July 2020

Appendix 4: Guidance on Allowed Revenue Direction

Ofwat

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Introduction

This document is a consultation on the guidance for the implementation of DPC Allowed Revenue Directions. The aim of this document is to provide greater detail as to how the DPC Allowed Revenue Direction for a CAP Agreement will operate.

Duration

The Allowed Revenue Direction would apply for the term (as set out on day one) of the relevant CAP Agreement. Ofwat could elect to extend the DPC Allowed Revenue Direction where appropriate.

There may need to be certain events – such as events of force majeure and changes in law – that delay the construction period and result in automatic extensions of the DPC Allowed Revenue Direction. These would have to be set out in advance and agreed with Ofwat. The determination as to the length of the consequent extension of the DPC Allowed Revenue Direction would be a matter for Ofwat following verification by the Independent Technical Adviser.

CAP Charges

The DPC Allowed Revenue Direction will need to reflect the formula for CAP Charges under the approved CAP Agreement as at day one. That is to say, we expect the payment formula in the CAP Agreement to be replicated in an appropriate section of the Allowed Revenue Direction.

Alterations would be made so that change/compensation events and performance deductions/rewards are administered separately under the DPC Allowed Revenue Direction (see below for further guidance on compensation events).

The structure of the CAP Charges Section of the DPC Allowed Revenue Direction will depend upon the pricing model in the approved CAP Agreement.

Whereas we intend to review the payment mechanisms proposed by Appointees for relevant CAP Agreements, we are not prescribing them. It is for the Appointee to consider the most appropriate payment mechanism for their DPC project. In doing so, we would expect Appointees to consider how customer interests are protected, how value for money is achieved and how the CAP is appropriately incentivised to deliver the DPC Delivered Project.

Example Payment Mechanism

As stated, the Allowed Revenue Direction will need to mirror the payment mechanism in the CAP Agreement. To assist companies we set out one possible example, at a high level, of how a payment mechanism in a CAP Agreement may operate. This is for illustrative purposes only and, for the sake of simplicity, is not written out in full.

As mentioned above, we expect companies to develop a payment mechanism that is suitable for their project and that demonstrates value for money to customers.

To note, in our example:

- We flag aspects of the payment mechanism that will be determined by the DPC Procurement Process in **blue.** These are the terms and proposals put forward by the CAP during the bidding.
- We set out aspects that will be separately determined under the DPC Allowed Revenue Direction and the CAP Agreement in **red**. The key distinction here is that, in general, the value of these items will be determined outside the bidding process and will be ongoing after contact award.

Example: High Level Formula for Payment Schedule in CAP Agreement:

> ***Annual CAP Charge*** = *(PFCB* x *Bid Return)* + *PFCBD* + *Opex Allowance* + ***Change/Compensation Event Sums*** + ***Performance Payments*** - ***Refinancing Gain share*** + ***Indexation***

Where:

	Term	Explanation
1	*PFCB*	PFCB is project fixed capital budget as at the date of the CAP Agreement based on the competitive process (**PFCB is determined in the DPC Procurement);**
2	*Bid Return*	Bid Return is the financial return, expressed as a percentage, required by investors and to be set at the date of the CAP Agreement. (**Bid Return is based on a competitive process**)
3	*PFCBD*	This is the undepreciated remaining PFCB in the relevant charging year. This is the residual value of the asset at the end of contract. This would be recovered by bidders and represents the End of Concession Payment in this instance. In our example depreciation policy for the asset would be set at the procurement and therefore determined during the bids (**PFCBD could be based on the competitive process)**
4	*Opex Allowance*	This is a charge for operating and maintenance (maintenance being non capital spend) set at the date of the CAP Agreement based on the competitive process (**Opex Allowance is based on a competitive process)**
5	*Change/Compensation Event Sums*	These are events relating to the construction of the asset which increase the cost but could not be foreseen at time of procurement and therefore not included in the original bid price. We provide more details in the section below**; (Change/ compensation Events determined after contract award and governed by the CAP Agreement)**

