

Northumbrian Water Comments on Consultation on proposed amendments to licence conditions for Direct Procurement

As Northumbrian Water does not have a DPC proposal for 2020-25, we have not responded in detail to this consultation. We have instead made some observations on the overall process.

Acting in Customers Interests

The key test of a DPC contract should be whether it is in the interest of customers.

The proposed licence change requires the “Appointee must at all times use all reasonable endeavours to ensure it achieves best value for customers.” This requirement seems to us to be difficult to interpret, for example, what should happen if an Ofwat requirement results in an approach that the Appointee considers is not in the interests of customers?

We interpret this duty as stating that if a DPC scheme is not in customer interests then it should not go ahead. A key test of this is a comparison test against the option of delivering the scheme under the existing regulatory system.

It is not clear to us from the consultation whether and when this test is applied. The consultation also refers to the *‘unlikely scenario in which DPC schemes need to revert to in-house delivery within the control period. It is our view that reversion to in-house delivery within a control period should be a rare event’*

This appears to pre-judge the outcome of a competitive tendering process that could result in bids that offer worse value than using the regulatory cost of capital.

By requiring an interim determination process rather than a more automatic reversion, Ofwat risk forcing companies to retain a DPC approach that is uneconomic to avoid a possible financial penalty under the interim determination approach (e.g. if the claim is under the materiality threshold). We understand that Ofwat will consult on this separately and we suggest that there should be no materiality threshold – if a scheme is material enough for a DPC approach, it should be material enough for a change in the price control if reverted to the Appointee.

Finally, we do not see any provision for an appeals process in the proposals. With Ofwat a key decision maker in many parts of the complex procurement process, it is important that companies have some way of appealing what could be a material issue.

Risks to Customers of a DPC approach

We note that the Thames Tideway scheme had a headline bid WACC of 2.497% (real RPI). This is fixed until 2030. The Ofwat Final Determination has a real WACC of 1.92% (real, RPI).

So, over 2020-25, Thames Tideway customers will be paying more for Thames Tideway under the DPC arrangements than they would have under the standard RCV based regulatory approach.

This suggest to us that, whilst DPC may be worth considering and even market testing, it is not automatically in customers interests and there have to be provisions for taking it back ‘in house’.

It is critical that Ofwat and the industry learns the lessons from previous Government PFI and PPP contracts. What may initially appear an efficient proposition can become expensive over the long life of a contract.

Northumbrian Water, March 2020