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DPC Licence changes consultation
Direct Procurement
Ofwat
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Dear Sir or Madam

CONSULTATION ON PROPOSED AMENDMENTS TO LICENCE CONDITIONS FOR DIRECT PROCUREMENT TO CUSTOMERS

Thank you for the opportunity to respond to Ofwat's consultation on the proposed amendments to licence conditions for Direct Procurement for Customers (DPC). Although South West Water does not currently have any schemes under DPC, we recognise that any changes agreed now would apply equally to SWW in the future and therefore, we welcome the opportunity to comment on the proposals.

Appendix 9 (section 6) of the PR19 methodology refers to the need for licence changes to provide certainty for the Appointee, the CAP and customers. Due to the scale and complexity of DPC projects we agree that certainty and clarity will be essential for all stakeholders, including Ofwat. However, to create that certainty we believe that further work is required on a number of areas covered in the consultation. Additionally, in our view the proposed level of complexity in the proposed licence conditions and procurement process guidance will create barriers to the efficient and effective management of a DPC project, and additional risk for companies.

Of particular concern to us are:

- The number and extent of the proposed conditions in Condition U.

  We believe that many of the requirements would be better captured in detailed Ofwat approvals (particularly the DPC Allowed Revenue Direction), which can be tailored for the particular DPC project, and guidance. Condition U should be limited to the three basic processes required for a DPC project:

1. a mechanism for the designation of a DPC project;
2. a mechanism for the granting of DPC Allowed Revenue Direction (and necessary financing elements under condition B); and
3. a mechanism for de-designation of a project (with corresponding financial elements under condition B).

Accordingly, we have not provided detailed comments on the drafting of the proposed licence condition U as we consider that most of the proposed drafting is unnecessary for inclusion in the licence. Given that this is a pre-consultation, we anticipate a further opportunity to revisit the drafting once principles have been established. It is also challenging to predict what should be situated within the licence in the absence of proposed contractual DPC terms. To do one exercise in isolation from the other when the two are so intrinsically inter-related could give rise to inconsistency and uncertainty.

- The lack of certainty in relation to variations to the CAP Agreement and what would occur in practice should the CAP Agreement be terminated.

  The current proposal for Ofwat to have the right to veto decisions or intervene is not, in our experience, commercially sound. Firstly, this could be interpreted as inserting control points unnecessarily and one would expect to see a demonstration of Ofwat's experience and competency to position itself into such projects. Further, this additional unknown, the additional level of uncertainty created by Ofwat involvement is unlikely to be acceptable to the CAP or wider stakeholders involved in such projects, specifically around third-party funding. To ensure certainty for Appointees, CAPs and third-party funders, all terms should be pre-determined and approved by Ofwat at the time that the agreement is entered into.

- The current lack of a clear appeals process.

  An appeal process is needed to provide clarity and certainty should Ofwat and the Appointee be unable to agree a position at any point in the process. This is particularly important if, as is currently proposed, Ofwat has significant control over the lifecycle contract management and operation of the CAP Agreement after it is signed. It will also be necessary to look at how this fits with the contractual dispute provisions contained in the DPC agreement. In practice, what role and authority Ofwat could be afforded as a third party to a Construction Act compliant form of agreement which itself, includes mandatory provisions for dispute. It is not immediately obvious how the role of Ofwat as an external regulator would sit within the contractual framework.

We discuss these issues and other matters in our responses to your questions included within Appendix 1. If you have any questions please do not hesitate to contact me.

Yours faithfully

[redacted]

Sally Mills
Regulatory Director
D: [redacted]
E: [redacted]

APPENDIX 1
CONSULTATION QUESTIONS

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

While we agree that it will be imperative that there is clarity and certainty for all stakeholders, and support some, but not all, of the issues presented in section 3 of the consultation, we do not agree that they should be addressed through detailed licence text in Condition U.

