Haweswater Aquduct Resilience Programme

Response to consultation on licence amendments and DPC briefing note

United Utilities Water is pleased to have the opportunity to comment on Ofwat's proposed licence amendments in relation to "Direct Procurement for Customers." We provide these comments in the interests of ensuring that the novel DPC mode of procurement has the potential to be utilised as a means of delivering services and infrastructure in a way which serves the best long term interests of customers, is compatible with the statutory and legal obligations which apply to Appointees and is implemented in a way which supports Ofwat's duties.

Ofwat should note that nothing in this response should be taken to provide consent (indicative or otherwise) of any licence changes. Changes to the instrument of appointment are a matter reserved for the Board and proposals will be considered in view of the detailed proposals which will be set out by Ofwat in due course. We do, however, trust that our comments which are being provided at the working level provide helpful input for Ofwat's consideration as it progresses the drafting process.

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Response to consultation on licence amendments and DPC briefing note

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

The proposed new DPC condition - Condition U

#	Issue	What Ofwat needs	Why Ofwat needs it	*UU Comments*
1	**General:**	A licence condition which ensures that customer interests are protected.	It is important a DPC project is in customers interests and represents best value for money. We need a licence condition to require there to be appropriate controls in place. Ofwat will not undertake the procurement. However Ofwat will be reviewing the procurement process undertaken and provide, if appropriate, consent at key stages to ensure the interests of customers are protected and a project represents best value for money. We have prepared a separate guidance document (the "DPC Briefing Note") and already shared this with water companies as part of industry engagement to outline a generic view of the process. The DPC Briefing Note is not a substitute for the licence and retains flexibility about how the process is implemented. The licence will place critical obligations on a water company to ensure our principles outlined in our PR19 Methodology (and restated again in July 2019) are met.	***This is acceptable, in principle, although we note that this is already implicit from Ofwat's primary duty to protect the interest of consumers.*** ***DPC licence amends should be aimed at ensuring that the approach is aligned to support fulfilment of <u>all</u> of Ofwat's duties, not just those related to protecting consumers, i.e.*** • *further the consumer objective to protect the interests of consumers, wherever appropriate by promoting effective competition* • *secure that water companies (meaning water and sewerage undertakers) properly carry out their statutory functions* • *secure that water companies can (in particular through securing reasonable returns on their capital) finance the proper carrying out of their statutory functions* • *secure that water supply licensees and sewerage licensees properly carry out their licensed activities and statutory functions* • *further the resilience objective to secure the long-term resilience of water companies' water supply and wastewater systems; and to secure that they take steps to enable them, in the long term, to meet the need for water supplies and wastewater services* ***Whilst it is understandable that Ofwat would want to affirm the need to protect customers, DPC contracts also create new uncertainties for water company boards and investors. It is therefore also important that Ofwat provides sufficient confidence to them that companies will not be left with unacceptably high levels of additional risk from entering into***

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				a DPC arrangement. In particular it is important that equal consideration is given to: • ***whether entering into a DPC contract leads to an unacceptable financial burden, impacting on credit ratings and harm to the financial resilience of the company;*** • ***the need for certainty around end of contract residual payments, and payments in the event of contract termination; and*** • ***the risk of licence amendments (inadvertently) leading to a requirement for unacceptable contract terms that undermine support for the DPC process.***
2	**Achieving best value**	A licence condition that places an obligation on water companies to ensure that best value for customers is achieved in the DPC procurement.	The water company will be responsible for undertaking the procurement of a CAP. We believe it is important the licence places obligations on water companies to ensure the procurement process delivers outcomes that achieve best value for customers**.**	***Agreed – although Ofwat should recognise that this requirement should be subject to (and subsidiary to) the other, potentially conflicting demands made in the licence, which may ultimately impinge on the company's ability to deliver best value for customers. Similarly, if the company's view is that a DPC does not achieve best value for customers but it is precluded from exiting the DPC arrangement through Ofwat's refusal to grant this, then it is difficult to see how the company could be compliant with this condition in isolation.*** ***We also note that there are many components to a "value" assessment, such as whole life bill impacts (across both CAP and incumbent), impact on risk (e.g. if DPC process takes longer than in house, leading to additional risk), etc.*** ***DPC contracts should aim to provide the best <u>long term</u> value for customers, rather than just the "best value" for customers, i.e. Ofwat's phrasing should take the form of "to procure in a manner most likely to deliver best long term value for customers".***

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3	**Management of CAP**	A licence condition to assure best management of the contract for customers throughout the life of the contract.	Under the contract model, the CAP is contracted to the water company (with the contract referred to as "the CAP Agreement"). To ensure the water company acts in its customers best interests we propose a licence obligation requiring the CAP Agreement to be managed by the water company in a manner that achieves best value for customers. We believe this obligation is important because if not in place a water company could take a passive role which may lead to sub-optimal outcomes for customers. We note that under the contract model Ofwat does not have a direct relationship with the CAP.	***The key principle of DPC is that the appointee is contracting for the financing and delivery of services (or assets) on behalf of customers. The key protection for customers is the terms of the contract, which should incentivise the CAP to behave appropriately in the best interest of customers.*** ***In the event that the CAP fails to perform (on construction cost or operational performance), then the CAP's contract will compensate customers accordingly, and (similarly) if the CAP outperforms (e.g. by delivering at a lower cost) then pain/gain incentives will share that value directly with customers.*** ***Ofwat must recognise that, in a DPC, the company's primary role is as executor and enforcer of the CAP agreement – the company should not be held liable for any ex post interpretation of what is in the best interest of customers, particularly if that is unenforceable through the CAP agreement. It should also be recognised that company and customer interests are aligned – it would also be sub-optimal for the company for it not to enforce the terms of the CAP agreement, particularly if it risks leading to the delivery of inefficient or poorly performing assets. Provided that the company manages the CAP agreement in its ordinary course and in accordance with its terms (including enforcing the contract where necessary) then the company is managing the contract in the interests of customers and so any licence condition ought to be limited in line with this.*** ***The need to manage the DPC contract in the best (long term) interests of customers must also be placed in the context of all the company's overall roles and responsibilities, and it should not be to the detriment of those responsibilities.*** ***We expect that this may be more of an issue during construction phase, and less of an issue during operation for***

