is **proposing** to set £100 million in capital expenditure as the minimum value for an onshore transmission project to be tendered. Ofgem notes that a £100 million threshold would mean that the potential benefits from cost savings and innovation will significantly outweigh the potential administrative and interface costs.

Our final case study relates to the use of competitive tendering by the Northern Ireland Authority for Utility Regulation (NIAUR) regarding the extension of the Northern Ireland natural gas network to the five largest towns in counties Tyrone, Fermanagh and South Londonderry (known as the 'Gas to the West' pipeline).

Case study: Gas to the West – adapting Ofgem's approach in Northern Ireland

A number of areas located in the west of Northern Ireland did not have access to gas. Consequently, in January 2013 the Northern Ireland Executive agreed to support the extension of the gas network to a number of towns in these areas, by providing a grant of up to £32 million towards the cost of the transmission pipeline infrastructure. This then led to the development of competition for two licences regarding:

- **transmission assets** to connect the designated towns to the existing natural gas network; and
- **distribution assets** required in the designated towns to provide connections to individual supply points.

The licence tendering was conducted by two public bodies, where NIAUR was responsible for granting licences, and the Department of Enterprise Trade and Investment (DETI) was responsible for the published criteria against which licence applications must be judged.

Given the levels of uncertainty surrounding the projects, the NIAUR opted for a two-phase approach to their tender process, which involved competition to assess how applicants performed against the criteria followed by consulting on the licence conditions and granting licence(s). Key features of the competitive application process to award transmission and distribution licences are set out below.

In addition to the above, final specification of tender requirements and delivery times were

uncertain at the beginning of the process. Therefore, to speed up tendering and reduce cost and time burdens on applicants, only some cost items were **'competed'** on.

The key features of competition are as follows.

- **Competition was limited to 'controllable costs'**. This included most operating costs and some elements of capital costs (design and project management, mobilisation, contingency and 'other costs').
- Applicants could base their bids on either **'revenue cap'** or **'operating cost pass through'** models (allowing the NIAUR to reflect varying risk profiles associated with these differing regulatory frameworks when assessing bids).
- There is no revenue recovery mechanism during the construction of the pipeline. Allowed costs will be capitalised at a rate of LIBOR +0.5%.

The tendering process for Gas to the West was widely regarded to be a success – and will allow:

- up to 40,000 new customer connections; and
- industrial operators to cut their energy costs.

Household customers will also have greater choice and benefits.

Source: [Northern Ireland utilities regulator](#).

The NIAUR largely drew from Ofgem's OFTO approach for the design of its tender process. However, it adapted it in a number of ways, most notably as follows.

- The NIAUR noted that there was a "much greater level of uncertainty" associated with the pipeline relative to offshore transmission asset development and consequently opted for a two-phase approach (as mentioned in the case study above).
- Ofgem's OFTO involved a 'fixed price' approach, whereby applicants submitted their annual revenue requirement to finance, operate and maintain a given transmission asset for a set period of 20 years, with the lowest application (subject to other criteria) being awarded the licence. Alternatively, the NIAUR only specified certain controllable costs that were 'competed' on.

Future development of direct procurement

Given the success of direct procurement models in other sectors and the successful outcome with the Thames Tideway Tunnel, we consider there is scope for its application in the water sector. We acknowledge that the legislative framework for SIPs may potentially limit the realisation of the full benefits for customers from direct procurement. We also acknowledge considerable interest in the use of direct procurement in the sector. We wish to be clear that we are not proposing further use of other elements of the Thames Tideway Tunnel approach such as the Government support package, which is explicitly targeted at addressing the particular risks facing the delivery of the Thames Tideway Tunnel.

Consistent with our strategy of getting companies to own responsibility for delivery to their customers, we propose that companies should develop proposals to use direct procurement for customers as part of their business plans. Given the potential to unlock value for customers from the use of direct procurement and the need to demonstrate efficiency in their business plans, we expect well-run companies will make use of this approach. We will take account of the use of direct procurement as part of our risk-based review of company business plans.

We see our role as setting out clear expectations about the use of direct procurement and addressing any potential barriers in the regulatory framework to its use. We are interested to hear from companies on potential barriers to this approach.

We will consider further what specific actions companies may need to make in relation to direct procurement for customers and whether licence condition changes would be required.

In terms of the scale of project considered for direct procurement, we consider that the threshold of £100 million proposed by Ofgem, would also be appropriate for the water sector. The table below sets out large enhancement projects that were larger than £100 million from the PR14 final determinations. We note that some of these projects may not be sufficiently discrete to enable effective procurement from independent providers, while the Thames Tideway Tunnel costs were incurred by Thames Water ahead of the procurement of the independent provider. Nonetheless, it illustrates the potential scope for direct procurement for customers for large projects in the sector.

Table 1: Large enhancement projects in the 2014 price review

Company	Scheme	Claim value (£m)
Severn Trent Water	Birmingham resilience main scheme	£265
United Utilities	Thirlmere and West Cumbria	£215
Thames Water	Thames Tideway Tunnel	£404
United Utilities	Davyhulme sewage treatment works	£130
Wessex Water	Integrated supply grid	£115
Thames Water	Counters Creek sewer flooding scheme	£257

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