In our view, it would be more appropriate to restrict licence text to higher-level processes supported by detailed guidance and any detailed lifecycle control points should be addressed in the DPC Allowed Revenue Direction. We envisage a similar approach to the process for periodic reviews, where licence text is kept to a minimum but supported by very detailed methodologies and/or guidance.

Adopting this approach would permit greater flexibility whilst removing a number of concerns we currently have regarding tensions between the proposed licence text and the commercial nature of a CAP Agreement. We agree that certainty is required, but that the licence is not the appropriate vehicle for it.

We lay out our detailed thoughts throughout the remainder of this appendix.

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?

In our response to the 'Consultation on proposed PR19 uncertainty mechanisms in respect of Direct Procurement for Customers' dated 15 November, we set out our views on the application of underperformance and outperformance Outcome Delivery Incentives (ODIs) for DPC projects. For ease, we have included our response to that consultation for the questions relating specifically to ODIs in appendix 2.

As set out in our previous response, we support the use of incentives within the regulatory framework but outlined some practical considerations in applying incentives which we believe are still relevant to these questions.

Balance of incentives

As previously outlined, we believe that if the balance of incentives is wrong, this may discourage DPC and the right outcome for customers may not be achieved. We consider there to be an excessive number of control points within the proposed processes and despite our strong support for ODIs overall, we could not support any ODIs as the procedural incentives are already unbalanced under these proposals. The introduction of ODIs would only create a greater imbalance and we suggest this would not drive the right outcomes for customers. One of the aims of DPC is to lower costs, however, uncertainty around the control points and lack of clarity as to whether Ofwat consent would be obtained at different stages of the DPC Agreement would drive additional costs into to the process as a CAP and its third party funders, would look to mitigate risk, resulting in a project that may not be as low-cost as it could have been otherwise.

Additionally, the imbalance of incentives would cause companies to avoid DPC when it would be in the customers' best interests e.g. a company may propose further maintenance schemes when asset replacement would be lower in whole life cost terms and therefore be in the long-term interests of customers.

Flexibility of design

We stated in our previous response that incentives should not overlap with existing incentives such as market incentives (i.e. competitive procurement). We believe that companies are already incentivised through the market incentives to achieve the best outcome for customers and the timing of revenues will also ensure effective management of the CAP Agreement since the revenue entitlement starts after construction is complete.

Overall, we believe that companies are already sufficiently incentivised to manage the CAP Agreement and to act in customers' best interests.

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?

To give maximum certainty to the Appointee, the CAP and third-party funders, our strong preference would be for the DPC Allowed Revenue Direction to set out those lifecycle control points where Ofwat consent is required in advance, rather than employing materiality triggers. In the wider experience of Pennon Group, which acts as contractor in a number of waste PFI arrangements through its subsidiary Viridor, PFI arrangements do not provide an unfettered right for a third-party regulator to veto variations. Any such condition could render a DPC project less attractive to potential CAPs and funders.

We would also suggest that it is inappropriate to focus licence text on 'amendments' to the CAP Agreement because this term is too simplistic doesn't align well with the lifecycle update mechanisms of a long contract. Given its likely duration, a CAP Agreement would by necessity and practice, include the usual commercial and technical review points and updates (such as submission and approval of updated operating plans and re-baselining for efficiency fees). Because these would be provided within the mechanisms of the CAP Agreement, they would not constitute amendments to the CAP Agreement itself. If Ofwat wanted to exercise control over these items then the proposed drafting, using a simplistic 'amendments' control point, would not allow for this. Conversely, other variations to the CAP Agreement might constitute routine updates to terminology or statutory references that the Appointee and CAP should be able to sensibly agree without Ofwat approval. This again supports our view that lifecycle control points should be set out in the DPC Allowed Revenue Direction, not in the licence conditions.