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				our project, although we accept that balance may differ for other DPC projects.
4	**Designation of a DPC Delivered Project**	We want to ensure that only suitable projects are procured through a DPC process.	We believe it is important that DPC Projects are clearly identified. The process relating to the procurement and delivery of DPC Projects should be limited to those projects that are suitable for DPC.	***Agreed – we presume our DPC project to (implicitly) already has this status, and await Ofwat's confirmation of this.***
5	**Requirement for written consent from Ofwat for the Appointee to undertake a DPC Procurement Process**	We want to approve the planned DPC procurement process prior to it being undertaken.	Before any DPC procurement process (by which we typically mean Invitation to Tender) is commenced, we want the water company to agree with Ofwat the key stages, timings and contact points. By having a "hard consent", the procurement process cannot proceed until such time as Ofwat, having considered, among other things, the procurement process, the proposed terms and conditions of the CAP Agreement. This will ensure Ofwat is satisfied that the interests of customers will be protected and best value for money achieved. We expect a water company and Ofwat to agree the procurement process so that both are clear about their respective responsibilities at each stage of the procurement process.	***Agreed – it is already expected that OBC would be a consent point.*** ***However, we note that OBC should be approved prior to Call for Competition (Contract Notice) being issued on the OJEU, not "at ITT". It is necessary, to avoid a delayed or aborted procurement process, that the consent point is concluded sufficiently in advance.*** ***Also, consistent with #3 above, this is the point that Ofwat confirms that it is content that the contract provides adequate customer protection.*** ***We would question Ofwat's claim that "This will ensure Ofwat is satisfied that…best value for money achieved". Approval of a tender process does not (in of itself) ensure that best value for money will be achieved – however Ofwat could be satisfied that such a tender process is capable of resulting in the best value outcome for customers (whether that be a DPC or an "in-house" procurement).***
6	**Ofwat agreement required for a project to exit DPC**	We want Ofwat to agree to the exit of any project from the DPC regime.	A procurement could fail during the procurement process itself such that the water company is unable to appoint a CAP (e.g. insufficient interest from bidders). The water company may then seek to return the project to an in-house delivery route. Under such circumstances Ofwat will want assurance that it is in customers' best interests to exit the DPC process instead of undertaking a further procurement process.	***First of all, it is important to note that a DPC procurement process may result in DPC exit, naturally, and correctly, resulting in in-house delivery of the project. This could be for many reasons – e.g. inadequate interest from the market, poorer VfM than an in-house solution, detriment to credit ratings and financial resilience caused by ratings agency views of IFRS16 etc. That would not constitute a "failed" procurement, but a successful identification that a DPC was***

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			Similar considerations will also apply in the event that a CAP Agreement is terminated and the water company wants to bring the project in-house. We therefore believe agreement with Ofwat to revoke the designation of a DPC Delivered Project and exit the DPC regime is an important mechanism to protect customers' interests.	***unable to provide a better customer outcome than in-house delivery.*** ***We agree with the need for consent, however this needs greater specification – e.g. (a) confirmation that the need is still required, and (b) that a subsequent IDoK is expected (to manage the costs to be incurred by the company), and (c) that Ofwat will act in a way that does not unduly delay the delivery of a project. There is also a need to recognise that some events, e.g. insolvency of CAP or withdrawal of all bidders from the procurement process, may necessitate DPC exit, outside of the company's control - in which case Ofwat should state the circumstances under which consent for exit should be presumed as granted.*** ***It should also be noted that this requirement for consent could lead to a disagreement whereby Ofwat refuses consent, despite the company identifying that the DPC has failed to yield better VfM for customers than an in-house solution. In this case, companies should not subsequently be held liable if the DPC project fails (in retrospect) to have been in the best interest of customers (as implied by #2 above).***
7	**Requirement for written consent from Ofwat for the water company to enter into a CAP Agreement**	We want the water company to require consent from Ofwat prior to entering into the CAP Agreement	As a DPC procurement process enters preferred bidder stage further discussions with the prospective CAP may take place – which could include negotiations on key points in the contract. To protect the interests of customers we need to ensure that any key clauses have not been compromised and/or additional clauses which are potentially to the detriment of customers interests have not been included.	***Agreed – it is already expected that FBC would be a consent point. We re-iterate that this is part of a procurement process and that it is essential that Ofwat's review is conducted to a fixed schedule, agreed in advance, and shared with all parties to the procurement process in order to demonstrate compliance with a process and minimise unnecessary regulatory uncertainty for all participants in the process.*** ***Similarly, it is also the case that the company is seeking to negotiate with potential CAPs in the interest of gaining best value for money for customers. If that results in negotiated changes, that Ofwat wishes to review and consent to, then it is essential that Ofwat closely collaborates with the company***

