David Young
Ofwat
7 Hill Street
Birmingham
B5 4UA

Via email: DPC@ofwat.gov.uk

21 April 2020

Dear David,

Re: Consultation on proposed amendments to licence conditions for Direct Procurement for Customers

Thank you for providing us with the opportunity to respond to Ofwat's consultation, which sets out draft amendment proposals for Affinity Water's licence, and additional discussion points, regarding Direct Procurement for Customers (DPC).

Overall, we support the approach taken by Ofwat in relation to DPC schemes and we welcome the prospective benefits of greater competition in scheme delivery and operations. It is however important for the success of DPC that the regulatory framework around these schemes achieves the right balance, protecting customers without over-burdensome regulatory processes.

We have also provided more information about the Interim Determination process to managing the risk of Competitive Appointed Provider (CAP) failure that forces delivery back in-house, and we are ready to work constructively on this topic when the planned work on risk management mechanisms takes place later this year.

We have provided more detail in our response below. Please do not hesitate to contact me should you wish to discuss any aspects of our response in more detail.

Yours sincerely,

[redacted]

Stève Hervouet
Strategy and Regulation Director

CC:
Pauline Walsh (CEO, Affinity Water)
Stuart Ledger (CFO, Affinity Water)
Keith Gardner (Director of Asset Strategy and Capital Delivery, Affinity Water)

Executive Summary

We welcome Ofwat's commitment to licence amendments to facilitate the operation of DPC schemes, as we expect that this will create formal regulations to ensure customer protection, whilst allowing companies to recover from customers, the costs payable to the third party providers (CAP) and put in place certain risk management mechanisms.

However, we are concerned that the proposed licence amendments do not strike the right balance. This is because the amendments give Ofwat powers to withhold its approval across multiple gateway stages of the process of procurement, award and operation of DPC. By withholding regulatory approval Ofwat can halt a DPC's progress until conditions are met, which effectively gives Ofwat significant powers to alter the arrangements put in place. At the same time, the proposed amendments hold companies responsible for the outcomes of DPC schemes, for example through penalties included in ODI mechanisms and proposed Condition U4 that deprives a company of a due diligence legal defence, even if it has implemented alterations required by Ofwat as conditions of regulatory approval.

It is therefore not clear to us that the licence modifications as proposed align well with Ofwat's stated intent that appointees manage DPC schemes and be responsible for outcomes (the occasions where Ofwat may intervene are set out in detail in the proposed licence amendments). We are mindful that DPCs are new in the water industry and we understand the logic behind the cautious approach taken by Ofwat. However, we would ask Ofwat to reconsider its proposed amendments to ensure it is not being over-cautious.

The clauses that we consider over-cautious are firstly Condition U5.1 which allows multiple Ofwat interventions that result in partial or phased approvals, potentially with attachment of conditions. Our concern is that this leads to Ofwat taking an overly interventionist approach, perhaps allowing only piecemeal progress, when at the same time we may be subject to time bound delivery ODIs. Secondly, proposed Condition 12 would allow Ofwat to make almost unlimited requests for information, all of which could require certification by the Independent Technical Auditor. Our concern is that Ofwat becomes over-reliant on technical audit, which if over-used may not be adding sufficient further value. We also wonder if technical audits requested by Ofwat will duplicate the technical and due diligence work that companies will be doing themselves to govern projects properly and make their Board Assurance statements.

We think the parts of the licence amendments relating to giving approval could benefit if it were clear that such approvals cannot be unreasonably withheld, and by including time limits within which Ofwat should make its approvals decisions. In addition, we would suggest a review of the DPC licence conditions towards the end of AMP7 when both the regulator and appointees will have practical experience of DPC operations. It would be clearer by then if the licence conditions were working well, or if companies could achieve customer protection with fewer approval stages and faster track regulatory approvals.

Question 1: Do you agree with the key aspects of the proposed licence amendments outlined above?

Overall, we consider that Ofwat has identified the right regulatory issues in the modifications. As noted above, we think the proposals skew too far towards an approvals based approach. Our concern is that this risks creating excessive approval seeking activity for companies, but also excess administrative burdens on Ofwat to assess, evaluate and give formal approvals, which should not be under-estimated.

In addition to the proposed licence requirement towards accomplishing best value for customers, it is also worth noting that in our discussions on strategic regional resources, we are reviewing with RAPID the wider societal benefits that should be an important part of our schemes (and it is important that these benefits are included within DPC considerations around customer interests).

Question 2: Do you think that a water company is sufficiently incentivised to manage the CAP Agreement? Do you think Ofwat should consider applying specific Outcome Delivery incentives to provide the right incentives for the water company to act in customers best interests?