Nevertheless, we recognise that Ofwat may still wish to carry out some form of assurance, in which case materiality thresholds could be appropriate to, for example, consider the impact of unforeseen CAP variations on customers' bills. However, as the simplified example in Appendix 3 illustrates, the combination of differing values of individual companies' bills, and DPC Allowed Revenue recovery timescales and annual recoverable amounts, would require variation threshold levels to be set on a case by case basis. That said, adopting this approach would ensure oversight of the impact on customers and inform decisions to vary the terms of the DPC Allowed Revenue Direction.

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 DPC framework is not yet sufficiently developed for us to comment definitively on whether we believe that the balance of risk is appropriate. We have therefore considered what we believe is a reasonable expectation, and where we believe undertaking DPC may change the level of risk a company might incur. We have identified three areas:

Financial

The regulatory risk and return framework is designed to drive better business planning and incentivise companies to deliver better service at an efficient cost. The risk companies incur is appropriately balanced with financial returns and it is therefore arguable that if undertaking a DPC project results in no additional return for the company then this level of risk should be maintained.

Project management

Water companies are experienced in managing large capital projects and are therefore familiar with the associated risks within the current regulatory framework. We agree that under DPC it would be appropriate for companies to be held accountable for risks under management control and normal project-risk.

It is also appropriate for that accountability to include running an efficient procurement process and managing the CAP effectively over the life of the contract while delivering best value for customers.

However, we are concerned that the number and extent of the proposed interventions within the process will risk compromising an Appointee's ability to manage the project effectively. We discuss these concerns in our responses to question 5.

Statutory and Licence obligations

Companies must be held accountable for meeting statutory and licence obligations. However, while recognising that this is draft licence wording only, we are very concerned at a number of proposals.

Legal obligations

Firstly, we are very concerned by the current proposed wording of licence condition U4.2 which aims to require Appointees not to rely on defences that may be available to them when subject to enforcement action brought by other regulators under entirely separate legal regimes. An Appointee's licence conditions should always align with the other legal requirements to which the Appointee is subject. We also believe that further thought is needed on how the DPC arrangement and CAP fits with other regulatory regimes. By way of example, the environmental permitting regime (noting that much of the Water Resources Act 1991 is now captured through the Environmental Permitting (England and Wales) Regulations 2010) determines who can be the operator of a permitted facility or activity based on the concept of 'sufficient control'. This cannot be dictated or overridden through an Appointee's licence conditions under the Water Industry Act 1991. Accordingly, Ofwat cannot impose whether the CAP or Appointee is the operator. The feasibility of the DPC proposals must be fully explored with other regulators and the implications understood before the implementation of the new framework.

Finally, if Ofwat does not wish any regulatory responsibility to be passed to the CAP this could significantly impact the activities that a CAP is able to carry out. For example, in the wider experience of the Pennon Group through its subsidiary Viridor, it is generally not possible for an organisation to hold the relevant environmental permit when a sub-contractor is operating a site on its behalf. Instead, the permit will be held by the sub-contractor as the organisation responsible for operating the site. Therefore if, as determined by the relevant regimes, the Appointee is required to retain control, the CAP Agreement will need to be scoped accordingly.

Other regulators

Many DPC projects are directly linked to both Drinking Water or environmental improvements with clear compliance dates. Delivery is driven to achieve compliance and to protect customers and the environment in line with Defra, Drinking Water Inspectorate and Environment Agency policies.

The proposed DPC process is extensive and we envisage that any DPC project would require 3-5 years of delivery through stages 1-5 before a contract award can be delivered and construction can begin. We consider that the proposed process will not be agile enough to respond to the needs of the WINEP and DWI programmes to deliver outcomes by set compliance dates. Ofwat recognised the lead time procurement of a third party using DPC could involve in its document 'PR19 draft determinations: Havant Thicket policy issues appendix', and we strongly support its decision to agree with Portsmouth Water's view and not adopt DPC for that reason. In this context the DPC process should consider whether the appointment of a CAP will expose a company to additional risk that it would not have otherwise incurred.

