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Regulation

Name: Nicola Cocks

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21 April 2020

Dear Martyn

Re: Consultation on proposed amendments to licence conditions for Direct Procurement for Customers”

This note provides our response to the above consultation that was issued on 24th February 2020. While the licence changes do not apply to Thames Water at this time, we are very interested in the proposals as we may have direct procurement for customers (DPC) projects in the near future.

Overall, we understand the proposed licence changes and Ofwat’s objectives:

- Introduce a new licence condition to establish the processes by which a water company could undertake the procurement of a third party appointed provider.
- Permit a water company to pass onto its customers the charges payable to the competitively appointed third party service provider.

We welcome and support the focus on customer protection. However, we have concerns around some of the proposals and consider the risk reward balance is not appropriate. In addition, we also draw attention to the potential impact of Covid 19 on the economy, resilience of the value chain and the financing of DPC projects.

Key strategic issues

Our key concerns with the proposals are:

- **Risk/reward balance:** Appointees retain all the obligations and potential penalties from the provision of the service of the competitively appointed provider (CAP), however they may not be able to take all appropriate remedial action without the consent of Ofwat and will receive no reward for the risks they take and in fact Appointees may not be able to recover all the contractual payments to the CAP. We consider it would be better, if once the CAP agreement is made (and approved by Ofwat), that appointees should be able to recover the contractual CAP charges and to operate the contracts within the constraints of the usual checks and balances of contract law, without the need for continual Ofwat consent unless the change would increase CAP charges by a material amount. While we appreciate the suggestion by Ofwat of continually being involved it seems unduly onerous on both regulator and company.
- **Step-in rights:** Given the important role the DPC projects will play in providing services to customers, we believe it to be important that in certain circumstances (for example, administration or contract termination) appointees should be able to step-in and take possession of the CAP assets. This would only happen after exhausting the agreed processes and is required to ensure services are provided to customers. The current proposals do not provide customers with sufficient

protection. Appointees should receive appropriate recompense for their costs in such circumstances.

- **Allowed revenue direction:** It does not seem appropriate for Ofwat to be able to cancel the allowed revenues direction, while the CAP Agreement continues. This would potentially allow the CAP to continue charging the Appointee, whilst the Appointee will be unable to recover any of the CAP charges from customers.

We are not sure it is appropriate for changes in ultimate controller of the CAP to be subject to a veto of companies or Ofwat, other than in limited specific circumstances that should be set out in advance. Protection could be better provided through contractual terms allowing companies to take over the CAP and its assets if the CAP is not performing for customers and all other remedial actions have been exhausted.

Covid 19

Subsequent to the issue of Ofwat's consultation, the UK and the rest of the world has and continues to suffer from the global Covid19 pandemic. The impact of the pandemic on the UK and world economy both now and into the future is yet to be quantified. Estimates of the shock to the UK economy vary from a short-term (10 to 35%) reduction in GDP to a long-term depression. In addition, the pandemic has highlighted the risks involved in creating breaks in the value chain and introducing less well capitalised entities.

These events could have two major consequences on future DPC projects:

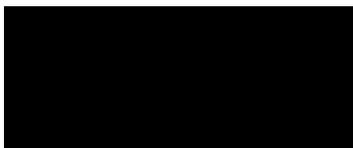
- **Resilience:** There will be more emphasis on ensuring new CAPs have the financial resilience to be able to withstand major events; and
- **Financing:** The challenge of access to capital markets for entities with "short" histories. This risk is reflected by increases in debt premia versus the risk-free rate. This is especially true for new debt issuance required to support a project during the construction phase. Where entities can access debt and equity markets, the current low cost of capital, will reduce the ability of third parties to provide financing benefits to customers versus a well-capitalised incumbent with a history of procuring and delivering capital projects. In addition, access to loans from the EIB (European Investment Bank) will be harder to obtain for new infrastructure projects given that the UK has left the European Union (EU).

Both of the above could make it more difficult for potential CAPs to demonstrate customer value. It may be appropriate for Ofwat to consider the impact of Covid 19 on the resilience of the different elements of the water chain and whether this has any implications for future DPC projects.

We set out our responses to the specific consultation questions in the appendix.

We are very happy to discuss these comments with you if that would be helpful. Please contact [REDACTED] in the first instance.

Yours sincerely



Nicola Cocks
Regulation Director

Appendix 1

This appendix sets out our response to the specific consultation questions¹

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

Answer

We agree with the objectives behind the proposed licence changes, although we are concerned that the balance of risk and reward is not right as set out in the covering letter and in response to Q4.

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?

Answer

We consider that the Appointee has sufficient incentives to manage the CAP agreement. There may be certain circumstances where ODIs may be appropriate, but these are likely to be bespoke to individual projects.

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?

