

# DPC Licence Modifications SRN consultation response

21 April 2020

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# 1 Consultation questions

Southern Water is working on three projects that are potential DPC candidates and are due to be delivered in AMP7 – desalination, water recycling and the extension of the water grid in Hampshire. The first two projects are alternatives to each other, and are part of the strategic regional water resource solution process now managed by RAPID.

We therefore welcome Ofwat’s issuance of the proposed Licence condition and associated guidance early in AMP7. This will help to provide necessary certainty for all those companies that are progressing with DPC schemes. It is timely to consult now, when the DPC projects are still at a relatively early stage of development.

We support the need for Licence changes to enable Direct Procurement for customers. We therefore intend this response to be interpreted as constructive, and we have sought to identify areas where relatively modest changes that could help to meet the needs of all parties.

The response is written “by exception”, so where we do not specifically comment we agree.

## Q1: Do you agree with the key aspects of the proposed licence amendments?

We agree that licence modifications are necessary to implement DPC and the appropriate changes to charges to customers and payments to CAPs, but we disagree with some of the proposed licence amendments. It is helpful to have an informal licence consultation with proposed wording.

### a) We do not agree in all cases with Ofwat’s stated need for clauses in the new condition.

- The new "best value" test is difficult to reconcile with other Appointee obligations (see 2.5 and 2.6 below).
- The obligation to comply with the CAP Agreement is at odds with the usual approach to the Appointee’s arms length commercial agreements (i.e. the Appointee does not in its licence agree to comply with all its commercial agreements). Such an obligation has the potential to result in the taking of enforcement action by Ofwat in respect of a contravention of obligations which are written for the benefit of investors / funders, which doesn't make sense and creates ambiguity as to its intended impact (see 2.5).

### b) We do not agree in all cases with the way the wording gives effect to Ofwat’s stated need, while agreeing with the need that Ofwat has set out.

- Restrictions on Variations to the CAP Agreement should be linked to impacts on customers and a materiality test (see 2.6).
- There is a contradiction between control exercised by Ofwat, which restricts the Appointee’s ability to manage its risk and the consequences for the Appointee (in terms of potential enforcement action) for actions of the CAP (see 2.6).
- The DPC Allowed Revenue Direction should link to the CAP Agreement payments plus any allowable cost of the Appointee (see 2.7).
- The restrictions on change of the Ultimate Controller of the CAP are too extensive (see 2.8).
- The Appointee’s ability to exercise rights of termination are too restrictive and the CAP Agreement financial consequences need to be recognised (see 2.9).

### c) We consider that in some cases the wording is ambiguous and would benefit from clarification.

- The information and ITA provisions should be more specific in their application / limits and cost consequences (see 2.11 and 2.12).

- It is unclear how it is proposed that the ITA is funded.

**d) We consider additional provisions are required.**

- A mechanism is needed for bringing the project back within regulated business if the DPC procurement does not ultimately result in the project being procured via DPC (see 2.9).
- There should be a set of rules or principles which Ofwat will abide by in giving the approvals. This would help to make the process more transparent to all parties.
- There should be a requirement for timeliness of Ofwat approvals. The licence addresses what happens if Ofwat fails to conduct a price review so should have a similar backstop if it fails to give the necessary approvals in an appropriate time frame (see 2.7).

We also note that the provisions in this clause will be of keen interest to CAP investors / funders. Extensive Ofwat discretion after financial close will be unattractive to bidders, and will be reflected either in the appetite of investors to bid, or the price bid, or both. We have highlighted a number of examples where we consider the discretion Ofwat is reserving is excessive.

**Q2: 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?**

Costs up to and including the letting of the CAP Agreement should be part of normal totex and should be included on the RCV or the PAYG component of revenue. Costs of managing the contract in life (as opposed to the CAP payment) should also be part of totex and included in the PAYG component of revenue. This will provide remuneration for the risks appointee is running in appointment of the CAP and management of the CAP Agreement.

Appointees should have an incentive to run an effective DPC process and to ensure effective management of the CAP Agreement. Ideally this would obviate the need for the more directive approach reflected in clauses like "best value one". This incentive would have most power if it operated like the pain / gain share mechanism for totex, rather than the proposed Outcome Delivery Incentive ("ODI").

Similarly, if the expectation is that the Appointee bears some risk in the process – as opposed to acting as the vehicle for procurement of these services – then that needs to be remunerated in the DPC Allowed Revenue Direction.

**Q3: Should a materiality threshold be applied to consent to vary the CAP Agreement? If so, what should the level of materiality applied be, and how should this be worded for the new licence condition? –**

We suggest a test be applied which places restrictions on Variations where it impacts on customers and is subject to a materiality threshold.

**Q4: 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?**

Essentially the risk for the Appointee should be to properly let and manage the CAP Agreement but not to take the delivery risk assumed by the CAP.

We think a pain / gain sharing incentive rather than an ODI would appropriately incentivise the Appointee. The costs of running the DPC process and of managing the CAP Agreement in-life should be a normal part of totex and recovered via the RCV and PAYG mechanisms respectively.