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

We consider the proposed number of control and information points to be excessively burdensome.

While we note that DPC has adopted principles from other processes including those used by HM Treasury, such controls are appropriate for public investment in infrastructure delivered under a more complex model i.e. the direct control of a government agency, for example the Environment Agency or Highways Agency etc, financed by Treasury, with overall control and financing by Government. Under this model it is appropriate that governance and decision points will be tightly controlled. However, given that DPC does not reflect this model and accountability remains with the Appointee, the proposed control and decision points are in our view inappropriate. Additionally, being activity focussed, the framework is also inconsistent with the outcome approach of modern regulation.

In our view the process presented in the draft briefing note risks placing overall accountability for the project delivery with Ofwat rather than with the Appointee, and this does not appear to be an appropriate balance. We consider that the number of control points should be reduced to two:

1) Between stages 3 and 4 - Outline Business Case
2) Between stages 5 and 6 - Full Business Case.

As we have stated in our response to question 4, many DPC projects are directly linked to both Drinking Water or Environmental improvements with clear compliance dates. The complexity of the proposed DPC process would require 3-5 years of delivery through stages 1-5 before a contract award can be delivered and construction can begin. In our view this process is too cumbersome to respond to the needs of, for example WINEP and DWI programmes.

There is also very limited information in the documents on how Ofwat will deliver its role in the process, the KPIs it would respond within and the resources it would use to deliver these decisions. All of which would be required to give a CAP and stakeholders assurance. DPC projects will require significant, competent engineering and regulatory decisions, supported by substantial engineering resource to review and reach effective decisions, it is highly probable that this level of resource would be required from external consultants. To create certainly for all stakeholders Ofwat needs also to present its proposed business processes, resource levels and KPIs for delivery.

Further discussion around the two distinct levels of disputes/appeals process is also required. Firstly, Appointees need to understand from Ofwat how the proposed roles of both the Independent Technical Adviser and Ofwat as a third party to a construction contract, fit with a court appointed arbitrator following the contractual dispute process (as required by statute). That arbitrator is empowered to make key decisions including contract extensions, costs awards, variations and termination. It is not immediately obvious how Ofwat could refuse to consent to a termination ordered by the court at the request of the CAP.

Secondly, we are currently lacking a discussion in respect of an appeals process against Ofwat's own decisions in the DPC process. If Ofwat refuses to allow a DPC to be designated or makes a DPC Allowed Revenue Direction that the Appointee considers to be too low for example, then what redress is available to Appointees? Similarly, if Ofwat retains lifecycle control points and refuses to allow an 'amendment' to the CAP Agreement which the Appointee and the CAP think is necessary, what would happen? Would the Appointee be able to refer the decision to the CMA, in the same way as the final determination, or would the Appointee instead have to wait for the next price review so that it can deliver the project 'in house'? Clarity and certainty on this is essential.

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?

In our view the required steps and consequences for termination of the CAP Agreement should be pre-determined and set out in the DPC Allowed Revenue Direction. This is because they will need to be project specific and acceptable to the CAP, Appointee and any third-party funders as well as Ofwat.

We do not believe that the current proposed conditions U9.3 and 9.4 would be acceptable to Appointees, CAPs or to third party funders as they do not provide sufficient certainty on payments due on termination. They aim to give Ofwat flexibility to make decisions on revenue at the time of termination, which we consider would be commercially unacceptable as funders need certainty of the full life-cycle costs and returns for a CAP Agreement. The plan for what happens to the asset should be decided at the outset and we do not agree that Ofwat should be able to impose a different outcome later in the process.

In this regard, Ofwat should consider that it is normal in a PFI arrangement for the contractor to receive a termination payment (with a decreasing profile over the course of the contract term) regardless of the reasons for termination, in order that the contractor or third party funder is able to recoup the up-front investment costs that it would then not be able to recoup through the on-going management fee. The DPC Allowed Revenue Direction will need to allow for this lump-sum payment on termination to be made, with any necessary adjustments for further payments that will no longer be required. Payments on termination cannot be a wholly discretionary matter or the DPC project will not be commercially viable for external funders who make the up-front investment.

