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DPC Licence changes consultation
Direct Procurement
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8 April 2020

Dear Ofwat,

Consultation on proposed amendments to licence conditions for Direct Procurement for Customers (DPC)

Thank you for inviting us to provide input on the above consultation. We have carefully considered the licence conditions proposed, namely the new licence condition (Condition U), as well as the amendments to existing licence conditions (Conditions A and B) and whether these would apply to Bristol Water's specific operating circumstances.

Further to Ofwat's telephone conference call on 30 March and the discussions that took place we would like to take this opportunity to underline some of the specific circumstances we feel need to be considered as part of this process. To recap, as part of our earlier discussion we highlighted the following:

- Following the re-assessment of our supply demand balance for the WRMP19 submission, there was no longer the justification of need for a supply side resource scheme the size of the Cheddar 2 proposal. Our forecast deficit is addressed using demand side options and a reduction in bulk supply to Wessex Water post 2025.
- Cheddar 2 is still listed as a feasible option in our options appraisal process, and assessed within the Strategic Environmental Assessment for the WRMP19, but was not selected as a 'best value' option for the final plan preferred options list to address the forecast deficit.
- The Cheddar 2 reservoir has been identified as a potential resource option within the context of Regional Planning, and is now part of the West Country North Sources scheme to transfer water to the South East Region (Southern Water). The assessment of the feasibility of this scheme has been identified as going on the 'fast track' Gated process to deliver the data and information requirements for Gate 1 by September 2020. There is considerable uncertainty relating to the potential utilisation of such an option.
- As Cheddar 2 is only one part of the West Country North Sources scheme, other practical factors, such as reinforcing the Wessex Water network to maximise a transfer from Bristol Water at Newton Meadows, needs to be considered before DPC is considered an appropriate solution. We are not fixed on Cheddar 2 as the only option; if Newton Meadows may be more appropriate and may become more beneficial for customers.
- As a regional solution, for Cheddar 2 it would be necessary to consider how the output could be transferred eastwards to meet demands in the wider network, and by



displacement a Southern Water transfer.

- The policy intent behind Ofwat's creation of a separate Havant Thicket price control for Portsmouth Water leads to questions over customer protection – most importantly customer protection in which supply area?
- The licence conditions and the risk underlying the conditions assume the DPC project correlates to customers in the supply area of the Appointee – for Bristol Water/ Cheddar reservoir this is not the case
- By the time the schemes are needed (we do not consider Cheddar 2 necessary until at least AMP9) the market may have changed and commercial risk/reward clearer (e.g. treated water rather than water resource pricing)

We of course continue to share Ofwat's view that the DPC process has the potential to unlock value for customers and we are supportive of the majority of the licence amendment proposals. Whilst Bristol Water was one of the six companies listed that the amendments would initially apply to, we do not agree that the DPC process is appropriate for the West Country Sources (North Solution) and we have assumed that the unique circumstances behind Cheddar 2 mean that not all of the licence conditions proposed are intended to apply to our position. This is partly because of the timing of when Cheddar 2 should be constructed, but more fundamentally, it is because unlike the other DPC designated schemes, Cheddar 2 is a reservoir. Our view is that the precedent set by the Havant Thicket (the provision of bulk supplies of water to a neighbouring water company and the creation of a new price control for the Appointee) is a better model for reservoirs. Similarly to Havant Thicket, in a scenario where Cheddar 2 is taken forward, rather than a licence condition applying to Bristol Water, an entirely separate price control may be more appropriate for this project, which would be tailored to recognise the specific geographical circumstances of the project, enable the promotion of efficient outcomes and to ensure customers are adequately protected. We note for example that Ofwat considered that for the Havant Thicket reservoir a separate 10 year price control "better aligns the cost and risk sharing arrangements between customers and shareholders of both Portsmouth Water and Southern Water given the long term nature of the project."¹ Under the West Country Sources (North Solution) project, which relates to water resources and which aims to ensure customers in the Southern Water supply area (rather than the Bristol Water supply area) it may therefore be more appropriate for a separate price control. This reflects the PR19 methodology report Ofwat commissioned from KPMG on the technical issues appointees should consider when determining whether a project is suitable for DPC, which concluded that reservoir assets were less suitable for DPC delivered projects.²

Whilst we agree licence changes are needed for the industry, we do not agree with a section of the wording as presented in the consultation. Likewise, there is a danger that the success of DPC is being hampered by the many stages of consent required (the Control Points) and whether the burden of responding to these requirements is potentially unrealistic. We highlight in particular the reference in the draft wording of licence condition U that "Ofwat may... by direction, from time to time" designate, modify or revoke the designation of a DPC project as a potential area of concern.