**Q5: Please provide your comments on the processes outlined in the DPC briefing note**

See our comments in section 3.

**Q6: 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 overriding principles at that time are that the Appointee has to still meet its CAP Agreement obligations and that customers still need the asset. Hence that is what the provisions need to address.

We consider that additional provisions for termination are necessary to cover all the possible circumstances in which a termination could occur (see 2.9).

**Q7: Please provide your comments on the proposed licence amendments set out in Appendix 1 and their wording.**

We have not set out detailed comments on the wording of the licence amendments but are happy to work with Ofwat on how to word any of the remedies for our comments, and more generally on the licence wording throughout the condition, if that would be helpful to Ofwat.

## 2 Comments on specific clauses

### 2.1 Interpretation

We have no substantive comments. There appears to be confusion between the terms "CAP Agreement" and "Approved CAP Agreement". "Ultimate Controller of the CAP" should be a more objective definition which clearly identifies the ultimate controlling company.

### 2.2 Designation of a DPC delivered project

We have no comments, although we note that paragraph 2.2 does not reflect the more iterative process of identification and agreement of potential DPC Delivered Projects.

### 2.3 Procuring of a DC delivered project

We have no comments.

### 2.4 Appointee's responsibilities

The proposed Conditions U4.1 and U4.2 (excluding the Appointee's ability to legitimately "reduce, restrict, limit or diminish [its] responsibilities, obligations or liabilities ...as a relevant undertaker in respect of the DPC Delivered Project...") are unduly onerous for a number of reasons.

We accept that the obligations of the Appointee will remain with the Appointee for any project that uses the DPC route, but there are differences in the circumstances of a DPC Delivered Project and those referred to in the Licences of Anglian and Dŵr Cymru.

Condition F1.4(a) and (b) of Anglian Water's Licence is predicated specifically on Anglian (i) choosing to outsource services, and (ii) "retaining full control of its assets and its ability at all times to discharge its functions...". The proposed provisions relating to the designation of a DPC Delivered Project and appointment and continued management of a CAP Agreement are entirely different, as Ofwat will have required a project to use the DPC route.

Similarly F4.2 is derived from Dŵr Cymru's procurement condition, but its application in that case is one where Ofwat do not have such extensive powers over the terms of the contract. In a situation where we cannot modify or terminate the contract without Ofwat approval it is not appropriate that we have an absolute liability for acts carried out under that CAP Agreement by the CAP.

An Appointee, having taken all reasonable steps and exercised all due and proper diligence, such as that in section 70(3)(b) of the Water Industry Act 1991, should be able to rely on having done so as a defence against prosecutions. We believe Ofgem has not applied similar restriction to electricity or gas companies. There have been a number of recent instances (e.g. Carillion) where a well-established entity in a similar role to that of a CAP have collapsed, demonstrating that contracts are no guarantee against failure.

The important point is that an Appointee should exercise due diligence and care in letting and managing the contract, but its failure to do so should be what creates a liability, not circumstances that might be beyond its control.

### Remedy:

We have set out our thoughts above. In addition, Ofwat should allow the Appointee to unilaterally amend or to terminate the CAP Agreement, where not to do so would result in the Appointee breaching its statutory obligations. Alternatively it should remove these absolute liability clauses.

## 2.5 DPC procurement process

“Best value for customers” is a new concept in water regulation. Its nature and the wording of the proposed conditions that refer to it are very different to the wording of obligations attaching to Appointees and the wording of Ofwat’s duties.

For example, Southern Water has obligations to maintain an “efficient and economical water supply:

*“37 General duty to maintain water supply system etc.*

*It shall be the duty of every water undertaker to develop and maintain an **efficient and economical** system of water supply within its area and to ensure that all such arrangements have been made”<sup>1</sup>.*

And for waste supply the obligations are to ensure that our area is “effectually drained”:

*94 General duty to provide sewerage system*

*(1) It shall be the duty of every sewerage undertaker—*

*(a) to provide, improve and extend such a system of public sewers (whether inside its area or elsewhere) and so to cleanse and maintain those sewers [F1and any lateral drains which belong to or vest in the undertaker] as to ensure that **that area is and continues to be effectually drained**; and*

*(b) to make provision for the emptying of those sewers and such further provision (whether inside its area or elsewhere) as is necessary from time to time for **effectually dealing**, by means of sewage disposal works or otherwise, **with the contents of those sewers**.<sup>2</sup>*

Ofwat has duties to “...further the consumer objective...wherever appropriate by promoting effective competition.. ” and to “...promote economy and efficiency on the part of companies holding an appointment...”

It is difficult to reconcile the obligations of the Appointee and duties of Ofwat with the concept of best value for customers. We understand that this is the prime purpose of the DPC process, but the proposed condition

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<sup>1</sup> Water Industry Act 1991, emphasis added

<sup>2</sup> Water Industry Act 1991, emphasis added

is subject to different interpretations by different parties so more clarity on how it would be applied is needed. In addition, we consider it should be applied separately to the pre-commencement phase and in-life phase of the DPC Delivered Project.

