

By email: DPC@ofwat.gov.uk
DPC Licensing Consultation
Ofwat

21 April 2020

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

Thank you for the opportunity to respond to this consultation. Our response is provided below.

Our expectation is that in our supply area the DPC model will be limited to the design, build and finance elements. This is likely to have implications for the details of the licence amendments that will be required, such that they will differ from those of other companies. As this has not been covered in the consultation, we would suggest that this will require further consideration of the detail, and we will be willing to work with Ofwat and the Welsh Government as appropriate on the detail. Our response to the consultation has been prepared based on the assumption that the operations and maintenance elements are excluded from the DPC model.

Best regards

Eleri Rees

Strategy and Regulation Director

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

In general, we agree with the principles behind Ofwat's proposed licence amendments. There are, however, a number of areas where greater clarity is still needed around Ofwat's processes and requirements in order to provide transparency and certainty to undertakers and potential bidders to be the Competitively Appointed Provider (CAP). We have provided detailed comments in our response to question 7. The key aspects where more detail is required are in relation to:

1. Ofwat consent
2. Revocation of the Designation of the DPC Delivered Project.

1. Ofwat consent

The proposed new Licence Condition U requires Ofwat's written consent in relation to a number of issues, most notably:

- awarding the CAP agreement (including conditions of consent);
- variations to the CAP agreement;
- change in Ultimate Controller of the CAP; and
- termination of the CAP agreement.

We understand the importance of Ofwat's role in these areas. However, for potential bidders Ofwat's role may represent a substantial additional unknown risk and this may affect their decision to bid (reducing the pool of available investors) and the price they bid. Water companies will need to manage this risk through timely and comprehensive engagement with potential bidders and, in the case of variations and change of control, potentially include commensurate provisions in the CAP agreement.

It is noted that before the procurement can proceed, a "hard consent" is required by Ofwat for the procurement process and the proposed terms and conditions of the CAP agreement. Timely engagement between Ofwat and water companies would, therefore, be required to agree the structure of the CAP, the list of key terms and conditions and in particular, to note any terms which are likely to be non-negotiable requirements for Ofwat. A detailed understanding of Ofwat's "red lines" would be helpful for water companies as it would then inform their commercial negotiation during the drafting and tender process. Ofwat's hard consent would also be required at preferred bidder stage to ensure that no clauses have been compromised or additional clauses included to the detriment of customers.

We therefore recommend further engagement on the specifics of Ofwat's consent processes and requirements, and further information included on these processes in the licence so that bidders have transparency and certainty.

2. Revocation of designation

While the proposed licence condition makes reference to revocation of designation by agreement, and the DPC briefing note identifies possible points when DPC exit is more likely to occur, the process for revocation is unclear. Given the situations in which revocation might need to occur, such as abandonment of the procurement process or termination of the CAP agreement, it would be helpful to have a clear path to revocation or retendering so that delivery of the project can progress in an efficient manner and the risk to customers of late/no delivery is minimised.

Please see our response to question 7 for further comments.

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?

We do not support the proposal to introduce Outcome Delivery Incentives related specifically to manage the CAP agreement. Companies are already incentivised to deliver DPCs, both reputationally and in order to fulfil their other commitments (including performance commitments) set out in the Final Determination.

By definition DPC Projects are of a size that means they are likely be strategically important to water companies and companies' ability to continue to provide services to customers. Poor contract management of the CAP agreement will result in works that don't meet the companies' needs, resulting in additional rectification costs, service failures, reputational damage and/or potential enforcement action. Therefore, the water company has a vested interest in the successful delivery of the works – in terms of scope, quality, time and budget. Furthermore, the incentives and risk transfer in the CAP agreement should be sufficient for them to deliver the works on time, budget and up to the required standard.

3. Should a materiality threshold be applied to consent to vary the CAP Agreement? If so what level of materiality should be applied and how should this be worded for the new licence condition?

Yes, we agree that a materiality threshold should be applied to the requirement for Ofwat to provide written consent to variations to the CAP agreement, and materiality should be considered in terms of:

- an impact on (current or future) DPC Allowed Revenue which would impact on customers' bills, subject to a defined de minimis threshold; or
- a change requiring a modification to the designation.

Any definition would need to align with the variation procedure in the CAP Agreement. For example, some PPPs have defined a material variation as a change where the costs to implement are above a certain threshold. Agreement of the definition of materiality could be considered as part of the process to approve the Full Business Case and consent to award of the CAP Agreement, and included in the documentation at that point.

Please see our response to question 7 for further comments on Ofwat's role in the variation process.

4. Please tell us your views on the appropriate balance of risk the water company is undertaking? What level of risk do you think the water company should be taking in this process?