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				during that time, rather than withholding consent at a later date (and thus undermining the procurement process). However, it should be noted that the tender documents present the "best version" of the contract for customers, and any negotiations will naturally weaken the contract for customers in favour of the CAP. ***It should also be noted that this requirement for consent could lead to a disagreement whereby Ofwat refuses consent. In this case, companies should not subsequently be held liable if the subsequent outcome fails (in retrospect) to have been in the best interest of customers (as implied by #2 above).***
8	**Requirement for written consent from Ofwat for changes to be made to a CAP Agreement**	We want the water company to obtain consent from Ofwat to agree changes to a CAP Agreement where there is a potential material impact on customers' interests. We welcome suggestions on how this can be best achieved.	We believe it is important that controls are in place to ensure customer interests are protected. As such Ofwat's prior approval of proposed changes to a CAP Agreement which directly impact on customers interests represent a check within the process.	***We recognise that material changes are likely to require Ofwat's consent. By their nature, contracts in the ordinary course will be changed – this is a normal function of contracts and contracting.*** ***We have set out our views in more detail below in response to question 3.***
9	**Requirement for written consent from Ofwat for the extension of the term of the CAP Agreement**	We want to approve any extension of the CAP Agreement	We believe it is important that the water company seek Ofwat's consent should it wish to extend the term of the CAP Agreement. We would be concerned about extensions if, for example: • the performance of the CAP over the duration of the CAP Agreement was demonstrably poor and to the detriment of customers interests; or • market conditions or technology have significantly changed such that further efficiencies could be achieved under a different arrangement.	***Agreed except in circumstances where UU is contractually required to extend the term of the CAP agreement (in which case Ofwat would have implicitly accepted such extension by approving the terms of the CAP agreement).***

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10	**DPC Allowed Revenue Direction**	We need to be able to issue a direction for the company to collect revenue associated with DPC	The DPC Allowed Revenue Direction will allow the company to collect CAP revenue from customers. The Direction is an approval by Ofwat on what can be recovered from customers.	***Agreed – however, it is essential that the DPC Allowed Revenue Direction takes account of both the standard contractual payments which will be due (i.e. basic CAP Charges) but also any adjustments and payments which are due under the CAP Agreement (which also amount to CAP Charges). Importantly, appointees should be able to meet contractual obligations in paying CAP Charges to ensure that CAP agreements are not undermined. This means that the DPC Allowed Revenue Direction should enable any appropriate adjustments for the cost of payment timing and bad debt to be recovered from customers, to protect the CAP from those uncertainties and to ensure that the company neither gains, nor is harmed, from the act of recovering payments due to the CAP on behalf of customers.***
11	**Ultimate Controller of the CAP**	We need the water company to ensure that the CAP has obtain consent from the water company before a change in Ultimate Controller. In turn the water company has to seek Ofwat approval for consent.	This supports the restriction in relation to Associated companies and ensures the interests of customers are protected from a change in ownership.	***It is not clear to us whether this would be feasible.*** ***Whilst we can understand that Ofwat would view this as a helpful protection, it is not clear to us that a potential CAP (i.e. its participants) would view this as an acceptable contract term – if Ofwat persists with this, then it should be recognised that it will likely impact on the propensity of CAPS to bid and/or the price at which they will bid. It may be reasonable to a change of ownership only being permissible to refer to a 'Suitable Alternative Company/ Shareholder' and to define that in the CAP Agreement', provided that the restrictions are not too onerous. Otherwise, however, we would not expect a bidder to accept a position where the water company or Ofwat has any right to refuse a change in ownership. Many equity participants' business model assumes they would be free to exit once the asset is completed (indeed, there is a significant secondary market in the UK for project finance transactions).*** ***It should be noted that in some situations (material breach, insolvency, step in) a change to the shareholders and or controllers of the CAP may be inevitable irrespective of***

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				Ofwat giving or withholding consent. Ofwat's consent should only be required where under the CAP Agreement UU has unqualified discretion to refuse consent to a change in ownership of the CAP (e.g. proposed transfer of shares in first 12 months post completion, or proposed transfer to a Restricted Person (e.g. somebody who is not a suitable alternative shareholder) ***We would expect that appointees would, of course, keep Ofwat informed in line with existing and proposed licence conditions but we would expect that that should sufficient control for Ofwat given the other obligations of appointees and the terms of the CAP agreement.***
12	**Provision of Information**	We want the ability to obtain appropriate information in relation to the procurement of a CAP, the performance of the CAP and the delivery of the project	We will, from time to time, need information to understand how a DPC project is progressing (including procurement and delivery). As such we seek an obligation on the water company to provide this information, to the extent that it is not covered by existing obligations. Furthermore we also expect the water company to have reporting requirements in place within the CAP Agreement (e.g. progress against milestones). Some of the collected information would therefore be part of ongoing contract management. During the procurement and the term of the CAP Agreement information requirements as set out in Ofwat's Regulatory Accounting Guidelines may, after consultation, change and as such provision to obtain any information required to meet any such requirements would need to be reflected in the CAP Agreement. We will expect information provided to be appropriately assured by boards.	***We accept that we will need to provide Ofwat with information, insofar we are able to obtain that from the CAP.*** ***It would be helpful to be able to define potential information requirements prior to finalising contracts, at the beginning the procurement process so that the right expectations are set and so bidders can evaluate the potential costs of compliance. We are happy to provide information that we have obtained from the CAP, but it is unrealistic to expect our Board to underwrite assurance of information (particularly at a project level of detail) in relation to such information provided by a third party, which is also over and above the approach that is commonly taken by regulators to information requests and annual regulatory reporting. Each party needs to be responsible for providing its own assurance on its own information. We may need to consider the role of the ITA in the provision and assurance of any data from the CAP.*** ***This could, in theory, be provided for in the CAP agreement although any such requirements would need to be clear and would need to strike a balance between Ofwat's oversight and the cost and time burden which would be imposed on***

