July 2019

Trust in water

PR19 draft determinations

Delivering customer value in large projects

Ofwat

PR19 draft determinations: Delivering customer value in large projects

Contents

1 Summary

As part of PR19, we introduced direct procurement for customers, a process for water companies to competitively tender for a third-party (a competitively appointed provider) 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.

We set out in our PR19 methodology that we expected company business plans to consider direct procurement for customers where this is likely to deliver the greatest value for customers. Direct procurement for customers promotes innovation and resilience by allowing new participants to bring fresh ideas and approaches to the delivery of key schemes. Companies were to consider direct procurement for customers for discrete, large-scale enhancement schemes expected to cost over £100 million, based on whole-life totex.

All of the responses to the initial assessment of business plans, including all of the companies' revised business plans, provided by the 1 April 2019 are taken into account in our decisions where relevant. Where appropriate, we explicitly set out our response to points and issues raised by respondents.

Our decisions also take into account the representations made on the fast track draft determinations where the points and issues raised are relevant to the slow track and significant scrutiny draft determinations. We will deal with the other elements of the representations to the fast track draft determinations as part of the final determinations.

We have not necessarily been able to take full account of all late evidence, submitted after the 1 April 2019 business plans, and we will consider this information for the final determination.

This document provides:

a) A summary of potential direct procurement for customer schemes identified in business plans.
b) A high level overview of the business case submissions that accompanied company business plans in September 2018 and our expectations of a high quality and well evidenced direct procurement for customers assessment.
c) A consideration, building on the PR19 methodology, of the development of direct procurement for customers as a delivery mechanism during the 2020-25 period including the role of uncertainty mechanisms.

1.1 Direct procurement for customers schemes

Table 1.1 below sets out schemes deliverable by way of a direct procurement for customers process identified from company business plans for the 2020-25 period or that have the potential to become direct procurement for customer schemes during the 2020-25 period or later.

The delivery of United Utilities' Manchester and Pennine resilience scheme through a direct procurement for customers process was set out in their fast track draft determination in April 2019. We have identified the Anglian Water Elsham and Dŵr Cymru Cwm Taf schemes as direct procurement for customers schemes for delivery in 2020-25 in their draft determinations.

There are a number of Thames Water schemes and one Anglian Water strategic resource scheme which we would expect to be delivered through a direct procurement for customers process if approved at a future date.

Similarly, Southern Water's Fawley and Peacehaven schemes are potential alternative strategic water resources schemes, subject to further analysis as to feasibility and desirability. If Southern Water's schemes go ahead, we expect delivery to be by direct procurement for customers.

Other schemes which have the potential to be delivered through a direct procurement for customers process are identified in draft determinations. We expect companies to consider in respect of identified schemes, where there has been a material change in circumstances or assumptions, the delivery approach which provides the greatest value for customers.

Table 1.1: Potential schemes deliverable by way of direct procurement for customers

Potential direct procurement for customers schemes			Estimated milestones		
Company	Project	Type of scheme	Procurement Period	Construction Period (start)	In Use Period
United Utilities	Manchester & Pennines Resilience	Transfer	2020-25	2020-25	2025-30
Anglian Water	Elsham treatment and transfer	Transfer	2020-25	2020-25	2025-30
Dŵr Cymru	Cwm Taf water treatment	Water Treatment	2020-25	2020-25	2025-30
Thames Water	NE London resilience	Water Treatment	2020-25	2020-25	2025-30
Southern Water	Fawley water resources	Desalination or Re- use	2020-25	2020-25	2025-30
Southern Water	Peacehaven Re-use	Re-use	2020-25	2020-25	2025-30
Severn Trent	East Midlands Reservoir	Reservoir	2020-25	2025-30	2030-35
Thames Water	London Re-use	Re-use	2020-25	2025-30	2030-35
Anglian Water	South Lincolnshire Reservoir	Reservoir	2025-30	2025-30	2030-35
Thames Water	South East Strategic Reservoir Option	Reservoir	2025-30	2025-30	2035-40

2 Our approach to direct procurement for customers at PR19

In chapter 7 and Appendix 9 of the PR19 methodology we set out our approach and expectations for direct procurement for customers in relation to company business plans.

At PR19 we were expecting companies to consider the use of direct procurement for customers for large-scale enhancement schemes that were expected to cost over £100 million, based on whole-life totex. We were not expecting companies to use direct procurement for customers for every scheme that met this threshold, rather they should have considered for each relevant scheme which delivery approach had the potential to drive the greatest possible benefits for customers.