Answer

There should be a materiality threshold applied. It is difficult to specify on a general basis as materiality will vary for each project. Some scope for variations could be built into the contractual terms of the CAP agreement with Ofwat being updated as and when they are changed. We have commented in more detail on this in the response to Q7

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?

Answer

At present it seems that the Appointee is taking all the risk, while obtaining no reward in a process which is entirely controlled by Ofwat. This does not seem appropriate or the optimal way to obtain maximum value for customers.

The Appointee will incur costs in running the tender process, negotiating contracts, maintaining the contract and interfacing with the CAP. It is not clear how these costs will be recovered. In addition, it is not clear that contractually payable CAP amounts will always be allowed to be recovered in charges by Ofwat. So, it is not clear that an Appointee will be able to recover its legitimate costs and there are no incentives to provide any form of reward.

In this context, the Appointee remains liable for all its statutory and regulatory obligations even if the failure is entirely the fault of the CAP. So, as well as potentially not being able to recover its legitimate costs, an Appointee may be liable for penalties (including ODI penalties) and fines for reasons beyond its control.

¹ Consultation Questions p 17 (Consultation on proposed amendments to licence conditions for DPC)

In addition, the proposals require Ofwat to consent to any termination or variation of the contract, both of which are tools normally within the control of the contract manager so reducing the ability of the Appointee to mitigate risk exposure to itself and to customer performance in a timely fashion.

And finally, in the event of cessation of services by the CAP, the Appointee is not able to step in and take control of assets and resources to continue operation of services and obtain recompense for so doing.

Overall this does not seem to provide the appropriate balance of risk and reward for Appointees, in that Appointee appear to take all the risks and obtain no reward and may possibly earn a negative reward.

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

Answer

We believe that the process should safeguard customer interests and ensure that value for money is achieved with the DPC. At the same time the process should ensure that the appointee and the CAP are incentivised and receive the appropriate reward for the risk that they each undertake. The process should also ensure that the Appointee can operate the DPC under contract law with the usual checks and balances.

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?

Answer

Yes. It is likely that these relatively large projects will be providing essential services to customers and be important in delivering performance commitments. It is essential therefore that Appointees are able to continue to be able to provide the services using the CAP assets and manpower, if required, and obtain appropriate recompense for the costs incurred. An option, to provide suitable recompense, may be to allow the Appointee to continue to collect the CAP contractual revenue and retain the income until such time as the price controls are reset.

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

Answer

We set out our comments on Condition U and Condition B below.

Condition U

As a general overall point there are many references to Ofwat needing to approve and give consent to various activities but no timescales by which they must approve or disapprove. There need to be time limits to these consents to allow these projects to progress effectively. There should be a recognition that any consent, approval or direction will not be unreasonably made or withheld, or impose unreasonable conditions, where that impacts on the Appointee's ability to comply with its statutory duties or other obligations under the Licence or obligations under the CAP Agreement. Where consent impacts on performance or remedies under the CAP Agreement, the Appointee could refer the matter to the

Independent Technical Adviser for an opinion on the likely effect, of giving or not giving the consent, approval or direction, on the CAP Agreement

Para 2.1 - We assume this means that a direction requires the prior agreement of the Appointee but it would be helpful to make that clearer.

Para 3.2. - This seems to suggest that once a project is designated as a DPC project (a DPC Delivered Project), a CAP has to be appointed unless Ofwat do not think it appropriate; but the Appointee may consider the appointment of a CAP would not be best value for customers or does not offer a viable solution. The Appointee should have the right to apply for a project designation to be revoked.

Para 4.2.3 - We believe that paragraph 4.1 should be sufficient and that paragraph 4.2 is inappropriate as it seeks to modify statutory responsibilities or the operation of statutory provisions. It also seeks to unduly fetter the rights of an Appointee to raise a defence.

Para 6.2.2. We suggest insertion of "material" before "breach"

Paras 6.4, 6.5, 6.6 - We consider that there should be an exception to the requirement to obtain written consent from Ofwat in these paragraphs, where the course of action being followed is as set out in the contract between Appointee and CAP, which will have been approved by Ofwat.

We believe that Ofwat approval should not be required for variations to the services (as opposed to the terms of the contract) unless the effect of the variation is to increase the Cap Charges by more than say 10%, bearing in mind the obligation to achieve best value for customers under paragraph 6.3 and bearing in mind that variations are limited by the Utilities Contracts Regulations

Paras 7.1 and 7.2. - The CAP charges are approved by approval of the CAP Agreement. The difference between the CAP Charges and the DPC Allowed Revenue should be limited to that already included in the definition of DPC Allowed Revenue: ie excluding any attributable to fraud, misconduct, breach or negligence – but see also, in relation to this, comments on definition of DPC Allowed Revenue below.