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				the CAP. We would be concerned about overly extensive or onerous information requirements which are not customary to potential bidders. ***The time to define those requirements is at OBC. We should not be placing unduly uncertain (and open ended) information requirements on the CAP, which might influence the CAP's price upwards to the detriment of customers.***
13	**Independent Technical Adviser**	We expect the water company to support information provided to Ofwat with evidence from a technical expert	We see an Independent Technical Adviser (ITA) as having a crucial role in providing supporting evidence for the procurement process and the CAP Agreement. This will promote customer protection by ensuring that Appointee actions in management of the CAP Agreement are assured and/or verified by independent parties.	***This is a new requirement and (potentially) a significant additional cost, which will need to be recovered from the CAP. It is also unclear whether the specified requirements (not least the duty of care to Ofwat) would be obtainable from the market at any sort of sensible cost.*** ***The point refers to the ITA "having a crucial role in providing supporting evidence for the procurement process", which implies that it has a role prior to contract award. Given that we are already a substantial way through that process it is essential that, in the case of UU's HARP project (a) the requirements are established as soon as practicable, and (b) that Ofwat will not require any retrospective review by the ITA for prior information provided into the DPC process, leading to further unwarranted delays.*** ***The role and remit of the ITA needs to be better defined and clarified, and in particular the role of the ITA in Ofwat's points of consent, and in any assurance activities (including the provision of information on the project to Ofwat).*** ***Ofwat should also clarify what obligations the ITA has to which parties (cf. the former "reporter" role, was procured by company, subject to approval by Ofwat, and was accountable to Ofwat, with Ofwat also setting the scope of its reviews.)***

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14	**Responsibilities of the Company**	The water company will continue to be the responsible provider of water and sewerage services	The company will continue to be responsible for meeting its statutory and licence obligations as a water and/or sewerage undertaker. The appointment of a CAP will not change these obligations.	***Agreed, given that the CAP is not a licenced entity, which we support.*** ***However, we would point out potential conflict between this and points #6, #7 and #8 (requirement for Ofwat consent for DPC exit, entering into a DPC agreement, and for negotiated changes to DPC contracts during the tender process). Given that the company continues to be responsible for meeting its statutory and licence obligations, Ofwat should be extremely cautious about vetoing decisions being proposed by the company, as this may leave the company, in its view, of being at risk of a breach of its licence obligations whatever course of action it takes..***
15	**Prohibition on entering into CAP Agreements with Associated Companies**	We want to ensure that companies do not enter into a CAP Agreement with an associated party.	Consistent with our Contract Principles any associated companies of the Company may not bid in a DPC procurement process or be appointed as the CAP.	***Understood, and we note Ofwat's views on this matter. However, we do not expect this restriction to apply to an associate company being able to bid for a DPC project in a water company within an unrelated group (as appears to be implied by the current drafting).*** ***It is also possible on a failure event (or a termination event) that UU would need to take over the CAP or step in temporarily – we fully expect that this would be permitted.***
16	**Requirement for written consent for Termination**	We need to be able to approve or prevent a water company terminating a CAP Agreement	The termination of a CAP Agreement may have a significant detrimental impact upon customers' interests. To protect customers the water company will need to seek and obtain written consent from Ofwat before termination.	***Understood. However, we would also note that termination of a CAP agreement may also be strongly in customers' best interest, and the requirement for consent should not prevent that.*** ***It is also important to recognise that termination may have a significant impact on the company in meeting its obligations (as noted against point #1 above). There needs to be more clarity for all parties on what would happen in the event of a termination. For example, for example, with respect to the transfer of assets and the potential process where the appointee has to continue works in some way. Importantly, clarity is required in respect of how termination would***

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				interact with the DPC Allowed Revenue Direction and the ordinary price control in the different circumstances envisaged by Ofwat including consideration of, e.g.: • ***Payment for outstanding financial costs*** • ***Recoverability of termination payments*** • ***Legal costs, etc.*** ***It is also not clear if this only applies to early termination, or anticipated termination at the end of the contract (we would not expect to require Ofwat's consent for the latter).*** ***As noted above on point #6, some terminations will happen automatically or so quickly that obtaining consent will be impractical (e.g. on an insolvency).***

The proposed changes to Condition B:

#	Issue	What Ofwat needs	Why Ofwat needs it	*UU Comments*
17	**Pass through of CAP Charge**	The licence needs to be amended to allow a company to collect from its customers outside of price controls the appropriate DPC charges payable to the CAP.	Under the contract model CAP charges are determined through a competitive tender, a CAP charges a water company for the services provided, which in turn are recovered by a water company through charges to customers.	***Agreed, however this needs to refer to a DPC allowed revenue direction, per #10 and the comments below, which should enable both ordinary course CAP charges and other periodic charges under the CAP agreement to be translated into a recoverable cost from customers. As described above and below, we would welcome clarity which sets out that this will enable adjustments for payment timing and bad debt, to ensure that companies are not detrimentally affected (and also do not gain) from the act of collecting payments due to the CAP from its customers.*** ***Ofwat also need to clarify that termination payments (including end of contract residual value payments) are equally obligations to pay the CAP, fully equivalent to the annual CAP payments – that is (currently) not clear. It is essential that Ofwat provides this clarity for CAPs and incumbents, else contracts will appear to have significant obligations (e.g. residual value payments at end of contract) that otherwise appear to have no certainty of recovery from customers.***

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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?

