

11 July 2017

Trust in water

Delivering Water 2020: consultation on PR19 methodology Appendix 10: Direct procurement for customers

**Appendix to chapter 7:
Targeted controls,
markets and innovation:
direct procurement for
customers**

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Contents

1. Summary and context	2
2. How we propose to assess DPC costs	4
3. DPC procurement process	6
4. Draft principles for the DPC contract	11
5. DPC licence changes	14
A1 Draft DPC procurement and contract principles	15

1. Summary and context

Purpose

In our decision document '[Water 2020: Our regulatory approach for water and wastewater in England and Wales](#)' (and the [associated appendix](#)), May 2016, we set out our decision to introduce Direct Procurement for Customers (DPC). This followed extensive consultation and appraisal in December 2015 of a number of models ranging from a more flexible approach¹ to more prescriptive approaches². We stated in May 2016 that at PR19 we would encourage and enable direct procurement arrangements, but still allow water companies to self-provide, where it is well evidenced that it is efficient to do so. We also set out our views on the expected costs (£50-80m) and benefits (£450-930m) of DPC. We continue to consider that costs and benefits will fall within this broad range.

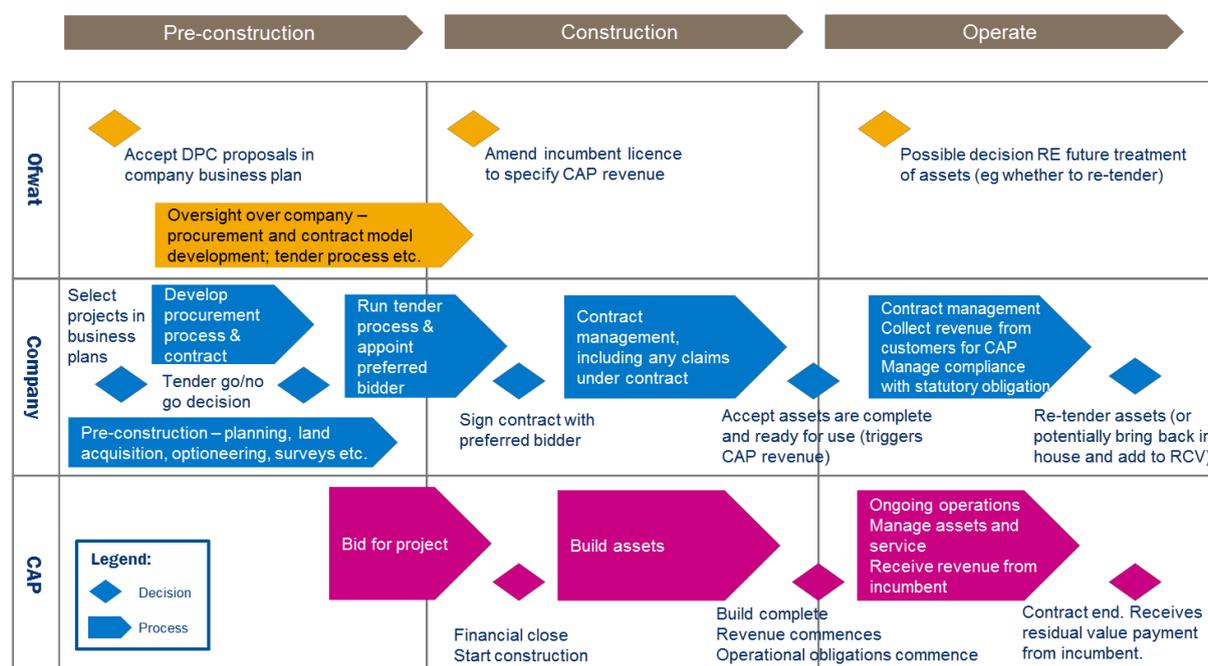
In this appendix we provide further detail on our proposals for DPC set out in chapter 7 of the PR19 Methodology document. We focus on several policy areas where we consider stakeholders would benefit from further detail on our current thinking, and the background to our proposals.

Figure 1 below outlines how we expect an illustrative DPC process to work (for a stylised project), and the roles we expect for the appointee, competitively appointed provider (CAP) and us.

¹ Where we rely on established regulatory tools to encourage companies to use direct procurement.

² Such as the Thames Tideway Tunnel and Ofgem's OFTO model.

Figure 1 Overview of the DPC process



We emphasise the following points that we consider relevant to the content of this appendix.

- We will have a role in scrutinising the appointee’s costs to run tenders. We propose to use our assessment of business plans to achieve this. This is discussed in Section 2.
- The process and timings for DPC projects would be influenced by the type of tender model companies use for DPC. Section 3 outlines our further thinking on different tender models that could be used for DPC, and our initial thinking on the principles companies should adhere to on the process itself.
- We are proposing principles for the contract between the appointee and CAP to provide clarity on appointee responsibilities, protect customers’ interests and ensure DPC is a success. Section 4 outlines our current draft principles.
- We propose changes to appointees’ licences to implement DPCs, protect customer interests and provide certainty around revenue recovery for DPC projects. Section 5 outlines our initial thinking on possible licence changes.