We note that Ofwat has already introduced ODI incentives for some companies as part of its PR19 Final Determinations for DPCs, so we wonder if this question has effectively already been addressed. Having said that, we consider there are already powerful incentives to manage CAP agreements. We note that new Condition U would require us to manage DPC activities so that they accomplished best value for customers. Further, our FD19 common and bespoke performance commitments apply across all our key activities so already incentivise outcome fulfilment measures that DPC projects could contribute to. Already strongly incentivised, we do not think that additional ODIs are necessary and if introduced could end up 'double counting' if they overlapped with existing ODIs.

We are also concerned at the prospect of being subject to further underperformance ODIs if they relate to meeting milestones in what could be highly complex procurement processes, where many factors outside of our control could alter timetables. As a general principle, we think it is only fair to operate out/underperformance incentives for matters that are within our control.

Question 3: Should a materiality threshold be applied to any consent to vary the CAP Agreement? If so, what level of materiality should be applied and how should this be worded for the new licence condition?

Proposed Condition U would require us to seek Ofwat prior approval at numerous stages of the DPC process including variations to CAP agreements (Proposed condition U6). Without a materiality threshold, there is a risk that we will need to seek numerous Ofwat approvals for changes that would not imply material effects on best value for customers. As well as the regulatory and administrative burden, these might also create time delays. We therefore support the idea of a materiality threshold which would allow us some flexibility to vary CAP agreements without needing prior regulatory approvals.

Ofwat's FD19 Appendix - *Delivering customer value in large projects* p26 refers to the need for licence modifications for changes in contract provisions for issues which materially impact upon the

costs recovered from customers. We suggest a materiality threshold of changes to the costs recovered from customers that could have a 5% effect on the level of DPC charges. In suggesting this, we note that as DPC will only form a small part of total water bills paid by customers, a materiality threshold around this level would not allow significant changes without these being approved by Ofwat.

We would want also to avoid a situation where a number of successive minor changes were made which individually did not meet materiality, but in aggregate amounted to a more significant change. Therefore, we think it would be necessary to maintain a cumulative count of the effects of charges so that at the point that the aggregate effects were likely to exceed the materiality threshold, this would trigger the need for Ofwat's approval. If approval were given, the cumulative count would then re-set to zero.

Question 4: Please tell us your views on the appropriate balance of risk the water company is undertaking? What level of risk do you think the water company should be taking in this process?

As a general principle, the water company should not be exposed to any more risk than it would have had to accept if the DPC scheme was treated as a normal in-house delivered project. To do otherwise acts as a disincentive to the DPC delivery route, does not help to grow competition in this activity and is less economically efficient.

The water company should be able to transfer risks to the CAP where the CAP is in a better position to manage those risks, through contractual arrangements as may be agreed because surely that is one of the desirable outcomes expected from seeking competitive provision.

Although not the direct subject of this consultation, we continue to have doubts about the adequacy of the Interim Determination mechanism proposed to manage the risk that procurement fails and the appointee has to take the project back in house. If this event did occur, it would bring expenditures already made on the project as well as those needing to be made in the rest of the AMP back within the regulated totex envelope. Other things being equal this would crystallise totex overspend which is subject to the underperformance sharing ratio, and so produce only partial cost recovery for the appointed business. As other companies also noted in their representations at PR19, interim determinations are a lengthy regulatory process with no guarantee that expenditures meet the 10% materiality threshold. As such, the mechanism may not produce any additional price control allowed revenue within the AMP, and if it did, only up to 2 years after the risk event materialised. As currently operated then, we think that Interim Determinations are not a satisfactory solution. If the Interim Determination framework is to be used, we think the materiality threshold would need to be reduced and as far as possible, the system should operate to produce the allowed revenues that would have been assumed at the most recent price review as if the DPC scheme been an in-house solution from the outset.

Question 5: Please provide your comments on the processes outlined in the DPC briefing note

The DPC briefing note provides a helpful description of the key stages of a DPC project. It provides useful insight into Ofwat's views of the key milestones where it may seek information and give regulatory approvals before the project can continue to its next stages.

We have noted that it is not intended to be a definitive guide or set of instructions to appointees to govern exactly how they should proceed and that it remains for appointees to manage DPCs in the way they calculate will accomplish best value for customers, comply with legal and regulatory requirements and meet other objectives. We do not have any further comments to make at this stage on the note.

Question 6: If a CAP terminates the CAP agreement with the water company should we consider further provisions in the new licence condition and what should they be?