The concept of “best value” is absolute and will be difficult if not impossible for either Ofwat or the Appointee to verify. We explain below in the proposed remedy that we consider that a successful letting of a CAP Agreement, with Ofwat having consented to each part of the process via the control points, should by definition, be deemed to represent best value, as it will be revealed to be better value for customers than the Appointee carrying out the project via a route other than a DPC Delivered Project. Were that not the case Ofwat would refuse consent.

Procurement law talks about the most economically advantageous tender, creating potential for conflict with wording around best value. The Utilities Contracts Regulations 2016 state:

*Section 82.—(1) Utilities shall base the award of contracts on the most economically advantageous tender assessed from the point of view of the utility.*

*(2) That tender shall be identified on the basis of the price or cost, using a cost-effectiveness approach, such as life-cycle costing in accordance with regulation 83, and may include the best price-quality ratio, which shall be assessed on the basis of criteria linked to the subject-matter of the contract in question, such as any one or more of the following—*

- (a) qualitative aspects,*
- (b) environmental aspects, and*
- (c) social aspects..*

*(3) Such criteria may comprise, for example:—*

*(a) quality, including technical merit, aesthetic and functional characteristics, accessibility, design for all users, social, environmental and innovative characteristics and trading and its conditions;*

*(b) organisation, qualification and experience of staff assigned to performing the contract, where the quality of the staff assigned can have a significant impact on the level of performance of the contract; or*

*(c) after-sales service and technical assistance, delivery conditions such as delivery date, delivery process and delivery period or period of completion, commitments with regard to parts and security of supply.*

The proposed condition U5.2 requires an Appointee to “use all reasonable endeavours to ensure that each DPC Procurement Process ...achieves best value for customers”, whilst proposed Condition U5.5 requires a DPC Procurement Process to be undertaken “in accordance with the Utilities Contracts Regulations 2016 ...or, if applicable, the Concession Contracts Regulations 2016”.

The proposed condition U6.3 also requires an Appointee “...at all times [to] use all reasonable endeavours to ensure it achieves best value for customers” in acting, omitting to act, exercising a contractual right, etc. with regard to an Approved CAP Agreement.

The above requirements are potentially wholly incompatible as the fundamental objective of the two public procurement regulations referred to is not “best value”, but rather (and almost wholly) the opening up of markets to trade. This incompatibility has been a struggle for English local authorities for many years as they also have a duty of “best value”.

The original duties were set out in s.3 Local Government Act 1999 – i.e. the duty "to make arrangements to secure continuous improvement in the way in which its functions are exercised, having regard to a combination of economy, efficiency and effectiveness" and to consult certain groups of persons "for the purpose of deciding how to fulfil the duty".

When best value was introduced it offered a "refreshingly simple way forward" to local authorities after years of compulsory competitive tendering (CCT) with its inherent complexity, but soon became (and remains) mired in complexity of its own.

That incompatibility and the true extent of the "best value" duty has never been properly resolved and continues to be the subject of numerous government guidance and papers on how best to reconcile it all. As an example, there is an authoritative book by Professor Arrowsmith of the University of Nottingham, on public procurement, which deals with the concept of the most economically advantageous tender under EU procurement rules and the place of value for money within the rules.<sup>3</sup> She has also written an article specifically that addressed the incompatibility of value for money within the rules.<sup>4</sup>

Without detailed additional guidance from Ofwat (and even with such guidance) as to how achievement of the proposed duty to ensure best value is to be measured and policed, it is difficult to envisage how water companies will not inadvertently fall foul of this proposed licence condition and/or be in breach of their public procurement law obligations in circumstances where both obligations do not align.

## Remedy

The concept of acting in the best interest of customers (as opposed to providing best value) is more consistent with the obligations and duties described above. Alternatively, Ofwat should redefine "best value" so that it is applied in two distinct phases: pre-commencement and in life, and make clear that letting a CAP Agreement represents best value.

### Stage 1) Pre-commencement phase:

Ofwat makes it clear in the proposed licence conditions and the briefing note accompanying the consultation that Ofwat consent is required at multiple steps and that it reserves the right to approve:

- a) the designation of a DPC Delivered Project (U2.1.1);
- b) the commencement of the DPC Procurement Process (U5.1);
- c) the base line against which DPC tenders will be assessed, i.e. selection of the best tender that delivers better value than the Appointee could; (Control Point F, in the guidance, via the Full Business Case including that the proposed CAP Agreement "represents best value for customers");
- d) the form and content of the CAP Agreement (Control Point F);
- e) the appointment of the CAP itself (U6.1).

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<sup>3</sup> The Law of Public and Utilities procurement, Vols 1 & 2 , Arrowsmith, S., Sweet and Maxwell, 3rd ed., 2014, e.g. at para 2 – 25.

