

Response to Ofwat Consultation regarding Direct Procurement for Customers

Background

I am a Chartered Water & Environmental Manager with experience in both the regulated and non-regulated water sector in the UK. I currently work outside of the UK but am nonetheless keen to see a successful and sustainable DPC Policy enacted which will deliver high quality and innovative projects delivered at a lower cost to customer than the conventional model.

Andrew Heyes, 16 April 2020

Consultation Questions

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

Amendment to Condition U: Broadly the licence amendments set out in pages 9-16 are to be welcomed

I have some observations regarding a small number of the elements in the table:

Associated Companies

It is appropriate to exclude 'associated companies' (presumably as defined by the Companies Act 2006) in the manner set out in the proposed section 10. One might also consider whether these provisions should be broadened to explicitly set out a right for Ofwat to exclude other businesses which have a joint business relationship. This could include Appointee's current Delivery Partners (who will be very closely involved in an Appointee's current regulated business).

There may be other scenarios that are not adequately covered by the draft provisions. For example, if an Appointee desired to build a new impounding reservoir with the expectation that it would take 60% of the water and a neighbouring regulated water business would take 40% there is no obvious restriction to the participation of an entity related to the neighbouring regulated water company. Ofwat may wish to consider whether there should be restrictions in such a scenario.

The key issue is that potential conflicts of interest do not arise solely with regard to 'Associated Companies'.

Independent Technical Adviser (ITA)

In a DPC project one might expect that there will be a Technical Adviser appointed by the Lender financing the CAP and one might expect that the Appointee will have similar specialist technical advice.

Given that the role of ITA is essentially there to provide assurance, oversight and customer protection it may be appropriate for Ofwat to appoint that role and for the licence conditions to provide for a levy or recharge mechanism through which that role would be funded.

Responsibilities of the Company (i.e. the Appointee)

The updated licence condition sets out that the Appointee is not absolved of their statutory duties. Clearly the Appointee must maintain a reasonable level of scrutiny and customer protection under all circumstances but the draft provisions in the document appear potentially unfair to Appointees.

In the situation that an Appointee had determined to outsource services as part of its commercial or business strategy then they could have no reasonable defence regarding any regulatory infringement resulting from the actions of its contractor. However I would have sympathy for any Appointee that stated that DPC is a policy choice by Ofwat that necessarily changes the traditional autonomy of regional water monopolies.

If a CAP merely financed and created an asset (but the Appointee operated and maintained the asset) then I agree that the Appointee cannot use the CAP as a defence for a regulatory failure. However I consider that in the event that the CAP operates and maintains the asset then at the very least the Appointee will have a joint responsibility with the CAP. In the event that a Water Treatment Works operated and maintained by a CAP supplied water unfit for human consumption I would ideally like to see prosecution of both the CAP and the Appointee and leave it to the Court to determine what defence is reasonable and whether one or both parties are guilty and how any penalties should be applied.

Amendment to Condition B: The summary set out on page 16 is appropriate and does not require amendment.

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?

There is a risk that if the costs of the CAP are passed through to customers that there may be little incentive for Appointees to focus closely on cost control over the CAP during the construction and O&M phases.

Outcome delivery incentives are an ideal mechanism to ensure Appointees properly manage the CAP Agreement. During the Design and Build Phase this should focus on delivery against key milestones and in the operational period typically these should focus on asset availability.

In order to incentivise Appointees to closely monitor and manage the CAP it should be proposed that 50% of any performance deductions made under the contract to be retained by the Appointee while the remaining 50% of performance deductions to be put into a sinking fund (with a consequent reduction in future charges to customers).

It should also be the case that efficiencies delivered through an annual Continual Service Improvement Mechanism should be shared in the following proportions:

- 40% CAP
- 40% Appointee
- 20% Customer

Where power and chemical costs are material to the whole life cost of the project and where the Appointee's buying power enables them to procure these at a significantly lower rate than the CAP there should be provisions enabling such efficiencies to be delivered and for the benefits of these arrangements to be shared between the Appointee, the CAP and the Customer.

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

It would not be appropriate during the first wave of DPC projects to allow Appointees and CAPs to mutually agree changes without Ofwat signoff. However, it should be possible to provide for a flexible process with relatively small changes being signed off at an appropriate level within Ofwat without causing undue delay to the CAP and the Appointee.

A potential approach might be as follows:

Type of Change	Ofwat signoff
Change resulting in increased of less than 0.5% in Design & Build Cost	Ofwat Principal
Change resulting in increased of 0.5%-3% in Design & Build Cost	Ofwat Director
Change resulting in increase of greater than 3% in Design & Build Cost	Chief Executive or Board
Change resulting in increased of less than 0.5% in Operational Cost	Ofwat Principal
Change resulting in increased of 0.5%-3% in Operational Cost	Ofwat Director
Change resulting in increase of greater than 3% in Operational Cost	Chief Executive or Board sign-off
Change (of any size) resulting from Qualifying Change in Law (QCIL)	Ofwat Director (subject to confirmation from Ofwat's Legal Advisors that QCIL Applies)

The figures indicated in the table above are a very rough rule of thumb and it may be useful to check back against the approach that has been taken by Ofwat with regards to the Tideway project. **In any event it would be important to establish controls to ensure that CAP Agreement changes could not be disaggregated such that a succession of small changes could be approved and avoid appropriate scrutiny.**

Sometime in the future when Ofwat has empirical evidence from a significant group of DPC projects it may be appropriate to codify materiality within licence conditions.