- Direct Procurement is a means of externalising delivery of assets or services for customers away from the traditional role of the incumbent water company as responsible for both the provision and financing of services to customers. As a result of this change it needs to be recognised that under a DPC arrangement the delivery and financing of a project is - both as a matter of substance and as a matter of contract – principally a matter for the CAP. The CAP's contract should provide sufficient incentives for the CAP to behave appropriately and to deliver efficiently and effectively in accordance with the requirements. The company acts as contract manager on behalf of customers, and the company is held accountable by Ofwat to act in the best interest of customers in accordance with its duties.
- In the event that the CAP fails to perform, then the CAP's contract will compensate customers accordingly, and (similarly) if the CAP outperforms (e.g. by delivering at a lower cost) then pain/gain incentives will share that value directly with customers.
- This naturally follows the principle that incentives for delivery should be aligned to those best placed to manage the risk of delivery. In its own investigations into risk allocation in 2010[1], Ofwat concluded (para 38) "*The way in which we allocate risk in a price control is linked strongly to incentives. So, if the party best placed to manage the probability of a risk event occurring faced none of the consequences (positive or negative) if the event occurred, it would have no incentive to manage the probability of the event occurring.*" Given that the delivery is managed by the CAP, it is natural to assume that incentives for delivery should largely sit within the CAP agreement (which is enforced by the company, in accordance with its duties, for the benefit of customers) – otherwise, as noted by Ofwat, the CAP may have little or no incentive to deliver the DPC project effectively and efficiently on behalf of customers.
- The appointed company already has very significant incentives to manage the CAP agreement effectively, even absent any additional licence conditions (such as managing the project in the best long term interests of customers.) This is because the successful delivery by the CAP is essential to enabling the appointee to successfully deliver services to customers and the environment as required under its licence. In the case of the Haweswater Aqueduct programme – for example – around 1/3 of the potable water supply by United Utilities is directly facilitated by this asset. In those circumstances, it would be impossible to conclude that UU does not have a strong interest and incentive to manage the contract effectively, as doing so is entirely in line with its own long term interests and those of the customers it is appointed to serve.
- However, it is also the case that in removing the responsibility for delivery and financing of this piece of infrastructure from the appointed company and awarding it to the CAP, the scope for the appointed company to directly control and drive delivery is by necessity also reduced. Any incentives that may be applied to the appointed company therefore need to be proportionate to its degree of influence and control of the project delivery and these are significantly diminished as a result of the DPC policy. Applying incentives (positive or negative) which do not reflect the

[1] "Allocating risk and managing uncertainty in setting price controls for monopoly water and sewerage services – a discussion paper", Ofwat (2010), https://webarchive.nationalarchives.gov.uk/20150604004935/https://www.ofwat.gov.uk/future/monopolies/fpl/allocation/

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available degree of control to the appointee could not be justified as a proportionate approach to regulation. It would also not be consistent with protecting customers' interests as it would seem to be misdirecting incentives away from the party with most control of the outcome (being the CAP) and placing incentives on a party which is less able to control the outcome in favour of customers' 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?

- We suggest that there are four parts to this question:
    a. Should consent be required for all changes to the CAP agreement, or should Ofwat approval only be required for material changes?
        - There may be many minor changes, which could be very burdensome for Ofwat to manage. Therefore we agree that a materiality threshold should be applied.
    b. What should happen to the non-material changes?
        - Non material changes should be implicitly allowed without obtaining Ofwat's consent (and any cost implicationspassed to customers, where this results in a minor change to the CAP charge). A "change" should be very clearly defined to cover only changes to the terms of the CAP agreement.
        - Given that there is uncertainty around the potential for future changes, we propose that to the extent accommodated by the CAP agreement, all changes to the contract should be notified to Ofwat, and that Ofwat would have (say) 30 days to intervene before any non-material change becomes effective.
    c. What should the size of the materiality threshold be?
        - It would make sense for this to be set relative to the size of the DPC project, rather than (a) an absolute size (e.g. a fixed £m value), or (b) a value relative to the size of the company, as both of these latter approaches would tend to penalise larger DPC projects.
        - We propose that the materiality threshold for consent being required for any individual change should be set at 2% of the anticipated maximum annual CAP payment over the course of the contract (this then also allows the threshold to apply during the construction phase, prior to CAP payments being in effect).
        - Changes in respect of which UU does not have an unqualified right to object under the CAP agreement should be excluded.
    d. How should the materiality be assessed – on individual items, or a sum total of items?
        - We propose that this should apply to individual items.
        - If it applied to multiple items over a year, then Ofwat should also set a "triviality threshold" for individual items, to reduce the administrative burden.

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?

- In reflection of our response to question 2 above, we would note the following:

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  - The statutory obligations remain with the company, so the company is already in receipt of significant risks in any DPC arrangement, due to the delivery risk sitting with the CAP (and hence the company is one step removed from the activities of the contractor) – hence the appointed company already has very significant incentives to manage the CAP agreement effectively.
  - Given that responsibility for delivery and financing will (under DPC) be removed from the company and awarded to the CAP, the scope for the appointed company to directly control and drive delivery is by necessity also reduced. Therefore, the starting point for risk allocation should be that the CAP has (effectively) taken on the risks normally attributable to the appointed company in respect of delivery. Any risk allocated to the company should therefore be limited to reflecting its role in a DPC arrangement, i.e. its role in enforcing the CAP agreement, which Ofwat will have approved following a competitive tender process.
  - This is consistent with the approach to risk allocation explored by Ofwat in 2010[2], in which it noted (para 33) "*We seek to allocate each risk to the party or parties best placed to manage it. This may be the party best placed to reduce the probability of the risk event occurring or the one best placed to reduce the impact of the risk event if it occurs.*"
- In a "normal" project, the company shares risk with customers. However, the company also earns returns on the investment, which supports its management of the risk incurred. Conversely, in a DPC project, the incumbent earns no returns, and therefore has more limited capacity to absorb risk arising from the project. In a DPC project, by contrast, the project is procured from and financed by a third party CAP, which earns returns on the project - therefore the primary risk/return relationship must be expected to lie between the CAP and customers. Furthermore, that risk/return relationship is defined within the CAP agreement. This both protects customers from risks but ensures that they are not borne by the appointee insofar as it is not best placed to manage those risks.
- Given the particular nature of DPC projects where an appointee sits between the ultimate beneficiaries of the project (customers) and the entity delivering it (the CAP), there will be circumstances in which the water company could impede satisfactory delivery by the CAP with associated costs. Some of these instances will be in the 'ordinary course' and, as such, may be anticipated in the CAP agreement with CAP Charges applicable. In these cases, this is effectively the cost of ordinary risks which should appropriately be recovered from customers who will ultimately benefit from the continued running of the CAP agreement in the ordinary course (and would have effectively funded such issues under the counterfactual "in house" delivery in any event). This is not to say that the incumbent bears no risk in the project. There may be extraordinary instances where the company could impede satisfactory delivery by the CAP and in these cases it may be appropriate for the company to share in that risk.
- All of these risks, and the balance of risk between CAP, customer and company, will need to be defined within CAP agreement – we will be making further proposals on this in the coming months. It is important to note that Ofwat will approve the CAP agreement such that this allocation will be set out in advance and can be managed. It is also worth considering that, as set out above, the appointee's primary function is to manage the CAP Agreement and therefore this is the primary means to ensure that risk is appropriately allocated.

