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PR19 final determinations

Delivering customer value in large projects

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PR19 final determinations: Delivering customer value in large schemes

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1 Overview

Direct procurement for customers is 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 requires companies to consider using direct procurement for customers to deliver large-scale projects efficiently, contributing to affordable bills for customers and improving the delivery of projects, which in turn will improve the customer experience.

We set out in our PR19 methodology (as updated) that we expect company business plans to consider direct procurement for customers where this is likely to deliver the greatest value for customers. 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.

Our decisions take into account the representations made on all our draft determinations, responses from companies to our queries and additional information provided following further engagement with companies and other stakeholders as part of the final determination process. In the interest of brevity, where no representations have been made on our draft determination proposals, we do not repeat our reasoning in all cases. Please see the [PR19 draft determinations](#) for further details.

This document provides:

- A summary of potential direct procurement for customer schemes identified from company business plans.
 - 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.
 - A summary of the representations presented by stakeholders on our draft determinations and the development of direct procurement for customers as a delivery mechanism during the 2020-25 period including the role of uncertainty mechanisms and performance incentives.
 - Details of the decisions we made on the direct procurement for customers schemes and the development of direct procurement for customers as a delivery mechanism during the 2020-25 in reaching our final determinations.
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1.1 Our final determination decision

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 customers schemes during the 2020-25 period or later. The delivery of United Utilities' Manchester and Pennines resilience scheme, Anglian Water's Elsham treatment and transfer scheme and Dŵr Cymru's Cwm Taf Water Supply Strategy as direct procurement for customers schemes for delivery in 2020-25 is confirmed in relation to our final determinations.

Southern Water has the following schemes which are potentially suitable for a direct procurement for customers process; Fawley desalination scheme, River Itchen effluent reuse schemes, Brighton Wastewater Treatment Works indirect potable reuse scheme, Test Estuary Wastewater Treatment Works Industrial Reuse scheme and Inter-zonal (Hampshire) transfer scheme. In addition, Thames Water North East London Resilience, Affinity Water's Brett Sustainability Reduction scheme and Bristol Water's Cheddar Reservoir scheme are potentially suitable, subject to further analysis as to feasibility and desirability. If these schemes go ahead, we expect delivery will be through a direct procurement for customers process.

There are a number of strategic resource schemes, identified in the 'Strategic regional water resource solutions appendix', which we would expect to be delivered through a direct procurement for customers process if approved at a future date.

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: Potential direct procurement for customers schemes

List of 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 Supply Strategy	Water Treatment	2020-25	2020-25	2025-30
Southern Water	Fawley desalination / Itchen indirect potable re-use schemes	Desalination or Re-use	2020-25	2020-25	2025-30
Affinity Water	Brett River Sustainability	Water resources	2020-25	2020-25	2025-30
Other potential direct procurement for customers schemes subject to further evaluation					
Southern Water	Brighton Wastewater Treatment Works indirect potable reuse and/or Test Estuary Wastewater Treatment Works Industrial Reuse	Re-use	2020-25	2020-25	2025-30
Southern Water	Inter-zonal (Hampshire) transfer	Transfer	2020-25	2020-25	2025-30
Joint water companies	South West-Southern transfer	Transfer	2020-25	2020-25	2025-30
Thames Water	North East London resilience	Water Network	2020-25	2020-25	2025-35
Thames Water	London Re-use	Re-use	2020-25	2025-30	2030-35
Joint water companies	Anglian- Affinity transfer	Transfer	2020-25	2025-30	2030-35
Joint water companies	Thames- Southern transfer	Transfer	2020-25	2025-30	2030-35
Anglian Water	South Lincolnshire Reservoir	Reservoir	2025-30	2025-30	2030-35
Bristol Water	Second Cheddar reservoir	Reservoir	2025-30	2025-30	2030-35
Thames Water	South East Strategic Reservoir Option	Reservoir	2025-30	2025-30	2035-40
Joint water companies	Severn Thames Transfer	Transfer	2025-30	2025-30	2035-40

1.2 Our approach

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.