We answer some of the specific questions raised in this consultation in the pages overleaf. Please contact me if you would like to discuss our response in more detail. We look forward to taking part in the working group and the consultation on interim determination mechanisms for DPC projects due to be published later this year.

¹ [Havant Thicket appendix](#)

² [Direct Procurement for Customers: Technical Review](#)



Yours faithfully,



Iain McGuffog

Director of Strategy and Regulation



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

Our understanding is that the DPC process is unlikely to be appropriate for the West Country Sources (North Solution) and specifically is not appropriate for Cheddar reservoir 2. We are however supportive of the use of DPC in principle and we have therefore summarised in the table below our views on the proposed licence amendments.

Proposal to Introduce Condition U			
Issue	Summary	RAG	Bristol Water's Comments
General	A licence condition which ensures that customer interests are protected.		We to continue to share Ofwat's view that the DPC process has the potential to unlock value for customers. We question whether the West Country Sources (North Solution), and more specifically Cheddar reservoir 2, is an appropriate project the licence changes should apply to. We have proposed our potential solution to how this project could be taken forward, whilst protecting our customers, in response to question 4.
Achieving best value	A licence condition that places an obligation on water companies to ensure that best value for customers is achieved in the DPC procurement.		We are supportive of this licence amendment.
Management of CAP	A licence condition to assure best management of the contract for customers throughout the life of the contract.		We are supportive of this licence amendment.
Designation of a DPC Delivered Project	Ofwat want to ensure that only suitable projects are procured through a DPC process.		Reference to an Appointee being 'directed' to designate a project as a DPC delivered project by Ofwat should be removed. If Ofwat do "not consider DPC to be mandatory, but rather as an additional tool available to companies" than this reference is not necessary. ³
Requirement for written consent from Ofwat for the Appointee to undertake a DPC	Ofwat want to approve the planned DPC procurement process prior to it being undertaken.		We assume this is part of Control Point A. We would ask that such written consent is timely, particularly if it is required as part of a DPC project intended to be delivered midway through a price control period.

³ [Direct Procurement for Customers Industry Workshop notes](#)



Proposal to Introduce Condition U			
Issue	Summary	RAG	Bristol Water's Comments
Procurement Process			
Ofwat agreement required for a project to exit DPC	Ofwat want to agree to the exit of any project from the DPC regime.		Rather than agreement, we would urge that this is a requirement for Ofwat to be notified.
Requirement for written consent from Ofwat for the water company to enter into a CAP Agreement	Ofwat want the water company to require consent from Ofwat prior to entering into the CAP Agreement.		We are supportive of this licence amendment.
Requirement for written consent from Ofwat for changes to be made to a CAP Agreement	Ofwat want the water company to obtain consent from Ofwat to agree changes to a CAP Agreement where there is a potential material impact on customers' interests.		We are supportive of this licence amendment but would urge that the specific nature of the DPC project in question be taken into account. The relationship between Cheddar 2 and Newton Meadows for example demonstrates how changes may in the long-term arise that are more beneficial to customers.
Requirement for written consent from Ofwat for the extension of the term of the CAP Agreement	Ofwat want to approve any extension of the CAP Agreement.		We are supportive of this licence amendment.
DPC Allowed Revenue Direction	Ofwat need to be able to issue a direction for the company to collect revenue associated with DPC.		We are supportive of this licence amendment.
Ultimate Controller of the CAP	Ofwat need the water company to ensure that the CAP has obtain consent from the water company before a change in Ultimate Controller. In turn the water company has to		Should the CAP not have to obtain consent from Ofwat, rather than the Appointee having to obtain consent from Ofwat?