The balance of risk will vary according to project type and should ultimately be tested as part of market engagement. Overall, we consider water companies are taking a significant amount of risk through the DPC model. While it is right that water companies take on risk, the model is novel and untested, and therefore the allocation of risk between customers and the company needs to be carefully balanced. As a guiding principle, we do not believe that companies should take more risk in operations and maintenance under the DPC delivery route than they would under a conventional delivery option.

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

We welcome the publication of the DPC briefing note and consider it an important step in providing water companies, external stakeholders and potential investors with transparency around how the DPC procurement process is expected to work. The success of the DPC model will be dependent on water companies' and Ofwat's ability to effectively collaborate on key issues, and to provide confidence to each other, interested bidders, and stakeholders, in the transparency and certainty of each other's respective processes. Currently, the briefing note provides limited information on Ofwat's processes to review the various business cases and provide related consent. Further information on Ofwat's processes, for example, on the indicative timing of each approval point would allow companies to develop more robust procurement plans and manage stakeholders' expectations.

In relation to the briefing note and as a result of the proposed licence conditions, we have identified several areas where there needs to be close collaboration between companies and Ofwat to ensure (a) bidders have transparency and certainty around key processes, and (b) the licence conditions and the terms and conditions in the CAP agreement are appropriately aligned - for example, the processes for Ofwat to approve material variations and changes to Ultimate Control.

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?

Issues relating to termination of the agreement by the CAP should be covered in the Licence by the inclusion of a more general condition setting out the process for revocation of designation or re-tendering.

In addition, there are issues around payment of compensation on termination of the CAP agreement (regardless of who terminates) as well as payment of residual value on expiry of the CAP agreement, that need to be addressed in the Licence. The value of these payments could be extremely high and both water companies and bidders need to have certainty that the water company will be able to pay these sums. While, we understand Ofwat is considering uncertainty mechanisms to help manage these issues, it would help provide certainty to bidders if conditions U6 and U9 reflected that Ofwat will allow efficient costs associated with expiry and termination, including payment of compensation and "bullet payments", to be recovered from customers.

Please see our response to question 7 for more detail.

	<p>Ofwat will set out the scope of the DPC delivered project</p> <p>Additional clause required to refer to the impact of designation on the Appointee’s ability to undertake the DPC project itself</p>	<p>final CAP Agreement or in any proposed modification.</p> <p>May in any case want to include “and activities” after “scope” as below:</p> <p>2.2 As part of any direction issued pursuant to paragraphs U2.1.1 and U2.1.2, Ofwat will set out in writing the scope (or, if applicable, the modified scope) and activities of the DPC</p> <p>Delivered Project.</p> <p>While several other sections deal with the requirement for the Appointee to put the project out to tender, and to address the issue of whether the Appointee or its associated companies can bid in the procurement process, there isn’t a condition that deals with the possibility that the Appointee is required to implement the project itself following revocation.</p> <ul style="list-style-type: none"> - following any revocation of designation, the Appointee will not be required to implement the project without additional funding and Ofwat’s approval of the way forward following the revocation.
<p>eU2: Designation of a DPC Delivered Project</p>	<p>Revocation of a designation by agreement</p>	<p>While the briefing note on DPC identifies points where DPC exit might occur, the process is not clear. We would welcome further clarity on the process for revocation, particularly where</p> <ul style="list-style-type: none"> - the business case no longer shows delivery via DPC as value for money for customers; - the procurement process has to be abandoned; - Ofwat does not provide consent to award the CAP agreement; or

		<ul style="list-style-type: none"> - the CAP Agreement is terminated. <p>In particular, we consider that it would be in customers' best interests to provide for a time-limited process for both the Appointee to request revocation once one of the above conditions has been met, and a time-limited period for Ofwat to make a decision on the revocation.</p>
U4.1 Appointee's Responsibilities	The designation of a DPC Delivered Project, any consent issued by Ofwat (or failure to issue such consent) and the appointment of a CAP to undertake a DPC Delivered Project does not reduce, restrict, limit or diminish the responsibilities, obligations or liabilities of the Appointee as a relevant undertaker in respect of the DPC Delivered Project (including pursuant to the Appointment).	Given the CAP isn't a licensed infrastructure provider under WIA91, we recognise that the responsibilities as an undertaker are retained by the Appointee. However, the proposed licence condition needs to recognise that the undertaker's rights and powers in relation to the asset and its operation are limited by the use of DPC. While the CAP agreement can seek to manage these issues, the contractual mechanisms will limit the extent and the speed to which issues with the delivery or operations of the project can be resolved.
U4.2 Appointee's Responsibilities	<p>"The Appointee must not, if prosecuted for any alleged offence or accused of any breach of any provision in the Water Industry Act 1991 or the Water Resources Act 1991, or any regulations made under either such Act, which is alleged to have occurred in relation to any of its functions as the Appointee the performance (or non-performance)....</p> <p>... raise any defence of:</p> <p>4.2.3. due diligence, such as that in section 70(3)(b)</p>	<p>While a similar provision is already included in Welsh Water's Instrument of Appointment, the current condition relates to the outsourcing of business as usual services, where the control and ownership of the assets and services are fully within its control (and the regulatory ring-fence).</p> <p>DPC is a fundamentally different model, which places the ownership and control of assets outside of the full control of the undertaker and the regulatory ring-fence. Therefore, the extent of control over the CAP and assets is more limited.</p> <p>More generally, we do not consider that the use of any defence should be prohibited.</p>

