Information notice

IN 18/10 June 2018

This is a formal document that alerts our stakeholders to a change in the way that we regulate the water sector in England and Wales.

Direct procurement for customers (DPC): setting expectations for a high-quality and well-evidenced case

This note is intended to help companies provide high quality and well evidenced proposals for direct procurement for customers (DPCs) in their business plans. As part of PR19, we introduced 'Direct procurement for customers' (DPC), a process for water companies to competitively tender for a third party (a competitively appointed provider, or CAP) to design, build, finance, operate and maintain infrastructure. This initiative has the potential to provide significant benefits for customers through promoting innovation and enabling capital and operational cost savings as well as a reduction in financing costs.

This information notice reminds companies of our expectations for their business plans in September 2018 and emphasises the importance of developing a high quality and well-evidenced value for money (VfM) assessment. For the avoidance of doubt, this note does not set out any new requirements for business plans, but builds on what we set out in the PR19 methodology in some areas to provide further clarity.

Our approach to DPC at PR19

In chapter 7 and appendix 9 of the PR19 final methodology we set out our approach and expectations for Direct Procurement for Customers (DPC) in relation to company business plans.

At PR19 we are expecting companies to consider the use of DPC for large-scale enhancement projects that are expected to cost over £100 million, based on whole-life totex. We are not expecting companies to use DPC for every scheme that meets this threshold, rather they should consider for each relevant scheme which delivery approach has the potential to drive the greatest possible benefits for customers.

In their business plans we are expecting companies to provide an assessment of the suitability of each scheme for delivery via DPC. In section 7.2 of the final methodology we have set out high-level guidance on the types of issues that companies should consider in determining the suitability of a scheme for DPC. In assessing the technical suitability of a scheme, we expect companies to consider the findings of the technical review carried out by KPMG on behalf of Ofwat.

In order to ensure that companies put forward projects for DPC that deliver the greatest value for customers, we expect companies to assess the value for money of delivering a project through DPC against in-house delivery approach. Value for money assessments put forward by companies will need to be well-evidenced and well-reasoned.

Value for money (VfM) assessment

A robust value for money assessment will be critical to the successful delivery of a scheme by DPC over the life of the contract. It is important that companies develop a high quality and well-evidenced VfM assessment to support their business plans and to ensure successful procurement and management of a DPC contract.

In chapter 7 and appendix 9 of the PR19 final methodology we set out our expectations for the VfM assessment. For PR19 we are expecting companies to determine how best to undertake the value for money assessment, and to compare DPC with a default (in-house) delivery approach, and present it in their business plans.

We expect companies to explore each suitable project through a robust and iterative business case. Using a business case approach will enable companies to compare DPC with in-house delivery and identify which of the delivery options provides best value for customers. One example of an iterative business case is the Treasury five case model. Although we do not require companies to follow this model, this model illustrates our expectations of what we expect to see in a well evidenced and well-reasoned business case.

The Treasury five case model consists of five different cases: The strategic case, the commercial case, the economic case, the financial case and the management case. Companies are not required to use this approach, but we would expect whatever business case approaches are used to cover largely similar principles and processes, and to focus on optimal value for customers.

Companies should refer to the guidance we have provided in Chapter 7 and appendix 9 of the PR19 final methodology and the Treasury five case model for the details we expect companies to provide to support their business case. In the sections below we have provided an overview of our expectations for evidence in business plans using the cases in the Treasury model.

The strategic case

Companies should look at whether the scheme being delivered through DPC will meet the strategic and operational needs of a company. Under this case there should be a clear statement of the key objectives, business needs, and the potential scope and service requirements.

The economic case

The purpose of the economic case is to determine the optimal delivery approach - in-house or DPC and the preferred type of DPC - that offers best value for money for customers. It should assess how appropriate each option is in terms of critical success factors and investment objectives. Companies should consider the financial, technical and other impacts that influence the overall value to customers as a result of the delivery mode.

Companies should carry out economic appraisals using a best practice approach (we provide further details on best practice principals of economic evaluation on page 8 and 9 of appendix 9 of the final methodology). We expect companies to provide details of their appraisals, including the risks.

Companies need to assess the different tender models, justify their choice of tender model in their business plans, and explain how it provides the best value for customers compared to their other options. This may include evidence from market soundings of differences in financing costs between options.

Companies, based on their economic appraisal, should determine for each scheme which option provides optimal customer value.

The commercial case

The purpose of the commercial case is to assess the commercially feasibility of the proposed approach to DPC. It should consider the main contractual arrangements with, and risk transfers to the CAP and how the risk allocation and proposed approach impact on the attractiveness of the proposed approach to procurement is to those interested in becoming competitively appointed providers.

In developing the commercial case, companies should take into account some specific requirements set out in appendix 9 of the final methodology:

- Companies will need to take into account the procurement principles we expect companies to follow in the DPC procurement process. These principles are set out in table 9.1 of appendix 9 of the final methodology.
- Companies will need to consider the contract principles we set out in section 4 of appendix 9 of the final methodology. We expect companies to act consistently with these principles when negotiating DPC contracts.

The finance case

This case considers any impact on financing of the appointed company, including cashflow impacts and the accounting implications of a DPC. We would expect companies to provide forecasts of the capital and operating costs and revenue profiles of each option. Companies should consider the allocation of financing risk and contingencies between itself and the CAP. It should also consider the impact of revenue streams for each option on customer bills.

The management case

The purpose of this case is to consider the deliverability of the scheme as a DPC from the start, from a successful procurement to a successfully managed long-term contract. Companies should identify relevant risks and issues and provide a clear plan on how the DPC project can be successfully delivered through to the end of the contract where an asset may either be re-tendered or brought back in-house.

Initial assessment of business plan (IAP) test for DPC

We set out the process for our initial assessment of companies' business plans in chapter 14 and appendix 13 of the final methodology. For DPC we will assess companies approach using the following test.

IAP test for DPC

To what extent has the company clearly demonstrated that it has considered whether all relevant projects are technically suitable for direct procurement for customers?

Where it has one or more such projects, to what extent has the company provided a well-reasoned and well-evidenced value for money assessment supporting its decision on whether or not to take forward each technically suitable project using direct procurement for customers?

We provide details on what we expect companies to provide in a high-quality and in an ambitious and innovative plan in appendix 13 of the final methodology.

A high quality, ambitious and innovative plan will, in summary, need to demonstrate a high-quality approach to DPC together with a sector leading strategy and plan (supported by strong evidence) for delivering qualifying projects through DPC, where value for money assessment indicates a direct procurement approach will provide value for customers.

More information

2019 price review: Final methodology, December 2017, https://www.ofwat.gov.uk/regulated-companies/price-review/2019-price-review-final-methodology/pr19-final-methodology

Treasury five case model, HM Treasury, 2013, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/469317/green_book_guidance_public_sector_business_cases_2015_update.pdf

KPMG Technical guidance, 2017, https://www.ofwat.gov.uk/publication/direct-procurement-customers-technical-issues-approach-assessing-kpmg-report-ofwat/

The Greenbook, HM Treasury, 2018, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/685903/The_Green_Book.pdf

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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