Dŵr Cymru: Direct procurement for customers detailed actions

In Dŵr Cymru's business plan "PR19 Business Plan 2020-2025" Dŵr Cymru identified two potential schemes that met the cost threshold for Direct Procurement for Customers (DPC). We have reviewed Dŵr Cymru's assessments for these schemes and during our review we did not find the reasons why the Merthyr Water Treatment Works scheme was rejected by Dŵr Cymru for DPC convincing. We also require further clarification on the assumptions used for the Gwili Gwendreath Wastewater Treatment scheme.

We require Dŵr Cymru to supply us with the following information as follows:

Scheme	Action	Action Reference
Merthyr Water Treatment scheme	• A full explanation and supporting risk analysis for the Dŵr Cymru Board's decision to reject the Merthyr Water Treatment scheme as suitable for DPC on the grounds of "unacceptable risk to our customers". This should include, but not be limited to, the risks to customers in the event of default or financial difficulty of a third party operator and the areas where there was insufficient risk management available to the Board.	WSH.CMI.A5
Gwili Gwendreath Wastewater Treatment scheme	• A full explanation as to why under the DPC assessment the gearing level for Gwili Gwendreath Wastewater Treatment works was considered "optimal" despite being lower than for Merthyr Water Treatment scheme. • For Gwili Gwendreath Wastewater Treatment works, an economic analysis of the scheme including a Net Present Value analysis using the same gearing assumptions as the Merthyr Water Treatment scheme assessed under the DPC scenario. The analysis should clearly identify any additional benefit to customers of progressing this scheme outside of DPC.	WSH.CMI.A6

Table A – Standard assumptions for the NPV analysis of Direct Procurement for Customer schemes

The business case submissions from the water companies as part of the Price Review 2019 had thirteen economic assessments of schemes that were considered technically suitable for Direct Procurement for Customers (DPC). There were significant differences in the assumptions used to identify the NPV differential for the DPC case (factual) and in-house (counterfactual). The table below sets out a set of assumptions and range of sensitivities that should be used in the event that companies do not have any specific market information for the relevant scheme.

Area	Item	DPC (Factual) Assumptions	In-house (Counterfactual) Assumptions
Customer Payments	Value	Determined by CAP contract payments and Appointee costs	Determined by Allowed Revenues from PR framework
	Timing	From first payment by customers which would usually be expected after asset completion. If improved contractual terms are identified with earlier payments then these should be considered.	From first payment by customers which would usually be when the appointee starts collecting from customers as per its business plan 'allowed revenue' profile.
Contract period	Length	Mid-case 25 years, Lower-case 20 years, Upper-case 50 years	Not needed

Area	Item	DPC (Factual) Assumptions	In-house (Counterfactual) Assumptions
PV Calculation	Period	From the start of the customer payments until the end of the asset life (or until there is no difference in asset value, maintenance and finance costs).	
	Discount rate	Discount rate of 3.5% real decreasing overtime (Based on HM Treasury Green Book Supplementary Guidance: discounting (3.5% 0-30 years, 3.0% 31-75 years, 2.5% 76-125 years)	
Indexation		CPIH	CPIH
Asset Depreciation	Method	Straight line or as per companies policy for asset type, the treatment should be consistent between DPC and in-house deliver.	
	Depreciation Rate	Mid-case - As per company policy for this asset type Lowercase +25% faster company policy rate	As per company policy for this asset type
Financing Costs	Cost of debt	Construction: forward Libor 6m swap + 220bsp –240bsp Operation: forward Gilt / Libor 6m swap + 120bsp – 140bsp RCV bullet repayment: forward Gilt / Libor 6m swap + 120bsp –140bsp	As per company business plan
	Cost of equity	Equity IRR (Real) 8% (Upper case 7%, lower case 10%)	As per company business plan

Area	Item	DPC (Factual) Assumptions	In-house (Counterfactual) Assumptions
	Gearing	Mid case 85% (Upper case 90%, lower case 80%) after asset completion.	As per company business plan or Ofwat notional of 60%.
	Assumptions	Given the ranges available above, please provide explanation justifying your selections made	N/A
Cost differentials	Capex efficiency saving	Mid case 10% (Uppercase +15%, lowercase 5%)	In-house is base case
	Opex efficiency saving	Mid case 10% (Uppercase +15%, lowercase 5%)	In-house is base case
	Additional Bidder Costs	Additional bidder costs of 2% of capital spend, (Upper case 1%, lowercase 3%)	In-house is base case
	Procurement	Procurement costs of 1% of capital spend, (Uppercase 0.5%, Lowercase 2%)	In-house is base case
	Management	Contract management costs £150k per annum.	In-house is base case

Area	Item	DPC (Factual) Assumptions	In-house (Counterfactual) Assumptions
		(Lowercase £300k per annum for high operational interaction schemes)	
Terminal Value	Assumptions	Please disclose clearly any assumptions about terminal value	N/A