In the business plans we were expecting companies to provide an assessment of the suitability of each scheme for delivery via direct procurement for customers. In section 7.2 of the PR19 methodology we set out high-level guidance on the types of issues that companies should have considered in determining the suitability of a scheme for direct procurement for customers. In assessing the technical suitability of a scheme, we expected 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 schemes for direct procurement for customers that delivered the greatest value for customers, we expected companies to assess the value for money of delivering a scheme through direct procurement for customers against an in-house delivery approach. Value for money assessments put forward by companies needed to be well-evidenced and well-reasoned and additional guidance was provided in Information Notice IN 18/10.

2.1 Initial assessment of business plan test for direct procurement for customers

We set out the process for our initial assessment of companies' business plans in chapter 14 and Appendix 13 of the PR19 methodology. For direct procurement for customers we assessed companies approach using the following test.

The initial assessment of business plan test for direct procurement for customers

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 provided details on what we expected companies to provide in a high-quality and in an ambitious and innovative plan in Appendix 13 of the PR19 methodology.

A high quality, ambitious and innovative plan, in summary, needed to demonstrate a sector leading strategy and plan (supported by strong evidence) for delivering qualifying schemes through direct procurement for customers, where the value for money assessment indicated that the approach would provide better value for customers.

We assessed the business plans in three consecutive stages and if a company did not pass the scheme through a stage there was no further evaluation. These stages were as follows:

- A threshold assessment
- A technical assessment
- A value for money assessment

Companies generally carried out and evidenced satisfactorily the threshold assessment of large scale enhancement schemes. However we are disappointed by both the poor quality justification and insufficient supporting evidence provided by some companies when rejecting schemes on the basis of technical suitability without progressing to a value for money assessment, and the quality of the value for money assessments undertaken when comparing a direct procurement for customers approach and a traditional in-house delivery approach.

Our expectations and the level of detail provided in a high quality and well evidenced plan at each stage is outlined below.

2.2 Threshold assessment

We expected companies to consider large scale enhancement type schemes that were estimated to cost over £100m, based on whole-life totex. We expected companies to outline the process that had been followed and to provide evidence of results of that review.

High quality and well evidenced plans provided a process that explained the approach that had been taken in assessing a company's capital programme for suitable schemes. In addition, for schemes that passed the threshold, details were provided including the estimated whole-life totex of the schemes on an undiscounted basis. For smaller companies, providing details on schemes that were either just below the threshold or the largest capital scheme that are planned for the 2020-25 period was considered best practice.

2.3 Technical suitability assessment

For schemes that met the threshold we expected companies to clearly identify those schemes that were considered suitable and those that were considered either less or not suitable and set out why this was the case. We expected an overview of the process that schemes had been tested against and evidence of the results of the assessment.

High quality and well evidenced plans explained the approach that had been taken to assessing the technical suitability of the schemes. The best practice approach demonstrated how it considered all the criteria raised in the technical review carried out by KPMG on behalf of Ofwat.

High quality and well evidenced plans then assumed that schemes should progress to the value for money assessment unless there was a well justified reason with robust supporting evidence why a scheme was not suitable.

The types of schemes identified by the companies as being suitable for further assessment were as follows:

- Reservoirs and water storage schemes
- Transfer schemes
- Effluent re-use schemes
- Water treatment works including desalination plants and
- Wastewater treatment works

This list is based on the types assessed and future assessments should not be limited to this list.

2.4 Value for money assessment

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

In chapter 7 and Appendix 9 of the PR19 methodology we set out our expectations for the value for money assessment and gave further guidance in Information Notice IN 18/10. For PR19 we were expecting companies to determine how best to undertake the value for money assessment, and to compare direct procurement for customers with a default in-house delivery approach, and present this in their business plans.

We expected companies to explore each suitable scheme through a robust and iterative business case process, which enabled companies to compare direct procurement for customers with in-house delivery and to identify which delivery option provides best value for its customers.

A well prepared business case enables a company and its key stakeholders to understand, influence and shape the scheme's scope and direction early on in the planning process, assists in understanding key issues, helps to avoid schemes that should not proceed, demonstrates the continuing viability of the scheme and provides the basis for management, monitoring and evaluation during and after implementation.

One example of an iterative business case is the Treasury Five Case Model which provides decision makers and stakeholders with a proven framework for structured 'thinking' and assurance. The Treasury Five Case Model consists of five different elements: the strategic case, the commercial case, the economic case, the financial case and the management case. Although we did not require companies to follow this model, this was the most common model provided or referenced in the PR19 business plans.