<sup>4</sup> See Arrowsmith, S. (2012). The Purpose of the EU Procurement Directives: Ends, Means and the Implications for National Regulatory Space for Commercial and Horizontal Procurement Policies. Cambridge Yearbook of European Legal Studies, 14, 1-47.  
doi:10.5235/152888712805580390

In addition, none of these stages may proceed without Ofwat's prior written consent.

Since a successful DPC tender would deliver the solution on better terms than by the Appointee (step c above) and given that it will be the result of a competitive tender (step c), the appointment of a CAP approved by Ofwat (step e) should *by definition* demonstrate that best value for customers has been met.

Ofwat should re-word U5.2 to acknowledge that best value is achieved by running and concluding a successful DPC Procurement Process that is in line with Ofwat's guidance that it may from time to time publish.

### Stage 2) in-life phase

The Appointee should continue to act in the best interests of customers by managing the CAP Agreement and agreeing any variations to it so that they are (within the scope of the CAP Agreement) in the best interest of customers.

Ofwat should re-word U6.2 to ensure that the Appointee manages the CAP Agreement in a way it believes (within the scope of the CAP Agreement) is best calculated to ensure best value for customers. This is similar wording to that in the Act applied to Ofwat about how it should apply its duties.<sup>5</sup>

## 2.6 CAP Agreement

Clause U6.2.1 requires the Appointee to comply with any CAP Agreement. Failure to do so would put the Appointee into licence breach. This obligation to comply with the CAP Agreement is at odds with the usual approach to the Appointee's arms-length commercial agreements (i.e. the Appointee does not in its licence agree to comply with all its commercial agreements). Such an obligation has the potential to result in the taking of enforcement action by Ofwat in respect of a contravention of obligations which are written for the benefit of investors/funders, which doesn't make sense and creates ambiguity as to its intended impact.

It is highly likely the CAP Agreement will contain provisions for dispute resolution, which could include, for example, delayed or partial payment to the CAP. In the circumstances where the Appointee is operating within the procedures contained in the CAP Agreement but a part or parts of the CAP Agreement are in dispute, there should be a provision for any clause of this nature not to be applied until the dispute has been resolved.

Clause U 6.3 again requires the Appointee to "use all reasonable endeavours to ensure it achieves best value for customers." We have explained under paragraph 2.5 above that it will be very difficult to objectively measure, or be certain that value is "best" rather than simply better than the Appointee could deliver.

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<sup>5</sup> "the Authority shall exercise and perform the powers and duties mentioned in subsection (1) above in the manner which he or it considers is best calculated— (a) to further the consumer objective... promote economy and efficiency... etc." WIA 1991, Part 1, Section 2.

Clause U6.4 prohibits of the assignment of an Approved CAP Agreement without consent. This should be subject to a reasonableness test in case assignment is, for example, required as part of the Appointee's financial structuring.

In paragraph U6.5, Ofwat's control over Variations should be subject to a test of whether the Variation will impact customers' interests and a materiality test.

## Remedy

We have described above how we believe “best value”, if it is to be applied, should be applied during the pre-commencement and in life phases of operation.

## Stage 2) in-life phase

Management of the CAP Agreement in-life should refer to its operation in accordance with the CAP Agreement, and that and variations to the CAP Agreement, including terms and conditions, price payable etc. are what is referred to. The Appointee will have little influence over the CAP and no control, so should exercise due care and diligence to ensure it acts in the way it considers best calculated to deliver best value for customers when managing the CAP Agreement within the scope of its terms.

Ofwat should introduce an appropriately specific materiality test for requiring its consent to vary the CAP Agreement, in addition to a condition that the variation should impact on customers' interests.

We would propose that the following would not be material:

- where any variations, irrespective of their monetary value, have been provided for in the initial procurement documents that were approved by Ofwat (including the Approved CAP Agreement);
- where a variation does not alter the services provided, and the payment for those services, but provides for better management of the CAP Agreement in the light of experience or events;
- variations shall be deemed immaterial until the cumulative impact of all variations is equal to or greater than +/- 5%<sup>6</sup> of the value of the original Approved CAP Agreement. The variation that reaches that point and all subsequent ones will require Ofwat consent.

## 2.7 Allowed revenue direction

The wording of clause 7 suggests a level of Ofwat discretion over which parts of the CAP Charges will be deemed to be allowable for the DPC Allowed Revenue Direction. For example:

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<sup>6</sup> Precedents for what is considered not material are contained in Regulation 88 (1) of the Utilities Contracts Regulations 2016 - Modification of contracts during their term. Similarly Regulation 88 (7) expands on what is material.

*7.1 Ofwat may....set out those CAP Charges (or categories of CAP Charges) approved by Ofwat and eligible for inclusion as part of the DPC Allowed Revenue Direction.*

*7.2.4...those categories of CAP Charges eligible for inclusion as part of the Appointee's DPC Allowed Revenue*

*7.2.7...those CAP Charges that will not be eligible to be included in the Appointee's DPC Allowed Revenue.*

There are similar issues with the wording of the changes to Condition B, which refers to the DPC Allowed Revenue Direction, not CAP Charges.

