Severn Trent

Response to consultation on proposed amendments to licence conditions for Direct Procurement for Customers

21 April 2020

WONDERFUL ON TAP

Response to the proposed licence condition amendments for DPC

Introduction

About the consultation

Ofwat has proposed a set of amendments to the licence conditions for the six water companies that PR19 confirmed will deliver schemes through direct procurement for customers (DPC). As Severn Trent was not one of these six companies, the licence condition changes would not apply initially – although they could come into play when we have confirmed DPC schemes to take forward.

The first proposed modification would see a new licence condition introduced that establishes the processes by which a water company could undertake the procurement of a third-party competitively appointed provider. A second modification would then amend the existing Condition B to permit the water company to pass onto its customers the charges payable to the competitively appointed third-party service provider.

Ofwat has also made reference to the notified item uncertainty mechanism that will be in place during AMP7 should DPC schemes need to revert to in-house delivery. It recognises that the interim determination process that applies to notified items has drawbacks for some schemes. So, it plans in due course to look at introducing a specific interim determination process with bespoke criteria for DPC. Ofwat is not consulting on this at this stage and will instead do so separately and engage with stakeholders during 2020.

The type of consultation underway is an initial non-statutory consultation on Ofwat's current views on the required licence amendments. What this means is that the comments and responses that Ofwat receives from this consultation will then go on to help inform the final form of the modifications, which it will hold a statutory consultation on later this year.

Overview of our response

We welcome Ofwat's proposals and agree that updates to the water companies' licences are a necessary part of (i) helping establish clear processes for companies to undertake DPC procurement and (ii) providing a mechanism that allows companies to recover the relevant efficient costs from customers. We see this as a way to give greater clarity on the process for delivering competitive DPC procurement – by providing more certainty and confidence to the market which, in turn, should encourage a greater number and more competitive bids.

From an overarching perspective, we think that the regulatory process for DPC delivery should be designed in a way that ties in with the sector's drive for efficiency. In our experience, the more a process is based around rules rather than principles, the greater the risk that it unintentionally becomes bureaucratic and starts to act as a drag on efficiency. This isn't to say that rules are not required. Rather we would suggest that, where rules are needed, they are designed in a way that strikes a good balance for efficiency and for customer protection.

Ahead of progressing with the licence changes, we think that the balance of risk and its allocation requires further consideration and options looked at for resolving these risks. As it stands, the risks look somewhat loaded towards incumbent water companies – in a scenario where companies are responsible for the outcome, but not in full control of the process, DPC begins to look a lot less attractive.

In broader terms, we recognise that customers need protection from under and late delivery. To us, it's important to select the right protection mechanism (Licence, ODI or CAP agreement) in the right

circumstances. For example, a licence condition is unlikely to be suitable where (i) flexibility and (ii) opportunity to put in bespoke protections are needed. In other words, it's worth making sure that the licence does not end up too loaded when a delivery ODI or contract arrangement could work better for customers.

Where ODIs are being considered for wider application for DPC, it's important to consider whether these would add to the existing incentives for companies across a DPC's lifetime. Otherwise, there's a risk that incentives are duplicated without any additional benefits for customer protection.

We set out our further thoughts on these areas in the following section, along with our thinking on some of the other focus areas in the consultation.

Further detail on our response

Risk for incumbent water companies

The areas where we think incumbent water companies are being asked to carry additional, potentially, outsized risks are (i) timetable risk, (ii) the number of hard consents in the process and (iii) potential extra tests.

Under the proposed arrangements **timetable risk** for incumbents includes important elements outside of their control, mainly in relation to the time taken to obtain hard consents – such as for proceeding to the next step in the process or moving delivery in-house in the (albeit unlikely) event that the DPC procurement process does not deliver in customers interests. We think it may be worth having a timescale attached to when Ofwat will be able to provide the consent. This could be particularly useful for avoiding a position where a company has everything ready to go to market but is unexpectedly waiting for its consent that is putting overall timescale at risk.

The number of hard consents in the process could potentially draw out timelines and create risk that could be avoided if process is further streamlined. One option is to consider whether the hard consent for going-ahead with a DPC procurement process is needed in all instances. In the event that a price review has already approved the scheme, and that the totex for that scheme already exceeds the DPC threshold, there's a question whether the approval gate would be needed. If it is mainly a repeat of earlier decisions, then the DPC process could allow an option to bypass this steps when it's not needed.