2. How we propose to assess DPC costs

The majority of costs associated with DPC will be determined by the market through competitive procurement, not determined by us through cost assessment. However, appointees will still incur a small proportion of overall costs to develop projects before running a tender and in running the tender itself. Our proposed approach for DPC is to scrutinise companies' proposed costs through PR19 and, as far as possible, to build on our existing processes for cost assessment. We consider there are three main types of DPC costs, as outlined in Table 1 below:

Table 1 DPC cost categories

Type	Proposed approach	Comments
<p>Companies' pre-construction costs</p> <p>Includes, for example: Analysis of options, planning consent, early design work, engineering studies.</p>	<p>We propose to include these costs in companies' totex base allowances.</p> <p>There will be a separate data table to ensure no double counting.</p> <p>We will scrutinise these with PR19 business plans.</p>	<p>No real change to current cost companies face or costs for non-DPC schemes.</p> <p>Companies should be able to forecast accurately in business plans. We may need to consider approach under an 'early' tender.</p>
<p>Companies' tender/procurement costs</p> <p>Includes, for example: Legal and commercial costs mainly to run a procurement process. Also includes process development.</p>	<p>We also propose to include these costs in companies' totex base allowances. Also to be included in a separate data table.</p> <p>We expect bidders would bear their own tender costs.</p>	<p>We expect these costs would also be broadly similar in magnitude to companies existing costs in procurement or market testing for these types of projects.</p> <p>We therefore expect that companies should also be able to accurately forecast these in their business plans.</p>
<p>CAP delivery costs</p> <p>Includes, for example: Project capex and opex (as well as financing costs).</p>	<p>No specific cost assessment – procurement process itself will identify project costs.</p> <p>Will not be added to companies RCV or recovered through existing price control.</p> <p>Company will recover the CAP's allowed revenue from customers and then pass this through to the CAP.</p>	<p>Companies do not require a return on these cost as CAP costs will include finance.</p> <p>Competition itself will determine efficient costs so no upfront allowances.</p>

We note that our May 2016 Document raised the possibility of a separate price control for DPC. We do not currently consider that, in general, this is appropriate, because:

- Companies can specify in their business plans what costs they need to recover for PR19. We can assess the efficiency of these proposals when we evaluate business plans.
- CAP costs will not require a change to a company's cost allowances (as the company will pass these costs through to customers). There is therefore no requirement for us to make a separate price control determination.
- Preconstruction and procurement costs are unlikely to be material for most projects. We do not consider it is therefore proportionate to have a separate price control, given the quantum of costs involved.

However, there is the potential that for larger projects it may be better to use a separate price control for pre-construction or tender costs. This is the approach we took with Thames Tideway given the size of these costs. We will consider the approach on a case by case basis.

For CAP delivery costs, we would need to be satisfied with the outcome of the tender in order to allow companies to recover the CAP's revenue stream from their customers. We expect to consider further how best we could assure ourselves that the process was efficient, such as the use of independent assessment to inform our decision. We may tailor our approach to the project, for example by seeking independent assurance for larger or more complex projects. We consider this will be necessary to ensure that customers are protected through the DPC process.

We discuss potential DPC related licence changes to enable our proposed approach in Section 5.

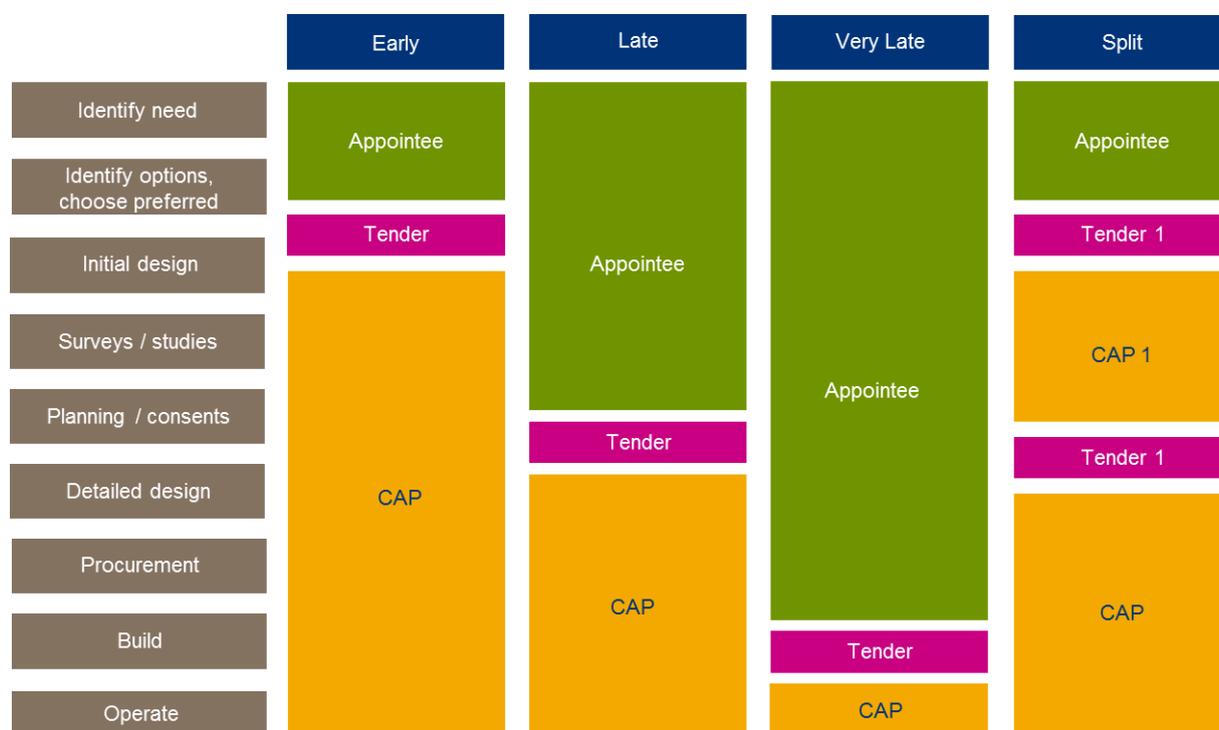
3. DPC procurement process

Potential DPC tender models

In Chapter 7 of our methodology consultation we noted that a range of tender models may be appropriate for DPC.