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?

Page 2 of the Appendix 2 Briefing note outlines 'The CAP will be responsible for the creation of the asset, its financing and potentially the operation and maintenance' and therefore provides for two quite different risk profiles.

In an arrangement in which a CAP merely finances and creates an asset (and the Appointee will operate and maintain the asset) the associated risks to an Appointee (using a 'late' tender model) are broadly similar with the existing model of asset creation and delivery.

The alternative model in which the CAP also operates and maintains the asset does provide greater risks to the Appointee (and potentially to customers also) but may well result in innovation as well as cost efficiencies.

The 'Finance/Create-only' model may be a useful low risk model to develop the DPC concept but ultimately the models with higher risks should be favoured as they drive higher benefit to customers and a greater level of efficiency and innovation.

Potentially the most interesting (and higher risk) use of DPC would be to deliver projects via the Early Model which include O&M provision. This would represent the pinnacle of the DPC policy.

5. Please provide your comments on the processes outlined in the DPC Briefing Note?

The processes set out in the DPC Briefing note are appropriate. It may additionally be useful to consider what provisions should be made for the appointee to publish any Business cases generated under this process (e.g. on their website) and similarly the form that any review by Ofwat of those Business Cases should be publicly available.

I would observe that the processes in the Briefing note do not include graphics for some scenarios that *may* occur in the post award phase including re-financing or a change in the Ultimate Controller of the CAP. Any refinancing should certainly include an information point for Ofwat and a change in the Ultimate Controller is specified elsewhere in DPC documentation as requiring an Ofwat control point. Invocation of any Dispute Resolution Mechanism or any amendment of the payment mechanism should include an information point for Ofwat

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 these be?

There should be some provision within the licence conditions for the event that either the Appointee exercises step-rights (in accordance with terms and conditions that were overseen by Ofwat at the outset of the agreement) or that the CAP terminates the CAP agreement. A potential mechanism could be for a logging up/logging down mechanism until such time as either (a) a new CAP is appointed or (b) the asset is approved by Ofwat for transfer to the Appointee's Regulatory Asset Value.

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

The response to question 1 sets out potential adjustments which could be applied to draft provisions on Associated Companies, Independent Technical Advisers and Responsibilities of Appointees. Consideration of other elements is set out below:

Section 7: Allowed Revenue Direction

The provisions set out in section 7 are appropriate in their current form.

The Allowed Revenue Direction should be relatively straightforward where the term of the CAP agreement is equal to the asset life. A model with a fixed availability charge and variable charge based on output/throughput should provide for a reasonably transparent and predictable charge. It will be necessary for customer charges to be based on estimates and for there to be annual reconciliation of those estimates.

It may be useful to consider in any Allowed Revenue Direction whether there will be opportunities for Appointees to 'game' the system e.g. if a Water Treatment Works was built as a DPC project would there be any opportunity for the Appointee to ramp down flows from other treatment works and avoid cost and risk in the regulated business without an associated reduction in the 'non-DPC' water charges?

Any future consultation may wish to review in greater detail how the Allowed Revenue Direction might be determined in the very likely event that regulatory changes during the period of the CAP Agreement require commissioning of additional assets (e.g. new process stages to address emerging pathogens). This will be a particular issue as such items are likely to require depreciation beyond the period of the CAP.

It is recommended that there is a consultation exercise on how information should be provided to customers regarding the allowed revenue direction e.g. should it be shown as a separate line on water bills or will it be sufficient to provide information by leaflet or merely on an Appointee's website?

While the payment mechanism should ensure that costs to customers are reasonably predictable it is important to note that *force majeure* events are potentially very costly. It is important that Ofwat and the Independent Technical Adviser have close oversight where *force majeure* is invoked in a DPC project to ensure that customers are adequately protected.

Amendments to Condition B

Each of the amendments highlighted in yellow in pages 32-34 of the consultation document appear to be appropriate amendments and should be adopted in that form.

Page 35: Timing and Collection of DPC Allowed Revenue.

I would anticipate that payments from the Appointee to the CAP would be made on a monthly basis and one might expect this to be certified by the 15th day of the month following the month of service. Clearly it will be necessary for customers to be charged in advance of the payment to the CAP. It would be necessary to identify a reasonable annual budget in advance (including an appropriate contingency).

Summary

Very broadly the changes in the document are to be welcomed as they should facilitate innovation, creativity and value for money in the water sector. There are some risks and challenges that are presented by the policy (not least the creation of new interfaces and touchpoints) but the updated licence conditions will provide appropriate mechanisms to deal with those challenges.