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[2] "Allocating risk and managing uncertainty in setting price controls for monopoly water and sewerage services – a discussion paper", Ofwat (2010), https://webarchive.nationalarchives.gov.uk/20150604004935/https://www.ofwat.gov.uk/future/monopolies/fpl/allocation/

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

- We note the control point D requirement for the company to provide assurance that the proposed procurement will not cause the company to be in breach of its licence conditions. We note two issues in relation to this:
    - First, this is not a sufficient justification for proceeding with a DPC arrangement. For example, pursuing DPC may (due to ratings agency interpretation of IFRS16) harm the company's credit rating. Whilst that may not result in a loss of investment grade (and hence not conflict with licence requirements), it would still be sufficiently harmful to the financial resilience of the company, such that it would result in DPC exit.
    - Ofwat should consider this requirement in light of the new DPC licence conditions being proposed, and how these may translate into a proposed CAP contract (in order for the company to be able to state that would meet its licence obligations). Items such as clause 11.3 (requiring board assurance of CAP information) would likely result in unacceptably intrusive contract terms for a CAP. It would be unfortunate if the need to satisfy licence amendments led to unintended consequences which led to failure of the DPC process.
- As per the response to question 1 (#4, Designation of a DPC delivered project), we believe that Ofwat's key consents should align to the business case submissions. The Value for Money (VfM) proposition of DPC is assessed at these 3 key junctures, and key licence designations should align to these assessments. Flexibility should be retained in the Control Points relating to the development of procurement and contractual materials (i.e. Control Point C and Control Point D) to allow appointees to take the necessary steps to ensure the tender is successful to enable the project to proceed.
- We welcome the possibility of staggered consent at Control Points D and E as a useful form of flexibility to allow Appointees to progress with delivery in the best interests of customers.
- We also welcome the notion that the "DPC Allowed Revenue Direction" should be made available in draft to Appointees in advance and are of the view that this and consultation with the appointee should be a formal part of the process of issuing a DPC Allowed Revenue Direction.
- We recognise and support Ofwat's proposal that companies submit their procurement plans and programme timelines early on, with a view to Ofwat providing support, review and approval. However, the DPC process guidance places significant obligation upon UU to produce materials for Ofwat's review throughout scheme development, the tender process itself and into the delivery phase. As Appointees commit to deliver in line with pre-approved timelines, Ofwat must also provide certainty around its role in the process, specifically:
        - Timescales for review of Appointee submissions. This is particularly important throughout the development of Appointee submissions, so that the procurement process and CAP Agreement are developed in line with Ofwat's expectations and aligned to agreed principles, i.e. there are no surprises and consent control points; and
        - At consent Control Points E and F, where any delay has the potential to disrupt the CAP procurement process. Certainty of the timescales for review here will be essential to give comfort to potential CAP bidders.
- The nature of approval Appointees can expect to receive - see the above response to Question 1, section 5 for our comments on the approach to approval at Control Point E. The nature of approval at all Control Points requires some further definition (e.g. what Ofwat is providing in

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response to control points C and D, if not approval). Ofwat's assessment and the form of consent must also take into account Ofwat's obligations towards Appointees, in addition to its obligation to customers.

- The nature of the relationship between the Appointee, Ofwat and the ITA needs further definition. Ofwat state that assurance and evidence at key decisions points may be required from an ITA. If this is to be the case, then it will be necessary to identify which elements of each Control Point submission will require an ITA to review/input/assure/approve materials in advance of Appointee submission. Clarification would also be welcome as to when an ITA is expected to be involved. Discussions with Ofwat have suggested that this role would be effective from when the contract is awarded (after Control Point F), whereas the document references an ITA being involved during the Appointee's development of schemes in advance of contract award.
- Further consideration needs to be given to Ofwat's expectations of the Appointee's role in the CAP's delivery and for the duration of the contract once award has been made. Ofwat's expectation that Appointees are not "risk neutral" implies an intention for Appointees to take an active role in CAP management throughout the life of the programme – however, it is important to note (as set out in response to questions 2 and 4 above) that delivery risk will have primarily transferred to the CAP, and that the appointees role in a DPC is more limited to enforcement of the CAP agreement. The nature of this expectation will need to be defined well in advance of any formal tender process, and should be tested with the market. The contractual terms will need to be sufficient to manage CAP delivery.
- We welcome increased recognition of residual value payments and the challenges these might present, particularly for assets with long asset lives. It will be essential to the success of DPC procurements that CAPs (in managing their counterparty risk) have clarity and certainty on how residual payment will paid for and financed.
- On DPC exit, whilst we note the need for Ofwat's consent, where UU has discretion over whether or not to exit the DPC, the process under which an Appointee would provide evidence that exit was necessary risks becoming lengthy, and potentially detrimental to the market's interest in projects themselves. We suggest that Ofwat's approach to this should emphasise pragmatism and customers' interests, and should be time-limited to reduce uncertainty.
- We note that the most recent formal publication of Ofwat's DPC principles can be found in its DPC draft determinations document published in July 2019, although variations and consultation on these principles have been shared and discussed with Appointees since this time. We propose that Ofwat confirm whether:
    - The July 2019 principles are now considered final and will not be subject to further revision; or
    - Whether a further iteration of the principles is to be expected, and if so, when these will be made available to Appointees and finalised.

6. If a CAP terminates the CAP Agreement with the water company should we are consider further provisions in the new licence condition and what should these be?