Figure 2 below sets out some further details on the 'early', 'late', 'very late' and 'split' tender models we describe in the main document. The main difference is around when in the project development process the competition takes place. However, timing affects the scope of works that the appointee would have completed before the tender, and therefore the scope and focus of the competition itself. We expect that all models would involve competing project financing costs, consistent with our position in our May 2016 Water 2020 decision document.

Figure 2 Simplified representation of different tender models



As noted in chapter 7, we consider that all models have the potential to drive significant customer benefits, albeit by focusing competitive pressure in different areas. There are however trade-offs in terms of innovation and levels of certainty over projects and pricing that can affect customer outcomes. Table 2 below summarises these.

Table 2 Comparison of example tender models

Model	Advantages	Disadvantages
Early: Focus on identifying different options, or alternative designs within a preferred option. Can be viewed as a competition to deliver outcomes.	Appointee (as the client) can make informed choices about potentially innovative proposals. Greatest scope for innovation and efficiencies (for example evidence from electricity transmission in North America of winning bids being 20% to 60% lower than incumbent's best price).	Usually requires transfer of planning risk which may reduce range of investors interested and require specialist skills to manage. Challenge of meaningful assessment of bids, given potential diversity of proposals and cost may not be a significant factor in the procurement. Can be hard to procure and contract for outcomes.

Model	Advantages	Disadvantages
<p>Late: Generally occurs after planning. Focuses on detailed design (within consent envelope), procurement/capex, opex and financing. Can be viewed as a competition to deliver outputs.</p>	<p>Common model in similar types of procurement, which facilitates engagement by bidders and investors.</p> <p>Focus of competitive pressure is capex and financing and there is potential for significant savings or cost discovery.</p> <p>There are strong synergies between construction and financing (investors can see where to realise value).</p>	<p>Usually involves risk transfer around pre-construction works (and tends to need indemnities etc.), increasing financial risk.</p> <p>Construction risk reflected in higher financing costs. Customers could lose value on refinancing and equity sales.</p> <p>As the project develops to late stage, the outputs are more detailed and specific; this restricts the potential areas of innovation by the CAP.</p>
<p>Very late: Occurs after planning and design, but before construction. Can be viewed as a competition on financing costs.</p>	<p>This is likely to drive very competitive financing on cost of capital (as happened with Thames Tideway and the OFTO regime) as these are the main undetermined parameters at this stage.</p> <p>Incumbent very clearly specifies what's needed (even contracts for construction). This may reduce interface issues.</p>	<p>Lost opportunity for innovation around design and construction. Potential loss of synergies between capex and opex over the project life.</p> <p>More due diligence is required (for example, to cover planning as well as construction quality), which leads to higher transaction costs.</p>
<p>Split model: Different CAP across stages, such as planning stage (eg studies and consents) and construction stage (including procurement and operation).</p>	<p>Allows more specialised entities to compete for different elements of model.</p> <p>Likely to drive competition in early planning and design as well as financing and construction.</p>	<p>Reduces the number of candidate projects that could raise investor interest due to smaller size, particularly for the planning stage.</p> <p>Highest transaction costs because of the greater due diligence demands, contracts and negotiations (eg legal fees).</p> <p>Higher interface risks.</p>

The 'split' tender model is a two stage process which focuses competitive pressure on both stages, such as on initial design (as with the early model) and then on capex, opex and financing (as with the late model). It therefore has the potential to realise significant customer benefits, but would do so at the expense of adding another process step of running an additional tender. One potential variant of this model would be to only use the second tender in the event that costs deviate significantly away from those proposed in the first tender; this may act to contain any potential cost overruns as the project develops.

Procurement process

As set out in chapter 7, we consider that establishing a general procurement template that can work across all of the above stages, allowing variations for the procurement process, for all companies, and all project types, will promote value for money for customers by:

- making DPC a repeatable proposition that minimises transaction costs and promotes interest from investors. This is clearly demonstrated by KPMG’s³ report; and
- reducing the potential development costs for each project (such as the cost to develop bespoke arrangements for each company/project).

We have developed initial principles for the procurement process that we consider will enable this. However, we also expect that several elements of the procurement model may change for either different project types or differences between tender models. Based on consultation responses and our ongoing work in this area, we will provide more details of our proposed approach in our final methodology, when we have considered further which tender model(s) companies should use for DPC.

Table 3 summarises our initial principles around the procurement process. These are more fully set out in the supplementary annex. We welcome stakeholders’ views on these proposed principles.