In the sections below we provide an overview of the best practice in business plans using the cases of the Treasury Five Case Model as a framework.

2.4.1 The strategic case

We were expecting companies to provide a clear statement of the key objectives, business needs, and the potential scope and service requirements for the scheme consistent with the strategic plans.

We also expected companies to provide details on whether a scheme being delivered through direct procurement for customers met the strategic and operational needs of a company.

High quality and well evidenced plans provided the links to the company's strategic plan and future requirements for water supplies or wastewater treatment. A robust case to support the choice of scheme to meet the strategic needs of the customer and company was essential.

2.4.2 The economic case

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

We expected companies to carry out economic appraisals using a best practice approach and to provide details of their appraisals, including the risks. Companies were expected to assess the different tender models, justify their choice of tender model in their business plans, and explain how it provided the best value for customers compared to their other options. This was expected to include evidence from market soundings of differences in financing costs between options where they were available.

We expected companies to progress schemes through an iterative business case process until the economic analysis identified that direct procurement for customers would no longer deliver benefits for customers beyond those of delivery in-house.

High quality and well evidenced plans provided the following supporting evidence for their economic case:

- A net present value analysis which clearly identified the differences between the benefits of delivery under direct procurement for customers and in-house delivery.
- A reasonable set of comparable and consistent assumptions for direct procurement for customers and in-house delivery, which highlight the key criteria by which value for customers can be assessed.
- A sensitivity analysis for a set of options that drive the most value for customers.
- A well-reasoned decision on the suitability for further progression under direct procurement for customers or in-house.
- The assumption that the scheme would progress as a direct procurement for customers scheme until the business case identified that the direct procurement for customers option would no longer deliver benefits to customers.

An iterative business case approach allows the development of the business case as it progresses through the various stages. For example, the Treasury Five Case model recognises that the commercial, financial and management cases will be less developed in the early phases of a scheme. We expected that companies to recognise this in their business plans and provide an appropriate level of detail dependent of the stage of the case.

We also considered that where the economic case was strongly in favour of an in-house solution that there was less need to provide in-depth commercial, financial and management cases.

2.4.3 The commercial case

We expected companies to assess the commercial feasibility of the proposed approach to direct procurement for customers. We expected plans to consider the main contractual arrangements with and risk transfers to the competitively appointed provider. The impact of the risk allocation and proposed approach to procurement on those interested in becoming competitively appointed providers was expected to be considered.

High quality and well evidenced plans provided a convincing case for the chosen procurement approach for the specific scheme. These plans considered:

- The approach to the procurement principles, as set out in Annex 1, which we expected companies to follow in the direct procurement for customers procurement process and whether these were within companies' existing capability.
- The contract principles we set out in section 4 of Appendix 9 of the final methodology and in Annex 1 hereto, and whether there were any significant issues on the schemes when following these principles when negotiating direct procurement for customers' contracts.

2.4.4 The finance case

We expected companies to consider any impact on financing of the appointed company, including cashflow impact, accounting and credit rating implications of a scheme delivered through direct procurement for customers. This was anticipated to include any significant changes to the forecast capital and revenue profiles for each option.

High quality and well evidenced plans provided a convincing case for the chosen procurement approach for the specific scheme. These plans considered:

- The different revenue profiles and the impact on customer bills.
- The accounting impact particularly as regards the treatment in terms of a lease.
- The potential impact on the appointee's credit rating under both direct procurement for customers and in-house delivery options.

2.4.5 The management case

The purpose of this case is to consider the deliverability of a scheme through direct procurement for customers from the start, from successful procurement to a successfully managed long-term contract. We were expecting companies to identify relevant risks and issues and provide a clear plan on how a direct procurement for customers scheme could be successfully delivered through to the end of the contract where the asset would either be retendered through a further direct procurement for customers process or brought back in-house.

High quality and well evidenced plans provided a convincing case that the company had considered its ability to deliver the scheme utilising direct procurement for customers. These plans included:

- The timescales for delivering the scheme.
- Critical success factors concerning the successful management of the scheme.
- An assessment of the management capabilities required to deliver the direct procurement for customers.
- The gaps in management capability and the need for specialist third party support at certain stages in the process.

3 Development of direct procurement for customers

3.1 Uncertainty Mechanisms

We set out in our PR19 methodology that we expect companies to consider direct procurement for customers where this is likely to deliver the greatest value for customers. It is possible, albeit unlikely, that following our final determinations, there is material change in circumstances, for example, financial market conditions or changes in relevant legislation, which in changing the value for money assessment would justify revisiting the use of the direct procurement for customers approach.

