

March 2023

# Guidance for Appointees delivering DPC projects

Ofwat

## About this document

This document provides guidance to our stakeholders and Appointees on our regulatory and commercial expectations where Appointees are developing projects to be delivered using Direct Procurement for Customers (DPC). The document also sets out principles for how Appointees should assess value for money (VfM) for DPC compared to the in-house counterfactual.

Attached to this guidance as **Appendix 2**, is a draft template Allowed Revenue Direction.

**Appendix 3** sets out details of the DPC Licence Conditions. With minor changes, these are the DPC Licence Conditions already included in the licence conditions of Appointees currently pursuing DPC projects and are the licence conditions we are proposing for companies delivering DPC projects in the next Price Review period.

We consulted on the draft guidance in the Autumn of 2022 and hosted a workshop with water companies in January 2023. We are grateful to those who responded for their inputs and have reflected much of the feedback in the guidance. Our consultation response document which can be found [here](#).

This document supersedes any prior guidance or briefing notes issued by Ofwat in respect of DPC.

## Executive summary

Ofwat seeks to create a regulatory framework to encourage the development of innovative solutions that seek to deliver best value for customers.

As part of PR19, we introduced Direct Procurement for Customers (DPC), a process for water companies to competitively tender for a third-party (a competitively appointed provider) to design, build, finance, operate and maintain infrastructure. This initiative has the potential to provide significant benefits for customers through promoting innovation and enabling capital and operational cost savings as well as a reduction in financing costs.

We set out in our PR19 methodology that we expected company business plans to consider DPC where this is likely to deliver the greatest value for customers. DPC promotes innovation and resilience by allowing new participants to bring fresh ideas and approaches to the delivery of key schemes. For PR19, Appointees were required to consider DPC for discrete, large-scale enhancement schemes expected to cost over £100 million, based on whole life totex.

Our [PR24 final methodology](#) continues the development of the DPC model. Moving forward, Appointees will be required to use the DPC mechanisms, by default, for all discrete projects above a size threshold of £200m whole life totex. Ofwat reserves the right to explore the use of DPC for major projects below this size threshold, where it may offer value for money for customers to do so.

This guidance sets out our expectations for the commercial model applicable to DPC projects and our approval and assurance processes to support DPC projects.

The purpose of the guidance is to:

- provide **confidence in the regulatory framework**: Appointees and investors can understand Ofwat's requirements for DPC projects and the regulatory framework underpinning it;
- enable **flexibility in the framework**: while the guidance sets out our expectations for DPC projects, we are open to different approaches where the Appointee can explain why an alternative approach may be more appropriate and can demonstrate how this achieves best value for customers; and
- **be a living document**: the guidance will continue to evolve as more projects proceed as DPC projects and we commit to reviewing the document on a regular basis to ensure it remains relevant and useful to Appointees.

This guidance sets out:

- the regulatory framework for DPC projects and how this interacts with the commercial arrangements;
- the approvals process and Appointee assurance processes for DPC projects;
- a standard, efficient risk allocation for DPC projects;

- the commercial arrangements including incentives on the CAP and the Appointee; and
- the assessment of value for money for DPC projects.

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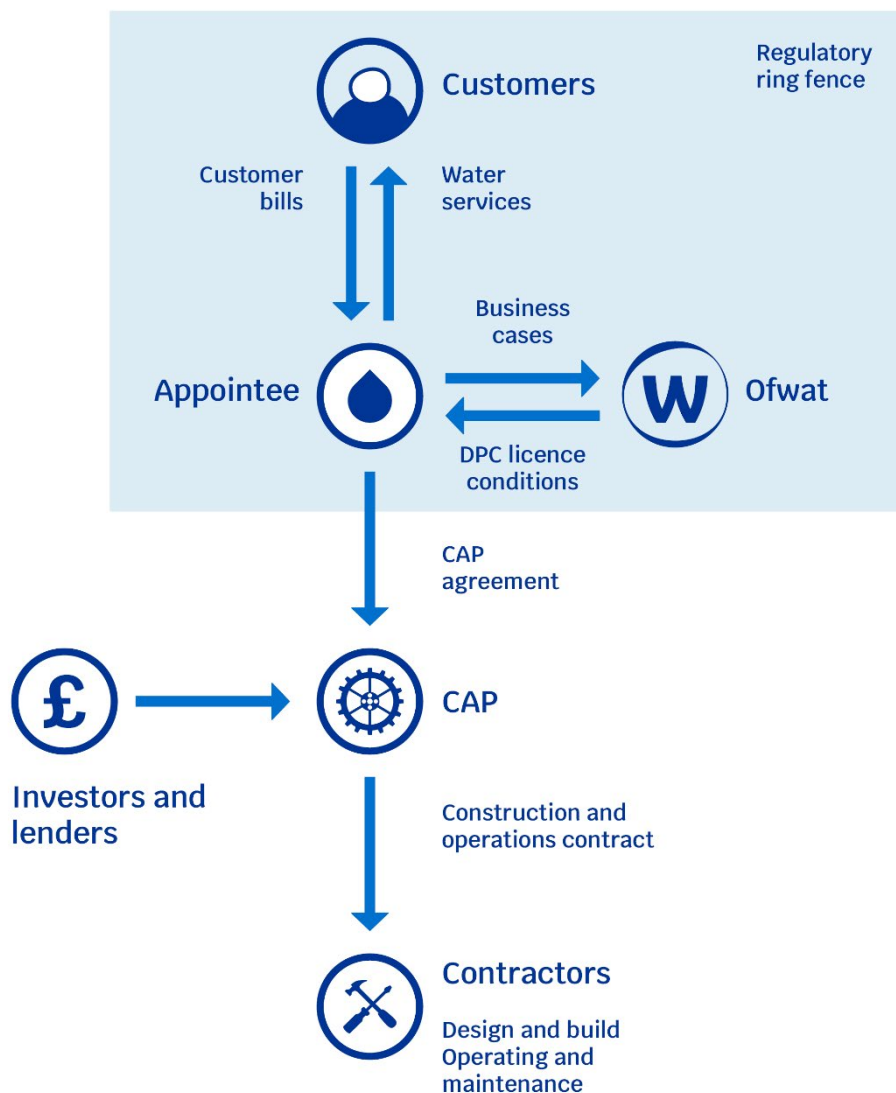
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# 1. Introduction

## 1.1 Background

At the 2019 Price Review (**PR19**) we introduced a procurement model, Direct Procurement for Customers (**DPC**), for the delivery of large infrastructure projects. The approach requires Appointees to put large infrastructure projects out to competitive tender where delivery by a third party is likely to offer better value for money for customers. A Competitively Appointed Provider (the **CAP**) may be appointed to design, build, finance, operate and maintain the relevant infrastructure. An Appointee will enter into an agreement with a CAP (a CAP Agreement) to deliver the asset and the relevant services.

At PR19 we published procurement principles and contract principles that were applicable to DPC projects, and to the development of the commercial structures for DPC projects. Appointees are required to follow these principles in the development of a DPC project. We have set out, in the diagram below, details of the principal parties to a DPC project.





Our PR24 final methodology continues the development of the DPC model. For PR24 DPC will apply by default for all discrete projects above a size threshold of £200m whole life totex.

Ofwat will reserve the right to explore the use of DPC for major projects below this size threshold where it may offer value for money for customers to do so.

For PR24 Appointees will:

- identify all infrastructure projects that are over £200m of whole life totex;
- assess the extent to which these infrastructure projects are discrete, using our updated technical discreteness guidance to be issued in early 2023<sup>1</sup>; and
- undertake a robust value for money assessment of delivering the infrastructure project through DPC.

For PR24 we will:

- allow the efficient costs for Appointees to run the DPC procurement process and manage the CAP when we set totex allowances for PR24;
- implement a focused incentive package for Appointees to run a good procurement process for DPC projects; and
- amend the licences of those Appointees likely to deliver DPC projects in the next AMP if they do not already have DPC Licence Conditions in their licences.

In general, the costs of a DPC project will not be part of a Price Review but Ofwat will issue an Allowed Revenue Direction which will enable an Appointee to recover the costs payable to the CAP from customers. The CAP Agreement (and the Allowed Revenue Direction) are expected to be long term arrangements that will span multiple Price Review periods. The Appointee's costs of the project, primarily development costs, will be recoverable by the Appointee as part of a Price Review.

Appointees must have regard to this guidance in the development and implementation of any infrastructure project that may be designated by Ofwat as a DPC project.

This guidance only applies to DPC projects which have not yet been designated for delivery as DPC projects. It therefore applies to projects identified from future Price Reviews (including PR24) and all future schemes identified from RAPID<sup>2</sup>. In general, we anticipate that multi-party projects identified from RAPID, will have a lead Appointee that will enter into the contract with the CAP, and we think in most circumstances, this guidance will apply to such projects.

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<sup>1</sup> See Ofwat consultation on [Technical Discreteness](#) published 16 February 2023

<sup>2</sup> The Regulators' Alliance for Progressing Infrastructure Development which is a partnership of three water regulators, Ofwat, the Environment Agency and the Drinking Water Inspectorate focussed on facilitating the delivery of strategically important new water resource infrastructure solutions to meet future water needs.



Appointees delivering DPC projects which have already been designated by Ofwat as DPC projects, should continue to have regard to the PR19 procurement principles and the contract principles<sup>3</sup> and to the extent that this guidance develops those principles, rather than changes them, they should also have regard to this document.

Some large projects may be delivered under the Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 (**SIPR**). The guidance was not drafted with SIPR in mind and does not apply to projects being delivered using SIPR. However, significant parts of the guidance may be useful for Appointees developing projects for delivery under SIPR.

We have amended the licence conditions of five Appointees to establish the regulation of DPC projects and we intend making similar amendments to the licence conditions of those Appointees that will be delivering DPC projects in the next Price Review period.<sup>4</sup> These amendments, described in more detail at **section 2**, mean, Ofwat, with the consent of the Appointee, may designate an infrastructure project as a DPC project. Once designated, that DPC project must be delivered in accordance with Condition U (Direct procurement for customers) of the relevant Appointees' licence conditions.

Once designated as a DPC project, the Appointee must follow the Ofwat approvals and derogations process set out in **section 3** of this guidance. In terms of Condition U, Ofwat's consent is required at various gateways, including before the start of the procurement process and before the parties enter into a CAP Agreement. Ofwat will also issue an Allowed Revenue Direction which enables the Appointee to recover from customers the charges payable to the CAP under the CAP Agreement.

## 1.2 Purpose of this document

This guidance applies to new infrastructure projects that have not yet been designated for delivery as DPC projects at the date of publication of this guidance.

This guidance sets out:

- the regulatory framework for DPC projects and how this interacts with the commercial arrangements for each DPC project;
- the approvals process and Appointee assurance processes for DPC projects;
- a standard, efficient risk allocation for DPC projects;
- the commercial arrangements including incentives on the CAP and the Appointee; and
- the assessment of value for money for DPC projects.

