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3 April 2020

Dear David

RE: OFWAT CONSULTATION: PROPOSED AMENDMENTS TO LICENCE CONDITIONS FOR DIRECT PROCUREMENT FOR CUSTOMERS

Further to your emails dated 24th February and 23rd March, please now find attached our response on behalf of Anglian Water Services Limited.

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

We have found it extremely difficult to assess the proposed licence changes in isolation, given that any licence changes relating to the uncertainty mechanism will not be the subject of consultation until later on in the year. As will be seen from our comments below, water companies may have to bear a variety of costs as a consequence of the draft licence changes, were they to be implemented. It is therefore impossible to know – in the absence of a holistic proposal – whether the suggested changes are viable and so we cannot agree to them at this juncture.

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 acknowledge that Ofwat has provided specific funding to allow the water company to manage a CAP agreement where that is needed, which is helpful.

One approach to strengthening incentives on companies to secure that the contractor completes the project under budget could be to consider an ODI. However, we would observe that the Government's experience with PFI contracts (which closely resemble the DPC regime) was that contractors frequently ensured that contracts were drafted in a way that reduced their own risk, by ensuring the commissioning body funded any additional works required as a result of any event outside a defined set of assumptions.

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Therefore, whilst an ODI might reward the early completion of the project, we question whether this approach would provide an incentive for the water company to ensure overall quality within the project.

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?

We believe that it would be challenging to draft a threshold that would be objectively measurable in all cases. By this, we mean that the spectrum of possible variations to a contract is infinitely wide, but a threshold would have to be precise; and clearly this would need to be reconciled in a way that both the water company and regulator could be sure, in objective terms, whether the threshold had been met or not.

Having said that, we are not clear as to what benefit there is in Ofwat oversight of modifications at all. Modifications are either allowed under section 88 of the Utilities Contract Regulations or they are not. The water company could not lawfully alter the terms of a DPC Agreement in a way that allowed the contractor greater rewards than the minimum amount a losing bidder had declared itself willing to accept.

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?

We are concerned that the proposed provisions place all of the risk on the water company, especially bearing in mind what we say above – that experience of PFI contracts over the last 20 years indicates that contractors have ensured that the contract price is fixed only insofar as circumstances do not deviate from a detailed set of assumptions.

If additional costs can be passed on to customers outside of the price control, then water companies would not be worried by this trend. However, there are two indirect adverse consequences for water companies. Firstly, there could be negative reputational consequences for water companies if they are associated with a significant project overspend – this could have an impact on CMEX scores. Secondly, the provisions appear to assume that not all CAP Charges are eligible to be included in water companies' DPC allowed revenue. This means that water companies bear all the risk of ineligibility without, as discussed above, any corresponding reward. This situation is further exacerbated by the lack of any sort of criteria setting out the nature of eligible or ineligible CAP Charges. We can see a financial risk associated with CAP charges being disallowed.

We note that it has been expressly provided that water companies may not use the existence of a CAP Agreement as an excuse for non-compliance with any legal requirement. Whilst we agree with this principle, we are concerned that companies will be inclined to "man-mark" the contractor in order to ensure the risks of non-

compliance are minimised. This activity will require additional operational expenditure which may fall to the water company, and may not be included within DPC Allowed Revenue. The risks of cost escalation will also all fall upon the water company. This tendency towards cost escalation was noted by the Office for Budget Responsibility as one of the failings of PFI contracts.

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

The Briefing Note sets out a great deal of detail, with which we do not disagree, but does not deal with the fundamentals. We have a number of general observations, which are as follows:

a) Ofwat's consent is required to designate a project a DPC – if consent is given, the costs of the project can be recovered from customers outside the price control. But if consent is not given, how would the project would be funded? Should Ofwat's consent be sought for a DPC one AMP ahead of the project so that if consent is not given, submissions can be made as part of the price review? Or is it intended that projects that are unfunded because of a lack of consent should be the subject of an interim determination (assuming that the threshold is met)? Would there be a CMA reference process if the water company in question did not agree with the withholding of consent or the interim determination?

b) Ofwat can designate a project as being suitable for a DPC where it considers that this method of delivery might provide better value for customers. However, we would like to understand how Ofwat would make a fair comparison of financing between a project delivered within the price control over one or two AMPs and operated in perpetuity and a project delivered and operated over a 40 year period, especially given the uncertainty of finance over that far a horizon.

c) We also wonder how such a long-term contract drives innovation. Such a long-term contract, with limited scope for termination or variation by the water company is unlikely to drive the contractor to try out innovative methods of working. The PFI experience has shown that the tendency is – if not for the contractor to "sit on its laurels", risking nothing, and delivering only what it is contracted to do – then at least to keep to itself the benefits of any new or more efficient methods of working. Precisely because these efficiencies are innovative, it is extremely difficult for the water company to legislate for them in the original contract drafting. Thus, neither the water company nor customers benefit.

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?

The main difficulty for the water company is that, in this situation, it will not in the Final Determination preceding the project have been allowed the funding to prosecute the project; and given that the position settled upon in that Final

Determination can only be altered by an IDOK with a materiality threshold that will probably not be met, that mechanism will not therefore be usable.

In addition, the water company will effectively have been handed back a major infrastructure project with no personnel (unless they transfer under TUPE). We consider that the water company needs the right to an automatic adjustment mechanism in these circumstances, which is (i) streamlined in order to ensure that funding is not delayed and (ii) not constrained by materiality thresholds.

On the matter of streamlining, we think that it may be possible to design different levels of scrutiny for these determinations, depending on the circumstances. For example, if the water company feels that, following termination, it can complete the project itself with no overall greater amount of funding than was in the original CAP Agreement, then the adjustment mechanism ought to be very light-touch.

However, if it requires greater funding than the amount contemplated by the CAP Agreement, a greater level of scrutiny is required, but at least the regulator has a rough benchmark as to the market view of project costs (although this would need to be tempered if failure was ostensibly attributed to the bidder pitching too low). Where direct procurement failed because there were no bidders at all, then clearly this is a situation appropriate to greater scrutiny, but without the constraint of a materiality threshold.

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

The proposed wording of condition U2.1 provides for an infrastructure project to be designated by Ofwat as DPC (or varied or exited) "with the agreement of the Appointee and by direction". Is this intended to mean that both agreement and direction are required or that direction can be given without the company's agreement? We think that the sentence could be read conjunctively or disjunctively and would benefit from clearer drafting.

There is a general undertaking in the licence provisions that whatever water companies do with respect to the operation of a CAP agreement, they must at all times use reasonable endeavours to ensure it achieves best value for customers. We are concerned that the somewhat nebulous concept of "best value" *could* be construed as solely meaning the companies must prioritise completion of the project at least cost. That would not be appropriate: companies need a discretion to balance cost against other important drivers such as legal and regulatory compliance, worker and public safety, carbon neutrality, and environmental protection. We think therefore that the wording could be improved in this respect.

Our final point relates to the DPC Allowed Revenue Direction. We think that companies will replicate the terms of the Direction in the CAP Agreement, and will not vary from that formula, otherwise they risk having to bear the costs themselves. We do not, however, have anything to add in respect of the categories described.

If you have any further queries, please do not hesitate to contact me.

Kind regards

Alex Plant
Director of Strategy and Regulation