If the CAP terminates the CAP agreement, we see two alternatives. We would either need to begin a procurement process to appoint a new CAP, or take the project back in house. In the first case, and assuming that the Ofwat did not revoke the designation (proposed Condition U 9.5) then the process of appointing a new provider would presumably be regulated under proposed Conditions U3, U5, U6, U8 and if necessary U7. It is not obvious to us that additional licence conditions are necessary.

If the CAP is not suitable for re-tendering and Ofwat revoke the DPC under proposed Condition U2.1.3, then the remainder of the project will need to be carried out in-house. We do not think new licence conditions are necessary for this, but we have commented elsewhere in this response on what we see as the main the shortcomings of the interim determination approach to dealing with this event.

As an aside, in the event of termination, it may become more difficult or impossible for us to obtain information from the CAP as may be needed to comply with proposed Condition U 11.4.

Question 7: Please provide your comments on the proposed licence amendments set out in Appendix 1 and their wording?

We give in the sections below our views on the proposed licence modifications.

Proposed Condition U Part 2

This condition gives Ofwat powers to issue directions, with or without the appointee's agreement to designate, and to modify or revoke a designation of a DPC project and we do not object to this.

Proposed Condition U Part 3

We do not object to this condition that requires that we put DPC projects to tender and appoint one or more CAPs to undertake the project.

Proposed Condition U Part 4

As noted elsewhere there is a tension in the proposed licence conditions between the scope for Ofwat to intervene, whilst at the same time, appointees are held responsible for outcomes, even if those outcomes are in some part consequential from Ofwat's directions and conditions. This is evident in this proposed condition that removes a due diligence defence against Water Act or licence breach, even if all of our actions have been taken with Ofwat's express approval and by our following regulatory directions.

Proposed Condition U Part 5
We do not have any objections to the wording of this part but would draw attention to our earlier comments about whether the scope of this condition is over-cautious.

Proposed Condition U Part 6
This section deals with the materiality thresholds inside of which we could make minor adjustments to CAPs without needing to seek Ofwat's approval. Our comments on materiality threshold are set out above.

Proposed Condition U Part 7
We agree with parts 7.1 and 7.2 which authorise collection of DPC allowed revenue from customers and set out the contents that might be anticipated in such an allowed revenue direction.

Parts 7.3 and 7.4 are a concern as they allow Ofwat to give enforceable directions to vary, or revoke any allowed revenue direction, after consultation. It does not list or limit the circumstances where Ofwat may seek to make these directions, nor is there any formal appeals process for a company or CAP, should there be serious objections not satisfactorily addressed at consultation. This is a departure from normal price regulation, where price controls are set for a fixed term and can only be varied in certain circumstances (e.g. interim determination), and where there is a mechanism for appeal for companies if they cannot agree with Ofwat's price limit proposals. Our concern is that these significant powers to modify allowed revenue could increase risk perception amongst potential investors in CAP projects.

Proposed Condition U Part 8
We do not object to this condition, which prevents unapproved changes in the ultimate controller of the CAP.

Proposed Condition U Part 9
This section deals with the circumstances surrounding termination of a CAP agreement. Parts 9.3 and 9.4 give Ofwat powers to issue enforceable directions as to the treatment of revenue collected by us, but not yet paid over to the CAP. The implication is that Ofwat may direct us to withhold some or all of the revenue. We suspect that this creates uncertainty for potential CAP operators as it suggests that notwithstanding consultations, Ofwat may issue directions that we, or the CAP, may not agree with. As above in relation to Condition U Part 7, there is no list of or limit to the circumstances where Ofwat may seek to make these directions, nor any formal appeals process for a company or CAP, should there be serious objections that were not satisfactorily resolved at consultation. Our concern is that these significant powers to issue enforceable directions about revenue collection could increase risk perception amongst potential investors in CAP projects.

Proposed Condition U Part 10
We do not object to the proposed wording of this part, which acts to prohibit associated companies to Affinity Water, from bidding for, or being awarded a CAP agreement, without express Ofwat consent.

Proposed Condition U Part 11
We do not object to Ofwat taking power to collect information held by appointees that is reasonably required in relation to Ofwat's functions regarding DPC. However part 11.4 is potentially problematic in that it would oblige us to provide not only information that we hold, but also information that the CAP holds. Appointees do not have direct responsibility or ownership of CAP information as the CAP is its own, separate entity. It is at least possible that a CAP is unable or unwilling to provide to

us information that only it holds, for the purpose of this condition. This would presumably leave us potentially unable to fulfil the information provision requirement, but without the means to remedy the situation.