We expect companies to consider the use of direct procurement for customers for large-scale enhancement schemes that are expected to cost over £100 million, based on whole-life totex. We do not expect companies to use direct procurement for customers for every scheme that meet this threshold, rather companies should consider for each relevant scheme which delivery approach had the potential to drive the greatest possible benefits for customers.

We expect companies to provide an assessment of the suitability of each scheme for delivery via a direct procurement for customers process. In section 7.2 of the PR19 methodology we set out high-level guidance on the types of issues that companies should consider in determining the suitability of a scheme for direct procurement for customers. 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 schemes for direct procurement for customers that delivered the greatest value for customers, we expect 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 need to be well-evidenced and well-reasoned and additional guidance is provided in [Information Notice IN 18/10](#).

1.3 Changes from our draft determinations

There have been no significant changes in our approach or to the eligibility of schemes since our draft determinations. The focus of the responses was on the following areas:

- Company totex allowances should a scheme no longer be suitable for delivery through a direct procurement for customers process due to exceptional circumstances.
- Performance incentives for the schemes suitable for delivery through a direct procurement for customers process.
- The licence modifications that will be required to enable the successful delivery of the schemes.

We have considered the scenario where a material change in circumstances following our PR19 final determinations changes a scheme's value for money assessment and justifies revisiting the use of the direct procurement for customers approach. We include notified items in our final determinations for the relevant schemes that we consider could be delayed

in those circumstances if there is not a mechanism to change price controls within the period 2020-25.

We have consulted on the use of performance incentives on schemes that are suitable for delivery through a direct procurement for customers process. We include under and out performance incentives for those schemes that are confirmed and that are not subject to other performance incentives.

Changes to instruments of appointment (“licences”) that will be required to further direct procurement for customers will be developed in consultation with the water companies concerned in early 2020. We will also consider further how schemes will be treated in regulatory accounts to ensure that schemes are appropriately treated.

2 Direct procurement for customers

2.1 Introduction

Direct procurements for customers are arrangements where a water company competitively tenders for a third party (a competitively appointed provider) to design, build, finance, operate and maintain large scale infrastructure that would otherwise have been delivered by the incumbent water company.

Direct procurement for customers is different to other tendering and contracting arrangements that appointees currently use, for example, outsourcing agreements or market testing. Direct procurement for customers involves third party companies tendering to deliver more aspects of a service, including, most importantly, the financing for the scheme. We consider that this makes direct procurement for customers a different process to appointees' existing commercial arrangements. We do not intend for direct procurement for customers to replace the provisions companies currently make for outsourcing services to third party providers to deliver ongoing operations and maintenance. We still expect companies to consider the most efficient delivery model for all their activities.

We view direct procurement for customers as a complementary approach that will provide an alternative delivery option for large-scale enhancements. We consider that direct procurement for customers has the potential to realise significant customer benefits by:

- reducing the direct costs that customers pay for the largest / most expensive new assets;
- lowering scheme costs by focusing competitive pressure on capital and operational expenditure (capex and opex);
- involving the market, rather than the regulator, in setting the cost of capital for a specific scheme – we consider that the evidence from the water and other sectors (for example, electricity transmission) shows that this has the potential to lower financing costs for schemes;
- promoting innovation by encouraging new providers to deliver and operate infrastructure – we note the evidence from other sectors, where tendering has led to more technical and commercial innovation and greater scope for supply chain participation; and providing both us and appointees with benchmarks for efficient costs, which we can reflect in future price controls.

2.2 Our approach

In chapter 7 and document 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 expect companies to consider the use of direct procurement for customers for large-scale enhancement schemes expected to cost over £100 million, based on whole-life totex. We did not expect companies to use direct procurement for customers for every scheme that met this threshold, rather to consider, for each relevant scheme, which delivery approach has the potential to drive the greatest possible benefits for customers.