Table 3 Draft DPC procurement process principles

Principle	Details and rationale
Companies cannot bid in their own process (this principle would exclude an associate of the incumbent company from competing, or the incumbent from setting up a separate bidding unit).	<p>We consider there to be significant conflicts of interest, both real and perceived, if incumbents bid. The process needs to be seen to be fair to attract potential bidders and drive competitive benefits for customers.</p> <p>Companies need to be able to manage the DPC project effectively. There is a risk of poor customer outcomes if the same company is both the buyer and the provider.</p> <p>We expect that companies could compete outside of their appointed area. We would expect appropriate arrangements to ensure clear separation of the appointed business and the CAP to be put in place to comply with ring fencing and transfer pricing conditions.</p>

³[Direct Procurement for Customers](#). A report prepared for Ofwat, May 2017. KPMG.

Principle	Details and rationale
	<p>In circumstances where incumbent appointees have a non-controlling interest in a potential bidder it would be important that sufficiently robust arrangements could be put in place to manage actual and perceived conflicts of interest potentially with strict rules of separation and control. We would require companies to justify any proposed involvement in the bidding process in terms of potential benefits to customers and to explain how they were safeguarding their role as procurer in the process and over the delivery of the contract.</p>
<p>Companies need to establish clear and transparent governance and resourcing of their approach to procurement.</p>	<p>It is vital that companies effectively act in customers' interest as buyer of a DPC project. An unsuccessful tender is not in customers' interests, and it would potentially increase costs to customers (eg to re-run the process).</p> <p>We consider that this process would require specific skills to manage effectively.</p> <p>There are risks involved in running competitive procurement exercises. Companies need to show that they are managing these risks.</p>
<p>Companies should make all relevant information available to bidders during the tender.</p> <p>Pre-construction works need to be completed to a standard that ensures bidders can prepare robust bids.</p>	<p>This principle is key for risk management. Funders are likely to want to conduct significant due diligence before they are comfortable with financing.</p> <p>The quality of pre-construction works can affect pricing in a competitive process, especially around risks like land rights and access.</p> <p>Pre-construction works need to be transferable/assignable to the CAP where appropriate.</p>
<p>Companies should evaluate bids on a range of criteria, not simply price.</p>	<p>This principle is key to ensuring that CAPs are chosen on the basis of how well they are likely to deliver a project. We expect DPC to provide value for money, not simply lower prices for customers at the expense of standards or quality. We expect companies to balance the robustness of bids against the price proposed when evaluating tenders.</p>

4. Draft principles for the DPC contract

Our regulatory strategy for PR19 puts companies and their customers at the heart of the process. We think this applies equally to DPC. We therefore expect companies to develop the detailed arrangements to implement DPC. Companies will be the procurer and the client for the services that the CAP provides. They therefore have a responsibility on behalf of their customers to both run an efficient procurement process, and to manage the CAP effectively over the contract life. We will hold companies to account for this to ensure that they deliver the best value for customers.

We sought advice from KPMG on investors' views to our DPC proposals. KPMG's report showed that investor appetite will be essential to increase levels of rivalry in any procurement and maximise the benefits for customers. The report advised us to consider a number of areas to increase investor appetite, such as risk allocation and security of investor revenues. A full copy of this report is published alongside our PR19 Methodology Consultation.

KPMG's analysis also suggested that investors would take comfort from regulatory involvement in designing detailed arrangements. KPMG also states that developing a standardised or repeatable model across different companies and projects is likely to minimise transaction costs and maximise investor appetite. Both of these would benefit customers by ultimately reducing the cost of delivering projects under DPC.

It is in this context that we have developed our draft principles below around the contract we expect companies to use to deliver DPC projects. We would expect companies to adhere to these principles when procuring a DPC project. We have developed these principles to provide clarity on our expectations for DPC projects and how we consider we can best protect customers' interests in the process. We consider this will, to some extent, standardise the contract model for DPC projects.

Table 4 summarises our initial principles. These are more fully set out in the supplementary annex. We welcome stakeholders' views on these proposed principles.

Table 4 Draft contract principles

Area	Principle	Details and rationale
Contract duration	Default contract length of 15-25 years, plus construction period	KPMG's report highlights that there is a pool of debt and equity investors that seek long-term returns. We consider 15-25 years balances investor horizons with widely varying asset lives in the water industry. Aligning this pool