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<sup>3</sup> [Appendix-9-Direct-procurement-FM.pdf \(ofwat.gov.uk\)](#)

<sup>4</sup> The five water companies are listed here with links their published licence conditions. The DPC Licence Conditions are set out in Licence Condition B and Licence Condition U : [Anglian Water Services Limited](#), [United Utilities Water Limited](#), [Dŵr Cymru Cyfyngedig](#), [Southern Water Services Limited](#), and [Affinity Water Services Limited](#).

This guidance sets out our expectations for the commercial model for DPC projects; our processes to support DPC projects; and to provide clear guidance for Appointees developing DPC projects to:

- provide **confidence in the regulatory framework**: Appointees and investors can understand Ofwat's requirements for DPC projects and the regulatory framework underpinning it;
- enable **flexibility in the framework**: while the guidance sets out our expectations for DPC projects, we will be flexible in the application of the guidance, where the Appointee can explain why an alternative approach may be more appropriate and demonstrates how this achieves best value for customers; and
- **be a living document**: the guidance will continue to evolve as more projects proceed as DPC projects and we commit to reviewing the document on a regular basis to ensure it remains relevant and useful to Appointees.

We have learned from the DPC projects developed to date. We believe that the guidance should capture the lessons learnt from these early projects for the benefit of future projects. In addition, the guidance offers an opportunity to establish a **standard reference model** for risk allocation in future DPC projects. This should reduce the transaction and development costs of delivering a DPC project for both Appointees and Ofwat. It will also support the streamlining of Ofwat's approval process moving forward and should allow us to place more reliance on assurance from Appointees.

This document sets out:

- In **section 2**, the regulatory framework to support DPC projects throughout their whole life including arrangements at the end of any concession period (the **Regulatory Framework**);
- In **section 3** the Ofwat approvals process for DPC projects (the **Approvals Process**);
- In **section 4**, guidance for the commercial and financial structure for DPC projects, including the standard project risk allocation and contractual documentation required to support DPC projects (the **Commercial Framework**);
- In **section 5**, value for money assessments of DPC projects as the procurement process progresses (the **VfM Assessments**).

## 2. Regulatory framework

### 2.1. Introduction

We set out in this section, guidance on the operation of the regulatory framework, including the Allowed Revenue Direction (ARD) to support DPC projects throughout their life including arrangements at the end of any concession period.

Owat will regulate DPC projects in accordance with statute and the DPC Licence Conditions. When exercising our judgement and discretion, we will act in accordance with our statutory duties including as set out in section 2 of the Water Industry Act 1991.

These duties include:

- protecting the interests of consumers, wherever appropriate, by promoting effective competition;
- securing that the functions of water companies are properly carried out;
- securing that water companies are able (in particular, by securing reasonable returns on its capital) to finance the proper carrying out of those functions; and
- securing the long-term resilience of water supply and wastewater systems by securing that water companies take steps to enable them to meet, in the long term, the need for the supply of water supplies and the provision of sewerage services to consumers.

Subject to those duties, Owat also has duties (among other things) to promote economy and efficiency and contribute to the achievement of sustainable development.

## 2.2. DPC Licence Conditions

We have amended the licence conditions of five Appointees to establish the regulation of DPC projects. We intend making similar amendments to the licence conditions of those Appointees that are likely to deliver DPC projects in the period following PR24.

Following a review of the current DPC Licence Conditions, we are proposing to make several minor modifications to them moving forward. These modifications are summarised in [Appendix 3](#).

The licence changes introduced a new Condition U and introduced some DPC specific provisions into Condition B.

There are three main elements to the DPC licence provisions. A change to licence Condition B9 to permit an Appointee to recover from its customers the charges payable by the Appointee to the CAP pursuant to the CAP Agreement.

A new provision in Condition B introduces a bespoke DPC interim determination. Under this provision, an Appointee may bring an application for an interim determination when certain trigger events take place, including the expiry or termination of the CAP Agreement; the revocation of the ARD; the modification of a DPC project Designation; or if the procurement process for a DPC project will no longer deliver best value for customers.

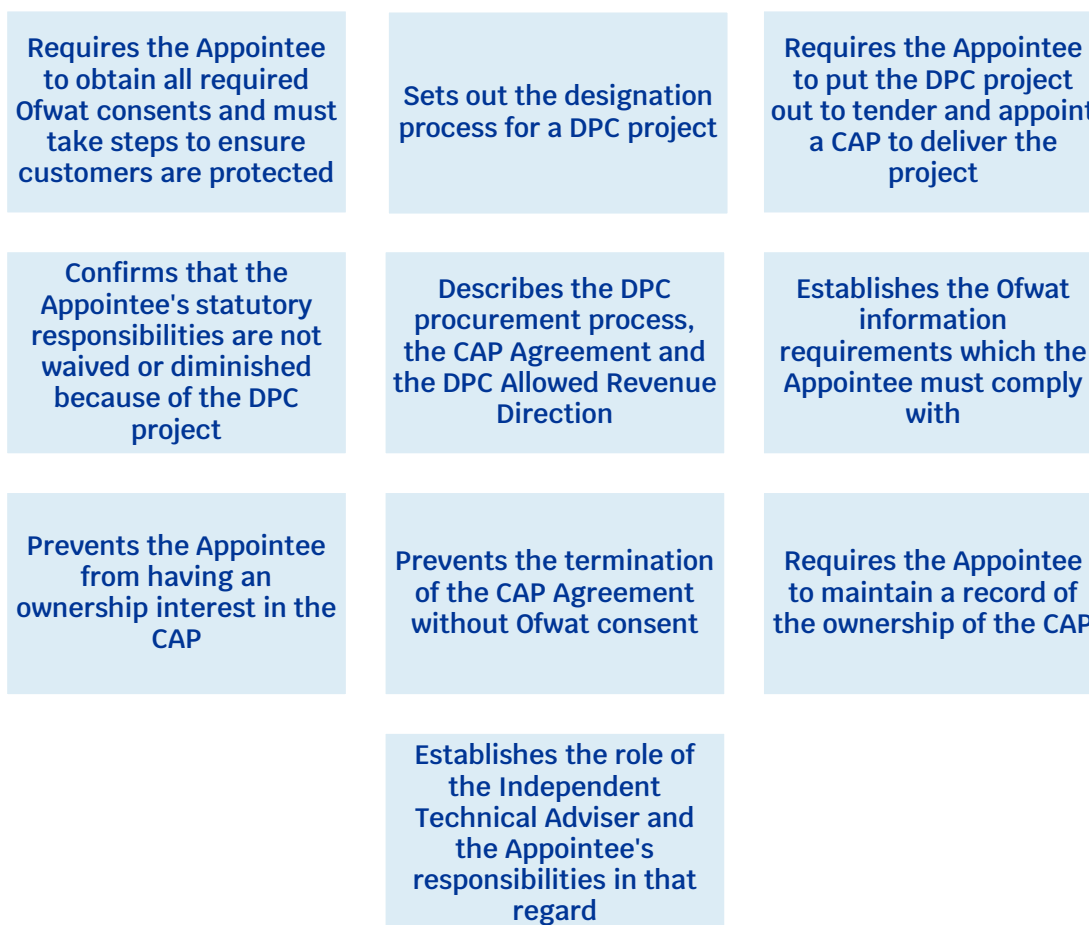
Licence Condition U sets out how DPC projects are to be regulated.

Condition U places obligations on Appointees regarding the development and delivery of DPC projects. DPC projects must be competitively tendered by Appointees to select a

third-party, the CAP, to design, build, finance and/or operate and maintain new infrastructure.

Appointees need obtain Ofwat's consent at key points in the development process, the procurement process, and before entering into a CAP Agreement. There may also be clauses in the CAP Agreement that require Ofwat's consent during the life of the DPC project.

The key aspects of Licence Condition U are summarised here:



## 2.3 Independent Technical Adviser

A key part of the regulatory framework is the Independent Technical Adviser or ITA. Licence Condition U establishes the requirement for the appointment of an ITA and sets out the Appointee's responsibilities in respect of the ITA. The role of the ITA is designed to protect customers over the whole life of a DPC project. Ofwat requires this role to obtain assurance around the costs and delivery of a DPC project both during the construction programme and to operate over the life of the DPC project.

The role will be project specific. An Appointee will need to consider the scope of the ITA for its DPC project and agree with Ofwat what assurance Ofwat will require from the ITA for each DPC project. The required assurance will change over the life of the DPC

project and an Appointee may need to consider the extent to which the identity of the ITA and the skills and expertise they require may change as well.

The ITA may be appointed by the Appointee or jointly, by the Appointee and the CAP. The ITA will have a duty of care to Ofwat, the Appointee and the CAP. The ITA has responsibility for providing information to Ofwat and verifying and overseeing the operation of certain aspects of the CAP Agreement.

Bidders for the CAP role will have the opportunity to provide comments on the terms of the ITA appointment during the procurement process. We would expect the costs of the ITA to be a CAP cost which is recoverable as part of the CAP Charges.

The tasks undertaken by the ITA will be project specific but could include providing independent technical advice on the operation of key contractual mechanisms. For example, during the construction phase, any delays or compensation events that may result in increased costs for customers, may be assessed by the ITA.

The ITA will provide expert guidance which is impartial to all engaged with the DPC project. It is intended to speed the resolution of sometimes critical activities during the construction phase. The ITA will also have a role in agreeing the CAP Charges that can be recovered on an annual basis during the DPC project term.

## 2.4 Designation of a project

Condition U, permits Ofwat, with the agreement of the Appointee, to designate a large infrastructure project for delivery as a DPC project. Designation describes at a high level the activities to be delivered by the CAP, including the split between CAP activities and the Appointee's activities.

Once designated, the Appointee must put the DPC project out to competitive tender. Ofwat's consent is required at various gateways, including before the start of the procurement and before the CAP Agreement between the Appointee and the successful CAP is entered into. Details of the Ofwat's approval process are set out in [section 3](#) below.

A designation will remain active until the end of the concession period or until revoked or amended by Ofwat. Revocation and/or amendment of the designation requires the Appointee's consent. The timing of designation will be project specific.

A designation may be revoked in the following circumstances:

- where, during a procurement process for a DPC project, for reasons outside the control of the Appointee, the delivery of the infrastructure as a DPC project is no longer in the best interests of customers;
- when an ARD has been revoked under Condition U; or
- when a CAP Agreement is terminated.

## 2.5 Allowed Revenue Direction

Ofwat, having consulted the Appointee, must issue an Allowed Revenue Direction. The Allowed Revenue Direction is a key part of the regulatory framework and enables the Appointee to recover from its customers the charges payable to the CAP under the CAP Agreement. Ofwat may not change the Allowed Revenue Direction without the Appointee's consent.

We have prepared a template Allowed Revenue Direction for use in DPC projects. This is set out in [Appendix 2](#). Each Allowed Revenue Direction will be project specific and needs to reflect the arrangements for CAP Charges and other aspects of the DPC project under the CAP Agreement. The template is, therefore, a starting point and will need to be modified to reflect the circumstances of each DPC project.

As well as the ongoing CAP Charges, the Allowed Revenue Direction will recognise the Appointee's obligation to pay, if any, end of contract payments and will confirm that the Appointee will be able to recover these through future price controls.