Once a CAP Agreement has been approved by Ofwat, all CAP Charges should be a pass through to the DPC Allowed Revenue Direction. Failure to do so would result in the exclusion of costs that should by definition be deemed to be efficient, or in this case best value for customers. See our comments on clauses 5 and 6 above.

This condition should also provide for the reimbursement of any costs incurred by the Appointee in running the process as well as the costs incurred from in-life management of the CAP Agreement. This implies the DPC Allowed Revenue Direction should at least cover the (legitimately incurred) CAP Costs but may be higher.

Setting a revenue direction and making any changes to it should be done in a timely manner, so changes can be reflected in the subsequent year's charges. Ofwat need to make their determination by no later than a certain date each year, to allow for charges to change on 1 April. For example, 15 November is used for setting in-period ODIs and this is written in to the licence in Anglian's case:

*"Any such determination by the Water Services Regulation Authority must be made no later than 15 November in the year before the first Charging Year for which any adjustment to a Price Control would take effect."*<sup>7</sup>

Clause 7.2.3 is unnecessary, since there will be no over/under collection of DPC Allowed Revenues from customers, if that is what the clause is referring to, as there need be no attribution of any overall revenue under- or over-recovery to the DPC Allowed Revenue Direction element of our revenues. It would be simpler to assume that any revenue under- or over-recovery is attributable solely to our main charges and therefore dealt with by the Revenue Forecasting Incentive. If this clause is meant to refer to under- or over-over-recovery of revenues from the CAP, it should say so and indicate in what circumstances such variations could occur and be considered legitimate.

There will be CAP Agreement variations that affect price, and clause 7.3 should refer to valid reasons why Ofwat should be able to change the DPC Allowed Revenue Direction from time to time to allow for these changes.

It would be helpful if Ofwat could share a draft pro forma of what a revenue direction would look like prior to modifying the Licences.

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<sup>7</sup> Anglian Licence, Condition B12.3

## Remedy

Clause 7 should make an explicit reference to the fact that, once agreed via a CAP Agreement, it is expected that payments to the CAP should become a pass through to total allowed revenue. The mechanism should also acknowledge payment to the Appointee for its own costs as described above. The clause should also refer to a need for Ofwat to make determinations in a timely way, or refer to a specific date each year by which determinations would be made, to allow for charges to change in the subsequent year.

## 2.8 Ultimate controller of the CAP

Clause 8.1 is overly restrictive. Restrictions on the Ultimate Controller of the CAP will be unattractive to investors/funders, particularly equity investors. A consortium of investors will have members who may want to exit at different times. It is common for shareholdings in CAPs to change hands, including changes in the "ultimate controller". There are secondary markets in both shareholdings in CAPs and in PFI / PPP deals after financial close.

Anything that is unduly restrictive will deter investors and / or be reflected in the price tendered. Either outcome would reduce the benefit of the DPC process to customers. We believe the market for such deals, including DPC, would probably accept specific provisions on restrictions on future ownership, but probably not an unfettered discretion by Ofwat to decide ex-post who could be an owner.

It would be better to have say that consent to a change in ultimate controller would be subject to a "fit and proper person" test.

This clause could also be divided into two phases: construction and in-life management. During construction, it would be expected that all original investors would be in place from financial closer to successful commissioning, and that Ofwat might have full discretion over agreeing to a change. After commissioning, long lock-ins (or things that will be perceived that way) will be unattractive to investors and a change should be possible having carried out appropriate tests.

For comparison, Southern Water's Condition P in respect of ultimate controllers does not refer to consent for a change. Instead it places obligations on the Appointee to secure undertakings from the ultimate controller that ensure that the Appointee's obligations are enabled and not compromised.

## Remedy

Ofwat should not have unlimited discretion to disallow changes in ultimate control of the CAP. It would be better to allow such changes subject to a "fit and proper person" test.

## 2.9 Termination of an Approved CAP agreement

There is a potential conflict between the ability to terminate in clause 9 and the obligations of the Appointee in clause 4. We would not have the right to terminate without Ofwat consent, but would have unfettered responsibility to fulfil our licence obligations, as clause 4 makes clear. It is possible that the performance of the CAP could have deteriorated to be unacceptable over a long period of time, or in such a way that the CAP has become an impediment to our ability to meet our obligations. Ofwat should be required to respond constructively and in a timely way if the Appointee can present sufficient evidence that termination is in customers' best interests.

Clause 9.1 prevents us from termination without Ofwat consent. This is too restrictive. Termination prior to financial close, particularly where a complaint DPC process has shown that a project should revert to in-house delivery, should have provisions in the Licence. In these circumstances there needs to be an uncertainty mechanism. Ofwat should consult and agree on the uncertainty mechanism prior to changing the Licence. We have a legally enforceable agreement with the EA to deliver specified infrastructure solutions by 2027, and will have to do so whether the DPC process successfully appoints a CAP or whether it does not. We are not able to wait until the next price review in order to provide appropriate evidence on the efficient cost of funding and managing construction ourselves.