- The key principle here is that both customer **and** appointee should be appropriately protected from CAP termination, which may not be due to any fault of either party and could be demonstrably in the long term interests of both parties.
- As such it is essential that (a) ongoing service to customers should be protected – as such so the appointee should have instantaneous control over any CAP assets, and (b) reasonable costs incurred by appointee should be recoverable from customers – e.g. if we have to buy the CAP

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out of the contract early, or pay compensation on termination to the CAP, then that should be clearly specified in the licence as a recoverable cost (fully equivalent to annual CAP payments, and to residual payment at the end of the contract).

- We also recognise that, depending on the point of exit, there may be additional costs arising the project if (for example) the CAP has left the appointee with restitution costs that may not otherwise be recoverable from the agreement (e.g. due to insolvency). It is essential for Companies (and CAPs, in understanding their counterparty risk) to have clarity on how this would work – e.g. whether this would be eligible for Ofwat's proposed new DPC class of IDoK mechanism, or whether costs are directly recoverable from customers (e.g. if they result directly from the CAP agreement).

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

- In its summary of Licence Amendment 2 – Amendment to Condition B (Charges), Ofwat states *"Ofwat will safeguard customer interests and ensure that value for money is achieved as the decision to proceed with the DPC will be taken through a rigorous procurement process with gated decisions. It is important to note that* ***DPC arrangements do not allow the CAP to charge more than would be the case if the project were undertaken in house****"* (Emphasis added). We do not agree that will necessarily be the case. For example, if the CAP requires a smaller residual payment than would be implied by in-house delivery, then it could require higher payments within the contract period – these payments may result in higher bill impacts than in-house delivery during the contract period, even though (when taken together with the residual payment) it is still delivering better overall long term value for customers. We suggest that such definitive statements are probably unhelpful to the success of the DPC approach, and it would be better just to refer to DPC contracts needing to provide better longer term value for money for customers than in-house approaches. We would also suggest that Ofwat should clarify that the approved CAP agreement is the ultimate outcome of Ofwat's process and gated decisions to ensure that there are no concerns from potential CAPs that contractual arrangements could later be deemed to not have been 'value for money' if there is a policy change.

Our comments on the proposed licence amendment drafting is set out below:

Condition U

- On section 2 (Designation of a DPC Delivered Project) and section 4 (Appointee's Responsibilities), as we note above in response to question 1 (#XXX) these is a risk of a conflict if the appointee considers that a project's DPC designation is contrary to its other obligations.
- In section 4, whilst we accept that appointees obviously remain liable for compliance with their licence, we would be concerned about a limitation on any legally available defences to any relevant offence(s). There would be, in our view, a number of legal issues raised by a general licence condition which resulted in a breach of licence where defences available in statute at the will of Parliament or in common law are used (although the wording of 4.2 still technically allows the defence to be used, it limits its application in a way not found in statute). We would respectfully suggest that Ofwat should be cautious about seeking to limit appointees' legal defences or rights of defence more generally.
- 6.22 – the requirement for Ofwat to be notified of breaches by the CAP is understandable but it is important to distinguish between material breaches and small, inconsequential breaches. The

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latter would impose a significant information burden on both the CAP and the Appointee (as well as Ofwat). Given the existing cooperation within the water regulatory regime and Ofwat's proposed information request provisions (as well as existing licence provisions) this would be a more proportionate approach.

- 6.4 may be triggered by events outside of our control (e.g. CAP insolvency), and hence it may be helpful for Ofwat to either allow for those eventualities within the clause, or to state that there would be deemed consent in such circumstances.
- 6.5 – see our response to Q3 above, on how to assess material changes requiring consent.
- Section 7 feels, in general, to be insufficiently certain (as described above and in our specific comments below). It will be unhelpful for both companies and CAPs if collection of revenues from customers (for CAP payments) is not more of a direct and mechanistic consequence of DPC designation. Our working assumption is that there would generally be a clear 'pass-through' of CAP charges but this is not clearly set out at present in the drafting. In particular, clauses 7.3-7.4 are framed too generally, and appear to provide Ofwat with the ability to modify/revoke the DPC allowed revenue direction, without specifying the circumstances under which could trigger Ofwat activating these clauses (such as at the appointee's request, on insolvency or in the event of DPC exit etc.). Given that the CAP agreement and the allowed revenue direction should correctly defined from the outset, it is difficult to see how any subsequent changes could be justified, or acceptable to either company or the CAP. In the event that there is a problem that needs to be addressed, this could be subject to the general allowance to vary the contract with Ofwat's consent.7.2.1-7.2.7 – this appears to provide sufficient flexibility to enable both (a) different approaches to the phasing of payments (e.g. to enable payments for completion of sections of tunnel in the case of our project), and (b) allowances for reflecting the cost of differences in the timing of payments, and the cost of bad debt, within the revenue agreement. On that basis, we are content with the drafting, noting that the specific details will be set out within the revenue agreement. It would be helpful for Ofwat to confirm that is the intent of these clauses.
- 9.1 – as noted above, in some circumstances we may have no choice other than to terminate a CAP agreement, so it would therefore be helpful if that is recognised in the drafting, in particular given that there may be circumstances where any active management obligation in the licence would require it or where it is manifestly in the best interests of customers. We will also have contractual obligations in relation to any payments due at the point of termination. Ofwat will have already approved the CAP agreement, which will have included such clauses, and denial of that could put us in breach of contract.
- 9.4 - whilst we understand this in principle, appointees should not be put in a position where a licence obligation and / or Ofwat's direction puts them in breach of the CAP agreement as this could undermine the CAP agreement from the outset.
- 9.5. – we presume that the purpose of this clause is to enable re-procurement of new DPC contract following termination of an existing CAP agreement. Whilst we understand the intention, this process should be explored further to ensure that there are no issues arising which could harm either (a) the continuity of service to customers, or (b) the ability of the company to finance the transition from one CAP arrangement to a new one – in particular any compensation/termination payments that are payable due to the terminated CAP agreement, and/or the cost of the re-procurement of a new CAP arrangement.
- 10.1.2 – this seems to suggest that the associate of any appointee could not bid for a DPC even if it was a DPC undertaken by a different water company. We do not believe that this is what Ofwat intended.