The proposed condition U9.5 is also problematic as it aims to give flexibility to Ofwat to determine what happens if a CAP Agreement is terminated. Again, the consequences on determination should be pre-determined for the particular project. It appears to us that the default position can only be de-designation of the DPC asset and an interim determination to allow for revenue through the normal route, as in practice it is very unlikely that the Appointee could quickly appoint a replacement CAP as it would need to go through a full planning and contract scoping process, a regulated procurement, and any assurance steps that Ofwat considered necessary.

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

As this consultation is a pre-consultation and in light of our views on the extent of the licence conditions that we consider to be necessary, we have kept our comments at a relatively high-level and have not provided full comments on the wording of the draft conditions.

Condition U

While we recognise that it will be necessary to have some licence conditions to allow for DPC designation and the particular funding route envisaged for DPC, we question whether the majority of proposed licence conditions in the new Condition U are necessary and represent useful regulatory tools.

Broadly, we suggest that proposed conditions 3, 4.2, 5, 6, 8, 9.1, 9.2, 10, 11 and 12 are unnecessary. In our view, the only new licence conditions required for DPC would be conditions to provide:

- a mechanism for the designation of a DPC project,
- a mechanism for the granting of DPC Allowed Revenue Direction (and necessary financing elements under condition B)
- a mechanism for de-designation of a project (with corresponding financial elements under condition B).

Our reasoning is set out below.

Level of complexity and control

Under the Water Industry Act 1991, the licence conditions are intended to be conditions to the appointment itself and should, accordingly, be of general application and at a high level, supported by more detailed guidance or rules issued by Ofwat. They were not intended to be tools to control individual projects and we do not consider that they would be well-suited to this use. Ofwat has a number of different tools that it can use, and licence conditions should not be the default option. We suggest that the proposed licence conditions would not be sufficiently flexible and detailed to fit the requirements for each DPC project and that, in reality, Ofwat and the Appointee would not refer to the proposed licence conditions and would instead follow detailed Ofwat approvals and guidance contained in other documents.

Appointees will not want to appoint a CAP without having obtained a DPC Allowed Revenue Direction meaning Ofwat will already have a high degree of control over a DPC project. We would envisage that Ofwat could specify at the point of designation any required control points relating to the DPC planning and procurement phases. Any further control points required for the management of the CAP agreement can be set out in the DPC Allowed Revenue Direction itself.

Any requirements as to documentation or assurance standards that Ofwat expects Appointees to meet can be set out in detailed guidance or in the above designation and DPC Allowed Revenue Direction. This would then more closely follow the approach for the five-yearly price review cycle, with very minimal licence conditions and very detailed guidance.

Provision of information

In our view, any information that Ofwat wishes to request on an ad hoc basis can already be obtained through existing Licence Condition M, while any information that Ofwat knows it will want the Appointee to provide can be set out in the DPC designation or DPC Allowed Revenue Direction, depending on the phase of the project.

Tensions with existing requirements

Some of the proposed conditions appear at odds with existing licence conditions and the regulatory approach taken to other business planning and assurance activities. For example, proposed conditions U5.2 and U6.3 would create a licence condition obligation to use 'all reasonable endeavours' to achieve 'best value for customers'. There is no equivalent licence condition in relation to the five-yearly price review cycle, so it is not obvious why such a licence condition is needed for a DPC project.

Achieving 'best value for customers' is certainly part of the five-yearly price review cycle and an important concept in the Regulatory Accounting Guidelines. 'All reasonable endeavours' and 'best value for customers' are broad concepts and we would suggest that the proposed licence conditions would lack certainty and would not serve any real regulatory purpose. Their inclusion in the licence will not provide the clarity and certainty that the licence changes are aiming to create, for example, would Ofwat ever take enforcement action for a breach and if so, how would Ofwat demonstrate that such a condition had been breached?

