Meeting note

Monday 9 October 2017
PA Consulting Offices, 10 Bressenden Place, London, SW1E 5DN
9.30 am to 4.00 pm

Direct Procurement for Customers Industry Workshop

Attendees (organisations represented)	
Affinity Water	Ofwat
Anglian	PA Consulting (Ofwat consultants)
Bristol Water	KPMG (Ofwat consultants)
Northumbrian Water	Balfour Beatty
Portsmouth Water	British Water
Severn Trent	Drinking Water Inspectorate
South East Water	Omers
Southern Water	Skanska
South Staffordshire Water	
South West Water	
Thames Water	
Thames Tideway Tunnel	
United Utilities	
Welsh Water	
Wessex Water	
Yorkshire Water	

Opening session

Ofwat opened the session and provided an overview of how it intended Direct Procurement for Customers (DPC) should work. The following key points were emphasised:

- The aim of the workshop was to facilitate companies to envisage how DPC will work in practice and therefore Ofwat's role would be to faciltate rather than lead discussion. Ofwat intended for companies to take ownership of the DPC process.
- Ofwat was in the process of developing its final methodology, which will be published in December.
- Ofwat's intended purpose in introducing DPC was to drive value for customers.
- Ofwat did not consider DPC to be mandatory, but rather as an additional tool available to companies. Not every company is expected to have suitable candidate projects and not every project above the £100m totex threshold will necessarily be suitable. We provided draft guidance in July (to be finalised in December) about the types of project we consider suitable.
- Where a project meets the criteria, then there is a presumption in favour of DPC. However, if a company can make a compelling case why it can provide the project at better value for customers than the market, then it needs to do so in its business plan.
- Companies will be both undertaking procurement and managing DPC contracts and need to be appropriately skilled and resourced to do so.
- Companies remain responsible for all their statutory obligations – these cannot be contracted away.

A short question and answer session followed which covered the following topics:

- The extent to which DPC is innovative, where there was a consensus that DPC is innovative in the water sector, is not a direct copy of the approach in other sectors and allows companies the opportunity to shape the design of it ahead of application.
- The appetite for DPC, where it was argued the level of appetite would depend on the types of schemes and the final policy design and guidance.
- The lessons learned from other sectors that can support DPC design, where the merits of a standardised process in terms of certainty for investors was weighed against the greater scope for innovation and flexibility from non-standardisation.
- The benefits of a visible pipeline of schemes in encouraging the market.
- A need for flexibility in learning lessons from the initial round of tenders and the scope to refine and enhance future rounds.

Working Group Session 1

Tender models: benefits, opportunities and risks of early and late procurement models

Anglian and United Utilities gave presentations which considered the merits of the different timing of tender models.

Break-out groups discussed whether different procurement models worked better for certain specific asset types and whether other factors were relevant for the choice of model. They also weighed the balance between optionality (favoured by earlier procurement) and certainty (favoured by later procurement).

A range of key points were fed back to the main session, including:

- That there were a range of factors which might influence the suitability of the type of procurement model for each individual project. These could include:
  - the nature of the asset and the scope for innovation it presented;
  - the scale and complexity of a project which could encompass the number of number of interfaces it has, the regulatory challenges it presents (for example, planning consents), and any timing challenges;
  - The physical characteristics of the proposed site of the asset (greenfield vs brownfield);
  - the depth of the market;
  - the pipeline of similar projects; and
  - the capability of the market to deliver innovation, which could grow over time.
- The value of de-risking a project (under a late model) in delivering a lower cost of finance was considered as well as the value of innovation in delivering lower costs of capital and operation under an early model.
- It was noted that the novelty of the DPC process might influence the choice of procurement model for PR19 projects and that this may change in future as the process matures.

Working Group Session 2

Risk allocation: Efficiently managing and allocation risks between parties to ensure value for money

Thames Water and Anglian gave presentations which considered approaches to the allocation of risk between appointees, the competitively appointed provider (CAP) and customers. Breakout groups then separately considered technical and commercial risks.

Groups considering technical risks noted:

- Different risks would manifest throughout the project lifecycle, starting with the project definition and design, through pre-construction activities, construction, delivery, and operation.
- The ownership and management of certain types of risks would naturally sit with the appointee or CAP in many cases.
- There were a number of different ways in which risks could be mitigated and managed and many of these could be built into the design of the DPC process, while others could be managed contractually.
- The benefits of the use of filters to identify suitable candidate projects was noted.
- The benefits of being able to define the discreteness of an asset as a filter was noted, but that other filters were likely to be required in addition to identify the most suitable candidate projects.

Groups considering commercial risks noted the need to allocate the following types of risk:

- Demand and coordination;
- Exclusive use versus third party opportunities;
- Availability and performance;
- Variable costs (such as inflation);
- Technology and obsolesence;
- Residual value;
- Political and regulatory; and
- Those arising from the nature of the transaction (such as accounting and tax).

Working Group Session 3

Regulatory reopeners: balancing (un)certainty and customer protection

United Utilities presented on the different types of contract variations that typically arise and the factors which might account for these being dealt with through contracts or through other forms of resolution.

Breakout groups discussed the types of variations that occur and the best means of managing these. Key points made included:

- Reopening contracts was generally undesirable if the issues could be anticipated and resolved through contractual mechanisms. It was noted that in other sectors a wide scope of variables are managed contractually. It was noted that inherent uncertainties unaddressed by the contract terms would have an impact on bid prices.
- It was suggested that the types of trigger for contract reopeners might typically be exogenous risks with very material impacts which are beyond the power of either counterparty to anticipate or manage. Examples provided centred around legal changes which might in some way alter the parameters of the original contract.
- It was noted that there was a significant inter-relationship between the condition in the appointees licence that governed the flow of revenue to the CAP and any variation in revenues (agreed or exceptional) between the appointee and the CAP. Anticipated variations could include project refinancing and levels of performance and the rewards or penalties pertaining to these.

Working Group Session 4

Evaluating value for money for selection into DPC (including discussion of discreteness and technical risks)

Thames Water outlined a method that might be used to assess the value for money of undertaking a project via the DPC route or the in-house route. PA Consulting provided an overview of HM Treasury's five business case model, which is an approach commonly used to assess value for money with PFI contracts.

Breakout groups discussed issues around undertaking value for money assessments for potential DPC projects. Key points included:

- There was a broad recognition that it was important for an appointee to be consistent in the way it evaluated the value for money of potential DPC projects for in-house delivery or DPC delivery. It was noted that while it was desirable for appointees to all use a similar method of evaluation to each other, this was not essential and that some methods might be revealed to be more effctive than others.
- The HMT five business case model was recognised as being a sensible approach with a proven track record.
- It was noted that cost, quality and risk were key things to measure when assessing the value for money of different delivery mechanisms.