Termination after financial close could be for a range of reasons. Typically there are three circumstances in comparable contracts:

- a) termination due to the Appointee's fault;
- b) termination due to the CAP's fault;
- c) no fault termination.

Investor appetite will be strongly influenced by clarity on the treatment of costs on termination, particularly repayment of outstanding debt, and the ability of the relevant parties to raise funds to pay them. Unless the Appointee has the ability to make necessary payments the DPC Delivered Project may not be financeable.

CAP investors will want to be assured there is a robust basis for payment of compensation in all termination scenarios, including CAP default.

The more discretion Ofwat retains over termination, the more likely it is that it will be reflected in investor appetite and / or the bid WACC in the tenders received.

## **Remedy**

There should be a mechanism where Ofwat can review the mechanism for payments on termination in all circumstances and consider whether they are reasonable. This should be in the context of what is in the CAP Agreement. Terms that are within the Approved CAP Agreement should not be subject to Ofwat's discretion while terms that were outside the CAP Agreement should be at Ofwat's later discretion. The more discretion it retains, the higher the likely impact on the bid WACC and investor appetite.

## **2.10 Associated companies**

We have no comments.

## **2.11 Information provision**

Ofwat already has extensive powers to require information provision under Condition M. In general the provisions in Clause 11 are similar. However 11.3 refers to Ofwat reasonably requiring a "certificate warranting the accuracy of the information provided in a form acceptable to Ofwat.

A certificate of warranty of accuracy is a very high bar, and not comparable to other reporting regimes. Elsewhere in the Licence, financial assurance and information provision by the Board/Appointee does not require a warranty. Accurate provision of information to Ofwat is rightly the accountability of Boards, but a warranty would create a liability to Ofwat, where the information concerned is likely to be provided in the main or even entirely by the CAP. It would be necessary for the Appointee to pass on this obligation to certify to the CAP in order to be able to discharge it, as the CAP would also have to provide a warranty to the

Appointee. The CAP (including its investors / funders) may not agree to this seemingly unfettered right. Seeking unattainable precision will only add to costs in the CAP tender.

## Remedy

Ofwat should not require the Appointee to provide a warranty of accuracy. Instead it should adopt wording consistent with the existing information provision Condition M in the Licence (or cross-refer to Condition M), making it clear that obligations to information provisions extend to any activities that are a DPC Delivered Project. It should also be acknowledged that the obligations may have to be reviewed if potential CAP investors/funders raise reasonable objections to them.

Condition M says:

- *M1 The Appointee must provide Ofwat with any Information that Ofwat may reasonably require for the purpose of carrying out its functions under any enactment.*
- *M2 The Appointee must provide any Information required by Ofwat by such time, and in such form and manner, as Ofwat may reasonably require.<sup>8</sup>*

Condition F, Regulatory Accounting Statements, contains provisions that refer to quality and assurance of information:

- *F1 Ofwat will publish the Regulatory Accounting Guidelines which will:*
  - *F1.1 relate to the accounting records that must be kept by the Appointee and the accounting Information that must be provided by it to Ofwat; and*
  - *F1.2 have the purpose of ensuring that:*
    - *F1.2.1 Ofwat may obtain all appropriate accounting Information in respect of the Appointed Business; and*
    - *F1.2.2 the financial affairs of the Appointed Business are recorded and reported on, and may be assessed, separately from any other business or activity of the Appointee.*
- *F2 The Regulatory Accounting Guidelines may in particular include provisions in relation to:*
  - *F2.1 the form and content of the accounting records that the Appointee is required to keep;*
  - *F2.2 the form and content of the accounting statements, and any associated reports or analyses, that the Appointee is required to prepare;*
  - *F2.3 any audit of the accounting records and statements that the Appointee is required to procure, the terms on which that audit is to be procured, and the basis on which the record and conclusions of that audit must be provided to Ofwat; and*
  - *F2.4 the time by which the Appointee is required to provide any accounting Information to Ofwat and any requirement on the Appointee to publish that Information.<sup>9</sup>*

A combination of the wording in these licences would enable Ofwat to ensure appropriate provision of information which has been subject to a form of external assurance that could be specified by and acceptable to Ofwat.

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<sup>8</sup> Southern Water Licence, Conditions M1 and M2.

<sup>9</sup> Southern Water Licence, Condition F extracts.

## 2.12 Independent technical assessor

The powers of the ITA are extensive, but they need to align with the provisions in the CAP Agreement. The CAP will be subject to obligations, e.g. keeping records, reporting, maintenance of assets, audit rights for the Appointee etc. but for ITA to be effective, its rights over the Appointee should be limited to and by what is reflected in the CAP Agreement.

Whilst the Appointee can seek rights over the CAP for information provision, investors / funders will resist intrusive clauses, or put the price up accordingly. As an example, Clause 12.5 refers to the ITA not doing anything materially disruptive to the operation of the DPC asset. We believe it is unlikely investors would accept any materiality clause here if there is any impact on revenue / return. They would expect to be compensated for any disruption of their ability to operate within the CAP Agreement.

It is unclear how it is proposed that the ITA is funded.