We expect relevant schemes to be assessed in three consecutive stages and if a company did not pass the scheme through a stage there was no further evaluation. The stages are:

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

Companies are expected to also consider the findings of the [technical review](#), carried out by KPMG on behalf of Ofwat, and the additional guidance on value for money assessments provided in [Information Notice IN 18/10](#).

2.3 Initial assessment of business plans

We set out our process for the 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 plans test for direct procurement for customers

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

Where it has one or more such schemes, 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 scheme using direct procurement for customers?

In our assessment, we considered the extent to which companies:

- demonstrate a process and the results of a review against the £100 million threshold;
 - carry out a thorough technical review using the guidance and based on the assumption that projects should be assessed for value for money unless there was clear and well documented evidence to reject the scheme; and
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- provide a robust business case with a clear understanding of the delivery through direct procurement for customers placing customer interests at the core of the case.

We graded companies highly when they provide a well evidenced process for identifying schemes and testing them against the technical guidance, and closely follow a best practice business case approach, such as the HM Treasury Five Case Model in their value for money assessment. Further detail was provided in our [PR19 draft determinations: Delivering customer value in large schemes](#).

3 Document structure

We provide details of our approaches and decisions for the following areas:

- Assessment of suitable schemes
- Uncertainty Mechanisms
- Outcome Delivery Incentives
- Licence changes

4 Assessment of suitable schemes

Introduction. In the initial business plans submitted in September 2018, companies identified 47 schemes that met the threshold of £100m whole-life totex. Of these schemes companies considered that 33 were unsuitable for technical reasons and eight were unlikely to deliver value for money benefits to customers. The remaining six schemes were considered by companies as both technically suitable and offering customers value for money if progressed using a direct procurement for customers approach.

Threshold assessments. During our review of companies' investment plans we identified an additional two schemes that meet the threshold criteria.

Technical assessments. Our review of technical assessments of the schemes that meet the threshold identified the following:

- 14 schemes where we agree with the companies conclusion that the schemes were less suitable for direct procurement for customers, and,
- 19 schemes where companies provide insufficient evidence or justification for the conclusion that the schemes were unsuitable.

Value for Money assessments. Of the eight schemes that companies considered we agree with five of the assessments but are unconvinced by three of the evaluations as some of the assumptions used are outliers when compared with the evaluations prepared by other companies.

In our actions from the initial assessment of plans we requested further information on, or re-valuation of, 22 schemes.

4.1 What we said in our draft determinations

At the draft determination stage, we identified the following schemes as suitable for direct procurement for customers:

Table 2: Potential direct procurement for customers schemes at draft determination

Company	Project	Type of scheme
United Utilities	Manchester & Pennines Resilience	Transfer
Anglian Water	Elsham treatment and transfer	Transfer
Dŵr Cymru	Cwm Taf water treatment	Water Treatment
Thames Water	North East London resilience	Water Network
Southern Water	Fawley water resources	Desalination or Re- use
Southern Water	Brighton Wastewater Treatment Works indirect potable reuse	Re-use
Thames Water	London Re-use	Re-use
Severn Trent Water	East Midlands Reservoir	Reservoir
Anglian Water	South Lincolnshire Reservoir	Reservoir
Thames Water	South East Strategic Reservoir Option	Reservoir

4.2 Stakeholders' representations

In company representations on the draft determinations, companies agree that these schemes should be progressed through a direct procurement for customers process. The representations add schemes that are proposed as a result of consideration of strategic regional water resource solutions and are identified to meet individual company water resource requirements. The following schemes are proposed by companies in addition to the list of potential direct procurement for customers schemes:

- Brett River Sustainability (Affinity Water)
- Brighton Wastewater Treatment Works indirect potable reuse and/or Test Estuary Wastewater Treatment Works Industrial Reuse (Southern Water)
- Inter-zonal (Hampshire) transfer (Southern Water)
- South West-Southern transfer (Joint)
- Anglian-Affinity transfer (Joint)
- Thames-Southern transfer (Joint)
- Second Cheddar reservoir (Bristol Water)

Severn Trent Water remove the East Midlands reservoir from its list of schemes for procurement within the period 2020-25.