We would also suggest that there is duplication with the Utilities Contracts Regulations 2016 which require the Appointee to select the most economically advantageous tender. On a related point, U5.5 is unnecessary and unacceptable because it represents double-regulation as Appointees are already legally required to comply with procurement law.

Another example of a proposed condition that appears at odds with the existing licence conditions and the regulatory approach taken to other business planning and assurance activities is the requirement for an Independent Technical Adviser. This is not a licence condition requirement for the five-yearly price review cycle so it is not apparent why it is needed for DPC. It is also at odds with the statement on page 22 of the Briefing Note that the '*level of assurance will be equivalent to that required as part of the Appointee's PR19 Business Plan submission*'. For large projects and significant documents like charging arrangements and charging schemes, Appointees already carry out three-stage assurance: multi-level internal assurance, external assurance and board assurance, before any submission is made to Ofwat. If there is a requirement for another layer of external assurance before submission to Ofwat then each DPC submission will potentially go through five layers of assurance. We question whether this duplication would deliver benefits and provide value for money for customers. It is also not clear how the fees of the mandatory Independent Technical Adviser will be met.

As stated above in response to consultation question 4, we also have particular concerns about U4.2.

Appeals process

As stated above, in the response to question 5, there needs to be an appeals process if the appointee does not agree with the decision of Ofwat in respect of the DPC.

Condition B

The proposed modifications to Condition B align with our view that licence text should be high-level, and we are satisfied that they facilitate the objectives bulleted above, and that they are clear in their intention.

We welcome Ofwat's recognition that the interim determination process as currently applied is not appropriate for some DPC scenarios and support the introduction of a specific interim determination process. We look forward to further engagement to develop an appropriate mechanism.

Collecting DPC Allowed Revenue and tariff setting

In response to Ofwat's request for comments surrounding timing challenges in respect of collecting the DPC Allowed Revenue and tariff setting, we have considered the key areas that we believe will require discussion and certainty ahead of a tariff setting process in any charging year.

As we have already stated, to provide maximum certainty for all parties our strong preference would be for the DPC Allowed Revenue Direction to be set out in advance. Whilst accepting that Appointee's cannot be 'risk neutral' they still need a clear indication of what Ofwat will allow Appointees to recover from customers in the Allowed Revenue Direction both in general terms and in project specific terms. This ought to be clear prior to contract execution at the latest.

Separately, but related Appointees (and their investors) would need to understand the position if a court appointed arbitrator agrees with an application by a CAP and terminates the DPC agreement and directs the Appointee to make a lump sum payment in respect of build costs. Will these be recoverable in part or in full by customers?

The Direction will lay out, under Conditions U7.2.1 and U7.2.2, the period of time for which the Direction will subsist and the commencement date for the collection of the relevant DPC Allowed Revenue. Condition B1.7 will permit the Appointee to collect DPC Allowed Revenue for the relevant charging year. However, what is not clear is at what point relevant charging year revenues will be set. To allow Appointees to comply with charging rules and effectively engage with their customers clarity on this will be important. For example:

- Annex A2 of the Wholesale Charging Rules requires companies considering making any significant changes to primary wholesale charges to publish information informing stakeholders of the scope of the proposed changes six months before publishing final wholesale charges. Presuming that Year 1 commencement of the DPC Allowed Revenue Direction could result in significant changes to bills DPC Allowed Revenue for that charging year should be determined in good time to allow companies to comply with this requirement.

- Where DPC Allowed Revenue is set such that changes are not considered to be significant enough to require compliance with Wholesale Charging Rules Annex A2, DPC Allowed Revenue for any given charging year should be determined early enough to ensure that the company can reflect the impact in its indicative wholesale tariffs for the year in which recovery will commence.