## 3 Comments on the guidance and control points

It is clear that the majority of the gates specified for the strategic solutions process managed by RAPID and the DPC control points do not align, and have the potential for considerable overlap. This means that we will have to generate and develop separate reports and submission and duplicate effort in very short spaces of time. Additionally, it is currently unclear how long RAPID<sup>10</sup> and Ofwat will take to approve each gate or control point, which in turn has potential for extended delays to the programme.

It seems likely that the burden on all parties (Ofwat, RAPID, Appointee or Appointees) could be reduced if overlaps were reduced, for example by agreeing that passing a Gate could also demonstrate passing certain control points, or considering gates and control points together in the same RAPID gate window.

This issue will affect all schemes that are both in the strategic solutions process and actual or potential DPC candidates. Southern Water has an acute version of the problem, as Ofwat has agreed at our request an accelerated timetable for the gates, to assist in meeting the timeline of our Section 20 agreement with the EA concerning remedying the supply / demand deficit in West Hampshire.

We provide below a summary of the interactions between the gates and the control points. We then provide a more detailed comparison.

### 3.1 Summary of interactions

- Control Point A can be completed prior to or at Gate 1, but there is potential for overlap.<sup>1</sup>

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<sup>10</sup> We note that RAPID has set out opening and closing times for the gates, but it is not yet clear at which point RAPID will make a recommendation and Ofwat will approve the decision on the next round of funding for the subsequent gate.



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|---|--|
| <ul style="list-style-type: none"> <li>Initial drinking water quality considerations</li> <li>Initial outline of the solution procurement strategy</li> <li>Initial considerations of planning application route</li> <li>Initial comparison of solutions' costs and benefits in early draft regional plans with consideration given to inter-regional supply options and systems impacts</li> <li>Regional stakeholder engagement including customer preferences</li> <li>Details of efficient spend to gate submission on gate one activities,</li> <li>Assessment of key risks</li> <li>Identify impacts of solution on current supply-demand balance delivery plan.</li> <li>Identification of any changes in solution partner (other water company) or solution substitutions</li> <li>Develop solution programme plan to determine the activities that need to be undertaken prior to each subsequent gate</li> </ul> |  |
|---|--|

Comment: Control Point A can be completed prior to or at Gate 1, but there is potential for overlap.

| <b>Gate 2</b><br><b>Detailed feasibility, concept design and multi-solution decision making.</b>   | <b>Control Point B</b><br><b>Strategic outline case</b>  |
|--|--|
| <ul style="list-style-type: none"> <li>Develop procurement strategy including assessment for potential direct procurement for customers' delivery</li> <li>Pre-planning application activity plan (land referencing, field surveys, environmental permitting plans)</li> <li>Full comparison of solutions' costs and benefits as tested in regional or national modelling with consideration of inter-regional options and systems impacts</li> <li>Identification of mutually exclusive solutions</li> <li>Updated regional stakeholder engagement including customer preference studies</li> <li>Details of efficient spend to gate submission on gate two activities</li> <li>Assessment of key risks</li> <li>Identify impacts of solution on current supply-demand balance delivery plan with simple comparison to current programme solutions.</li> <li>Identification of any changes in solution partner (other water company) or solution substitutions</li> <li>Develop solution programme plan to determine</li> </ul> | <ul style="list-style-type: none"> <li>The strategic context for the project.</li> <li>Business and customer needs to be met by the project – as well as the interaction between this project and existing arrangements.</li> <li>The scope of the project.</li> <li>The project's benefits, risks, constraints and dependencies, in particular, risk allocation of different procurement options should be considered</li> <li>Setting out critical success factors for the project</li> <li>Selection of tender model.</li> <li>Assessing the range of delivery options (both technical and contractual) and recommending a way forward (including why DPC is considered to be the preferred option).</li> <li>Value for Money (VfM) case for the use of DPC.</li> <li>Procurement timetable including key milestones</li> </ul> |

the activities that need to be undertaken prior to each subsequent gate

Comment: Ofwat Control Point B requires the submission of a Strategic Outline case which is an overlap of the relatively developed elements required within Gate 2. Control point B aligns reasonably with Gate 2 but there is overlap, and differences in the requirement. Both Gate 2 and Control point B require a preferred solution to have been identified. Other options would not be taken forward from this stage. Ofwat Control Point B and RAPID Gate 2 have an overlap with regards to the requirements and could potentially be subsumed into one.