4.3 Our final determination decision

Our approach to the selection of suitable schemes at the final determination stage remains unchanged from that applied for our draft determinations, and remains consistent with the guidance we have issued. We consider the following schemes as suitable for direct procurement for customers process based on the technical and value for money assessments provided by the companies:

- Manchester & Pennines Resilience (Unites Utilities)
- Elsham treatment and transfer (Anglian Water)
- Cwm Taf water treatment (Dŵr Cymru)
- Fawley desalination and/or River Itchen effluent reuse (Southern Water)
- Brett River Sustainability (Affinity Water)

Further detail is provided in our PR19 draft determinations on each company for the first five schemes. For the Brett River Sustainability, the potential solution of a desalination plant met the threshold and technical suitability requirements and our rationale is in the PR19 final determinations: Affinity Water final determination.

We consider that the following schemes are potentially suitable subject to further evaluation of the requirement:

- Anglian - Affinity transfer (Joint project)
 - Second Cheddar reservoir (Bristol Water)
 - Inter-zonal (Hampshire) transfer (Southern Water)
 - London Reuse (Thames Water)
 - North East London resilience (Thames Water)
 - Brighton Wastewater Treatment Works indirect potable reuse and/or Test Estuary Wastewater Treatment Works Industrial Reuse (Southern Water)
 - Severn – Thames transfer (Joint project)
 - South East Strategic Reservoir Option (Thames Water)
 - South Lincolnshire Reservoir (Anglian Water)
 - South West-Southern transfer (Joint project)
 - Thames - Southern transfer (Joint project)
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5 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 a 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.

5.1 What we said in our draft determinations

In our [PR19 draft determinations: Delivering customer value in large schemes](#) we indicate that it is possible, albeit unlikely, that following the PR19 final determinations there could be a material change in circumstances, for example financial market disruption or a change in applicable legislation, which in changing the assessed value for money for customers would justify revisiting the validity of the direct procurement for customers approach. Consequently we proposed 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 proposed that such a decision would require approval from Ofwat.

At draft determination we discussed two options for the form of the uncertainty mechanism:

- a Notified Item detailed in a company's final determination that could, subject to the relevant thresholds being met, lead to a change in the level of price controls through an interim determination;
- the scheme costs incurred by a company during the relevant control period being recorded and monitored for consideration at the next relevant price review when 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.

At draft determination, we proposed, as our preferred uncertainty mechanism, to utilise a Notified Item for direct procurement for customers' schemes transferring back to an in-house delivery route. We did so because we considered that this option provided stronger incentives for companies to manage costs and the risks of developing schemes and would not require detailed on-going monitoring of costs by Ofwat and third parties.

We received representations from the following companies:

- Anglian Water;
- Dŵr Cymru;
- Southern Water;
- Thames Water and
- United Utilities.

In addition, in our [consultation on proposed PR19 uncertainty mechanisms in respect of Direct Procurement for Customers](#) we consulted further on our proposals to include a bespoke uncertainty mechanism in respect of direct procurement for customers within PR19 final determinations. The consultation identified a further uncertainty mechanism alongside the two considered earlier. The additional uncertainty mechanism considered was a potential adjustment to allowed totex at the 2024 price review (PR24), where an amount is where appropriate added to the companies allowed costs for the direct procurement for customers projects unfunded at PR19.

Responses to the consultation were received from the following stakeholders:

- 9 water and sewage companies – Anglian Water, Northumbrian Water, Southern Water, Severn Trent Water, South West Water, Thames Water, United Utilities, Dŵr Cymru and Yorkshire Water
- 3 water only companies – Affinity Water, Bristol Water and Portsmouth Water.

Within this document, we focus primarily on issues raised about the need and type of mechanism that may be required to address the direct procurement schemes for the period 2020-25.

5.2 Stakeholders' representations

We focus below on the issues that companies consider the most important which are also identified in our [consultation on proposed PR19 uncertainty mechanisms in respect of Direct Procurement for Customers](#).