The Allowed Revenue Direction will also set out the circumstances in which Ofwat may not allow full recovery from customers by an Appointee when there is an early termination. Ofwat's guidance on this is set out in [Appendix 4](#) which deals with project incentives.

We have set out below some further information and guidance about the way that the Allowed Revenue Direction will manage the calculation of end of contract payments and the obligations of the Appointee in that regard.

### Expiry of CAP Agreement Payments and Termination Payments arising from early termination

Under paragraph U5.1 of Condition U, Ofwat's consent is required before an Appointee enters into a CAP Agreement. Before giving consent, Ofwat will consider the information and assurances submitted by the Appointee. This will include amongst other matters, the provisions of the CAP Agreement in respect of:

- (where relevant), payments due from the Appointee to the CAP at the end of the Approved CAP Agreement ([Expiry of CAP Agreement Payment](#)); and
- payments due upon early termination of the Approved CAP Agreement ([Early Termination Payment](#)).

Expiry of CAP Agreement Payments and Early Termination Payments fall within the definition of CAP Charges<sup>5</sup> and, subject to the potential disallowance referred to below, they are fully recoverable from customers. The CAP will have a contractual right to recover these sums, as agreed or determined by the CAP Agreement, in full.

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<sup>5</sup> See Licence Condition A.

The ARD will recognise that Expiry of CAP Agreement Payments will be recoverable in full by the Appointee, but subject to the Price Review methodology in place at the time.

The ARD will recognise that, subject to the potential disallowance described below, the Early Termination Payments, will be recoverable by the Appointee, but subject to the Price Review methodology in place at the time.

The ARD will provide that in cases of Appointee default or voluntary termination, Ofwat may determine that a proportion of the Early Termination Payment should not be recovered from the Appointees' customers. The ARD will set out the maximum amount of any potential disallowance. In considering whether to disallow any part of an Early Termination Payment, Ofwat will consider the extent to which the Appointee's failure to act as a prudent and efficient Appointee contributed to the termination, if at all.

**Appendix 4** provides guidance on the factors Ofwat will consider in determining whether any amount should be disallowed. As the decision to disallow any portion of an Early Termination Payment will be made at a Price Review or interim determination, the decision will be subject to appeal to the CMA (as part of a wider appeal of a final determination or interim determination).

Ofwat's discretion and **Appendix 4** do not apply to any Expiry of CAP Agreement Payments.

As for previous Price Reviews, and in line with good regulatory practice, Ofwat will consult the industry and other stakeholders on our proposed methodology for each future Price Review and will consult on draft Price Review determinations before finalising such determinations. Ofwat expects that amounts incurred by an Appointee in respect of Expiry of CAP Agreement Payments and Early Termination Payments would be recovered from customers in a manner consistent with our then policy position on the recovery of Totex.

By way of illustration only, if an Expiry of CAP Agreement Payment had been paid by an Appointee to a CAP pursuant to an Approved CAP Agreement and such payment was reflected at PR24, Price Review such sum would have been capitalised and added to the Appointee's relevant regulatory capital value. The means by which the then capitalised amount would be then depreciated and remunerated over time would be determined at and in accordance with our stated policy position at future Price Reviews.

## 3. Ofwat's approvals process

### 3.1. Introduction

Under condition U5 of an Appointee's licence, Ofwat's consent is required before the Appointee can put a DPC project out to tender or enter into a CAP Agreement.

This section sets out the information and assurance that Appointees must submit to us to enable us to make these decisions.

For the early pathfinder projects, our approach adopted the principles from HMT's five case model and involved a series of control points at key stages in the project (Control Points A – F).

Drawing on the experience gained from the pathfinder projects, we have streamlined this process, by focusing it on the points at which we are required to make decisions and increasing our reliance on assurance provided by the Appointees. We have also sought to align the DPC process with the RAPID gated process to avoid duplication.

We continue to use HMT's five-case model as a guide for Appointees; however, we do not necessarily require the full five cases to be provided. For example, it may not be necessary to repeat the strategic and management case at every stage. Instead, we will rely on appropriate assurance, primarily from the Appointee, to inform our decision making.

The assurance required from Appointees to allow us to follow this streamlined process is set out in this guidance. This revised process should reduce the time and costs for both us and the Appointee.

Our new process involves four key submissions:

**Stage 1:** Establishing the Strategic Case;

**Stage 2:** Approach to procurement plans, outline of the commercial model and designation of the project;

**Stage 3:** Gaining consent to procure the project; and

**Stage 4:** Gaining consent to enter into a CAP Agreement.

We set out the high-level information and assurance requirements that Appointees must provide at each of these stages below. Some of the detailed information and assurance requirements may vary by project, dependent on project specific characteristics and Appointees' proposals. Where more information or assurance is required at formal submission points, we will discuss these with the Appointee ahead of their submission (where possible). Where sufficient assurance has not been provided, we may have to ask Appointees to for further information.

## 3.2. Key stages

### Stage 1: Establishing the strategic case.

Appointees must establish the needs/strategic case for the DPC project at the relevant Price Review or, (where relevant) via the RAPID gated process. In determining if a need for the project has been established, the Price Review process and/or the RAPID gated process will consider the Appointee's WRMP<sup>6</sup> or DWMP.<sup>7</sup>

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<sup>6</sup> Water Resources Management Plans

<sup>7</sup> Drainage and Wastewater Management Plans



Once the need for a project has been established, Appointees must assess whether the project will be suitable for delivery under DPC using guidance we provide at the relevant Price Review and provide the information requirements below. We expect in most cases that Appointees will meet these requirements through business plan submissions and/or at Gate 2 of the RAPID Gated process. Where the information requirements required to establish the needs/strategic case for the DPC project are not met via these routes, a separate Stage 1 submission will be required.

We do not expect the strategic case to be reassessed again after this submission if it remains unchanged throughout the DPC process.

### **Information requirements**

Information required at Stage 1 includes:

- An explanation of the need for the project including any options and optioneering completed by the Appointee;
- An assessment of the project against our PR24 requirements for delivery as a DPC project. We no longer require a VfM assessment of delivery via DPC versus the in-house counterfactual at this early stage in the DPC process.
- A high-level programme plan;
- A procurement timetable showing key milestones;
- An explanation of the proposed tender model proposed; and
- An outline of the proposed commercial model including a high-level risk allocation, highlighting where the Appointee is proposing to deviate from the guidance. We are looking for a high-level approach and do not expect Appointees to provide a significant level of detail at this stage.

### **Assurance**

At this initial stage, we expect assurance to be in line with any assurance requirements for Appointees' Price Review business plan submissions or RAPID gated submissions, depending on where the strategic case is being established.

The timing of our approval of the Stage 1 submission will be aligned to the relevant process by which the information requirements are being met e.g. the relevant Price Review.

### **Stage 2: Approach to procurement plans, outline of the commercial model and designation of the project**

Stage 2 will focus predominantly on the procurement plans that Appointees submit to us and will also signal the start of engagement on the VfM assessment for delivering the

project via DPC, both of which we expect to agree with Appointees ahead of Stage 3. More detail of our approach to value for money is set out at [section 5](#) of this guidance.

Appointees must provide detailed Heads of Terms for the CAP Agreement at this stage. We will review the Heads of Terms and identify those parts of the CAP Agreement that we need to see in full, to support our drafting of the Allowed Revenue Direction. This means that we may no longer require the full set of tender documentation and contracts to be submitted to us, prior to an Appointee requesting consent to tender the DPC project.

A project identified as suitable for DPC, with sufficient detail of the technical scope, is likely to be designated after the Stage 2 submission with the expectation of designation occurring in advance of the Appointee's Stage 3 submission. The Designation is issued by Ofwat, with the written agreement of the Appointee.

With respect to the designation of RAPID projects, we will provide further guidance on how we expect the timing of designation will align with the RAPID gated process.

### Information requirements

As a minimum, information required at this stage includes:

- A summary of the scope of the DPC project and the CAP Agreement to be tendered;
- procurement procedure/route selected with the rationale behind this and how it aligns to Ofwat's procurement principles. Please see the Commercial Framework set out in [section 4](#);
- outline of an Appointee's chosen commercial model, particularly where there has been deviation away from the guidance to ensure the Appointee engages with us on this;
- outline of the technical scope;
- updated procurement timetable and programme timeline, including showing when designation is likely to occur;
- summary and outcome of market engagement, including the market appetite, and how this reflects procurement strategy and commercial model;
- an explanation of contracting strategy, which should include a high-level approach to risk, payment, termination/exit/asset management post CAP Agreement and incentivisation provisions. There should also be a high-level explanation as to how Ofwat's contracting principles will be met. Please see the Commercial Framework set out in [section 4](#);
- draft Heads of Terms for the CAP Agreement;

- an explanation of the Appointee incentives being proposed during the procurement process and over the contract life.
- an explanation as to the level of design and technical readiness that is intended by the date of release of any contract notice and the issuance of any Invitation to Tender (ITT), Invitation to Negotiate (ITN) or Invitation to Participate in Dialogue (ITPD);
- an explanation of how the procurement plan will maximise competition and deliver best value for customers, including information on the number of tenders to be invited to tender and/or negotiate and/or participate in dialogue and information on selection and award methodology criteria;
- a summary of key interfaces of the proposed CAP Agreement with other activities of the Appointee; and
- consideration of accounting treatment for the DPC project and any interaction with existing financing arrangements.

### **Assurance**

At this stage we are not making a decision on the contents of the submission and have limited the scope of the Appointee board assurance required. Appointees should follow their own internal governance and assurance processes before submitting any information to us. We require Appointee board assurance that:

- the Appointee has sufficient management capabilities/resources to progress and develop the project to Stage 3; and
- the Appointee's proposed approach and draft Heads of Terms for the CAP Agreement are in line with the guidance and any proposed changes in approach from the guidance have been communicated and agreed with us in advance of the submission.

Where we identify gaps or issues with the submission, we will engage with the Appointee on these areas and will agree a plan for the Appointee to address them ahead of the Stage 3 submission.

### **Stage 3: Gaining consent to procure the project.**

Ofwat's consent is required before a DPC project is put out to tender. We previously asked for a full outline business case (OBC) to be submitted at this point. We are now going to use a targeted approach, with a reliance on Appointee board assurance.

We do not expect to see a reassessment of the strategic case unless there have been material changes. We also do not expect to see a full management case. Instead

Appointees need to provide us with appropriate board assurance that they have sufficient resources, systems, and capabilities in place to tender the DPC project.

While we may ask for a full copy of the CAP Agreement at this stage, our review of the agreement is expected to be limited to those provisions that we identified at stage 2 as being provisions we wanted to review (and through any subsequent engagement).

### **Information requirements**

Under Condition U of the licence, an Appointee may not commence a DPC procurement process without our prior consent.