	Term	Explanation
6	*Performance Payments*	These are adjustments to payments for non-availability (deductions) and availability (rewards) of the service. **(Performance deductions determined after contract award and governed by the CAP Agreement)**
7	*Refinancing Gain-share*	An amount by which charges are reduced each year as a result of refinancing gain-share mechanic in the CAP Agreement (**Whereas CAP will propose gain-share rates during procurement the actual values will be determined post contract award and will be governed by CAP Agreement);**
8	*Indexation*	This will be an adjustment for annual indexation. (**Whereas CAP will propose indexation methodology during procurement the actual values will be determined post contract award and will be governed by CAP Agreement)**

Change and Compensation Events

As is common in many large construction projects, events can occur which were not forecasted during the procurement and which will increase costs.

The consequences of some of these events will be at the risk of the CAP and will have been taken into consideration as part of the CAP's risk assessment and bid based on the project information made available during the procurement.

For other events, the CAP will not have been allocated the risk and responsibility for the financial consequences and the subsequent occurrence of such events will not have been included in their original bid price. The cost of these events will need to be recovered by the CAP to ensure the project is delivered. We discuss below how the Allowed Revenue Direction would adjust the pricing mechanism for the events that the CAP has not been allocated responsibility for.

At a high level we propose the Allowed Revenue Direction identifies two types of construction events:

(1) **Compensation Event:** Compensation events that arise due to no fault circumstances (these are the equivalents of supervening events) – e.g. an unforeseeable change in relevant law. These will differ between construction and operations phases.

(2) **Change Event:** Changes that arise other than agreed compensation events – e.g. a change in the scope of the Project (whether or not customers pay in part or fully for these changes may or may not be permissible depending on whether or not Ofwat considers it is reasonable for the Appointee to recover revenue in respect of such a change).

The treatment of these will depend on the payment mechanism proposed by the Appointee and which Ofwat will review.

The approach described below is designed to enable changes to the CAP Agreement between the Appointee and the CAP without the prior consent of Ofwat. The CAP and Appointee would be free to make any changes to the CAP Agreement but the Appointee would only be entitled to collect relevant revenues from customers for such a change/compensation event where it went through the approvals process set out below. The Independent Technical Adviser ("ITA") is used to synchronise decisions under each of the two approaches.

Example –Events within Fixed Charge

In a fixed Charge example the amount of the CAP Charges that can be collected from customers under the DPC Allowed Revenue Direction would not vary from the formula save in limited circumstances. Namely even if the CAP Agreement is varied by the Parties the revenue to be collected from customers would only change for:

(1) **Compensation Event** – The Allowed Revenue Direction would contain specific circumstances (to be agreed on a project by project basis) which can occur. Where the Appointee considers this has occurred it will make a submission to Ofwat setting out why it has occurred and the appropriate valuation. This submission will be verified by the Independent Technical Adviser and will be accepted by Ofwat provided it has been verified.

(2) **Change Event** – The Appointee can make a submission to Ofwat that a change is needed (e.g. change to scope). Ofwat will determine whether it accepts that additional revenue should be allowed to be collected from customers given the event. Then (if Ofwat accepts this) the ITA will verify the value of the Change.

In each case the decision under the CAP Agreement, between the CAP and the Appointee, to allow the relevant change/compensation event may not determine the outcome under the DPC Allowed Revenue Direction. However the role of the ITA allows for greater alignment between DPC Allowed Revenue Direction and the CAP Agreement, providing greater certainty for the Appointee on cost recovery.

We provide further worked examples below to demonstrate how this would operate.

Worked Examples

Example 1. A **Compensation event** occurs. The Appointee and CAP agree the amount of capex and opex required with an amendment to the CAP Agreement, if required. The Appointee submits the details to the ITA, who verifies the occurrence of the circumstances of the compensation event and the amount of additional capex or opex arising therefrom and Ofwat takes a decision under the DPC Allowed Revenue Direction to allow additional DPC Allowed Revenue to the Appointee without further review or re-assessment.