Materiality threshold.

Companies represent that for a number of schemes, should the scheme need to revert to in-house delivery, the additional costs in the period 2020-25 would not meet the materiality threshold of an interim determination in isolation. In this scenario the companies consider that they would be financially impaired or that the project would have to be delayed to the next period to ensure their ability to recover totex allowances from customers.

Reliability of the process.

The company representations argue that the outcome of an interim determination process was unreliable and that there have been no recent examples of a successful application for an interim determination.

Process Cost and Timeliness.

Companies consider that an interim determination process is not undertaken lightly and imposes a significant administrative burden on Ofwat and companies alike particularly if overlapping with preparations for a price review. In addition, companies also consider that, as interim determination applications must be submitted at least 6-months in advance of the first charging year for which price limits could change, there would be delay of 6-17 months before a company could start recovering additional costs from customers.

Scope of reassessment of scheme deliverables

Companies consider that even though a scheme will already have been assessed through a price review process a full re-opening of the process, and the potential offsetting of other items that are non-trivial against a claim before determining materiality in an interim determination process, may leave significant expenditure to progress the scheme being treated as a “totex overspend” and thus subject to cost sharing. Companies expect, for schemes that have been approved within the price review, to have efficient costs allowed, whereas at present companies consider that the interim determination process will result in a full re-assessment.

5.3 Other issues

The following areas are also considered as part of our assessment of the mechanisms:

Cost sharing impact of totex overspend.

As detailed in the PR19 methodology, where companies under or out perform their totex allowances the under or out performance is shared with customers. The application of this mechanism to schemes returning in-house would allow companies to reclaim a proportion of the efficient scheme costs in the end of period reconciliation.

Cost efficient assessment of allowances.

The determination of cost efficient allowances by Ofwat is a part of the current methodology. In any mechanism, we would need to ensure that the allowed revenue associated with the in-house delivery of the scheme was reviewed to a similar standard to that used at PR19. In

addition, as part of any review the scope, including the overall need and options, would need to be considered. If there was limited evidence available at the price review we may need to carry out a more in-depth assessment than if a fully defined project and cost assessment was available during the price review.

Customer impact

In the consideration of any mechanism the impact on customers' needs to be considered in terms of delays, additional costs or lost benefits.

Approval and control of process.

The overall control of the process associated with any uncertainty mechanism and the method of approval is an integral element of regulation and the legal framework. The process and approval of any mechanism must be within the current licence framework or will need amendment to the current licences to facilitate its implementation.

5.4 Our assessment and reasons

We have assessed the feedback provided from the consultation against our stated preference. The issues raised by companies and other stakeholders are important to ensure the uncertainty mechanism provides an appropriate balance between customer protection and securing that companies are able to finance the proper carrying out of their functions while securing that companies take the necessary steps to enable them to meet, in the long term, the need for water supplies and sewerage services. We provide further details on our additional assessments below.

Materiality and Triviality.

Most responses to our consultation express some concern about the ability of companies to meet the materiality and triviality thresholds¹ even if they agreed with the principle of using interim determinations. We consider this in greater detail below.

A review of the schemes with significant construction spend in the period 2020-25 against the interim determination materiality and triviality thresholds is shown in Table 3.

¹ Note: Under the materiality threshold we test the company's application for an interim determination against a set level. If the changes in costs, receipts or revenues are at least equal to 10% of the company's turnover we say the application is material. A company can add together a number of specific changes. The triviality threshold considers the value of a change relating to one issue which is less than two per cent of the company's turnover which we would not include in the materiality test.