We propose to allow for an uncertainty mechanism by which, in circumstances beyond its control, a company may seek appropriate recognition in price controls to deliver the scheme by way of a traditional in-house delivery process rather than through the expected direct procurement for customers approach. Given the potential risks to customers, we propose that such a decision would require approval from Ofwat.

We propose to set out an uncertainty mechanism when we publish our final determinations which, unless a scheme is deferred to a future price control period, facilitates the transfer of a scheme back into the traditional in-house model to ensure timely delivery.

We have identified two options for the form of the uncertainty mechanism:

a) A Notified Item detailed in a company's final determination and which could, subject to relevant thresholds, lead to a change in the level of price controls through an interim determination, or
b) the scheme costs incurred by a company during the relevant control period would be recorded and monitored for consideration at the next relevant price review and those costs deemed efficient would be added to a company's RCV. An analogous mechanism was utilised in respect of Thames Water's costs incurred during the development of the Thames Tideway Tunnel, where we undertook a detailed ex-post review and assessment of costs, which was financed through a special licence fee.

We propose to utilise a Notified Item as our preferred uncertainty mechanism for direct procurement for customers schemes transferring back to an in-house delivery route. We believe this provides stronger incentives for companies to manage costs and risk of developing schemes and does not require detailed on-going monitoring of costs by Ofwat and third parties.

We also expect the risks to customers of direct procurement for customers schemes not progressing, or for the non or late delivery of outputs, to be reflected in appropriate performance commitments and outcome delivery incentives.

We welcome views from stakeholders on this approach.

3.2 Licence changes to facilitate direct procurement for customers

A direct procurement for customers arrangement between a company and a competitively appointed provider, would, to enable the company to recover from the company's customers amounts payable under the arrangement to the competitively appointed provider, necessitate an amendment to Condition B of a company's Instrument of Appointment.

We propose to consult later this year on the licence changes which we consider necessary to facilitate the delivery of direct procurement for customers schemes.

At this stage we propose licence changes should be incorporated in the Instruments of Appointment of Anglian Water, Dŵr Cymru, United Utilities Water, Southern Water and Thames Water. Licence changes for other companies we expect to develop direct procurement for customers schemes may be proposed when we publish our final determinations.

3.3 Direct procurement for customers schemes during 2020-25

We do expect companies to continually assess the suitability of schemes for direct procurement for customers. Where companies have identified potential schemes for PR19, whether to be procured during the 2020-25 period or later, we expect these schemes to remain under review during the 2020-25 period to ensure, if suitable, direct procurement for customers benefits customers. If a scheme's scope or assumptions change, companies should re-assess whether direct procurement for customers is an efficient delivery route.

Furthermore, as companies identify schemes for delivery beyond the 2020-25 period we would expect them to apply direct procurement for customers principles to ensure best value for customers. Additionally we will expect companies to provide appropriate evidence to support their decisions in respect of such schemes.

We recognise that direct procurement for customers has potential implications for procurement timetables. However for future schemes we would expect companies to factor in these considerations for their assessments. We do not necessarily view an extended procurement timeline as a barrier for direct procurement for customers. Where companies believe the extended timeline restricts direct procurement for customers as an option for delivery we will expect compelling and convincing evidence.

Annex: Principles applying to the direct procurement for customers procurement process and customers contracts

Principles applying to the direct procurement for customers - procurement process

Competitively appointed providers

1.1	The contract cannot be awarded to an associated company of the appointee.

Resources and governance

1.2	Appointees should have clear and transparent governance processes for their procurement.
1.3	Appointees should have access to the skilled resources required to carry out specialised procurement and contract management activities.
1.4	Appointees should make sure they have processes in place to respond to bidders' questions and clarifications throughout the procurement process.
1.5	Appointees should make sure they have clear processes in place to manage any intellectual property bidders may reveal through the tender process.

Process

1.6	Appointees must adhere to the Utilities Contracts Regulations 2016 where appropriate.
1.7	Appointees should standardise the process as far as possible.
1.8	Appointees should outline clear process timescales and use all reasonable endeavours to meet them. In doing so, appointees should consider the impact of these timescales on the bidding market.
1.9	In the early stages of the process, appointees should use market engagement and testing to establish the appetite for DPC projects. The range of possible technical solutions the market can offer should be explored.
1.10	Appointees should make all reasonable endeavours to minimise the time between appointing a preferred bidder and awarding the contract, bearing in mind the potential due diligence requirements a preferred bidder may need to complete and the appropriate standstill period.