Paras 7.3 and 7.4 - We do not see how a DPC Allowed Revenue Direction can be modified or revoked by Ofwat when an Approved CAP Agreement has been entered into. We can see that there may be a disagreement between Ofwat and the Appointee as to what the CAP Charge is and there should be a mechanism for resolving any such issue, which might make use of the Independent Technical Adviser.

There is no obvious appeal route in respect of Ofwat's consents, approvals or directions. In the absence of such appeal routes, it is even more important to include a provision that that any consent, approval or direction will not be unreasonably made or withheld (see general comments on Condition U above).

Para 8.1 - as the Appointee cannot give consent to a change in ownership of the Ultimate Controller without Ofwat consent, it would seem more appropriate for the CAP to directly seek Ofwat consent for a change in Ultimate Controller.

Para 8.1- 8.3 – it is not clear to us that an Appointee should be able to block a change in ownership of the ultimate controller of a CAP. This may also make a CAP Agreement unattractive and reduce the competition for a CAP opportunity to the potential detriment of customers. We can see that there may be some control needed by the Appointee e.g. if the Ultimate Controller became a competitor or if it had a guarantee from a previous Ultimate Controller or if the Ultimate Controller was the bidder in the procurement; but Ofwat should be clear on the grounds on which it might object (e.g. links to an Associated Company). We also need to acknowledge that funders may need to take control of the CAP and an Ultimate Controller may be a plc

where control can change through market trading paragraph 9.1 – The requirement to seek Ofwat consent should not be required where termination is in line with the contract provisions. Delays in contract termination could, in certain circumstances, result in adverse customer impacts.

Para 9.3 – Any direction should not prevent use of revenue collected to meet payment obligations under the CAP Agreement to the extent that is DPC Allowed Revenue.

Para 9.5 – As the assets in the CAP will be essential for the efficient running of the business and delivery of services to customers, unless a new CAP steps-in, the designation needs to change so that the appointee can step-in and continue to provide the services to customers.

Para 10.3 – Presumably this restriction only applies in an Appointee's own area.

Para 11 – We question whether this paragraph is needed, given the already very wide powers of Ofwat to request information under Condition M.

Para 11.3 - The requirement to warrant the accuracy of information goes beyond normal assurance requirements and information held by the CAP may be unreasonable or impossible for the Appointee to obtain. It would not seem appropriate, in particular, for the Appointee to provide a warranty on information provided by third parties including the CAP.

Para 12.2.1 - How is it intended the Appointee will fund the cost of the Independent Technical Adviser's services? – see comment on definition of DPC Allowed Revenue below.

Para 12.5 - Requirements on the Appointee to provide access should also take account of any restrictions under the CAP Agreement or by law

Condition B

The proposed amendments to paragraphs 9.1, 9.4, 10.2, 14.2 and 16.2 will need to be modified if applied to the TWUL licence because of the similar clauses already existing for the pass through of IP charges.

Ofwat have asked for specific comments on the timing challenges in respect of collecting the DPC allowed revenue and tariff setting.

Tariffs are normally finalised in the December preceding the tariff year and therefore would be based on forecast CAP charges. Inevitably, there will be changes in both applicable CAP charges as the year progresses and collected income from tariffs, as for example, metered consumption varies from expectations.

We do not see this as a material issue. In our view the inevitable differences can best be accommodated through wholesalers carrying the timing difference through an amended RFI process, the CAP charges will be only a small proportion of overall allowed revenues.

We consider that CAPs should be paid the appropriate contractual income for the relevant year with any variation from that assumed when charges were set netted from the overall under/over recovery of allowed revenue as illustrated by the simplified example below.

At time of setting tariffs:

Allowed revenue = £1000; Expected CAP charges = £10; Charges set to recover £1010

Actual reported position

Collected revenue £1030, CAP contractual charges £15; payments to CAP £15

RFI Adjustment

The Appointee should return £15 to customers to reflect that it has recovered £20 more than originally intended less the £5 additional payments made to the CAP.

Definition of DPC Allowed Revenue

The reference to a CAP Charge having to be “justifiable” seems inappropriate given that a CAP Charge has to be payable under the terms of the Approved CAP Agreement.

Presumably the reference to “misconduct” is referring to breach of statutory duty or breach of the Licence, but it should be clarified.

The CAP Charge definition seems to cover any compensation on termination as may become payable (other than termination for Appointee breach). We assume such termination payments will be dealt with as an adjustment to the Price Controls given the DPC assets are likely to be taken in house, and not by way of DPC Allowed Revenue. We note that further Licence modification is planned following consultation in the DPC uncertainty mechanism, but we remain concerned that compensation payable under the CAP Agreement (excluding any loss attributable to Appointee breach) may not be fully recoverable through the Notified Item route which Ofwat proposes is to be used.

As the Appointee’s costs in relation to a DPC Delivered Project, including administering the CAP Agreement and the cost of the Independent Technical Adviser, seem to be excluded from the Price Controls, should not those costs also be picked up within DPC Allowed Revenue?