To enable us to consent, we will need to see evidence of the following (as a minimum):

- The project has been developed in accordance with our DPC guidance;
- The detailed payment mechanism;
- Full details of the commercial model and risk allocation (including customers, CAP and Appointee as appropriate), including proposed Appointee incentives, highlighting any changes from information provided in the procurement plan;
- Confirmation of how the Appointee's approach addresses key legal and regulatory requirements including but not limited to issues such as The Security and Emergency Measures Directions, Drinking Water Quality Regulations, and Ofwat's Public Value principles;
- Full details of the VfM assessment, including a full financial model and customer bill impacts<sup>8</sup>;
- Confirming the selected procurement strategy, including any detailed developments from the procurement plan submitted in the second stage;
- Detailed approach to accounting treatment;
- Copy of the draft CAP agreement that will be provided to bidders as part of the procurement process; and
- Updated market engagement activities.

### **Assurance**

At Stage 3, we would expect to see appropriate Appointee board assurance on:

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<sup>8</sup> This does not apply to RAPID projects. For RAPID projects we are removing the requirement to provide a VfM assessment. Please see section 5.2 for more information.

- the strategic need for the project;
- the preferred approach for the project (the commercial model and the procurement strategy) and that it will deliver an effective and competitive procurement ensuring best value for customers (based on evidence available in the market);
- the Appointee's management resources and that it has sufficient management and financial resource in place to effectively carry out the procurement of the project; and
- the CAP Agreement and appropriate tender documentation and that they are consistent with the ARD and the guidance; or alternatively, that any departure from the guidance has been agreed with us.

Once an Appointee submits their Stage 3 submission to us, we will aim to respond within 40 working days. To meet this timetable, we will need regular and productive engagement with the Appointee, throughout the process, with relevant information provided to us in advance.

#### **Stage 4: Gaining consent to enter into a CAP agreement.**

At this final milestone, we no longer require the Appointee to submit a full business case. We have reduced the information and assurance requirements to focus on the key elements that will inform our decision whether to grant consent for the Appointee to enter into an agreement with the CAP.

In order to enable us to provide consent to enter into the CAP Agreement, we require the Appointee keep us updated during the procurement on any potential material changes to the commercial and regulatory framework.

#### **Information requirements**

At this stage, to help us make our decision, the Appointee must provide the following:

- Evidence that delivery via DPC still offers best value (see section 5.4). Customer bill impacts of the preferred bid must be provided;
- Evidence the procurement process has been effective and competitive including evidence of market engagement, and how market engagement has been managed;
- A summary of any changes to the commercial model and risk allocation, including confirmation that the Appointee incentives proposed at Stage 3 remain appropriate;
- The final version of the CAP Agreement;

- The Appointee's post procurement plan, including an updated programme plan covering the construction period, handover arrangements and commencement of revenue; and
- An engagement plan between the Appointee and Ofwat for the next period of the DPC project.

## Assurance

The Appointee must provide a board assurance statement confirming the following:

- Confirmation the CAP Agreement is in line with our DPC guidance and any significant changes to the risk allocation and commercial model, including but not limited to where it effects the ARD, have been communicated and agreed with us in advance of the submission; and
- The Appointee has sufficient management capabilities and arrangements in place to manage the DPC project.

Once the Appointee has submitted its Stage 4 information and assurance, we will aim to provide consent for the CAP Agreement to be awarded within 20 working days. This is subject to the Appointee keeping us updated on any issues throughout the procurement process. Once our consent has been given, the Appointee can enter into the CAP Agreement, and we will issue the DPC Allowed Revenue Direction.

## 4. Commercial framework

### 4.1. Introduction

Experience in other sectors (both in the UK and internationally) has shown that a standardised approach to the commercial and financial structure of infrastructure projects which use project finance can offer benefits to potential bidders as well as the client organisation putting the project out to tender.

The benefits of standardisation include reduced transaction costs; supporting efficient risk allocation; and ensuring contracts provide sufficient protection to both parties. We see benefits for the efficient delivery of DPC projects in creating a standardised framework for DPC which will allow the industry to be familiar with the approach to be taken across DPC projects. Whilst there are benefits to be gained from standardisation, we also acknowledge that we are at an early stage in the development of DPC and therefore the standard framework may evolve as we learn more from projects being delivered which may adjust the standardised approaches where it is deemed to be a better value outcome for customers.

This guidance seeks to facilitate that standardisation and we expect Appointees to develop their commercial approaches for DPC projects in line with this guidance.

However, we recognise that for some projects, their specific characteristics may warrant a different approach. As part of the Ofwat approval process set out in [section 3](#), Appointees should explain their approach and the rationale for departing from the guidance and demonstrate how this achieves best value for customers. Where there is a choice of approaches within the DPC guidance, the Appointee should provide evidence that their preferred approach delivers best value for customers.

There is ongoing work in RAPID<sup>9</sup> on the scope for standardisation of contracts. The commercial arrangements we consider here are likely to be applicable to RAPID schemes delivered by DPC. We will keep this guidance under review as the RAPID work develops.

In developing the guidance, we have had regard to sector specific infrastructure procurement template agreements (the Thames Tideway contract suite for example), other regulated infrastructure procurements such as the Ofgem Offshore electricity transmission regime (OFTOs) and the standard form project finance models that exist in the UK (such as SOPC 4<sup>10</sup> and the Mutual Investment Model utilised by the Welsh Government). These project finance models may provide template drafting for many of the contractual processes and mechanisms that may be appropriate to be included in the CAP Agreement. They can also provide templates for much of the standard legal drafting that will need to be included in the CAP Agreement.

The Infrastructure and Projects Authority have published a Project Development Routemap which has guidance for organisations embarking on infrastructure projects<sup>11</sup>. Use of the Routemap is not mandated by this guidance. The Routemap is a structured and tested methodology used to set up infrastructure projects for success. It captures best practice and learning about the most common causes of project failure are considered at crucial early stages of project development.

## 4.2. General principle for risk allocation

Ofwat want Appointees to identify the risks which exist in their DPC project. Once identified the commercial arrangements for a DPC project should seek to ensure risks are allocated to the party that is best able to manage them. Where risks are unquantifiable and unmanageable, it may be better value for customers for risks to be shared among all the DPC stakeholders including customers, the CAP, and the Appointee as appropriate. For example, the CAP may have responsibility for the management of certain identified ground risks which they can manage and share with their subcontractors; however the cost of managing certain unidentified ground risks might be shared with an Appointee and Customers to avoid unnecessary risk pricing by the CAP.

Any sharing of risks should ensure the party who is able to influence the outcomes of a risk materialising is incentivised to ensure that it is managed efficiently and effectively.

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<sup>9</sup> Please see [RAPID - Ofwat](#) for more information

<sup>10</sup> Standardisation of PFI Contracts Version 4

<sup>11</sup> [PDR-Handbook.pdf \(publishing.service.gov.uk\)](#)

The CAP Agreement should capture the risk allocation and incentivisation measures for the DPC project. The role of the Appointee is to structure the commercial arrangements for a DPC project in the most effective way to ensure best value outcomes are achieved for customers.

Appointees need to understand the risks inherent in their DPC project and the market's attitude to those risks on a project-by-project basis. Appointees must demonstrate their approach to risk sharing to Ofwat as the project progresses as set out in [section 3](#) of this document.

In developing the CAP Agreement, Appointees should ensure that interfaces between the construction and operational arrangements; financing arrangements; and the ARD are considered.

During the development of a DPC project we expect Appointees to engage with the market to consider the optimal risk allocation for their DPC project. That would include the views of both construction and operations contractors and potential funders. We expect an Appointee to propose a risk allocation which is specific to their project and will deliver best value for customers. We expect the Appointee to consider alternative approaches to allocating risk and to consider the use of incentives (for the CAP and its construction partner and for the Appointee) to manage and mitigate the impact of the risk allocation for customers.

### **4.3 Standard risk allocation**

We have set out here the contract principles and risk allocation that Appointees should reflect in the development of their DPC projects and the CAP Agreement. We have grouped together the contract principles and risks to reflect the different aspects of DPC projects. Each section sets out the major issues that will need to be addressed.

In [Appendix 5](#) we set out the supporting contract principles which must also be addressed by Appointees. We refer to the supporting contract principles separately as they are drafting matters which support the main contract principles.

#### **CAP Charges**

The CAP Agreement will set out the CAP Charges to be paid by the Appointee to the CAP for the delivery of the DPC project. This process is governed by a payment mechanism. Each DPC project will have its own payment mechanism which reflects the specific requirements of the DPC project. It will reflect the costs incurred by the CAP to deliver the DPC project and the revenue that the CAP must recover from the Appointee via the CAP Charges to pay for those DPC project costs.

The CAP must recover revenue from the Appointee to meet the costs of delivering the DPC project. Those costs will include several elements across the whole life of the DPC project. These elements are the construction costs, operation and maintenance costs, financing costs and the timing of the commencement of payments under the CAP Agreement. The CAP's revenue stream required to recover the costs of a DPC project will determine the CAP Charges recoverable from customers under the CAP Agreement.



We recognise that the design of the payment mechanism will be project specific and will need to reflect the assets being built as well as operational and maintenance services being delivered by the CAP. For example:

- a project to deliver an asset which requires a predictable level of ongoing operation and maintenance support is likely to benefit from a revenue stream which is predominantly fixed with incentives for availability; where as
- a project to deliver an asset which may have a variable level of ongoing operation and maintenance support depending on the demand for use or volume is likely to benefit from a revenue stream which is comprised of fixed and variable elements.

The difference in approach reflects the profile of each DPC project. A project with a fixed revenue stream is likely to have incentives for availability of the asset. The variable element of a revenue stream will allow the CAP to recover incremental costs related to additional use.

An Appointee should have regard to the principles on project incentives set out in [section 4.4](#) when developing the required contractual mechanisms.

## Depreciation

The guidance expects CAP assets to depreciate over their useful lives. This means that assets may not be fully depreciated over the period of the CAP Agreement if this is significantly shorter than the useful life.

This approach, to ensure generational fairness, is a key part of our regulatory approach. Future customers who get beneficial use of assets, across its useful economic life, should pay a fair share of the costs to deliver those assets.

Where CAP assets are not fully depreciated at the end of the DPC contract period the CAP Agreement must specify the approach to residual (or terminal) value of the CAP assets when the CAP Agreement expires. This mechanism should use a pre-determined description of the condition that the DPC project assets should be in when the contract expires. That mechanism will be project specific and reflect the extent to which the CAP is responsible for the repair and maintenance of the assets over the life of the DPC project.

Please note [Appendix 5](#), which has a section with additional guidance on [Termination](#) and [Residual Value](#).

## Indexation

The approach to indexation should secure the best value for money for customers.

The approach should reflect the elements of the DPC project revenue stream over the whole of the project. CAPs will be able to access both nominal and index-linked debt. We therefore do not consider that their revenue streams should necessarily be index-linked. We expect Appointees to consider the best approach for each DPC project. This could include project indexation being a competitive bid back item in a procurement process for a DPC project which would allow bidders to propose their best approaches to both the proportion of the revenue stream to index and the index to use.

## Duration

We would expect the duration of DPC projects to be in the region of 25 years with flexibility for longer durations e.g., 40 years + where that reflects the requirements of the DPC project, and it represents best value. An Appointee should consider the optimal duration for any DPC project and fix that prior to the commencement of the procurement process.

Factors which may be relevant in considering a longer-term contract may include the nature of the asset and the services required, the requirements of any likely providers of debt, the Appointee's pre procurement market engagement, value for money testing and the useful economic life of the assets.