Area	Principle	Details and rationale
	CAP revenue starts on completion	market expectations should drive effective competition. We think it is appropriate to only allow revenue on successful completion because this aligns the CAP's interest with customers', and ensures that customers will only pay when they receive benefits. Whilst this raises financing risk, this is an approach commonly used in stand-alone infrastructure projects in other sectors. We would expect any companies making alternative arrangements to be able to show evidence of benefits for, and support from, customers.
Finance costs	Finance costs are fixed over contract period, with a provision to capture a share of the benefit of any debt refinancing for customers	This approach would lock in benefits for customers from the competitive process over the contract duration. Including a mechanism to share the benefits from debt refinancing (eg once the assets are operational and the risk profile changes) would allow any benefits to be passed back to customers and reduce risk to equity investors.
Termination	The contract will be terminated at a specified end date, with additional provisions to allow for early termination	We consider it important to give investors some certainty around how the end of the contract will be treated. We propose that ownership over the assets would pass back to the appointee at the end of the contract. However, we will also leave open the question of whether the appointee should then retender the project or bring it back in-house.
Residual value	The assets should be depreciated over their useful life, aligned to the current regulatory regime	We consider it important that future and existing customers pay a fair amount for services. The appointee would need to pay the CAP any non-depreciated capital expenditure, or capex (residual value), equivalent to a regulatory capital value (RCV) figure at the end of the contract. There may also be requirements related to the state of the assets at handover. Specifying this in the contract should help to mitigate any potential credit risk attached to the residual value.
Operational expenditure (opex) and maintenance	Opex could be fixed for the life of the contract, or just for an initial period (eg five years) followed by periodic reviews (potentially aligned to the price control process)	We consider that the model should ensure competitive pressure on opex costs/whole-life costs and then lock these benefits in for customers. Fixing opex allowances would achieve this. However, a provision for allowances to be reviewed, similar to setting efficient allowances in price controls, may help make sure the contract is flexible enough to deal with changes to scope (eg from new technologies). This may be in customers' interests if, for example, there is scope for a significant reduction in costs.
Risk allocation	We expect this to broadly reflect the risks allocated to the appointee and the CAP's ability to manage risk, unless there is good justification why it should be different	We consider that, in general, the risk profile should be the same as for the appointee, and the appointee should look to pass on to the CAP the risks it would normally take when delivering a project. We do not expect customers to bear more risks as a result of DPC. However, we also consider there to be some potential circumstances where it will not be efficient to pass on risk to the CAP, and where the appointee will keep control of the risk. For example, there is a risk of underutilisation of an asset if the appointee specifies the scale of the asset.

Area	Principle	Details and rationale
Step-in rights	The appointee can step in under specified circumstances (eg non-delivery)	We consider that the appointee needs to be able to take over to keep providing services to its customers. We expect this could be ensured through a provision in the contract. However, we also expect the contract to build in safeguards that go as far as possible to prevent this outcome.

5. DPC licence changes

As outlined in Chapter 7 we consider that companies taking forward DPC projects would require licence changes to provide certainty to appointee, DPC providers and customers. We consider that setting out the nature and scope of the proposed licence changes will help stakeholders to understand our thinking, and give us an opportunity to gather feedback before our final methodology. Table 5 below outlines our initial views on possible DPC related licence changes.

Table 5 Draft outline of DPC licence changes

Proposed license requirement	Further details and rationale
Specify that appointee can recover CAP revenue from customers	<p>We expect this would require a change to condition B.</p> <p>Current licence condition would not allow the appointee to recover the revenue from customers unless it was included in a price control. We note changes to Thames Water’s licence for the Tideway Tunnel project as an example of how this might work.</p> <p>Will provide some certainty to CAP investors. This is necessary as the contract would span several price control periods.</p>
Requirement to use all reasonable endeavours to run a tender process that achieves an efficient outcome and appoints a successful bidder, in line with our principles	<p>Will ensure benefits to customers are maximised from a well-run procurement process.</p> <p>Will help ensure that no party can gain an unfair competitive advantage through procurement of a DPC project.</p> <p>We consider this would help to maximize the potential for competitive tension for DPC projects, ultimately benefitting customers.</p>
Requirement for the appointee to adhere to specified aspects of its contract with the CAP	<p>Likely to be limited to key contract parameters to ensure CAP investor certainty – eg that CAP base revenue over contract period is reasonable or as set out in the contract.</p> <p>Appointee would require our approval to change these terms.</p> <p>We consider this would provide greater certainty for DPC investors and make the DPC more ‘bankable’ to investors, driving better customer outcomes and lowering financing costs.</p> <p>Potential to also cover any areas where revenue varies over the contract (eg possible opex changes or refinancing gain-sharing). This would ensure appointee passes on any such changes to customers.</p> <p>May also include a provision to inform Ofwat of any sales in the equity of the CAP or changes of ownership.</p> <p>We welcome views on what other elements would need regulatory determination, what would need variation control, and what should be bilaterally agreed without necessary Ofwat oversight.</p>
Prohibition on the appointee (or an associated company or related undertaking) from	<p>We consider appointees should be prohibited from bidding into their own procurement process to avoid real and perceived conflicts of interest and maintain the integrity of the process to encourage wider bidder and investor interest.</p>

bidding into its own DPC procurement process	We will specify the rules around who can compete, including complex multi-party projects. Designed to provide clarity for potential investors, as well as companies running the process. Potential to have some flexibility around participation as a non-controlling interest in a joint venture if real or perceived conflicts of interest can be overcome.
Requirement to provide information to Ofwat and keep us informed of progress with tendering a project	Will ensure we are kept up to date with progress – the process from final determinations to appointing a CAP may take several years.

We expect that we would be able to make many of these licence changes upfront (ie before or at final determinations) once we have reviewed business plans. However, other licence changes, such as to allow the appointee to recover the CAP revenue stream, might not be appropriate until the tender process is complete.

We seek views from stakeholders, including appointees and potential new entrants on these licence changes, or any further areas where the appointee's licence may need to change to accommodate DPC.