	of the Water Industry Act 1991 (or any provision to similar effect)...”	
U5.1 Procurement Process	Conditions imposed by Ofwat consent for Appointee to commence the DPC Procurement Process	<p>We understand that Ofwat may need to include conditions in its consent for an Appointee to commence the DPC process. It will be important that any conditions are first discussed and agreed with the Appointee, this is to avoid conditions being imposed that will have a negative impact on the procurement process and could disproportionately increase costs for customers. We, therefore, propose that the licence condition is updated to reflect that conditions will only be included following consultation and agreement with the Appointee.</p> <p>Please see the comments made earlier on.</p>
U5.2	A licence condition that places an obligation on the Appointee to takes all reasonable endeavours to ensure that the DPC process achieves best value for customers	<p>As noted in our previous consultation responses, in order to achieve best value for customers there needs to be an uncertainty mechanism with triviality and materiality threshold appropriate to the size of DPC projects.</p> <p>Repeated tender processes as a result of the failure of the value for money test at the FBC stage could result in unacceptable delays in the delivery of outputs to meet regulatory obligations. We would welcome a clear process for the project to exit the DPC delivery route at this stage.</p>

<p>U6.2.2 CAP Agreement notifications</p>	<p>Notifications of any breach or non-compliance with any Approved CAP Agreement by the Appointee or the CAP</p>	<p>As noted below it is unlikely to be feasible or value for money for Ofwat to be notified of every breach or non-compliance with the CAP agreement by either the CAP or the Appointee. We consider that a materiality threshold should be introduced to limit such notifications to those that may impact upon termination of the CAP Agreement or customers' bills.</p>
<p>U6.4 Ofwat's written consent</p>	<p>The Appointee must not without the prior written consent of Ofwat, assign, novate, transfer or suspend an Approved CAP Agreement (or any part thereof).</p>	<p>It is proposed that the clause is amended to remove the requirement to obtain Ofwat's written agreement where suspension of an Approved CAP Agreement or step in may, in the opinion of the Appointee, be required for H&S or public health reasons.</p>
<p>U6.5 CAP Agreement - variations</p>	<p>The Appointee must not, without the prior written consent of Ofwat, adjust, vary, modify or amend an Approved CAP Agreement (or any part thereof).</p>	<p>Given the average CAP agreement is likely to be c. 25-30 years in length, and that by the end of AMP 8 there could be 10-20 agreements in the industry, it is unlikely to be feasible or value for money for Ofwat to provide consent to every variation to the CAP agreement.</p> <p>We, therefore, consider it proportionate if consent is only required for material variations where the variation results in:</p> <ul style="list-style-type: none"> • an impact on (current or future) DPC Allowed Revenue that would impact on customers' bills subject to a defined de minimis threshold; or • a change requiring a modification to the designation. <p>Any definition would need to align with the variation procedure in the CAP Agreement. Agreement of the definition of materiality could be considered as part of the process to approve the Full</p>

		<p>Business Case and consent to award of the CAP Agreement</p> <p>To ensure the variations process is timely and operates efficiently, we would welcome further engagement with Ofwat on its requirements for the process to consent to material variations. This will ensure that the variation procedure is realistic and that the CAP has transparency and confidence in the process. In particular, as Ofwat will not be a party to the CAP agreement, bidders (and the successful CAP) are likely to look for commitment that Ofwat will operate within the scope of the variations procedure. This should sit outside the Licence in separate Guidance document.</p>
U6: CAP agreement	Expiry of agreement	<p>Currently the licence condition does not provide any reference to the payment of end of contract payments to the CAP. These bullet payments are intended to cover the residual value of the asset and could be extremely large. Given the potential value of these payments, it will be important that bidders have certainty that the water companies will be able to make these payments whether they fall at the end of the project period or earlier as a result of termination.</p> <p>While we would expect these costs to be allowed for in the price control mechanism and water companies would be able to recover these costs from customers, there is no certainty for bidders that this will be the case in 25-30 years. We therefore recommend that Ofwat includes a specific provision in licence condition U6 that Ofwat will allow water companies to recover from customers (through the relevant price control) the efficient costs associated with expiry of the CAP agreement (including bullet payments).</p>