Table 3: Schemes comparison to interim determination materiality and triviality threshold

Company	Project	Type of scheme	Construction Period (start)	Meets Materiality	Meets Triviality
United Utilities	Manchester & Pennines Resilience scheme	Transfer	2020-25	Likely	Likely
Anglian Water	Elsham Water Treatment Works and Transfer Scheme	Transfer	2020-25	Will Not	Likely
Dŵr Cymru	Cwm Taf water treatment works	Water Treatment	2020-25	Unlikely	Likely
Thames Water	NE London resilience	Water Network	2020-25	Will Not	Likely
Southern Water	Fawley desalination and/or /River Itchen effluent reuse	Desalination or Re- use	2020-25	Unlikely	Likely
Affinity Water	Brett River Sustainability	Water resources	2020-25	Likely	Likely
Southern Water	Brighton Wastewater Treatment Works indirect potable reuse and/or Test Estuary Wastewater Treatment Works Industrial Reuse	Re-use	2020-25	Will Not	Likely
Southern Water	Interzone (Hampshire) transfer	Transfer	2020-25	Will Not	Likely
Bristol Water	Second Cheddar Reservoir	Reservoir	2020-25	Likely	Likely

The review was carried out based on the estimated scheme construction costs for the period compared against the materiality and triviality criteria identified in Condition B of the relevant licences using predicted company specific business plan expenditure. Our analysis indicates that a number of schemes proposed for direct procurement for customers are unlikely to, or would not, meet the interim determination materiality threshold on their own based on the current estimated spend profiles. A notified item for those schemes would not lead to changes in price limits during the 2020-25 period unless combined with other eligible items.

Assessment Framework

In light of feedback and updated analysis we have evaluated our options. We show these in Table 4 below:

Table 4: Overview analysis of uncertainty mechanisms on companies and customers

Company Impact	Interim Determinations and Notified Items	Recorded Costs	Adjustments to Base Totex
Materiality	Current interim determination materiality threshold might not allow for all schemes to be funded through this route in period.	Interim determination materiality threshold does not apply to these mechanisms	
Financial recovery	Costs can be recovered in period	Costs are recovered via end of period adjustments.	
Project Delay	In some circumstances, a company may choose to delay projects when assessing the risk of having a claim rejected or costs not recoverable until the end of the period. For the schemes proposed in the period 2020-25 the risk is considered to be low that the process will have a significant impact on the overall project delivery.		
Certainty	An established process set out in company licences that requires changes to price controls if tests are met. Where schemes progress to procurement then the requirement and solution would effectively have prior approval. However, there would be no change to price controls if claims (which could include more than one eligible item) did not meet the materiality threshold.	The certainty on the recovery of some level of costs to companies is high although the absolute level of cost recovery is less certain.	
Customer Impact			
Cost Efficiency	Provides opportunity for focussed efficient cost review and protection for customers	Subjects company to <i>ex-post</i> review of costs and could require greater monitoring	Efficiency considerations will vary and depend upon the stage of procurement at exit.
Timeliness	No reason to suppose any of these mechanisms would directly impact on the timely delivery of benefits to customers of the direct procurement for customers' scheme.		
Process Impact			
Definition	Existing process defined in company licences	Process is not agreed or defined.	
Transparency for external stakeholders	Process includes consultation and publication of decision (and reasons). Interim determinations can be appealed to the CMA.	Proposed mechanisms are likely to offer less information on the evaluation and final allowances for external stakeholders than an interim determination.	

5.5 Our final determination decision

We considered the feedback to our [consultation on proposed PR19 uncertainty mechanisms in respect of Direct Procurement for Customers](#) and, after re-assessing each option, we still consider, on balance, that a notified item is the appropriate uncertainty mechanism. We therefore affirm that an interim determination will during the 2020-25 price control period be the form of uncertainty mechanism for the unlikely scenario in which direct procurement for customers schemes need to revert to in-house delivery. It is our view this provides the right incentives for managing cost efficiency (by more closely reflecting an ex-ante price review process than an ex-post recorded costs or adjustments to base totex approach) and it also has the advantage of utilising an established and familiar mechanism that allows price controls to be changed in-period in appropriate cases where there are material changes in costs. Although not all schemes are expected to reach the materiality threshold on their own, interim determination applications can include other eligible items (relevant changes of circumstance specified in Condition B or any other notified items).