A1 Draft DPC procurement and contract principles

DPC Procurement Process		
Area	Principle	Rationale
Incumbent (appointee) participation	Companies cannot bid in their own procurement process (this principle would exclude an associate of the incumbent competing or the incumbent setting up a separate bidding unit).	<p>We consider that there are significant conflicts of interest if incumbents bid. The process needs to be seen to be fair to attract potential bidders.</p> <p>Companies need to be able to effectively manage the DPC project; it may lead to poor customer outcomes if the same company is the 'buyer' and 'provider'.</p> <p>In circumstances where incumbent appointees have a non-controlling interest in a potential bidder it would be important that sufficiently robust arrangements could be put in place to manage actual and perceived conflicts of interest potentially with strict rules of separation and control. We would require companies to justify any proposed involvement in the bidding process in terms of potential benefits to customers and to explain how they were safeguarding their role as procurer in the process and over the delivery of the contract.</p>
	We expect that companies could compete to deliver projects outside of their appointed area.	<p>We consider that, where not responsible for running the procurement process and managing the contract, companies should be allowed to compete to deliver a DPC scheme.</p> <p>Where an existing appointee became a successful bidder, we would expect appropriate arrangements to ensure clear separation of the appointed business and the CAP to be put in place to comply with ring fencing and transfer pricing conditions.</p>
Resourcing and governance	Companies should demonstrate to our satisfaction that they have clear governance processes and adequate resourcing in place.	For DPC to be successful companies need to be able to run a successful procurement process, including effective decision making. Bidders will be putting their costs at risk to participate, and will also expect clarity around processes and governance. We therefore expect companies to assure us that they are aware of the risks in running tenders and have structures in place to mitigate these.
	Companies should ensure they have in place a process to respond to bidder questions and clarifications through the process.	Through the procurement process we expect bidders would seek clarifications on the tender documents. Companies must be prepared to respond to these as part of the process to mitigate the risk of bidders basing their submissions on an incomplete or inadequate understanding.

DPC Procurement Process		
Area	Principle	Rationale
	Companies should ensure there is a clear process in place for managing bidders' intellectual property that may be revealed through the tender process.	Bidders will provide information as part of the tender process. In some cases this information may reveal details of bidders' intellectual property (eg around how they propose to approach construction). Innovation is in customers interests, therefore we expect companies to put in place processes to manage sensitive information and bidders' intellectual property.
Process	We expect all companies to adhere to the Utilities Contracts Regulations 2016.	We consider that these would normally apply to this type of procurement process.
	Companies should standardise the process (across projects and between different companies) as far as possible.	As outlined above, we consider there are significant customer benefits to standardizing processes. It would lower transaction costs and help to build investor interest in the DPC model. It would also provide transparency to us and other stakeholders over the process.
	Companies should outline clear process timescales and use all reasonable endeavours to meet these. In doing so companies should consider the impact of these timescales on the bidding market.	A clear and streamlined process is more likely to be attractive to potential bidders. By setting out a procurement timetable companies will set expectations with potential bidders. As there are significant potential costs involved for bidders, we then expect companies to maintain these timings.
	Companies should make all reasonable endeavours to minimize the time between appointing a preferred bidder and financial close, bearing in mind the potential due diligence requirements a preferred bidder may need to complete.	We consider that companies should look to run the procurement process as late as possible, working back from the point they expect to require to appoint a CAP. This would ensure that there is sufficient certainty over the project at the point the tender is run. We also consider that an efficient preferred bidder stage will minimise the likelihood of reopening any of the details from the tender.
Preconstruction works	Companies should make all relevant information available to bidders during the tender (eg in a data room).	Bidders need to have access to all relevant information to be able to compile submissions. If there are omissions then these uncertainties would be reflected in the terms of the bid (eg risk premiums or reopeners). Minimising these will deliver better customer outcomes.
	Pre-construction works need to be capable of transfer to the CAP at financial close, or	If the CAP is required to take over any pre-construction works, these should clearly be capable of transfer. If pre-construction works were not clearly capable of transfer, this would add complexity and potentially cost to the finalization of

DPC Procurement Process		
Area	Principle	Rationale
	otherwise obtained in such a way as to allow the CAP to benefit from these.	arrangements. Potential risk may also be priced into bidders' submissions if there is uncertainty during the tender process.
Tender specification	Companies should provide a draft version of the contract as part of the tender specification.	We consider that, particularly for the initial DPC tenders, giving bidders early sight of the contract will improve customer outcomes. If bidders do not have sight of the contract, we expect this may create uncertainty which they would look to reflect in their submissions.
	Companies should allow bidders to comment on the draft contract in the preliminary stages.	Where bidders have an option to comment on the contract, it may allow companies to develop more robust arrangements and deliver, for example, better pricing. There is also the potential to clarify any contract terms prior to selecting a preferred bidder, which may also limit the potential for negotiation at the preferred bidder stage.
Bid evaluation	Companies should have in place, before starting each tender stage, a clear bid evaluation strategy and scoring system.	We consider that, to ensure a fair and open process, companies need to develop a robust approach to bid evaluation. This should be developed before the relevant stage of the tender process starts.
	Companies should ensure that the process gives adequate weight to the overall robustness or deliverability of bidders' proposals.	We expect that the evaluation strategy will need to consider a range of factors, not simply cost. Overall deliverability of proposals is likely to be important to protect customers from, for example, the failure of a CAP or one of its contractors. We also expect companies will need to assure themselves through the tender process that bidders can meet any relevant standards (eg on water quality).
	Companies should evaluate (either separately or via relevant tender sections) innovations being brought forward by bidders.	We consider that DPC has the potential to drive significant innovation in the sector. We therefore expect this to be reflected as part of the tender documents and the evaluation approach. This would encourage bidders to propose innovative solutions.