Preconstruction works

1.11	Appointees should make all relevant information available to bidders during the tender process.
1.12	Preconstruction works need to be transferable to CAPs when they are awarded the contract, or otherwise obtained in such a way as to allow CAPs to benefit from them.

Tender specifications

1.13	Appointees should provide draft versions of contracts as part of tender specifications.
1.14	Appointees should allow bidders to comment on draft contracts in the preliminary stages.

Bid evaluation

1.15	Appointees should have clear bid evaluation strategies and scoring systems in place before starting the procurement.
1.16	Appointees should satisfy themselves that bidders can meet the key contractual obligations (e.g. delivery milestones and regulatory requirements).

Principles for direct procurement for customers contracts

Revenue and financing costs

2.1	Contracts should generally last about 15-25 years for operation, plus a construction period.
2.2	A competitively appointed provider's revenue entitlement should normally start after construction is complete, when the appointee accepts the assets.
2.3	Revenue paid to competitively appointed providers should be fixed over the contract period, subject only to limited specified variations (e.g. performance incentives, specified cost or pre-agreed events).
2.4	Assets should be depreciated over their useful lives, aligned to the current regulatory regime. This may mean that assets are not fully depreciated over the contract period.
2.5	Revenue streams need not be indexed to the same inflation measurement used in the appointee's price controls. The appointee should use approaches that secure the best value for money for customers.
2.6	Contracts should include a provision to capture benefits for customers from any debt refinancing gains during the contract life.
2.7	Contracts should include provisions to require prior approval by the appointee of any change of control in the competitively appointed provider.

Risk allocation

2.8	The contract should allocate risks to parties based on their ability to best manage these, unless there is good justification to allocate them differently. Overall, customers should not end up with more risks allocated to them than they would have had if the appointee delivered the project in-house.
2.9	The contract may include provisions for force majeure events (with impacts on both costs and timetables). These should be clearly defined and strictly limited, in line with good industry practice.

Expiry, termination and step in

2.10	The contract should clearly specify circumstances under which the appointee can step in. These should be limited to material breaches (e.g. regulatory non-compliance).
2.11	The contract should clearly specify an end date. It should specify what happens to the assets at the end of the contract. It should specify any circumstances under which the contract can be terminated early. These circumstances should be strictly limited.
2.12	Contracts should clearly outline the required asset specification at the contract end date.
2.13	The contract should clearly specify residual (or terminal) asset values at the designated end date, associated with a prescribed condition of the asset. It should set out how this will be paid to the competitively appointed provider.
2.14	Contracts should clearly specify any compensation payable to the competitively appointed provider under early termination scenarios.

Construction programme and completion

2.15	Contracts should clearly specify construction milestones and the completion date.
2.16	Contracts should clearly outline the acceptance requirements for assets (i.e. to trigger formal 'completion').
2.17	Contracts may include provisions for liquidated damages (paid either to the competitively appointed provider 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.

Operations and maintenance

2.18	Contracts should clearly specify any operational requirements, including any performance commitments the competitively appointed provider must fulfil.
2.19	Contracts may include performance incentives linked to the delivery of agreed requirements. Where used, these should be capped at an appropriate amount to ensure delivery is affordable.
2.20	In general, operational costs should be fixed for the duration of a contract. But contracts may provide for variations in operating expenditure (opex) at periodic intervals, where this is likely to drive value for customers. Where this option exists, appointees should make this clear to bidders at the start of the procurement process. Appointees should notify us of such provisions in advance of contract award.
2.21	Contracts should include terms that enable appointees to fulfil any ongoing reporting or information requirements (in particular, those required for the appointee to fulfil any statutory or regulatory monitoring and reporting).

Security

2.22	Contracts may require competitively appointed providers to post security against late delivery or non-delivery of assets. If used, this provision should be sized appropriately to cover relevant costs to the appointee, taking into account the potential impact on the competitively appointed provider's costs if this is set too high.

Compliance with relevant legislation

2.23	Appointees remain ultimately responsible for making sure their statutory and licence responsibilities as water and/or sewerage undertakers are fulfilled. This responsibility cannot be contracted away.
2.24	Contracts must clearly specify all relevant statutory or licence obligations that a competitively appointed provider must comply with on behalf of the appointee.
2.25	Contracts may include provisions to vary allowed revenues because of changes in regulatory requirements. If used, such provisions should be limited.
2.26	A competitively appointed provider should be able to benefit from any relevant statutory powers of the appointee.

More information

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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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