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Dear David

Re: Ofwat consultation on proposed amendments to licence conditions for direct procurement for customers

Thank you for your emails regarding this consultation. Please find our response to your questions below.

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

We have highlighted initial concerns as part of our responses below. However, we feel we are unable to respond fully without being able to assess the overall impact of all proposed changes including those relating to the uncertainty mechanism, which will be consulted on later in the year. There are many open-ended questions in the amendments, and we do not feel it is appropriate to commence projects with such substantial value, or to implement licence conditions, without significant further clarity.

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?

Ofwat is adding a licence condition to ensure a water company's role is to manage a DPC scheme in its customers' interests. This is presumably intended to act as an incentive. Because a DPC is based on a contract with a third party, an ODI does not seem appropriate. ODIs were implemented to both provide an incentive to achieve stretching performance and to penalise poor performance. It is not clear on what basis an incumbent will be rewarded for managing a successful DPC.

In terms of ODI's penalising poor performance, it would seem that the contract, which Ofwat will agree in the process, should ensure that the DPC operates in customers' interests. If there is a major contractual issue, it is usually quite difficult to place blame on one side or the other and therefore penalising the water company does not seem appropriate as they will still need to manage the delivery of the outcome.

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?

Whilst some form of materiality threshold would need to be applied to any consent to vary the CAP Agreement, this is not straightforward given the wide range of potential variations and related consequences of such variations. This is something which has given rise to a substantial amount of case law in the European Court of Justice in the context of procurement law.

And indeed, as you are aware, the Utilities Contracts Regulations 2016 set out the circumstances in which contracts may be varied without a new procurement process including where:

- the changes are low value/below threshold;
- changes have already been provided for in the initial procurement documents in clear, precise and unequivocal review clauses (e.g. price revising clauses) provided such clauses state the scope/nature of the possible changes and the conditions under which they may be used, and the changes do not alter the overall nature of the contract;
- changes that are not “substantial” as defined by reference to the “materiality” tests established by the EU courts.

The Regulations further introduce a right for the Appointee to terminate the contract in certain circumstances which include “substantial” modifications.

It is not clear, therefore, what purpose such consent would serve as this process is well covered by EU law. Further, we cannot see how or why any materiality threshold should differ from that already established in EU law.

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?

Our reading of the amendments is that all (or almost all) the risk will fall on the water company. The original theory behind the DPC concept was that where a third party was willing and able to take on risk at a level lower than that allowed for under the price control, then there may be a cheaper way of delivering these large programmes. This only works if those third parties take on that risk. This is how the model works in all other similar schemes (offshore transmission, natural gas, Thames Tideway, etc.)

We agree that the final risk of non-compliance against legal requirements should fall with the water company but note that there is a real risk of cost escalation for water companies in managing the risk that a CAP does not allow such a failing, which will not be included within the DPC allowed revenue.

We do not believe it is appropriate that water companies should bear all the risk of ineligible CAP charges and propose that these should either be passed on or clearly defined in advance.

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

Whilst it is key to have a clear process in place including the various stages at which further information/consent is required and the role which each Ofwat and the Appointees will have to fulfil in that respect, there are a number of uncertainties and concerns which will need to be clarified and addressed:

- (a) This process should fit in with the procurement timetable generally and ensure that there is no undue delay which could potentially impact on the success of the procurement or have other financial consequences. It is not clear how this will be managed by Ofwat.
- (b) How Ofwat's withholding of its consent (or making it partial or conditional) at the various stage of the process will impact on the project, its funding and ultimately the customers. Ofwat will need to provide assurances to avoid any negative effects.
- (c) The briefing note states that whilst Ofwat is not mandating that information or assurance is externally assured in all circumstances, Ofwat may require reports from an independent technical adviser through the life of the DPC procurement process and the CAP Agreement. This requirement is reflected in the proposed amendments to the licence. This raises several concerns including requirement to fit in with the overall procurement process timetable (as set out above) and costs of such engagement. We feel that such appointment should be linked to clear stages in the process and would only apply in specific circumstances (to be determined);
- (d) Assurance and the CAP Agreement. Ofwat states that it will consider publishing additional guidance with respect to specific topics (change in control, disputes, design risk, pricing and indexation, revenue reopeners, termination etc.) to assist Appointees in developing their CAP Agreements. We would like assurances that this will be provided as this will in turn ensure a smoother procurement/consent process as well as consistency for all CAP procurement;
- (e) The briefing note states that if it is required for procurement of the DPC delivered project Ofwat may also make available a draft version of its intended DPC Allowed Revenue Direction. This will be informed by the draft CAP Agreement and will be subject to amendment and adjustment. It should be made clear in which circumstance this would not be required (on the basis that it is likely to affect the pricing evaluation for instance). Amendment and adjustment would also need to be fair, based on the offer received following the procurement process and based on the evaluation previously put in place.