DPC contract model		
Area	Principle	Rationale
Revenue and financing costs	The contract duration is likely to be in the region of 15-25 years for operations, plus construction period.	<p>We consider that a long term contract is likely to attract the greatest level of competition for DPC projects as potential investors will seek long term returns. We initially consider that a duration of 15-25 years would be attractive to equity investors, while providing competitive debt financing terms. Contracts in excess of 25 years may not accommodate fixing debt costs upfront for the contract duration, which could lead to additional uncertainties for financing costs and make the procurement process less effective.</p> <p>However, for certain projects with long (or short) expected asset lives, it may be preferable to consider the optimal contract period.</p> <p>We expect companies to consider for each project the balance between financing terms and asset life in deciding on the contract duration to use. Companies may be able to test this with bidders though the tender process itself (eg in the early tender stages).</p>
	The contractor's revenue entitlement should start on completion of construction and acceptance by the client of the assets.	<p>We consider that payment on completion provides a strong incentive on the CAP to deliver the assets on time. We consider that this protects customers by ensuring the appointee is able to provide services to its customers. We note this approach is common for other stand-alone infrastructure projects like PFI.</p> <p>We also consider that for DPC, in general, customers would only start paying for the assets through their bills once the assets are complete and in use. However we are open to possible alternative approaches where companies can justify the customer benefits and customer support.</p>
	Revenue stream paid to the contractor should be largely fixed over the contract period, subject only to limited variations (eg performance incentives).	We consider that a fixed revenue stream would ensure that the benefits of competing the project are locked in for customers over the duration of the contract. Limiting the potential to reopen any of these contract terms would therefore ensure that customers benefit over the long term.
	Assets should be depreciated over their useful life. This may mean that assets are not fully depreciated over the contract period.	<p>We consider that customers who get beneficial use of the asset should pay a fair share of the costs to deliver the asset. This is a key part of our regulatory approach. We propose to maintain this for DPC projects.</p> <p>In practice, with a 15-25 year contract, the assets are unlikely to be fully depreciated by the end of the contract. This would mean that the contract would</p>

DPC contract model		
Area	Principle	Rationale
		<p>need to specify a residual (or terminal) value for the assets when the contract expires.</p> <p>We expect that the contractor would own the assets for the duration of the contract.</p>
	Revenue stream may (or may not) be indexed to the same inflation measurement used in the appointee's price control. The appointee should consider customer value for money.	We note that there is a range of possible approaches to indexation that can lead to different customer outcomes. Under price controls the RCV is indexed to inflation, however for DPC projects there is no RCV. We expect CAPs to be able to access both nominal and index-linked debt. We therefore do not consider that their revenue stream would necessarily be index-linked. We expect that companies should consider the best approach for DPC projects, which could include 'biddable indexation' (or letting the market decide the proportion of the revenue stream to index).
	Contract should include a provision to capture the benefit for the appointee from any debt refinancing gains during the contract life.	We understand that with a competitive delivery model (like Ofgem's OFTO process) there is a scope for refinancing project debt after financial close, typically on cheaper terms. This can arise through a change in the risk profile of the projects, or through changes in financial markets (or both). This is particularly relevant where construction risk may be priced into the initial debt terms. We therefore consider that, where refinancing takes place, customers should be able to share in the benefits of this through a reduction in the CAP's contract revenue stream. These costs are likely to be driven primarily by markets, not management decisions. It is commonly used in similar procurement models.
	Contract should include provisions to require prior approval by the client of any equity sales by the asset owners.	DPC projects will represent key pieces of infrastructure delivering an essential service to customers. We consider that companies will want to ensure, as far as possible, that the owners of these assets are competent. Through the tender process companies can consider this as part of the overall robustness of bids. However, we also consider that some safeguards may be appropriate after financial close; this could be reflected in the contract.
Risk allocation	This should broadly reflect the risks allocated to the appointee and ability for	We consider that appointees' risk profiles should in general not be impacted by using DPC. In practice this means that we would expect them to transfer many of the risks associated with the project that they would face in a delivery position to

DPC contract model		
Area	Principle	Rationale
	CAP to manage risk, unless there is a good justification why it should be different.	the CAP. However, the risk allocation under a contract may need to be specified in more detail. We expect that overall there would be no increase in the risks allocated to customers.
	Contract may include provisions for force majeure events (impacting both cost and timetable). These should be clearly defined and strictly limited in line with good industry practice.	We consider that wherever the contract provides the CAP relief (ie a risk that is passed up to the appointee and potentially back onto customers) the circumstances should be tightly defined. This would ensure all parties have clarity over the allocation of risks and mitigate the potential risk of spurious claims under the contract by the CAP following financial close.
Expiry, termination and step in	Contract should clearly specify circumstances under which appointee can 'step in'. These should be limited to material breaches (eg regulatory non-compliance).	Given the critical nature of these assets, we consider that the appointee may need to have the ability to step in to ensure, for example, continuation of supply or compliance with relevant regulations. This should be reflected in the contract, however, and such rights should be limited to events with a significant impact on customers.
	Contract should clearly specify the end date, as well as any circumstances under which the contract can be terminated early. These should be strictly limited.	There may be circumstances where the appointee would benefit from being able to terminate the contract before the specified end date. This could occur, for example, where the CAP has not delivered the assets by a designated backstop date, or as a result of continued non-delivery of outputs over a prolonged period. To be bankable any such provisions would need to be limited and the terms proportionate.
	Contract should clearly specify the asset residual (non-depreciated) value at the designated end date, as well as indicate how this will be paid to the CAP.	We consider that to raise debt finance for the whole capex value of the project, funders would require significant certainty over any residual value they would receive at the end. We therefore expect that this should be set out clearly in the contract, as well as the actual mechanism for this to be paid (eg included in the final payment form the appointee to the CAP or equivalent). We consider this would mitigate the potential credit risk around residual value, and lead to improved pricing terms for the project's finance.