- Alongside these requirements the Appointee will need to engage with customers on annual bill impacts and comply with requirements within the Wholesale Charging Rules and Charges Scheme Rules to conduct bill impact assessments and develop handling strategies. To allow for early planning and effective engagement we would expect discussions between the Appointee and Ofwat on bill impacts over the duration of the DPC Allowed Revenue Direction to take place before DPC Allowed Revenue is determined, in order that an agreed understanding can be established. Notwithstanding changes to the CAP Agreement affecting revenues may be required, this will provide a ‘no surprises’ certainty for the Appointee ahead of undertaking these activities.

- Discussion papers circulated in November 2019 raised potential issues relating to timing of revenue collection, bad debt and forecasting accuracy and we note that the content of Condition U7.2 will facilitate the DPC Allowed Revenue Direction to address these issues. We support this approach which aligns with our view (above) that licence conditions should be of general application supported by more detailed guidance and rules.

APPENDIX 2

Previous response to ODI question in Ofwat's 'Consultation on proposed PR19 uncertainty mechanisms in respect of Direct Procurement for Customers'

3. Do you agree with underperformance incentives to ensure efficient delivery of CAP projects? What level of underperformance payment would be appropriate and what other methods could Ofwat consider to ensure customers are protected from delays?

and

4. Do you agree with companies being able to earn outperformance payments for successful procurement of a CAP? What level of payment would be appropriate for successful delivery?

We have combined our responses to Questions 3 and 4 into a single response around the applicability of incentives regarding DPC, as we have a similar response to both questions.

We support the use of incentives within the regulatory framework. Our customers have consistently told us that they wish for us to have strong incentives to deliver a value for money, efficient service. Our response to Q3 and Q4 is therefore focused on practical considerations in applying incentives.

We have grouped our response into three main points regarding the practical application of under and outperformance payments relating to DPC:

- Balancing incentives – i.e. achieving the right balance between customers and the company/contractor, ensuring incentives balance and reflect what is important to customers, and ensuring there is no disincentive to DPC relative to in-house delivery

- Flexibility of design – i.e. ensuring the design of the incentive avoids complex or overly prescriptive incentives which in turn hinders flexibility

- Scale of any payments – i.e. ensuing the right levels of payments are made to ensure fairness and avoid disincentives to DPC.

We discuss each of these in turn.

Balance of incentives

We are fully aware from our discussions and engagement with customers that they wish to see efficient bills, high service levels, supported by incentives that are fair and balanced, and drive a value for money service.

A common theme in all discussions with customers is that efficient bills is a very important priority. We believe incentives should drive efficient bills now and in the future. Hence, we consider it appropriate to share efficiency savings – this has been the cornerstone of our Watershare mechanism since PR14. Conversely it cannot be right that contractors retain all efficiency savings; and in some cases, it may be appropriate for customers to share overspend as well as savings. Incentives should drive whole life efficiencies – i.e. discouraging lower costs upfront and higher operating costs by considering a lifecycle cost assessment.

Service quality is also important to customers. Customers have told us that they believe incentives should be value based (i.e. reflecting the benefits or costs that they experience). Blanket penalty rates such as 3%-15% are unlikely to reflect customer impacts and we do not consider them to be appropriate. Indeed, the reason our customers are so supportive of our current ODI package is because they are value-based.

We note that the PR19 ODIs for scheme delivery as requested by Ofwat (for South West Water and other water companies) have been designed to discourage delays. We consider incentives around timeliness to be the least in line with our customer views. Short delays or early delivery is only important to customers if they experience a service impact as a result. This is rarely the case with DPC type schemes, as they are timed to be implemented prior to customer impacts being experienced or are implemented alongside other safeguards to protect customers until after the DPC is complete. Moreover, we believe the timing of revenues already drives an incentive on early delivery, since the revenue entitlement will start after the construction is complete.