Example 2. A **Change** occurs (not a Compensation event). It arises due to abnormal weather conditions requiring mitigation for the future. The ITA verifies that the change would cost £5m (capex) to implement.

Notwithstanding any decision by Ofwat the parties to the CAP Agreement could make this change to the CAP Agreement. The Appointee would not automatically be entitled to collect any of that £5m from customers (although application of Totex sharing under price controls could be considered if appropriate) without recourse to Ofwat.

If the Appointee refers the matter to Ofwat, Ofwat would determine the proportion the Appointee should be entitled to pass through to customers. In this case the valuation remains as the full amount of £5m and the Revenue Direction is amended by adding the £5m to PFCBD.

Example 3. A **Change** occurs. It arises due to a mistake by an Appointee's representative in the design and the CAP needs to rework its installation. The ITA verifies that the change would cost £5m (capex) to implement.

The parties to the CAP Agreement could make this change. The Appointee would not automatically be entitled to collect any of that £5m from customers (although application of Totex sharing under price controls to be considered).

If the Appointee refers the matter to Ofwat, Ofwat would determine the proportion the Appointee should be entitled to pass the amount through to customers. If the Ofwat does not allow the event the Appointee will bear the £5m cost (although application of Totex sharing under price controls could be considered if appropriate).

If the incident had been a **Compensation Event** – Ofwat would not have had discretion about whether to allow it.

Performance Payments

We expect the CAP Agreement will contain performance payments (deductions and rewards) as part of the payment mechanism. The approach to the performance deductions / rewards will be set out at contract award in the CAP Agreement and it will be mirrored in the DPC Allowed Revenue Direction. Each year the ITA will verify the performance payments under the CAP Agreement. Ofwat will expect the ITA's decision to be applied and amounts collected from customers in accordance with the Allowed Revenue Direction as though such deductions/rewards had been applied.

As with change events and compensation events, while the CAP and the Appointee could change the performance payments where they felt appropriate under the CAP Agreement there would be no flow through to customers unless Ofwat consents to a matching change in the DPC Allowed Revenue Direction.

Residual Value and End of Concession Payment

It is not uncommon in transactions similar in nature to DPC for service providers to receive an End of Concession payment. This is where a payment is made by the procuring authority (which for a DPC would be the water company) to the service provider for the transfer to the water company of the asset(s) at the end of the contract.

If the water company seeks the option to adopt the DPC asset at the end of the service contract we expect the DPC CAP Agreement to make provision for an End of Concession Payment. We note that a water company may propose alternative arrangements such as re-tendering or extending the service contract – in which case the need for an End of Concession payment may become unnecessary.

We further expect, in general, the residual value to be based on the capital cost of the asset and the remaining asset life which will allow the CAP to pay off the predicted outstanding debt at the end of the contract.

Recovery of End of Concession Payment

Subject to our ongoing consultations, and if appropriate, after cessation of the service contract the DPC asset could be added to the water company's regulatory capital value and the End of Concession payment recovered through ongoing customer charges. This policy needs to be refined but we nevertheless raise it as a potential option. Furthermore, as part of ongoing development of policy, the terms of the addition to the water company regulatory capital value may include considerations for asset condition and if necessary cost efficiency.

We have detailed in this consultation our proposals for amending the Interim Determination provisions in Condition B for DPC which we believe will be an appropriate mechanism for considering the recovery of such costs between price reviews, if needed.

Termination Payments

In the event of early termination there may also be associated termination payments. For the avoidance of doubt "Termination Payment" in this context does not mean "End of Concession Payment" but instead refers to payments associated with the early termination of the DPC CAP Agreement after contract award.

We understand that companies need certainty on the method for cost recovery for any Termination Payment if they are not included in the DPC Allowed Revenue Direction. We have proposed an amendment to Condition B to and set out changes to the Interim Determination which we believe will be an appropriate mechanism for considering the recovery of such costs between price reviews, if needed.

Appointee Revenues

We do not propose that the Appointee's costs in respect of the Appointee's own activities related to the DPC Allowed Revenue Direction will be within the scope of the DPC Allowed Revenue Direction.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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