However we recognise that interim determinations in their current form may have drawbacks for some schemes that need to be delivered in-house by companies. This may make their application during the 2020-25 control period difficult for these schemes. We will therefore consider the case for amending following consultation Condition B to introduce a specific interim determination process with bespoke criteria for direct procurement for customers.

Some respondents to our consultation express a preference for the adjustments to allowed totex which is based on the uncertainty mechanism used for the Water Industry National Environment Programme. In their view this would be more flexible, less onerous and provide companies with greater certainty. We do not agree that it would provide greater certainty and is less onerous. As we discussed in the consultation, Ofwat would need to be satisfied in advance that costs were efficient and this in turn could facilitate the need for further evidence. We consider interim determinations provide the best incentives for companies to manage efficient delivery of the project and protect customers.

We believe this approach is fair. It will allow companies, subject to considerations, an uncertainty mechanism to bring schemes in-house if extreme circumstances occur while also protecting the interests of customers.

6 Performance commitments

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.

6.1 Introduction

In our [consultation on proposed PR19 uncertainty mechanisms in respect of Direct Procurement for Customers](#) we invited views of stakeholders on performance commitments and associated outcome delivery incentives for companies undertaking direct procurement for customers schemes during the 2020-25 price control period. These outcome delivery incentives included both under and out-performance payments.

6.2 Responses to our consultation

We received a number of responses from stakeholders. There is general support for use of performance commitments, nevertheless we recognise the concerns of some companies.

We outline specific issues from the feedback below:

Principle of performance commitments. Three respondents, Anglian Water, Dŵr Cymru and Yorkshire Water, disagree with the application of performance commitments and outcome delivery incentives for both under and outperformance. In their view this introduces additional complexity and was unnecessary as companies are already incentivised to ensure delivery. Conversely, seven respondents support the principle of performance commitments with under and outperformance payments. In their view underperformance incentives would help govern a company in procurement (e.g. avoid delays and protect customers) while outperformance payments would help incentivise innovation. The other respondents give a mixed response – supporting outperformance payments but not underperformance.

Calibration of incentives. Nearly all respondents comment that incentives should be carefully calibrated. For underperformance, companies argue that outcome delivery incentives should lead to decisions that do not compromise schemes' overall effectiveness for customer outcomes. One respondent notes that in certain circumstances it may actually be in customer interests to delay project delivery. Other respondents argue that there should be consistency across companies to ensure a "common currency" for schemes to be delivered by way of a direct procurement for customers process.

Control of events. Most respondents express concerns with incurring an underperformance payment for events over which they had no control. They argue that great care should be undertaken in isolating the cause of the delay and that underperformance should only occur when it is clearly attributable to the water company. Other companies note that there may be factors beyond their control which can influence the procurement timetable.

6.3 Our final determination decision

We have reflected on the feedback provided to our [consultation on proposed PR19 uncertainty mechanisms in respect of Direct Procurement for Customers](#).

We consider that companies should be incentivised to deliver new major projects in way that delivers the best outcomes for customers. We consider that companies should deliver their plans for customers whilst also recognising that the direct procurement for customers will place new challenges on those companies delivering schemes through this process. We therefore set performance commitments with out and underperformance delivery incentives for United Utilities, who propose performance commitments in their September 2018 business plan, and in respect of Anglian Water and Dŵr Cymru we are intervening in respect of direct procurement for customers schemes and introduce performance commitments with out and underperformance delivery incentives.

The outcome delivery incentives for both over and under performance payments are both proportional and consistent for all schemes. The outperformance payment will be measured against the successful award by the company of a contract to a competitively appointed provider. The underperformance payment will be measured against the acceptance by Ofwat of the business cases associated with direct procurement for customers, for example the Outline Business Case, the Full Business Case and for some projects the Strategic Outline Business Case.

