July 2022

Creating tomorrow, together: consulting on our methodology for PR24

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Ofwat

About this document

In this appendix we set out further thinking on our proposal, set out in Chapter 3 of our consultation document, to require companies to use Direct Procurement for Customers (DPC) by default to deliver projects above a size threshold of around £200m. We set out the three options we considered and explain why our proposal is our preferred option.

1. Summary

We have assessed three options for our policy on direct procurement for customers (DPC) at PR24. We propose Option 3, which involves companies using DPC by default for all projects above a size threshold of around £200m,[1] with Ofwat reserving the right to explore the use of DPC for major projects below this size threshold.

DPC is a process whereby companies put major projects out to competitive tender for delivery by third parties. The successful bidders for DPC projects are known as Competitively Appointed Providers (CAP) and will be responsible for designing, building, financing, operating and/or maintaining the infrastructure.

DPC was introduced at PR19 with the aim of improving value for customers and the environment from major projects. It does this by driving down costs, while maintaining quality.

The UK government has set out its support for the use of DPC for future investment in the water sector in an open letter to the CEOs of Ofgem, Ofwat and Ofcom:

"We are supportive of you removing new strategic investments from the standard price control process, where appropriate, and opening them up for competition as we believe this enables a stable regulatory environment and gives infrastructure providers the confidence to deliver long-term projects in an innovative and efficient way. For example, Direct Procurement for Customers in the water sector has the potential to create new opportunities for investors, promote innovation, and drive down overall net costs for consumers."[2]

The Welsh Government's SPS strategic objectives and priorities includes a strategic objective to deliver value for money for customers, communities and the environment. The aim of our DPC policy is to deliver better value for money for these groups, supporting this strategic objective.

We are currently working with industry to progress three DPC projects ("pathfinder projects") in England and Wales.

We have considered three options for our DPC policy at PR24:

- **Option 1 (the "do minimum" option)** – Voluntary approach to using DPC for separable projects above a size threshold calculated by uplifting the PR19 threshold of £100m lifetime totex for inflation.

[1] Some very large projects may be eligible to use the Specified Infrastructure Projects Regulations (SIPR). The use of SIPR is not assessed in this appendix.
[2] Department for Business, Energy & Industrial Strategy, 'Strategic priorities and cross-sectoral opportunities for the utilities sectors: open letter to regulators,' January 2022.

- **Option 2** – DPC by default for separable projects above a size threshold calculated by uplifting the PR19 threshold of £100m lifetime totex for inflation.
- **Option 3** – DPC by default for separable projects above a size threshold of £200m lifetime totex, while reserving the right to consider DPC for projects below this size threshold.

Options 2 and 3 are likely to lead to more projects being delivered through DPC than Option 1, as DPC will be used by default rather than on a voluntary basis. However, Option 3 is likely to lead to fewer projects below £200m being designated for delivery through DPC than Option 2, due to the higher size threshold.

There are a number of benefits to customers from companies delivering projects through DPC. We consider that the competitive pressure from DPC is likely to lead to capital and operational cost savings. DPC can also lower financing costs by involving the market, rather than the regulator, in setting the cost of capital for a specific major project. It can also provide us with benchmarks for efficient costs which we can use in setting price controls.

DPC also gives rise to costs compared with delivery of projects using standard price control arrangements. Water companies will incur costs running the procurement process and managing the contract with the CAP. Bidders will incur costs preparing tenders, and Ofwat will incur costs providing regulatory supervision.

The benefits of DPC are likely to be greater and the costs smaller (as a percentage of the size of the project) for larger DPC schemes. Our engagement with the market suggests that larger projects of above £200m are likely to be more attractive to potential bidders, tending to increase competitive pressure. In addition, the costs of DPC may be smaller as a proportion of the project's costs for larger projects, as some of the costs of DPC may be fixed rather than varying with volume.

The most reliable information we have from "pathfinder projects" suggests that the use of DPC for separable projects above £200m can yield net benefits of between 6 and 40 per cent of project totex. At the same time, we have found that the net benefits of DPC can be marginal for projects below this size threshold. In the light of this evidence, we propose Option 3.

2. Options considered

Table 2.1 below describes our three policy options.