Proposal to Introduce Condition U			
Issue	Summary	RAG	Bristol Water's Comments
	seek Ofwat approval for consent.		
Provision of Information	Ofwat want the ability to obtain appropriate information in relation to the procurement of a CAP, the performance of the CAP and the delivery of the project.		A new reporting requirement could be added to the Annual Performance Report. This would be an opportunity to keep customers updated on progress against delivery. Under this proposal the requirement for Board Assurance would be covered as part of annual reporting process, instead of becoming an entirely separate regulatory requirement.
Independent Technical Adviser	Ofwat expect the water company to support information provided Ofwat with evidence from a technical expert.		We note that the briefing note states: "Appointees may consider the use of an independent technical adviser to provide evidence and assurance (indeed this may be required on occasion by Ofwat)" but the licence wording makes this a requirement rather than an optional consideration. We question the need for a technical adviser to be mandatory, especially if there is a licence condition for Board assurance.
Responsibilities of the Company	Ofwat's view is that the water company will continue to be the responsible provider of water (and sewerage services).		We are supportive of this licence amendment. The wording of paragraph 4 in Condition U is suitably appropriate (except in circumstances where the project moves water to another supply area, such as for the West Country Sources (North Solution) project).
Prohibition on entering into CAP Agreements with Associated Companies	Ofwat want to ensure that companies do not enter into a CAP Agreement with an associated party.		We are supportive of this licence amendment.
Requirement for written consent for Termination	Ofwat need to be able to approve or prevent a water company terminating a CAP Agreement.		We are supportive of this licence amendment.
Amendment to Condition B			
Issue	Summary	RAG	Bristol Water's Comments
Pass through of CAP Charge	The licence needs to be amended to allow a company to collect from its customers outside of price controls the		Based on our discussion on the telephone conference call on 30 March our understanding is that this licence condition would not apply to Bristol Water. This is because we do not anticipate why Bristol



Proposal to Introduce Condition U			
Issue	Summary	RAG	Bristol Water's Comments
	appropriate DPC charges payable to the CAP.		Water customers should pay for any new reservoir, as it is not needed for their water supply. They should potentially benefit from a share of water treatment costs, but this can be dealt with outside of a DPC scheme.
Amendment to Condition A			
Issue	Summary	RAG	Bristol Water's Comments
New definition	To insert a new definition over the interpretation of "DPC Allowed Revenue"		We are supportive of this amendment for suitable DPC projects; a fixed revenue stream over the period will potentially help 'lock-in' customer benefits and is typical for project finance contracts

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 are supportive of Outcome Delivery Incentives (ODIs) for DPC projects, both in terms of underperformance penalties and outperformance payments. The main difference and potential point of contention in this approach would be in the extent to which any ODI is applied if the fault for non-delivery of the scheme cannot be determined i.e. whether there are disagreements between the water company and the CAP. In other words, the difference between other scheme-specific performance commitments and a DPC ODI is that there is a large degree of company control over the former, whereas the latter is significantly impacted by the CAP. This may lead to unintended consequences, such as legal disputes over the application of the ODI as a result of non-delivery. Ofwat should therefore specify that in the event that a CAP terminates the CAP Agreement then responsibility for any scheme-specific ODI should be transferred to the CAP.

Basing ODI rates on development costs is reasonable as there would likely be no direct willingness-to-pay values for any DPC scheme. However, an alternative method would be to consider a proxy measure to determine the willingness-to-pay values. Depending on the type of DPC scheme, such a value could be derived from a measure to prevent supply interruptions greater than 24 hours (with specific customer valuation for long-term interruptions being based on these events being low probability high consequence failures) or even from water quality measures.

In addition, where the CAP is able to outperform its financing assumptions there should be a mechanism to ensure customers can benefit from this. To help ensure the CAP is incentivised to secure lower cost financing a sharing of the benefits could best achieve this as in line with other public-private partnership arrangements.

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

The wording and thresholds should align to those outlined in the Utility Contract regulations 2016.



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?

The licence conditions and the risk underlying the conditions assume the DPC project benefits customers in the supply area of the Appointee. This is unlikely to be the case with strategic national water resource schemes, and therefore a different approach to risk allocation than the proposed DPC model may be required.