| <b>Gate 3</b><br><b>Developed design, finalised feasibility, pre-planning investigations and planning applications</b>  | <b>Control Point C</b><br><b>Develop a procurement plan</b>  |
|---|--|
| <ul style="list-style-type: none"> <li>• Updated finalised feasibility, data collection and developed design</li> <li>• Cross-comparison of updated solutions costs and benefits in regional and national models</li> <li>• <b>Confirm procurement strategy including direct procurement for customers delivery decisions</b></li> <li>• Pre-planning application submissions</li> <li>• Start development consent orders pre-planning application investigations</li> <li>• Planning permission-related stakeholder engagement completed</li> <li>• Identify impacts of solution on current supply-demand balance delivery plan with simple comparison to current programme solutions.</li> <li>• Identification of any changes in solution partner or solution substitutions</li> <li>• Develop solution programme plan to determine the activities that need to be undertaken prior to each subsequent gate</li> </ul> | <ul style="list-style-type: none"> <li>• A summary of the scope of the DPC delivered project and the CAP Agreement to be tendered.</li> <li>• <b>The selected procurement route procedure</b></li> <li>• A summary of market engagement exercises that have been undertaken and a summary of market appetite and availability for this project.</li> <li>• An explanation of the contracting strategy</li> <li>• An explanation as to the level of design and technical readiness that is intended by the date of release of any contract notice</li> <li>• An explanation of how the procurement plan will maximise competition and deliver best value for customers; including information on the number of tenderers to be invited to tender and/or negotiate/ participate in dialogue and information on selection and award methodology and criteria.</li> <li>• Procurement and contract timetable.</li> <li>• Evidence of market testing.</li> <li>• A summary of key interfaces of the proposed CAP Agreement with other activities of the Appointee.</li> <li>• The Appointee’s CAP Agreement management approach.</li> <li>• An initial explanation of resilience considerations undertaken</li> </ul> |

Comment: It is clear that Gate 3 (Finalised feasibility, pre-planning investigations and planning applications) does need to be completed separately and prior to Control point C in order to enable a fuller, more robust market engagement for example. Control point C thus has to be submitted after Gate 3

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| <p><b>Gate 4</b><br/> <b>Developed design, finalised feasibility, pre-planning investigations and planning applications</b></p>  | <p><b>Control Point D</b><br/> <b>Develop full suite of procurement documents</b></p> <p><b>Control Point E</b><br/> <b>Produce an outline business case</b></p>   |
| <ul style="list-style-type: none"> <li>• Designs updated where necessary</li> <li>• Incorporation of pre-planning investigations</li> <li>• Cross-comparison of updated solutions costs and benefits in regional and national models</li> <li>• Implement procurement strategy including direct procurement for customers (where necessary)</li> <li>• Continue planning applications (where relevant)</li> <li>• Finalise development consent orders planning application investigations (where relevant)</li> <li>• Planning permission-related stakeholder engagement completed</li> <li>• Identify impacts of solution on current supply-demand balance delivery plan with simple comparison to current programme solutions.</li> <li>• Develop solution programme plan to determine the activities that need to be undertaken prior to each subsequent gate</li> <li>• Identification of any changes in solution partner or solution substitutions</li> <li>• Develop solution programme plan to determine the activities that need to be undertaken prior to each subsequent gate</li> </ul> | <p><b>Control Point D</b></p> <ul style="list-style-type: none"> <li>• Provide Ofwat with the full and finalised suite of documents with which the Appointee will go out to the market.</li> <li>• This includes the form of CAP Agreement.</li> </ul> <p><b>Control Point E</b></p> <ul style="list-style-type: none"> <li>• Revisiting the SOC and confirming approach.</li> <li>• Undertaking economic appraisals for relevant delivery options including DPC.</li> <li>• Undertaking a benefits and risks appraisal.</li> <li>• Selecting preferred option for the project (including delivery, contracting and procurement).</li> <li>• Confirming the selected procurement strategy (including any detailed developments from the procurement plan (above)).</li> <li>• Determining required outputs and service levels.</li> <li>• Setting out payment mechanisms and risk allocations.</li> <li>• Setting out contractual issues.</li> <li>• Considering accounting treatment.</li> <li>• Setting out plans for successful delivery</li> </ul> |

Comment: Control Point D and E have to be undertaken prior to Gate 4, because Gate 4 entails the implementation of the procurement strategy. Clearly, this would not be possible until after receiving Ofwat’s sign-off of Control Point C.

Control Points C, D and E have to occur in quick succession between Gates 3 and 4.

|  | <b>Control Point F</b><br><b>Produce a full business case</b>   |
|--|---|
|  | <ul style="list-style-type: none"> <li>• Provide the full and final suite of CAP Agreement documents</li> <li>• Provide FBC</li> <li>• The FBC will in general be expected to include               <ul style="list-style-type: none"> <li>• Revisiting the OBC and case for change.</li> <li>• Revisiting the OBC options (and value for money options).</li> <li>• Details of the procurement process and evaluation process.</li> <li>• Setting out final deal and contractual arrangements.</li> <li>• Setting out financial implications for final deal (including financial consequences for the Appointee).</li> <li>• Confirmation that CAP Agreement still aligns with Ofwat DPC principles and represents best value for customers.</li> <li>• Setting out project management/change/risk management arrangements.</li> <li>• Setting out post project approach (including handback and payments).</li> </ul> </li> </ul> |

Comment: Control Point F sets out the procurement outcome and must consequently come separately after Gate 4 and Gate 5, if it applies. In either event, Southern Water will need to seek consent via control point F immediately after the successful conclusion of the final gate.

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