Table 2.1: Description of options

	Option 1	Option 2	Option 3	Explanation
Approach to DPC	Voluntary	DPC by default	DPC by default	
Size threshold	PR19 size threshold of £100m uplifted for inflation	PR19 size threshold of £100m uplifted for inflation	Increased threshold of around £200m (while reserving right to consider DPC for smaller projects)	
Consider evidence on separability?	Yes	Yes	Yes	All policy options require an assessment of whether the project is sufficiently separable for DPC to be used. We are currently reviewing our technical guidance in this area and will publish our revised guidance prior to our final methodology.
Value-for-money (VfM) assessment	Used as eligibility criterion	Calculated to demonstrate VfM but not an eligibility criterion	Calculated to demonstrate VfM but not an eligibility criterion	Under Options 2 and 3, we would not treat a negative VfM estimate in the early stages as a reason not to proceed with DPC. This is because in most cases an accurate picture of what represents VfM for customers can only ultimately be determined by putting eligible projects out to tender.
Funding approach	Price control funding where company chooses not to propose DPC	No price control funding for in-house delivery of DPC eligible schemes; funding provided for companies to run DPC procurement process	No price control funding for in-house delivery of DPC eligible schemes; funding provided for companies to run DPC procurement process	Under Options 2 and 3, our DPC by default policy means no price control funding is required for eligible projects. Instead, such projects will be funded by customers outside price controls under an Allowed Revenue Direction for the DPC scheme.
Use of DPC linked to Business Plan Incentive (BPI)?	No	Yes	Yes	Under Options 2 and 3, we would penalise companies that do not comply with our DPC by default policy.

Under all the policy options, we propose:

- to set Price Control Deliverables for projects designated for DPC delivery, to protect customers by clawing back funding if companies do not deliver DPC procurement;
- to require companies to report CAP operating and maintenance costs for use in benchmarking of base costs at future price reviews;
- to include CAP revenues in the Revenue Forecasting Incentive, to incentivise accurate collection of CAP revenues; and
- to review the existing DPC licence conditions to ensure that they are still fit-for-purpose, and to add these DPC licence conditions to the licences of companies with DPC eligible schemes at PR24 if they do not yet have these conditions in their licences.

In our May 2021 discussion document, we said that we would consider whether conflicts of interest in the tender process could be sufficiently mitigated to allow incumbents to submit competing bids fairly. While some companies expressed support for allowing incumbents to bid, questions were also raised about how companies would be able to run a fair process in this scenario. We consider that the conflicts of interest that would exist in such a scenario would be likely to undermine fair competition, and hence we have not included this policy change within the above policy options.

3. Assessment of options

Options 2 and 3 are likely to lead to more projects being delivered through DPC than Option 1, as DPC would be used by default rather than on a voluntary basis. In particular, under Option 1 companies may prefer not to use DPC as projects delivered through standard price control arrangements will lead to an increase in their RCV. By contrast, under Options 2 and 3 no price control funding would be available for eligible projects except for the funding that is needed to run DPC procurement and to provide ongoing contract management. Companies would also face penalties under the PR24 BPI if their business plans do not comply with Ofwat's DPC by default policy.

Option 3 is likely to lead to DPC being used for fewer projects below £200m than Option 2, due to the higher size threshold of around £200m. However, Ofwat would still reserve the right to consider DPC for projects below this size threshold where it considered that this was in the interests of customers. For example, Ofwat might consider DPC for projects below the size threshold that were large compared with the size of the company. This might be appropriate if the project would cause delivery or financeability challenges for the company if delivered through standard price control arrangements.

In order to compare the costs and benefits of the three policy options, we have assessed the costs and benefits of DPC. We have also considered how the net benefits of DPC may differ for projects above and below £200m.

In their responses to our May 2021 discussion document, a number of stakeholders expressed support for the use of DPC for major projects. However, one company argued that our DPC policy was too weighted towards penalties, and another criticised DPC on the grounds that it would lead to long-term fragmentation of ownership and operation of key national infrastructure. We recognise that DPC will lead to some additional costs to water companies of managing the CAP, and these additional costs are included within our assessment of the costs and benefits of DPC.

3.1 Costs of DPC

DPC gives rise to a number of additional costs for water companies, bidders and Ofwat.

Water companies will incur additional costs under DPC running the procurement process. At PR19, our standard assumption was that DPC procurement costs were 1 per cent of capital spend, with a range around this figure of 0.5 to 2 per cent.[3] Ofgem has estimated procurement costs for its policy of applying late competition to future new, separable and

[3] Ofwat, 'Anglian Water: Direct procurement for customers detailed actions,' January 2019.

high value projects in electricity distribution networks during the RIIO-2 period.[4] In cases where the incumbent company runs the tender process, it estimated that the company would incur pre-tender costs of £0.5m to £1m and tender costs of 0.5 to 1 per cent of capital spend.

Water companies will also incur costs managing the ongoing contract with the CAP. The actual cost allowances we included for these costs at PR19 was £150k per annum. The contract management costs could be greater where contracts are more complex. By way of comparison, Ofgem assumed additional fixed contract management costs of between £0.5m and £1m per project from applying late competition in electricity distribution networks during the RIIO-2 period.