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- 10.2.3 – this appears to conflict with our proposed arrangements for "advance procurement" (e.g. land and utility connections) for the CAP. It is possible that a CAP may (for many reasons) refer to services being provided by the company within the CAP agreement – e.g. a CAP may sub-contract operations back to the company if its interest lie predominantly in the financing and construction of any assets. It may be that the "prior written consent of Ofwat" noted in clause 10.1 is sufficient.
- 10.3 – as noted above, we may be faced with a termination event that is outside of our control. In that case, the company may need to step in temporarily (or permanently) with immediate effect, to avoid detrimental impact on customer service (e.g. if the CAP has suspended operations).
- 11.3 – the requirement for "*a certificate warranting the accuracy of the information provided*", with the level of board assurance set out in 22.3.1 and 11.3.2 appears very unreasonable given (a) the broadly defined requirements in 11.1 and 11.2, (b) that information will be from a third party (the CAP) rather than directly sourced from the company's corporate systems, and (c) the (likely) detailed nature of project level information, which does not so easily lend itself to such onerous levels of board assurance. This also seems to go far beyond (without explanation) Ofwat's general powers to obtain information through condition M and, if unsatisfied by that process, through s203 of the Water Industry Act. We cannot therefore accept these requirements.
- 11.4 – it is not clear that it will be possible to meet this expectation - just because the CAP can reasonably obtain something doesn't mean they have to give it to the appointee, unless it is specified within the contract. Whilst we may attempt to "back to back" condition M into the contract, this may be unacceptable to potential bidders and the appointee is unable to rely on the same statutory backing that is bestowed on the regulator. Ofwat should recognise that water companies do not have the same information gathering powers as Ofwat, in relation the contracts operated by companies.
- 12.2.2 – in practice, the water company will procure the ITA, presumably with some involvement from Ofwat. Recovery of costs for the ITA will need to be included in the CAP agreement and paid by the CAP (or recharged back to the CAP by the appointee, and hence recovered from the charge to customers). As such, the company may be judged as providing a named service into the DPC contract, as per clause 10.2.3, and therefore an explicit exception needs to be made for the costs of this service. It is also unclear whether what Ofwat would like is obtainable from the market (at least in a cost effective manner).
- 12.3 – this mentions confidentiality, stating that the ITA can only disclose information to Ofwat and CAP – presumably the ITA can also disclose information to the water company. This should be clarified in the contract terms.

Condition B

- Paragraph 3 refers to Bioresources activities – it was our understanding the Bioresources projects were exempt from DPC.
- There are a number of questions which arise in relation to the drafting of the definition of DPC Allowed Revenue. We have set out a number of views above on where further information on how this is envisaged to interact with other areas and the issues that should be clearly set out in a DPC Allowed Revenue Direction. In basic terms, we would welcome a clear explanation of what will be included and the adjustments that would be catered for in principle within such a direction. We would also welcome clarity on the process which Ofwat envisages for finalising the

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DPC Allowed Revenue Direction. As noted above, we welcome the notion that appointees will be provided with drafts but we note with some concern that the current drafting appears to provide Ofwat with a wide discretion as to the CAP Charges to include in an Allowed Revenue Direction. Given that CAP Charges will be payable by the appointee, the general position should be that they will be included in the DPC Allowed Revenue Direction without the need for the application of discretion. It will be important for both CAPs and appointees to understand that due and payable charges under the contract which have been approved by Ofwat are not liable to subsequently be 'disallowed' and therefore potentially not payable (or left as a matter of dispute between the CAP and the appointee).

- In addition, we note the following points:
    - It appears unclear whether an appointee's own DPC costs are recoverable via the price control determination (as provided for in appendix 9 to the PR19 Methodology)
    - The drafting is forwards looking and does not appear to take account of any mechanics in the CAP agreement which would change the CAP Charges due within a year. Similar to the points raised above in respect of bad debt, payment timing etc., it will be important to ensure that the pass through mechanism appropriately accounts for changes in payment which mean that CAP Charges are due and payable and the potential time-lag for such changes to be collected from customers. Given the nature of the DPC process, appointees are not in a position to effectively finance such changes to customers' benefit and their own detriment.
    - Similarly, the proposed amendments to the licence do not specify particularly for how residual payments/early termination payments, and how these are also recoverable by UU from customers. We assume that these payments are all equally legitimate under the licence amendments, but it would be helpful for all parties if that was more clearly specified.
    - In sub-clause (2) the requirement for justification of CAP Charges seems to be superfluous if such charges are included in the approved CAP agreement, unless this is simply referring to the appointee ensuring that invoices have been issued.
    - It is unclear what the final paragraph of the definition is aimed at protecting. Again, we would expect a pass-through of due and payable charges under the CAP agreement. As described in response to question 4, above, the vast majority of breach or management issues should be legislated for in the CAP agreement and the appointee should not necessarily bear the risk of additional payments due in those ordinary circumstances. Whilst, clearly, customers should not be liable to pay for fraud or misconduct of an appointee, it is difficult to see how this could arise given that the contract will set out the relevant mechanisms for charges and, in any event, the law and regulation already provide remedies for such circumstances (although the definition of 'misconduct' is unclear). We also note that appointees generally take compliance and good governance seriously and devote significant resources to ensure compliance with the law and regulatory obligations.
    - It is also unclear whether Ofwat intends for the reference to agents or contractors to include (for example) the ITA or the CAP itself.

We have also set out proposed amendments to the licence condition drafting in the enclosed document “UUW response to DPC licence proposals – drafting comments.doc”.

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