## Commencement of revenue stream

We require Appointees to demonstrate that the approach to the commencement of the revenue stream to the CAP delivers best value for customers.

It is usual in project finance projects for payments to commence after the assets are constructed, commissioned and available for use. This approach puts construction, completion, and commissioning risk on the CAP (and its supply chain) responsible for delivering the project.

We recognise that this approach may not always be best value for customers and in some cases, it may be better for customers to start paying before the end of construction. For example, a project that involves a long construction period or construction activity that is unusual, or complex might attract a significant risk premium to progress if there is a post completion payment model. In addition, the approach might fail to demonstrate best value as the CAP Charges will include the cost of financing the building contractor's construction activity during the build period. If customers commence payment ahead of completion of an asset, the CAP can pay for the construction activity as it progresses, and so there may be a reduction in the overall cost of the DPC project.

An Appointee should seek the most appropriate approach for the DPC project and the solution which is most likely to offer best value for money for customers. An Appointee should also consider appropriate contractual incentives to support their preferred risk allocation including any required mechanisms to incentivise delivery on time.

## Change of control

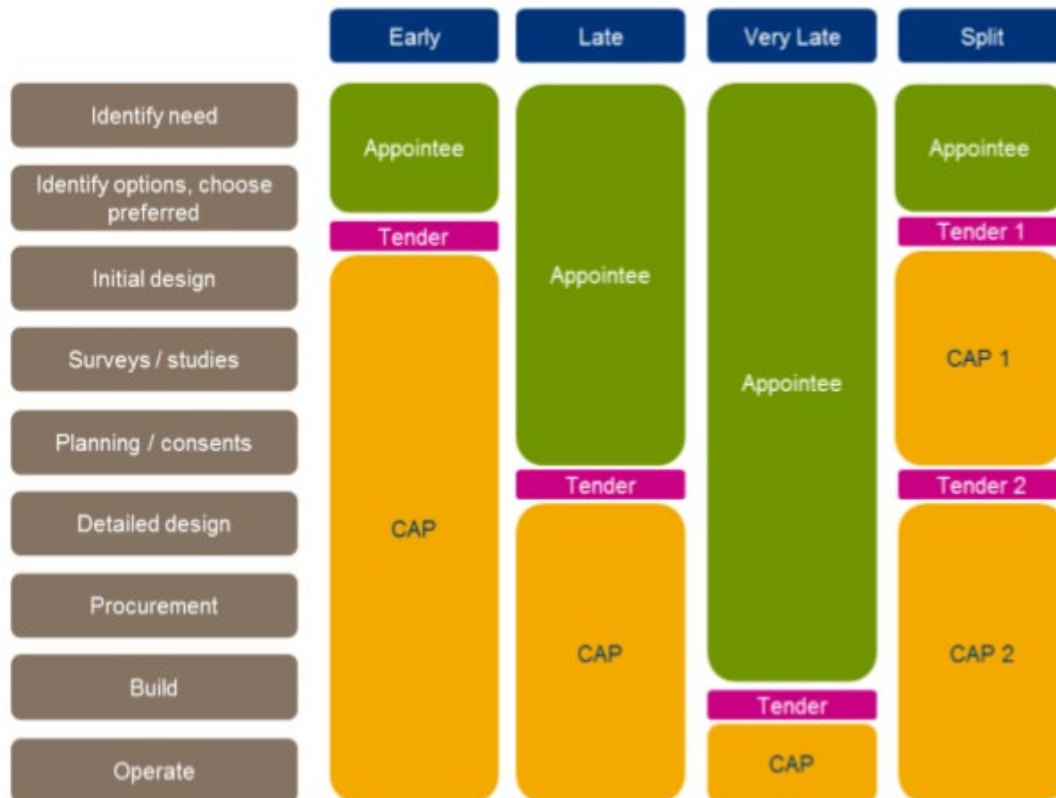
DPC projects will deliver strategic infrastructure delivering essential services to customers. The CAP Agreement should include provisions which require prior approval by the Appointee of any change of ownership or control as regards the CAP. We expect Appointees to be able to apply the same level of diligence and assurance to the competency and financial standing of any new owners as was applied to the original procurement process.

Appointees must also take account of their obligations to comply with any call in notice issued and other notification procedures under the [National Security and Investment Act 2021](#).



## Development risk

### DPC tender models



We recognise that there is scope to tender at different stages in the project lifecycle, and this gives rise to a range of possible tender models. We consider that all models have the potential to drive significant customer benefits, though each model would focus competitive pressure in different areas. Different project types may lend themselves better to different tender models.

Appointees must identify the tender model best suited to the requirements of the DPC project. Appointees will be required to set out the justification for their choice of tender model and explain how it provides the best value for customers compared to their other options.

Please refer to [section 3](#) above which sets out Ofwat's approvals process. As part of our Stage 1 assessment, we will consider whether the tender model proposed for each DPC project will deliver the best value for customers.

The choice of tender model will influence the expected risk allocation in respect of development risks. We use the term development risk here, to mean the risks associated with developing the project (planning, design, purchase of land, etc.) Under a late tender model these development activities will be carried out by the Appointee, whereas under an early tender model some or all of them will be carried out by the CAP. The choice of tender model could have consequential impacts on expected risk allocation for a project.

To date the DPC projects that have been developed have used the late and very late tender model. The table below sets out the expected risk allocation for a project under the late and very late tender model.

Development risks	Risk description	Customer	Appointee	CAP
<b>Planning</b>	Planning consent is not forthcoming, or conditions require changes to scope of project/impose additional requirements on the project.	✓	✓	
<b>Land</b>	Unable to secure appropriate land rights to deliver project, requiring change to project.	✓	✓	
<b>Other consents</b>	A project may require a range of other consents to deliver and operate the asset e.g., abstraction licences, discharge consents etc.	✓	✓	

Appointees can continue to consider the use of the early model (alongside the other tender models) where it can offer benefits, such as, early contractor involvement in the design of the assets. We recognise it may not be possible for a CAP to take all the land (selection and acquisition) and planning risk. An Appointee should consider an appropriate risk allocation to facilitate the use of an early tender model. For example, considering how it would need to support a CAP, establish important stakeholder relationships, and interaction with an Appointees' existing rights (under the Water Industry Act 1991) to deliver certain works that do not require planning permission.

## Land and planning strategy

In developing the land and planning strategy for a DPC project, Appointees must deliver best value for customers.

We expect that the land required for the delivery of the DPC project will be in the ownership or, where the land is needed temporarily for development purposes, control of the Appointee. In common with wider UK project finance projects we would not expect the land ownership to be transferred to the CAP. The CAP Agreement will give the necessary rights to the CAP to access the land to build and then maintain and operate the assets. If it represents best value for customers other land ownership structures may be considered by Appointees.

An Appointee's strategy for the acquisition of land rights to facilitate the build and subsequent operation of DPC assets should seek to deliver best value for customers. Rights that are required temporarily should be based on leasehold or licence rights. Land which is acquired but then becomes surplus should be sold and the proceeds used for the benefit of customers. The process for any disposal of any project land will be subject to Condition K of an Appointee's licence.

Where an Appointee considers it appropriate to do so, a CAP can act as an agent for the Appointee in acquiring land rights, including using the Appointee's statutory powers. Once the DPC project is tendered the CAP will be responsible for delivering the project

in accordance with the consents, land rights and other permissions. The CAP should be required to secure any additional rights to deliver the construction activity.

### Construction and asset delivery risks

The table below sets out our standard approach to risk allocation for construction risks in DPC projects. We accept that there may be reasons why this allocation might not be possible in all cases due to size, complexity, and delivery model. Below the table we have described some exceptions to this standard approach.

The CAP may pass risks to its subcontractors to manage but the CAP will act as a prime contractor with sole responsibility for delivery of the DPC project as far as the Appointee and customers are concerned.

Construction and asset delivery risks	Risk description	Customer	Appointee	CAP
<b>On time delivery</b>	The works cannot be completed to time		✓	✓
<b>Cost overruns</b>	The works cannot be completed to budget	✓	✓	✓
<b>Site conditions</b>	Site conditions (e.g., ground conditions) are different from the information made available by the Appointee during the tender process			✓
<b>Works information</b>	Inaccurate works information is provided to bidders as part of the tender process. Works information specifies the work required to be delivered and any constraints.		✓	
<b>Detailed design</b>	Detailed design does not meet requirements			✓
<b>Third parties</b>	Stakeholder and customer management during delivery of works		✓	✓
<b>Changes in scope (Also see the section dealing with changes in law)</b>	Changes to project requirements during construction e.g., because of unforeseen legal/regulatory changes. The Appointee must look for the best way to manage the impact of changes which affect a DPC project, which might mean changes elsewhere in its operations.	✓	✓	
<b>Interfaces with Appointee's existing assets</b>	Mismanagement and/or poor definition of interfaces results in additional work/delays.		✓	
<b>Commissioning</b>	Constructed works are not fit for purpose and/or do not meet contractual requirements			✓

### On time delivery

In general, completing the works on time will be in the control of the CAP. There may be circumstances, where the CAP Agreement needs to take account of issues which are outside the control of the CAP. For example, this might include, the Appointee not completing enabling works or giving necessary access. The Appointee should also consider the extent to which contractual incentives could be applied to those parties who are able to influence the timely delivery.

We do not expect customers to take the risk of late delivery unless there are project specific factors that need to be considered and for which a sharing of risk might produce better value for customers.

### Cost overruns

Our standard risk allocation assumes that the Appointee, the CAP, and customers share the risk of cost overruns through the contracting model e.g., a Target Cost model.

We recognise that market conditions and the complexity of the infrastructure being procured may mean that it is not possible to or there is a risk premium required to pass all that risk to the CAP and its subcontractors. For that reason, we expect an Appointee to consider cost incentivisation models such as a target price with incentives around an outturn price on completion. Appointees must demonstrate that the proposed model represents best value for customers.

We would expect the Appointee and the CAP to pass down the agreed risk sharing on a DPC project to its subcontractors and incentivise the delivery of assets on budget.

### Site conditions

To the extent possible, the CAP should manage ground conditions. We recognise that the risk allocation may vary from project to project, depending on site location, existing ground conditions, and whether a site is a brownfield or greenfield site. For example, a CAP might be able to manage the ground conditions risk on a site that is a greenfield, self-contained site that neighbours existing works. For other projects, it may be more efficient for the Appointees or customers to take this risk rather than asking bidders to price this risk.

Appointees must demonstrate that the proposed model represents best value for customers. An Appointee must also consider contractual incentives to ensure the parties are incentivised to minimise costs and deliver the project as efficiently and effectively as possible. Where Appointees are undertaking ground investigation work themselves, as part of their project development, they should seek to ensure the reports and other outputs are capable of reliance by the CAP moving forward.

Further guidance on the development of appropriate incentives to manage construction risks is set out below in [section 4.4](#).

### Operational risks

We expect DPC projects, in most circumstances, to outsource to the CAP the operations and maintenance functions for the assets. The inclusion of these services will offer opportunities to secure innovation in the delivery of the services and to deliver value for money across the whole life of the CAP Agreement because the assets delivered remain the responsibility of the CAP not just during the construction phase but into operations.