The DPC process also looks to have the **potential for extra tests** to be applied. The main consultation document explains that, in relation to the proposed changes to Condition B, it is "…*important to note that DPC arrangements do not allow the CAP to charge more than would be the case if the project were undertaken in house*." Clearly, there is a strong logic for updating Condition B to allow companies to recover from customers the DPC charges payed to a CAP.

What we are less certain on is the need or potential for additional tests as this would appear to add to risks for incumbent water companies. As it stands, the Briefing Note on DPC does not yet expand on this point and, as yet, does not set out how such a test might be applied given that incumbent companies are not able to bid for their own DPC schemes.

To our mind, if a company is already conducting a robust procurement process, in line with best practice and Ofwat's expectation, then this matter should already take care of itself without the need for further tests. And, in the unlikely event that DPC procurement does not look like it will deliver for customers, it would seem reasonable to expect that companies would identify this as an issue, bring it to Ofwat's attention and seek to find a solution that does work for customers.

ODIs for DPC

In terms of getting suitable ODIs in place to drive companies to manage CAP Agreements efficiently, we think this could prove challenging. It is likely that the bespoke and infrequent nature of DPC scheme

could require notably different and highly-tailored ODIs in each instance. It's not that we think they won't deliver, more that it could prove challenging and time consuming to get these ODIs in place in a way that will work consistently for customers and does so transparently. Given the existing range of incentives to deliver, it may not be worth spending time to overcome this challenge.

We note that the existing ODI regime already provides a range of incentives for water companies to manage their assets and businesses efficiently for customers. It's reasonable to think that companies would make sure relevant incentives are appropriately signalled for CAPs so that they too are incentivised to pursue performance with the same vigour as the company. Alongside this is the need for Ofwat's formal consent to enter a CAP Agreement or change it subsequently. This should help encourage companies to (i) appropriately structure these contracts to capture existing ODIs, (ii) manage the contracts effectively and (iii) make sure that any proposed changes are in the customer interest.

On balance, we think that ODIs have a role to play in making sure schemes are delivered on time and to the expected standards. By contrast, we consider however that the case for ODIs relating to the operation of CAP Agreements is much less clear cut and think that there's a strong possibility that the ODI would duplicate existing incentives without any additional benefits for customer protection.

Materiality threshold for consents to vary the CAP Agreement

We strongly support the concept of materiality thresholds for consents to vary the CAP Agreement. This would give discretion to the contracted parties make minor improvements and adjustments to the agreement that will ultimately have little or no impact on customer bills.

We think that a dynamic approach maintains values in real terms is the right way to go about setting materiality thresholds. We see this as preferable to adopting a fixed nominal amount as the threshold would end up falling in value in real terms overtime. One option for a dynamic approach would be to set the threshold in proportion to its expected impact on customer bills. For example, if this was set at 0.2% of the combined bill, this would allow for up to a £0.70 post-tax impact on a bill of £350. A further advantage of an approach like this is that it would give thresholds that are directly relevant to the amount that customers currently pay for their bills.

Rather than attempt to draft a possible licence condition to provide this materiality threshold, we think that a logical first step is to agree on the how the threshold should be calculated. Once this is in place, a relevant licence condition can be developed.

CAP agreement termination

Our final thought is that it would seem prudent for the updated licence conditions to set out the process to be followed in the event that either a CAP decides to terminate the CAP Agreement or that the CAP fails and a provider of last resort is required. We also think it is worth considering whether these or similar steps should be followed in the event an incumbent water company has to terminate the agreement for non-performance by the CAP. Such additional provisions can look to set out the process a company should follow, such as:

- when to notify Ofwat of the termination and what approvals it should seek from Ofwat, for example on selecting a new provider and agreeing the changes that might be required for a new CAP Agreement;
- how a company should go about seeking an alternative provider, and the circumstances and criteria that would allow the company to take on the CAP role itself; and
- whether a company that takes on the CAP role would effectively be deemed to be contracting from itself or whether the associated costs would eventually become part of the price controlled business and the arrangements that would bring this into effect.