We therefore believe any incentives should get the balance right by focusing primarily on efficiency and service quality and be tolerant of short variances around the delivery date.

If the balance of incentives is wrong, this may discourage DPC (e.g. in favour of in-house delivery) and the right outcome for customers may not be achieved.

Flexibility of design

The design of any incentive needs to ensure there are no overlaps with existing incentives such as regulatory incentives (under and outperformance payments) with market incentives (competitive procurement); and specific DPC incentives with existing service outcome delivery incentives (e.g. water quality, supply interruptions etc.).

There is also a need to recognise there are factors outside companies control in the design of any incentives. Our customers have told us that they do not agree with companies benefiting or being penalised for factors outside of the company's control.

Therefore, customers would support the use of mechanisms such as deadbands, for example where there are incentives that aim to prevent short project delays. The application of underperformance payments detailed in the consultation would appear to be applicable on the delivery of a DPC project, however, if when the contract is awarded, the competitively appointed provider becomes responsible for delivery of the project, then it would not be appropriate to penalise companies for delays that are not within the companies' control.

We support the development of flexible incentives that allow issues such as to what extent delays were outside of a company's control to be considered. We have found independent panels to be useful, such as our WaterShare Panel, which has been successful in ensuring fair assessments are undertaken of the company's performance. Independent panels can consider and balance a range of factors including the reasons for and extent of any cost differences, service impacts and delays in a way that a rigid incentive may not. Moreover, our customers have said they trust independent panels to act fairly on their behalf.

Scale of any payments

It is important to get the scale of any payments right – whether underperformance or outperformance payments.

Customers have indicated they want under and outperformance payments to be value-based i.e. compensatory and linked to the service impacts they receive/experience. The consultation details an underperformance rate set between 3% and 15% but does not provide any further details on how this rate would be determined. Additionally, the consultation does not provide details on how the incentive would apply if a company was unable to procure a CAP in a way that delivers greater value for money for customers when compared to an in-house delivery process.

We believe that customers will struggle with the concept of outperformance payments (and possibly underperformance payments) for simply reaching a milestone or procuring an asset. The application of an outperformance payment which results in higher customer bills without any specific and direct benefits to customers, would appear to be at odds with one of the principles of DPC delivering projects at lower cost to customers.

In conclusion, we do agree in principle with underperformance and outperformance-based incentives for DPC. The application in practice needs to ensure fair and efficient bills now and in the future, drive service quality, and be supported by fair and balanced incentives.

APPENDIX 3

Materiality thresholds: a simplified example

Further to our response to question 3, materiality thresholds could be appropriate to consider the impact of unforeseen CAP variations on customers' bills and inform decisions on varying the terms of DPC Allowed Revenue.

However, as shown below, assessing materiality in this way could result in lower CAP variation thresholds for companies with lower than average bills or fewer customers.

To mitigate the impact on water-only companies, 'Company B (adjusted)' suggests that the assessment could include the relevant wastewater provider's bills.

			Company A	**Company B**	**Company B (adjusted)**
	Company type		Water and sewerage	Water only	Water only
A	Average bill	£	400	150	350
B	Number of customers	Nbr	1,000,000	400,000	400,000
C	Total cost of project	£	100,000,000	100,000,000	100,000,000
D	Initial DPC allowed revenue pa	£	10,000,000	10,000,000	10,000,000
E	Number of years to recover	Nbr	10	10	10
F	Initial cost per customer pa = D / B	£	10	25	25
G	Annual average bill impact = F / A	%	2.5	16.7	7.1
H	DPC variation	£	5,000,000	5,000,000	5,000,000
I	Adjusted cost per customer pa = ((C + H)/ E) / B	£	10.5	26.3	26.3
H	Revised annual average bill impact = I / A	%	2.6	17.5	7.5
	% bill impact of DPC variation = H - G	%	0.1	0.8	0.4