Appointees are required to consider the most appropriate delivery model for their project based on the project characteristics, feedback from market engagement, and value for money for customers. As a result, the scope of the operations and maintenance requirements included in a DPC project will vary. For some assets, the profile of use or the scope of the operation and maintenance might be difficult to predict over the duration of the CAP Agreement and for the CAP to bear the risk on pricing. Appointees must look for an approach that will deliver best value for customers.

There may be limited circumstances where ongoing operations and maintenance are excluded from the scope of a project. For example, where the asset being delivered integrates with other assets and there is a benefit to maintaining common operations and maintenance regimes across the wider estate. The proposed scope and the management of the risks must be properly documented in the CAP Agreement. Given the long-term nature of DPC projects, Appointees should try to include as much flexibility as possible to future proof the design of the projects and the CAP Agreements. This would include a change mechanism in the CAP Agreement which draws on UK project finance model contracts (such as the Welsh Government's MIM model) to mitigate and manage the complexity involved in agreeing changes and securing the consent of the CAP's finance providers. This should include project specific mechanisms which reflect the nature of the project and the anticipated changes over the contract term and may include a menu of pre priced changes.

Where a change to the scope of a DPC project is necessary, Appointees will be required to demonstrate that they have considered all options including managing the impact of any changes elsewhere in its operations. There may also be circumstances where it is appropriate for elements of operational risks to be shared with customers.

The table below sets out our expectations for the risk allocation in a DPC project during the operational phase.

Operational risks	Risk description	Customer	Appointee	CAP
<b>Cost (opex and maintenance)</b>	Cost of operating and/or maintaining the asset to the required standard exceeds the costs tendered.			✓
<b>Operational performance</b>	Inability to operate the asset(s) to meeting required performance standards in the contract. Even where the CAP is not operating the asset it may still have performance requirements around availability.			✓
<b>Compliance with statutory and regulatory obligations which impact the scope of the DPC project.</b>	The Appointee is unable to meet its statutory and regulatory obligations because of poor operational performance by the CAP. The Appointee cannot contract out of its statutory or regulatory obligations, but the CAP should have responsibility for delivering the asset and services as required by the CAP Agreement.		✓	✓



<b>(Please see the section Legal, regulatory, and other risks below)</b>				
<b>Defects during operations</b>	Defects appear during operations causing interruptions to service and requiring remedial work.		✓	✓
<b>Demand risk</b>	Actual demand for use of the asset is lower/higher than expected. The Appointee should scope the project requirements to reflect expected demand.	✓	✓	
<b>Over-utilisation</b>	Demand to operate the asset above the design requirements, resulting in higher incremental unit costs than remunerated through payment mechanics. The Appointee should scope the project requirements to reflect expected demand.	✓	✓	
<b>Change in scope</b>	The Appointee requires the CAP to either operate the works differently and/or invest in the asset to meet new requirements, or due to changes in inputs to the works (e.g., raw water quality, sewage composition etc.).	✓	✓	
<b>Value testing</b>	The projected operational costs do not reflect the actual cost of operations and the CAP includes risk pricing.	✓		✓
<b>Condition of asset/ hand back risk</b>	Asset condition at the end of the contract period is lower than required by the contract.			✓

Further guidance on the development of appropriate incentives to manage operation and maintenance risks is set out below in [section 4.4](#).

## Financial risks

In line with UK project finance norms, we expect the CAP to take the risk of the costs of financing, where financing costs can be fixed during the bidding process. We understand that in some DPC projects, because of the length of the construction period, it may not be possible or represent best value for customers to fix financing costs. In these cases, Appointees may seek to share the risks of the CAP's financing costs with customers. Appointees should develop and evidence the solution which is likely to deliver best value for customers.

Any benefits from refinancing post construction completion are expected to be shared with customers by way of reduced CAP Charges. In line with UK project finance norms customers should receive a 90% share of any reduction in debt margins. For all other relevant refinancing, customers should receive 50% share. The Appointee should have the right to request a refinancing in terms of the CAP Agreement.

Financial risks	Risk description	Customer	Appointee	CAP
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<b>Financing costs</b>	Financing costs are higher than expected and included in the bid revenue stream.	✓		✓
<b>Refinancing gains</b>	Savings to the CAP's financing costs because of refinancing post construction	✓		✓
<b>Customer bad debt</b>	Increased under recovery of revenue from customers e.g., due to higher bills which may be partially driven by the DPC Project.	Subject to PR methodology	✓	

Further guidance on the development of appropriate incentives to manage finance risks is set out below in [section 4.4](#).

The UK Infrastructure Bank (UKIB) has indicated to Ofwat that DPC projects may meet their eligibility criteria and UKIB is willing to speak to Appointees preparing a DPC project to consider the details of the individual projects in more detail.

### Termination and step in rights

It is expected that CAP Agreements will run for the intended duration or contract term with limited termination rights.

CAP Agreements need mechanisms to deal with the process of termination and hand back of assets as well as mechanisms to deal with the risk and consequences of service failures, default, and early termination.

We have set out in [Appendix 5](#) contractual principles that will be required in the CAP Agreement to support default and termination issues arising in a DPC project.

### Legal, regulatory, and other risks

#### Regulatory Compliance

Appointees remain responsible for complying with their statutory and licence responsibilities as water and/or sewerage undertakers. This responsibility cannot be passed to the CAP via the CAP Agreement. This requirement is set out in paragraph U3 of Condition U of Appointees' licences.

The CAP Agreement will be a key delivery mechanism for the Appointee. An Appointee must ensure that the CAP Agreement includes robust specifications and contract management arrangements to ensure that the CAP has a responsibility to deliver the assets and services in a way which will allow an Appointee to discharge all its statutory, licence and other regulatory obligations. This should include for example, under the Reservoir Act 1975, the Security and Emergency Measures Direction 2022,<sup>12</sup> the Civil Contingencies Act 2004 and the Water Supply (Water Quality) Regulations 2016.

<sup>12</sup> [The Security and Emergency Measures \(Water and Sewerage Undertakers and Water Supply Licensees\) Direction 2022](#)

## Social and environmental value

In accordance with [Ofwat's public value principles](#) the Appointee should consider, and should require the CAP to consider, whether there are ways of maximising social and environmental value in the way that the DPC project is delivered.

### CAP obligations to comply with regulators' requirements.

CAP Agreements must clearly specify all the relevant statutory or licence obligations that a CAP must comply with on behalf of the Appointee in building the assets and delivering the operations and maintenance requirements of a project and must provide for potential changes in these obligations.

The guidance requires the provisions of the CAP Agreement to align with the requirements of the Allowed Revenue Direction.

### Ownership of assets, access requirements and development rights

The guidance requires the CAP Agreement to clearly set out who will own the assets during the term of the CAP Agreement. In the usual course, as with any other Appointee assets, that will be the Appointee. This approach supports the principle of regulatory compliance set out above.

Where an Appointee proposes that the CAP is the owner of assets, the Appointee must consider the extent to which that approach will align with the requirements of the Regulators. Appointees should develop and evidence the solution which is likely to deliver best value for customers.

There may be situations where a different route is preferable to deliver better value for money or to reflect project specific requirements. The guidance requires the CAP Agreement to include a provision which allows the Regulators access to the assets as required to discharge the Regulator's duties and responsibilities.

A CAP should be able to benefit from any relevant statutory powers of the Appointee.

### Change in law which impacts the activity of the CAP.

The long duration of DPC projects (25+ years) means that it is necessary to make provision for the consequences of changes in law or regulation that occur over the life of the project.

We have considered in the [sections above covering construction and asset delivery risks, and operational risks](#), changes in law or regulation that require the Appointee to seek a change in the scope of the DPC project. This section considers the impact of changes in law that impact on the activity being delivered by the CAP regardless of any change in scope.

The table below sets out our expectations for the allocation of risk for these changes in law and regulation which occur after the construction period. The CAP is expected to bear the risk of any change in law during the construction period or which is foreseen at the point of the bidding process and any general changes in law which have a revenue impact. We expect this approach to be standard across all DPC projects.

Customers will bear the risk of any material changes in law that do not have general application. This includes changes in law that are DPC specific. For example, legislation that requires the CAP or DPC projects to pay tax that does not apply more generally or changes in law that are specific to the water and wastewater industry or, a technical standard for operations that is specific to water companies operating in England and Wales and does not apply more generally. This is because it is not considered best value to require the CAP to take responsibility for and fund capital changes that may or may not occur over the life of a project.

This position tracks the UK project finance concepts of discriminatory and specific changes of law.

After the end of the construction phase, customers will bear the risk of general changes in law that require capital expenditure to be implemented. It is not considered best value to require the CAP to take responsibility for and fund capital changes that may or may not occur over the period of the DPC project.

	Risk description	Customer	Appointee	CAP
<b>Changes in law/ regulation which impact the activity being delivered by the CAP in terms of the CAP Agreement.</b>	The DPC project is impacted by changes in legislation and/or regulation specific to DPC projects, the water sector and/or structure of the water industry and which have an impact on the requirements for the project.	✓		
	The DPC project is impacted by general changes in law – not specific to the water industry/DPC project for example a change to tax law.			✓
	The DPC project is impacted by general changes in law which requires capex to implement. It is not considered best value to require the CAP to take responsibility for and fund capital changes that may or may not occur over the life of a project.	✓		✓

There will need to be appropriate change mechanisms in the CAP Agreement to support the management of changes in law.

### Variability of revenue and payment mechanisms

Ofwat expects Appointees to develop a payment mechanism which reflects the key aspects of its DPC project. The payment mechanism will be bespoke for each DPC project and will reflect the composition of the revenue stream; the assets being delivered; the nature of the operational and maintenance services being delivered; and the financing structure of the project. There are likely to be similarities in the structure and operation of payment mechanisms across DPC projects that share similar

attributes. Appointees should also consider model payment mechanisms that already exist in UK project finance sector, and which will offer some guidance on the process of developing a project specific payment mechanism and an approach for some of the key processes that need to be included in any payment mechanism.

The payment mechanism will need to reflect the approach being taken by the DPC project in respect of each of the risk areas described in the guidance.

The payment mechanism should calculate the monthly CAP Charge for the DPC project and manage the payment of sums between the parties.

The payment mechanism will need to include mechanisms to address the following issues.

Identify the point at which payments start and any process for ramping up payment to reflect a staged development of the asset or service	Allow for the payment of performance incentives due to the CAP such as any early completion bonus	Allow for Indexation to adjust the payments on an annual basis as appropriate
Reflect the requirements of the ARD	Calculate deductions for performance failure such as availability and performance deductions	Allow for the repayment of sums incurred by the Appointee in developing the DPC project such as land acquisition costs, where appropriate
Fix the financing costs after the construction period where relevant	Change the level of the CAP Charge following a compensation event, permitted change in law, refinancing, variation, benchmarking and market testing and any other CAP Agreement mechanism that requires a variation of the unitary charge	Calculate volumetric payments where relevant
	Support the calculation of End of Concession payments; Termination Payments terminations and handback payments where relevant	

#### 4.4 Project incentives and commercial arrangements

In designing the commercial structure for a DPC project, Appointees must manage several competing priorities and outcomes to identify the most appropriate structure. The guidance expects Appointees to identify a commercial structure that will deliver best value for customers; will attract appropriate providers of construction, operational and finance expertise to bid for the DPC project; and will allow the Appointee to manage

the CAP and the CAP Agreement to secure the successful delivery of the DPC project and the services that it will deliver.