Bidders will incur costs preparing their tenders when DPC is used to deliver a scheme. At PR19, these costs were assumed to represent 2 per cent of capital spend, with a range around this figure of 1 to 3 per cent. Ofgem assumed bidder costs of 1 to 2 per cent of capital spend from applying late competition in electricity distribution networks during the RIIO-2 period.

Finally, Ofwat will also incur costs overseeing the process of DPC procurement. We are responsible for developing the DPC framework, and companies are required to seek Ofwat's consent before putting a DPC project out to tender and before entering into an agreement with the CAP. Ofgem estimated that applying late competition in electricity distribution networks during the RIIO-2 period would give rise to one-off model design costs to the regulator of £3.5m and additional costs to the regulator of £0.5m to £1m per project (in cases in which the tender is run by the company).

To support our approach at PR24 we are drawing on experience from the progress of the "pathfinder projects" from PR19 and developing a DPC guidance document which we will publish shortly. This document will replace the PR19 DPC procurement principles and DPC contract principles. The provision of this guidance may help to keep the costs of DPC down by providing a standardised approach to DPC procurement across the industry.

The costs of DPC as a percentage of the lifetime totex of a project may be lower for larger projects. This is likely to be the case if at least part of the costs of DPC procurement are fixed in nature (ie they do not vary with project size).

3.2 Benefits of DPC

DPC has a range of benefits, including lower capital and operational costs, lower financing costs, and the provision of benchmarks for efficient costs.

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[4] Ofgem, 'Draft Impact Assessment on applying late competition to future new, separable and high value projects in electricity distribution networks during the RIIO-2 period', August 2020.

Under standard price control arrangements, companies have a potential incentive to overstate the capital and operational costs of projects to try to obtain higher price limits. Ofwat seeks to ensure that only efficient costs are included within price limits by applying an efficiency challenge to company cost estimates. However, Ofwat has less information available on the true level of costs than companies (a problem referred to as information asymmetry).

DPC should lead to the competitive costs of a project being identified through the tender process. Depending on what activities the CAP will be responsible for, this may include the competitive costs of designing, constructing, financing, operating and/or maintaining the infrastructure. Customers will benefit from this as only the competitive costs identified through the DPC process will be recovered from customers.

The competitive pressure harnessed by DPC may also lead to innovation and to lower capital and operational costs. For example, bidders may propose to use innovative new technologies or introduce more effective processes that have been applied in other sectors. Under DPC, the benefits of such cost savings would be passed through to customers.

The information revealed by DPC has the potential to be used by Ofwat to provide a stronger efficiency challenge to water companies at price reviews. For example, unit cost information revealed by DPC could be used to challenge company cost estimates for enhancement projects that are not eligible for DPC (eg because they are too small or not separable). This could benefit customers of companies other than the company that ran the DPC procurement.

In general, these benefits are likely to be greatest for larger DPC schemes. Our market engagement suggests that DPC schemes of above £200m are likely to be more attractive to the market and thus attract a wider range of bidders. This is likely to mean that there will be greater competitive pressure for larger DPC schemes, which will tend to increase the extent to which the process promotes innovation and reduces capital, operational and financing costs.

The use of competition for the provision of new infrastructure has been shown to yield substantial cost savings in the energy sector. For example, Ofgem has cited a figure of £700m to £1.3bn for the net present value of customer savings from the first three tender rounds of the competitive regime for Offshore Transmission Owners (OFTOs).[5]

The most reliable information we have from "pathfinder projects" suggests that the net benefits (ie benefits less costs) of DPC for projects above £200m may be in the range of 6 to

[5] Ofgem, 'Draft Impact Assessment on applying late competition to future new, separable and high value projects in electricity distribution networks during the RIIO-2 period', August 2020.

40 per cent of totex.[6] At the same time, we have found that the net benefits of DPC can be marginal for projects below this size threshold.

[6] While we present the savings as a percentage of totex in order to give a sense of scale, we note that the anticipated benefits of DPC come from lower financing costs as well as from capex and opex efficiency savings.

4. Proposal

Our proposal is to proceed with Option 3 which will ensure that DPC is used by default for projects above £200m. This is in line with the evidence available to us which suggests that the use of DPC for projects above this size threshold can give rise to substantial net benefits. It also allows DPC to be used on a discretionary basis below this threshold where it is in interests of customers. Unlike Option 2, it does not require all separable projects between the current threshold of £100m (adjusted for inflation) and £200m to be carried out using DPC. This is in line with the evidence available to us which suggests that the net benefits of DPC may be marginal for some projects of this size.

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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