<p>U7: DPC Allowed Revenue Direction</p> <p>(and new definition DPC Allowed Revenue)</p>	<p>Areas for further consultation and guidance</p>	<p>The proposed definition is currently unclear in a number of respects. The reference to amounts becoming due and payable “as a result of a breach of a CAP Agreement...” may catch de minimis impacts, and the use of the term “contractors” should make clear that this does not extend to the CAP (or its subcontractors) in any event.</p>
<p>U8: Ultimate Controller of the CAP</p>	<p>The Appointee must not, without the prior written consent of Ofwat, approve any change in the Ultimate Controller of the CAP.</p>	<p>We understand Ofwat’s interest in any changes to the Ultimate Controller of the CAP, and ensuring that a change of control will maintain strong performance of the CAP. However, the requirement for Ofwat to provide written consent for any changes in Ultimate Control for the entire duration of the CAP agreement could be perceived by potential bidders as unusually restrictive. This would also limit the potential for the secondary market to develop, which is quite important for investors in terms of their freedom to recycle private capital as necessary to suit their strategic interests.</p> <p>As commensurate restrictions would need to be included in the CAP agreement, this could likely become a key issue for bidders and may reduce the pool of interested investors.</p> <p>We recommend several actions that could address this uncertainty with bidders:</p> <ol style="list-style-type: none"> 1) Ofwat publishes guidance on the process it will follow to consider changes of control and the criteria it will consider in evaluation and any red lines it might have (e.g. level of dilution of control or includes these in a standard form agreement to form part of the suite of documents, and to which the CAP is a party; and

		<p>2) Time-limiting the requirement for written consent from Ofwat, for example, written consent from Ofwat could only be required for changes of ownership until the end of the commissioning and handover..</p>
U9.5 Termination of an Approved CAP Agreement	Any termination of any Approved CAP Agreement will not automatically result in a revocation of any designation of a DPC Delivered Project.	As per our comment in relation to condition U2, we would welcome more detail on the process following termination to either revocation of the designation or modification of the designation.
U9	Compensation on termination	<p>Similar to our comments in relation to U6, currently the licence condition does not provide any reference to the payment of compensation on termination. Compensation could be significant given that it will include within it the residual value of the asset.</p> <p>Given the potential value of these payments, it will be important that bidders have certainty that the water companies will be able to make these payments should the agreement be terminated by either party. While we understand that Ofwat is considering uncertainty mechanism that could address these sort of issues, these may not provide sufficient certainty to bidders. We therefore recommend that Ofwat includes a specific provision in licence condition U9 that Ofwat will allow water companies to recover from customers (through the relevant price control) the efficient costs associated with termination of the CAP agreement (including compensation payments).</p> <p>9.3 Ofwat direction of treatment of any revenue collected that has not been passed onto the CAP.</p>

U12	Independent Technical Advisor (ITA)	<p>It is understood that the role of the ITA is intended to apply only during the construction and commissioning phase of the DPC. It would be helpful if U12 could be amended to clarify this position.</p> <p>U12.3 as drafted precludes the ITA from disclosing information to the Appointee, it is suggested that the Appointee is included as a relevant party in this clause.</p>
B 9.4(1)	<p>“In respect of the Appointed Business's Water Resources Activities, Bioresources Activities, Network Plus Water Activities and Network Plus Wastewater Activities except for those activities for which there are Excluded Charges or those activities that constitute a DPC Delivered Project.”</p>	<p>Activities for which there are Excluded Charges are explicitly laid out in the Licence, so it would be good practice to set out the activities that constitute a DPC Delivered Project in a similar way. The proposed definition is:</p> <p>“DPC Delivered Project” means such project and associated activities that are so designated from time to time by Ofwat in accordance with paragraph U2 of Condition U”</p>
B 14.2(3)(i)(E)	<p>No account shall be taken of:...</p> <p>(E) any costs, receipts or savings that are associated with a DPC Delivered Project</p>	<p>At present, the drafting could be interpreted as excluding the Appointee’s costs, receipts or savings associated with a DPC Delivered Project (for example, its procurement and contract management costs), rather than the CAP’s costs etc. We propose that the drafting is changed to:</p> <p>any costs, receipts or savings that are associated with any DPC Delivered Project that is not a Notified Item or arising through a Relevant Change of Circumstance;</p>

<p>New definition to be inserted into Condition A: Interpretation and Construction at the relevant place (p.35)</p>	<p>Timing Challenges of Collection and Tariff Setting</p>	<p>Any DPC Allowed Revenue determined part way through a year would require a true-up, similar to the RFI for most of the wholesale Revenue Controls, to allow charges to be set in subsequent years to recover the full allowance. Alternatively, the calculation method for the DPC Allowed Revenue should result in an allowance that can be published on a full charging year basis taking account of any CAP Charges arising before the start of the DPC Allowed Revenue. We would expect that these issues would be discussed as we work with you on the form and process for the DPC Allowed Revenue Direction.</p>
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