Appointees should develop a package of commercial incentives for a DPC project that reflects the commercial structure of that DPC project, and which will promote the delivery of best value by aligning the outcomes of the CAP with those of the Appointee and customers. We expect the incentive package to be project specific and appropriate to the DPC project's commercial structure. The use of incentives should support delivery of positive outcomes for the DPC project and not become only a cost of delivery.

The guidance requires the CAP Agreement to include performance incentives linked to the delivery of agreed requirements. Performance incentives should be capped at an appropriate amount to ensure delivery is affordable.

Financial incentives may sharpen the incentive for a CAP to deliver against the most important agreed requirements. The contract could allow for these. Capping the amount of the incentive will ensure that uncapped risk is not priced into the contract, which would not be in customers' interests.

**Appendix 4** sets out some of the approaches to incentivisation that an Appointee might want to consider. The tables cover construction and delivery incentives, operations and maintenance incentives and financing incentives. We expect the incentives used by Appointees to vary across projects to reflect the size, complexity, assets being created, ongoing operations and maintenance, funding structures and the specific risk profile of each project.

### **Appointee incentives to deliver DPC well.**

Once a project has been designated as a DPC project, there is a need to ensure that the Appointee is incentivised to procure and manage the DPC project and the CAP Agreement well. At PR19 we identified a package of incentives for Appointees. Our experience of DPC projects to date suggests that these incentives were not sufficient.

For PR24 we have proposed a focused package of incentives for Appointees who are delivering DPC projects<sup>13</sup>.

The principles which guide our approach are to achieve the right balance of incentives and risk; to align Appointees' incentives to the risk customers are taking; to avoid overlaps with existing incentives; and to have a suite of incentives which offer flexibility and simplicity.

The Appointees will be managing the procurement of DPC projects and managing the CAP Agreements when they are operational. Appointees can influence the successful delivery of DPC projects in several keyways: at the pre procurement stage when scoping a project and putting the commercial structure in place; running the procurement process to get the best out of the market; and finally operating and managing the CAP and the CAP Agreement after financial close.

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<sup>13</sup> Please see Ofwat PR24 Final Methodology Appendix 5

We expect Appointees to adopt the appropriate incentives in respect of those risks that they are managing. We recognise that for each DPC project the incentives will need to be appropriate to the risks inherent in the project.

We have set out in the table below incentives that Ofwat requires an Appointee to consider so that an appropriate suite of incentives can be agreed for a DPC project.

<b>Appointee Incentives</b>	<b>Purpose</b>
<b>Compensation Events</b>	Incentives on both the Appointee and the CAP to ensure that Compensation Events (which involve additional costs not covered by the tender price) are controlled during the construction phase. Incentives on the role of the Appointee in the operation and management of this mechanism should be considered.
<b>Appointee Events</b>	A cost sharing mechanism to incentivise the Appointee to control costs for those risks which have been allocated to it.
<b>Pre-procurement incentive</b>	Aims to incentivise the Appointee by allowing it to keep a share of the incremental value-for-money created for customers by its approach to procurement, taking effect after award of a Cap Agreement.
<b>Incentives for delivering DPC.</b>	Outcome Delivery Incentives (ODIs) which provide a financial reward for the successful award of a CAP Agreement and apply financial penalties for delays to the submission of DPC business cases. At PR24 we will review the effectiveness of the applicable financial rewards and penalties and refine our approach to ODI's.
<b>Price Control Deliverables (PCDs)</b>	We may set Price Control Deliverables (PCDs) for projects designated for DPC delivery, to protect customers by clawing back funding if Appointees do not deliver a DPC procurement. PCDs will allow funding to be returned to customers in the event of under- or non-delivery of the DPC procurement.
<b>Good management of DPC contracts</b>	The Appointee remains legally responsible for compliance with its statutory obligations and licence conditions, where DPC used. This gives the Appointee an incentive to make sure that the CAP delivers what is needed for legal compliance. We also anticipate that the measured performance of Appointees against their Outcome Delivery Incentives will incorporate the effect of CAP performance, giving them an incentive to manage CAP performance well. We will consider whether further incentives are needed in this area at PR24.

## Governance

DPC projects are major projects which involve multiple stakeholders. The stakeholders will change over the lifecycle of the project. It is important for an Appointee to consider governance arrangements for the DPC project. The required governance arrangements are likely to be bespoke<sup>14</sup> for the project and must extend into both the construction phase and operations phase.

The governance arrangements must map out and establish the roles and responsibilities of the Appointee, the CAP, the CAP's subcontractors, the Independent Technical Adviser (ITA), and Ofwat at each stage of the project lifecycle.

<sup>14</sup> Please see the UK Government Infrastructure Projects Authority guidance on governance structure – Project Routemap Handbook Governance Module

A key part of that governance is to agree how disputes and disagreements will be resolved under the CAP Agreement. We expect an Appointee to ensure a suitable dispute resolution procedure is included in the CAP Agreement and that consideration is given to how disputes are resolved at each stage of the DPC project. A key part of that will be the role of the ITA. The DPC Licence Conditions require an Appointee to appoint an ITA. Ofwat requires this role so we can obtain assurance around the costs and delivery of the programme. The Appointee must procure the ITA and in broad terms must award the contract (ITA Appointment) at the same time it appoints the CAP.

Bidders for the CAP role will have the opportunity to provide comments on the ITA's Appointment. The ITA is to be appointed jointly by the CAP and the Appointee with the ITA having a duty of care to the Appointee, the CAP and Ofwat. There will also be a senior management escalation procedure in the ITA Appointment. The DPC Licence Conditions require that either the Appointee or the CAP meet the costs of the ITA.

The role will be project specific but is likely to include responsibility for an independent overview of the programme and costs during the construction phase and will support the incentive arrangements in the CAP Agreement, for example reviewing Compensation Events mechanism to protect customers from improper claims. The ITA will provide impartial guidance on the cost estimates provided by the CAP in the event that Compensation Events. This will give all parties confidence that events are properly identified as Compensation Events and those costs arising are properly incurred.

## 4.5 Standard drafting and contract principles

Appointees must also include in a CAP Agreement several supporting contract principles. These are set out in [Appendix 5](#), in tables which follow the key risk principles described in [section 4.3](#).

The CAP Agreement must reflect the requirements of the DPC Licence Conditions, the Allowed Revenue Direction, the finance documents that the CAP has in place to deliver the financing for the DPC project and the subcontract documents that the CAP has in place to deliver the build of the infrastructure and the subsequent operations and maintenance requirements.

Appointees should include in the CAP Agreement contractual mechanisms reflecting the standard form UK project finance models<sup>15</sup> which cover operational period risks and contract management issues including mechanisms for capturing the service requirements, including any requirements for maintenance and lifecycle, the monitoring of performance and reporting, quality assurance requirements, information rights and audit, the impact of no fault events on the delivery of services, insurance arrangements, change protocols and the impact of changes in law.

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<sup>15</sup> HMT SOPC4 guidance and the Mutual Investment Model utilised by the Welsh Government



## 5 Value for money assessment

### 5.1 Introduction

Delivering best value for customers is one of the central drivers for DPC projects. The DPC Licence Conditions provide that Ofwat can withhold its consent to the commencement of a DPC procurement where it is thought that the project is not likely to deliver best value for customers. It is important that where we make DPC decisions, those decisions are consistent between Appointees and are also based on a fair comparison of DPC to the in-house counterfactual. Consequently, we have set out a standardised approach for Appointees to follow when assessing value for money.

### 5.2 Background

VfM is one of the key reasons for introducing DPC, and DPC has the potential to create significant benefits for customers through the competitive exposure of large infrastructure projects. Prior to a competitive process being undertaken we need a way to consistently assess the potential benefits of DPC projects. We, therefore, require Appointees to assess the VfM of delivering the project via DPC prior to putting the project out to tender. This is required for all DPC projects except those that are being progressed under the RAPID process.

For RAPID Strategic Resource Options (SRO), we have removed the need for Appointees to carry out a VfM assessment of delivering the project via DPC compared to the in-house counterfactual. This is because the projects are of an order of scale or uniqueness that mean they are less suited to in-house delivery. It is accepted that delivery via a competitive delivery model will deliver VfM. In addition due to the unique and complex characteristics of the solutions e.g. the multiparty nature of the schemes, a relevant in-house counterfactual is not readily available.

Please see details of our approvals process in [section 3](#) of our guidance for further information of when a VfM assessment of delivery via DPC is required.

Under the DPC licence condition U, Appointees are required to gain our consent before they can put a project out to tender or enter into a CAP Agreement. As VfM is one of the primary drivers for DPC, we may not provide consent where we think DPC is not likely to achieve best value for customers, for example because:

- the terms of the proposed arrangements are unlikely to provide the best value for money for customers when compared to in house delivery; or
- the Appointee has not delivered a fair and robust procurement process.

We recognise that there are limitations to desktop VfM assessments and that only a real competitive tender process will reveal the true extent of potential benefits available. It is, therefore, important that the VfM assessments we receive from Appointees assess DPC and in-house delivery on a fair basis (i.e., not seeking to skew the assessment one way or the other). This will enable us to make consistent decisions between Appointees and consider the extent to which different scenarios could impact the VfM assessment.

For that reason, we are providing guidance to Appointees on the approach to assessing VfM of a DPC project compared to in-house delivery.

This section 5 sets out our general guidance on assessing VfM of DPC. We have developed a high-level, principle-based approach to provide flexibility to allow us to consider all the relevant factors for each DPC project, including how different project outcomes under each delivery model may impact VfM for customers. As part of this approach, we will ask Appointees to assess both “base case scenarios” and a range of other scenarios. This means the VfM assessments are not binary tests and will allow us to evaluate whether a project being delivered under DPC has the potential to deliver best value for money for customers.

For clarity, this VfM guidance does not apply to assessing the VfM of delivery under the Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 (“SIPR”). Where Appointees have projects (including RAPID SROs) that they consider appropriate to be delivered under the SIPR model, they should engage with us on how they will assess suitability for delivery under SIPR including how to consider VfM.

### 5.3 Assessing value for money prior to procurement

Prior to an Appointee putting a DPC project out to tender, they must gain our consent. **Section 3.2** explains the process and information requirements Appointees must meet prior to gaining our consent. In it we signal, that we expect early engagement with Appointees on the VfM assessment. We expect engagement to start following the Stage 2 submission. This engagement will be expected to cover, the Appointees' proposed assumptions and underlying justification, sensitivity scenarios, and how they link to the proposed commercial model. The aim of the engagement is to provide complete transparency around the VfM assessment and to agree with the Appointee the modelling assumptions and sensitivity scenarios ahead of the Appointee requesting consent to put the DPC project out to tender. Establishing the in-house counterfactual, which will become the template used for assessing VfM of DPC delivery after procurement closes, will be a key area of focus.