Establishing the precise risk allocation of the proposed DPC model is central to ensuring projects are financeable and attractive to target investors. Risk allocation between the CAP, the Appointee and customers who benefit directly from the DPC delivered project (in our case this would be Southern Water customers, not Bristol Water customers, with Wessex Water customers a further consideration) need to therefore be carefully considered. Our view is that Ofwat is allocating too much downside risk to the Appointee and there therefore needs to be consider a risk sharing mechanism (either with the CAP or with the Appointee whose customers benefit most from the DPC delivered project or with both), otherwise it is difficult to imagine Appointees choosing to accept that risk.

The risk profile of a water company should not change merely as a result of delivering a project under a DPC model. It is therefore important that water companies are not left with a high level of residual risk through adopting the DPC model. The licence conditions as currently drafted do not reflect an appropriate balance of risk for the incumbent water company. Although we agree a new licence condition (Condition U) is needed to codify DPC as an appropriate regulatory mechanism, this condition is not necessarily appropriate for the West Country Sources (North Solution). This project underlines the need to consider the appropriateness of a separate price control, as opposed for DPC licence changes, for certain investment projects. Reservoirs are large infrastructure assets and whilst they are relatively simple in design complexity, the scale and long construction period is likely to be considered higher risk especially considered that there have been no UK precedents in a number of decades.

As a potential risk sharing mechanism, as per our response to question 2, Ofwat should specify that in the event that a CAP terminates the CAP Agreement then responsibility for any scheme-specific ODI should be transferred to the CAP.

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

We welcome the desire not to introduce a one-size-fits-all approach and in particular the statement that *“there will be flexibility in approaches to facilitate innovation dependent on the specific features of the DPC delivered projects.”* We think that the specific circumstances of Cheddar reservoir 2 highlight why Bristol Water is not in the same position as the other five companies listed in the consultation document.

On the control points and information points outlined in the briefing note, to ensure the burden of reporting does not undermine the ambition of the DPC delivered project we propose that these become more informal – perhaps undertaken via a designated Ofwat employee similar to the working arrangements of PR19. This ensures that progress over DPC delivered projects are channelled through a direct engagement lead, whilst at the same time minimising the potential for repetitive reporting exercises.



The factors that may influence the decision made by Ofwat listed on page 46 of the briefing note need to include considerations over whether a DPC Exit would impact an Appointee’s customers. In the case of Cheddar reservoir 2 for example, any DPC Exit would not impact Bristol Water’s customers (at least in the 25-year timeframe).

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?

As per our response to question 2, Ofwat should specify that in the event that a CAP terminates the CAP Agreement then responsibility for any scheme-specific ODI should be transferred to the CAP.

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

Our proposed amendment is summarised in the table below.

Section (Condition U)	Existing Text	Action Required	Proposed Amended Text	Company rationale
2.1	“Ofwat may, with the agreement of the Appointee and by direction, from time to time:”	Delete “and by direction, from time to time”	“Ofwat may, with the agreement of the Appointee:”	Including the potential for Ofwat to direct a company to undertake a DPC project will have significant implications for investor confidence and potentially impact the financeable of the appointee. We think that this language is contrary to the principle of DPC delivered projects, namely that they are not compulsory.
4.2	Entire clause	Remove	N/A	See below
6.3 & 6.5	Re-order	Re-order	N/A	See below

We think that condition U 4.2 is problematic. It is a novel piece of regulation to specify in the Licence that a particular defence cannot be used for a prosecution, particularly as Ofwat are not the prosecuting authority. The matters concerned would fall within legal privilege and are not appropriate for a licence condition. Condition 4.1 is sufficient, and it would be a matter for the relevant courts and authorities to make the case that any defence a company may raise such as in 4.2 was incorrect. The condition would have no impact in that case, and the clause risks a breach of licence caused by a legal decision, which is therefore not in the public interest.

In section 6, Ofwat ask for views on what level of non-material changes to a CAP agreement should be made without Ofwat consent. The current wording of the licence condition does not allow any changes. This could be resolved by moving 6.3 to after 6.5. 6.4 we assume should have no permitted variation without Ofwat prior approval. It could then be clear that minor changes to the CAP



Agreement were possible as long as it supports the criteria in 6.3 being met (reasonable endeavours to ensure it achieves best value for customers)

On Condition B, whether the DPC Allowed Revenues should be considered at an interim determination may depend on the specific DPC project. Whilst we understand the principle, the application through condition B may be case specific.