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

This very much depends how the CAP terminates the CAP Agreement (e.g. voluntary termination, force majeure, breach by the Appointee, breach by the CAP itself, change in law etc.), and to a certain extent termination provisions of the CAP Agreement will cover the consequences of such termination. As commented above, we would expect to have some guidance from Ofwat in relation to such provisions.

Depending on the circumstances of such termination, the Appointee will need assurances from Ofwat in terms, for instance, of taking the project back in-house (it may not have the time to re-run a procurement process) and funding.

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

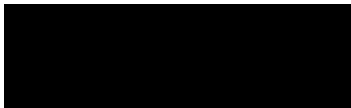
We refer you to the points raised above in relation to the proposed process. In addition, we would like clarification/assurances in relation to the below:

- (a) Condition U2.1 provides that Ofwat may, with the agreement of the Appointee and by direction designate, modify the designation of or revoke the designation of a DPC Delivered Project. It is not clear whether this means both the Appointee's agreement and direction are required, or either.
- (b) Condition U4.1 states that 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). Condition U4.2 further provides that the Appointee must not, if it is 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) of which was, at the relevant time included in the scope of any Approved CAP Agreement or any DPC Delivery Project, raise any defence of due diligence, such as that in section 70(3)(b) of the Water Industry Act 1991 (or any provision to similar effect). Given the proposed process including Ofwat's consent and engagement of an independent technical adviser at various stages of the process, we don't feel that such a wide exclusion should apply and circumstances should be assessed on a case by case basis as for any other procurement.
- (c) Condition U5.2 provides that the Appointee must use all reasonable endeavours to ensure that each DPC Procurement Process achieves best value for customers. "Best value" is not well defined and should include reference to objective criteria to include costs and non-costs factors.
- (d) Condition U6.3 provides that in undertaking any action or omission related to an Approved CAP Agreement (including undertaking its obligations (or failing to do so), exercising (or not exercising) or waiving its rights), the Appointee must at all times use all reasonable endeavours to ensure it achieves best value for customers. We are unclear as to why this Condition is necessary. There is a general requirement for the Appointee to comply with the terms of any Approved CAP Agreement and the procurement process will have ensured that this will have sought to achieve best value for customers.
- (e) Condition U6.5 provides that the Appointee must not, without the prior written consent of Ofwat, adjust, vary, modify or amend an Approved CAP Agreement (or any part thereof). We refer you to our previous comment in terms of materiality of any variations.

- (f) Condition U6.6. provides that the Appointee must not, without the prior written consent of Ofwat, extend the term of an Approved CAP Agreement. This should not include any extension permitted by the Approved CAP Agreement (as per the procurement process).
- (g) Condition U7. Please see above comments in relation to potential variation or termination of the Approved CAP Agreement which may affect funding. We would expect this to be taken into account in the final amendment.
- (h) Condition U9.1. Please see above comments regarding early termination of an Approved CAP Agreement. Condition 9.1 also provides that the Appointee must not, without Ofwat's prior written consent, terminate any Approved CAP Agreement – there may be circumstances where termination must occur without delay (e.g. to avoid breach of licence for instance), and it is not clear how this will be addressed.
- (i) Condition U12. Please see above comments in relation to the engagement of an Independent Technical Adviser.

If you have any questions or would like further clarifications, please do not hesitate to contact me.

Yours sincerely



Matt Greenfield
Director of regulation