We recognise that the direct procurement for customers process is new to companies and involves additional complexity in delivering their largest and most complex schemes. For early projects delivered through the direct procurement for customers process we consider that delivery performance should be recognised as a significant achievement. We have chosen the measurement against successful award of contract being within management's control whereas later milestones are dependent on the performance of the competitively appointed provider.

United Utilities, Dŵr Cymru and Anglian Water each receive in their respective final determinations totex allowances for development and procurement of their schemes. We believe to protect customers against delays it is important we introduce underperformance incentives to return money (provided for timely development and procurement activities) to customers should delays in delivery be experienced. In our consultation we proposed that an

underperformance payment would be linked to any delays experienced in the delivery of the direct procurement for customers projects. We will use the delivery dates of the companies' board approved business cases as the measurement points as these clearly define the scheme progression and procurement activities. The benefit of using the business case as a means of measurement for under performance is that we will not need to rely on detailed development and procurement plans with specifically defined milestones. We expect United Utilities, Dŵr Cymru and Anglian Water to indicate their submission dates of the Outline Business Case and Full Business Case when they submit their Strategic Outline Business Cases and we expect companies to identify the expected content and level of assurance that they will be providing in each of their business cases. This should be no less than the minimum expected using a HM treasury five case model. This will allow for clear and measurable delivery dates and expectations for these under performance incentives.

We will consider further outcome delivery incentives for future direct procurement for customer schemes after 2025 as part of the development of our PR24 Methodology.

7 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 outside of price controls amounts payable under the arrangement to the competitively appointed provider, necessitate an amendment to Condition B of a company's licence.

We propose to consult in early 2020 on the licence changes which we consider necessary to facilitate the delivery of direct procurement for customers schemes and ensure there are appropriate controls in place to protect customers alongside mechanisms for the company to manage any associated issues.

We will introduce a new condition for direct procurement for customers which will specify the process which companies are to follow. Under the new condition we propose that Ofwat consent will be required for the company to:

- undertake a procurement for direct procurement for customers;
- enter into a contract with the competitively appointed provider;
- exit an agreed direct procurement for customers procurement process; and
- change contract provisions for issues which materially impact upon the costs recovered from customers

In addition the new condition will require the company to notify Ofwat in the event of failure post contract award.

At this time we propose changes should only be incorporated into the licences of Anglian Water, Dŵr Cymru, United Utilities, Southern Water, Affinity Water and Bristol Water. Licence changes for other companies that develop direct procurement for customers schemes during the 2020-25 control period would be consulted upon as appropriate.

Annex 1: Company representations

This annex summarises company representations.

Table 5: Summary table of company representations – Uncertainty Mechanism

Company	Theme	Representation
Anglian Water	Interim Determination	The notified item and interim determination uncertainty mechanism proposed by Ofwat is considered to be unreliable and would not be available for Elsham scheme due to materiality.
Hafren Dyfrdwy		No representation.
Northumbrian Water		No representation.
United Utilities	Interim Determination	The notified item and interim determination has too much risk associated.
Southern Water	Interim Determination	Southern Water has significant concerns with the notified item and interim determination uncertainty mechanism due to materiality, additional costs and historical record.
Severn Trent Water		No representation.
South West Water		No representation.
Thames Water	Alternate proposal	Thames Water propose an uncertainty mechanism at draft determination stage.
Dŵr Cymru	Interim Determination	A notified item is an inappropriate uncertainty mechanism for the Cwm Taf scheme due to materiality. An in-period adjustment would be needed for funding.
Wessex Water		No representation.
Yorkshire Water		No representation.
Affinity Water		No representation.
Bristol Water		No representation.
Portsmouth Water		No representation.
SES Water		No representation.
South East Water		No representation.
South Staffs Water		No representation.

Table 6: Summary table of company representations – Other issues

Company	Theme	Representation
United Utilities	Licence amendments	Request for assurance that the licence will allow them to recover competitively appointed provider liabilities.
United Utilities	Performance commitments	Request that Ofwat provides United Utilities with a form of draft decision on its performance commitments for the delivery of the Manchester and Pennines Resilience scheme.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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