DPC contract model		
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	Contract should clearly specify any compensation payable to the contractor under early termination scenarios.	Where the contract is terminated early, depending on the circumstances of termination, the CAP may be entitled to compensation from the appointee.
	Contract should clearly outline the required asset specification at the contract end date.	Good asset management is of fundamental importance to the water sector. We expect a CAP would put in place robust systems, policies and procedures to ensure its assets are managed effectively over the contract period, and that the assets are in an appropriate condition when the contract ends. We consider that to achieve this the contract (and/or tender documents) need to clearly specify any expected condition requirements.
Construction programme and completion	Contract should clearly specify construction milestones and completion date(s).	This would need to be specified as part of the tender process to ensure bidders can provide appropriate proposals. The completion date would act as the trigger for the CAP revenue. Therefore this should also be clearly reflected in the contract, as would any provisions which could change this date.
	Contract should clearly outline the acceptance requirements for assets (eg to trigger formal 'completion').	Where there are any requirements related to 'completion' (for the purpose of triggering payment), these would need to be clearly set out in the contract to provide clarity for the CAP and the appointee.
	Contract may include provisions for liquidated damages (either paid to the CAP or to the appointee) in the event of late delivery resulting from circumstances within either party's control. Where used these should be proportionate and capped.	Non-delivery may have implication for the appointee in terms of meeting obligations and providing a service for customers. Therefore, some flexibility to include liquidated damages provisions in the contract may be appropriate. However, we note that generally bidders would price liquidated damages costs into their submissions, which may not be in the best interests of customers. We therefore would expect companies to be able to clearly demonstrate why liquidated damages are necessary as part of a CAP contract.
Operations and maintenance	Contract should clearly specify any operational requirements, including any performance commitments the contractor must fulfil.	We expect that, to ensure the appointee receives the required level of service, any service specifications or operational requirements should be specified in the contract. This would ensure a robust framework for the appointee to manage the CAP performance over the contract period.

DPC contract model		
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	Contract may include performance incentives linked to delivery of agreed requirements. Where used these should be capped at an appropriate amount to ensure financeability of the CAP.	Financial incentives may sharpen the incentive for a CAP to deliver against the most important agreed requirements. We consider that the contract could allow for these.
	In general operational costs should be fixed for the contract duration. But the contract may provide for variation to opex costs at periodic intervals where this is likely to drive value for customers. This should align to the appointee's price control periods.	We see potential customer benefits in maximizing the scope of costs that can be fixed during the tender process for the duration of the contract life. This would ensure customers are not exposed to cost variations, as well as mitigating the risk of bidders submitting unrealistic cost estimates to win the tender, then looking to increasing these later. However, we also consider that in some circumstances there may be factors that materially change opex costs over a long contract period (eg a significant technical change that lowers costs). This may apply to some project types more so than others. As such, we consider that some flexibility around opex may be beneficial to customers.
	Contract should clearly specify any ongoing reporting or information requirements, for example around asset condition monitoring.	There may be circumstances where the appointee needs the CAP to provide it with information. This could include information that we require from the appointee. The contract needs to include terms for the appointee to request this. As noted above, good asset management is imperative for both the appointee and the CAP. We therefore expect that the CAP would provide the appointee with reporting against asset condition requirements that would be outlined in the contract.
Security	Contract may require contractor to post security against late or non-delivery of the assets. If used this should be sized appropriately to cover relevant costs to the appointee, taking into account the potential impact on the contractor's cost if this is set too high.	There are potential costs to the appointee in the event of the CAP failing – including retendering or taking the project back in house. These costs should not be borne by customers, therefore some form of security posted by the CAP may be necessary. However, we also understand that a high level of security will increase the CAP costs, which is not in customers' interests. We therefore expect any security to be commensurate with the risk it is designed to mitigate.

DPC contract model		
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Compliance with relevant legislation	Contract must clearly specify relevant statutory or regulatory condition the CAP must comply with on behalf of the appointee.	We do not expect DPC to impact in any way the ability of an appointee to comply with relevant regulations. Therefore we expect that, where relevant, these obligations should be specified in the contract to ensure the CAP has clarity on them and what it needs to deliver.
	Contract may include provision to vary allowed revenues due to changes in regulatory requirements. If used, such provisions should be limited.	We consider that some changes to regulations over the contract period are possible This would likely affect some project types more than others. We expect that the contract would need to have the flexibility to ensure the CAP is also required to deliver the necessary outputs on behalf of the appointee.
	Contractor should be able to benefit from any relevant statutory powers of the appointee (eg access).	To deliver the project the CAP may need to be able to use some of the appointee's powers as a water and/or sewerage undertaker, such as in obtaining planning consent.