In terms of the Appointees' approach to modelling VfM we expect Appointees to follow the approach outlined below.

#### Basis of assessment

Appointees are required to model the difference in Net Present Value (NPV) of the revenue (in real terms) to be recovered from customers over the lifetime of the asset (i.e., until the end of its economic life) under DPC and under in-house delivery. At this stage of the project development, we expect a full financial model to be used. We are not asking Appointees to do a comparison against delivery under SIPR.

When carrying out modelling we expect Appointees to:

- model the in-house counterfactual following our approach to modelling wholesale revenue allowances at the relevant Price Review;

- assume the asset will transfer back in house at the end of the concession period; and
- provide us with a copy of the full financial model and modelling results.

With regard to modelling assumptions, as indicated above we expect Appointees to engage with us on these assumptions and sensitivity scenarios well in advance of their Stage 3 submission. In developing assumptions we expect Appointees to have regard to our standard modelling assumptions as well as current market conditions and intelligence from recent, relevant transactions. We expect Appointees to justify their proposed assumptions and provide supporting evidence.

We are in the process of updating our standard modelling assumptions and will publish updated assumptions here once they are available.

Please see [section 3.2](#) for information on our assurance requirements

### Capital and operating expenditure

#### *In-house counterfactual:*

- Under the in-house counterfactual, capex and opex should be based on a recent, robust cost estimate using up to date information which takes into account the maturity of the design and development of the project. We expect the cost estimate to include a level of pricing around the risks and how the project may outturn, and Appointees need to provide transparency around their assumptions for example, an Appointee may submit a P50 cost estimate.
- Appointees should explain the maturity of the cost estimate and explain how it has evolved or changed over the development of the project e.g. since the relevant Price Review and previous DPC submissions. Where costs have changed significantly from those presented at Stage 1 in the DPC approval process, we expect Appointees to provide evidence that this remains the best value solution for customers.
- We do not expect any additional capex or opex efficiency assumptions to be included in the cost estimate used in the in-house counterfactual to those that would have been assumed in the Price Review.

#### *DPC:*

- *Capex:* We expect Appointees to base the cost estimate on the base cost of the DPC project used in the counterfactual scenario plus efficiency assumptions because of the project being delivered by DPC.
- *Opex:* Appointees will reflect all operating costs that the CAP will pay plus any relevant efficiency assumptions because of the project being delivered by DPC.

Appointees will need to justify whatever efficiency assumptions they include in the base case scenario.

We expect our standard VfM modelling assumptions to be the starting point for capex and opex efficiency assumptions and where Appointees move away from these assumptions Appointees will need to justify the efficiency assumptions they are proposing to use.

- We will also ask Appointees to run sensitivity scenarios around its DPC and in-house delivery costs. Additionally, we will require Appointees to provide us with a breakdown of costs under the in-house and DPC delivery scenarios and explain any key differences between the two scenarios, this would include for example explaining any Appointee costs included in the DPC model and how these vary to those under in-house delivery.

## Financing costs

*In-house counterfactual:*

We expect Appointees to use the WACC in our standard modelling assumptions.

*DPC:*

We expect Appointees to develop financing cost assumptions taking into account our standard modelling assumptions as well as taking into account financing costs on similar transactions, market engagement, the proposed commercial arrangements, and the project specific characteristics. We expect Appointees to engage with us on these assumptions well ahead of their Stage 3 submission and to justify their proposed assumptions and provide evidence to support their proposed approach.

For both financing costs on the DPC and in-house delivery scenarios, we will ask Appointees to carry out sensitivity scenarios around the WACC. Appointees are also required to calculate the comparable WACC under the DPC model using the estimated costs of debt and equity observable in the market and based on similar transactions.

## Capital structure.

While Ofwat models a notional capital structure at Price Reviews, the appropriate structure for a DPC project is likely to be very different – reflecting project finance norms and the specific projects. This is likely to result in different gearing assumptions for DPC compared to the in-house counterfactual. This reflects that while Appointees have a portfolio of activities and risks that they need to manage and broader/deeper regulatory requirements around provision of service to customers, DPC ring-fences the risks associated with the project to a single entity – allowing more flexibility around gearing levels. It is the responsibility of the Appointee to ensure that the CAP has an appropriate capital structure, taking account of the risk allocated to the CAP. We would expect this to be assessed as part of the tender process.

*In-house counterfactual:*

For the counterfactual Appointees will use the notional capital structure used at the relevant Price Review, depending on the year of project submission. This will be confirmed in our standard modelling assumptions.

*DPC:*

We expect Appointees to use our standard modelling assumptions as a starting point for Appointees to justify the proposed capital structure for the CAP (including any changes over time) based on their market engagement and their proposed commercial model. This should be informed by information that they and/or their advisers have observed in the market for similar transactions.

## **Depreciation**

Regarding depreciation, it is important that depreciation in all sensitivities is carried out on the same basis. We, therefore, would generally expect Appointees to use a straight-line basis for this assessment, and we are open to discussing this approach with Appointees.

## **Normalisations/adjustments for differences in risk allocation**

We are not proposing to allow normalisation adjustments except in exceptional circumstances.

Normalisation adjustments are adjustments to one side of the VfM modelling to reflect differences in risk allocation between DPC and the in-house counterfactual. For example, a CAP may be required to purchase various insurances for the project, while an Appointee may typically "self-insure". In this scenario, the base case for DPC would include insurance costs but the BAU base case would not.

While developing this guidance on assessing VfM, we considered whether normalisation adjustments might be required to the in-house counterfactual to address differences in risk allocation between DPC and in-house delivery. Following engagement with the early DPC projects, we have concluded that it is inappropriate to use asymmetric financial adjustments to VfM assessments when estimating the impact differences in risk allocation have on whether DPC provides VfM. First, it can skew the assessment towards one delivery route without justification, and second it makes it more difficult to understand the impact on value for money of the risk allocation in the base case scenario and how those changes in different circumstances.

We are, therefore, proposing not to allow these adjustments except in exceptional circumstances where we agree there is a need and there is a material impact on the assessment. Instead, we intend to explore the differences in different risk allocations using sensitivity analysis. In the case of the example above, we do not think a normalisation adjustment is required for insurance costs.

## **Sensitivity scenarios**

We expect Appointees to identify the most relevant sensitivity scenarios to run their VfM analysis against and we will look to discuss and agree these with them in advance. Broadly, we are expecting to agree a range of sensitivity scenarios for costs and financing costs, as well as how different aspects of the contractual arrangements affect

value for money (e.g., approach to compensation events). Individual discussions with Appointees may be required to ensure the analysis captures all the relevant factors relating to the specific project and proposed commercial model.

## **5.4 Assessing VfM before entering into a CAP Agreement**

Appointees are required to gain our consent before entering into a CAP Agreement with a CAP. During the consultation process in respect of the draft guidance, concerns were raised around the challenges and complexity of assessing value for money at the end of the procurement process. Considering the feedback, we have reviewed our approach to this consent process. In reaching our decision we will consider the following factors:

- Evidence from the pre-procurement VfM assessment;
- The outcome of the Appointee's procurement process and evidence that the Appointee has acted in customers' best interest during the procurement and a best value price has been achieved;
- That a competitive tender process has been successfully run;
- Any material changes to the scope of the project and/or risk allocation between the CAP and customers since the start of procurement;
- Wider benefits of delivering the project via DPC (for example innovation, greater resilience, customers' benefitting upfront from market tested prices, the overall risk transfer etc.); and
- The impact on the project (including time and cost) of withholding consent.

In considering all five factors, we will look for evidence that the procurement process drove best value and the Appointee acted in customers' best interests. To support this approach, we would likely place a condition on Appointees to act in customers' best interests when procuring the project. Under licence condition U4.1 we can provide conditional consent to an Appointee to procure a DPC project.

By focussing on whether a competitive procurement process has been run and a market price achieved, we gain confidence that best value has been achieved for customers. We consider this approach significantly reduces complexity at the end of the procurement process and provides greater transparency around our decision making to Appointees and potential bidders.

## Appendix 1: Glossary of terms

<b>Allowed Revenue Directive (ARD)</b>	The legal instrument by which the Appointee can collect revenue associated with DPC from its customers.
<b>AMP</b>	Is the 5 year asset management plan for each Price Review
<b>Appointee</b>	The water company engaged in the deliver delivery of a DPC project and who competitively tenders for a third party (CAP) to deliver a large-scale infrastructure project.
<b>Approvals Process</b>	The process set out in section 3 of the guidance, and which involves several key milestones that requires Ofwat approval to allow a project to be progressed as a DPC.
<b>Competitively Appointed Provider (CAP)</b>	The successful bidder awarded the contract (CAP agreement) for delivery of a DPC project.
<b>CAP Agreement</b>	The contract between the Appointee and the CAP.
<b>CAP Charges</b>	The revenue stream to be paid to the CAP for the provision of services.
<b>Commercial Framework</b>	A standardised framework with which the Appointee should develop its commercial approach in line with the principles set out section 4 of this guidance.
<b>Condition B</b>	Licence condition B of an Appointee's licence.
<b>Condition U</b>	Licence condition U of an Appointee's licence which sets out how Direct Procurement for Customers is to be regulated.
<b>Derogations</b>	An exemption or relaxation of an expectation / requirement in the guidance. This must be approved by Ofwat.
<b>Designation</b>	A decision made by Ofwat to allow a project to be specified as one that must be put out to tender and delivered via DPC.
<b>Direct Procurement for Customers</b>	A process for water companies to competitively tender for a third-party (a competitively appointed provider) to design, build, finance, operate and maintain infrastructure
<b>DPC Licence Conditions</b>	The regulatory framework for the delivery of DPC projects, which includes a set of obligations on Appointees regarding the development and delivery of DPC projects
<b>DPC projects</b>	Projects that are developed and delivered via Direct Procurement for Customers (DPC).

<b>Early Termination Payment</b>	Payments that are due upon early termination of an approved CAP agreement.
<b>Expiry of CAP Agreement Payment</b>	Payments due from the Appointee to the CAP at the expiration of the approved CAP agreement
<b>Heads of Terms or HOT</b>	A non-binding document setting out the main terms of the CAP agreement between the Appointee and the CAP.
<b>HMT</b>	HM Treasury (HMT) is a government department responsible for developing and executing public finance and economic policy. We previously adopted its 'five-case' model approach.
<b>Independent Technical Advisor</b>	An independent assurance provider with focus on engineering and commercial matters
<b>Interim Determination</b>	A mechanism to allow Ofwat in specific circumstances to review the level of price controls between five yearly Price Reviews. This is dealt with in Condition B.
<b>Net Present Value (NPV)</b>	The current total value of a future stream of payments.
<b>Payment Mechanism</b>	Usually, a schedule to the CAP agreement which governs the calculation of the CAP charges payable by the Appointee to the CAP
<b>Price Review</b>	The process through which revenue controls are set every five years. The current Price Review is for 2024 (PR24) which we will use to set controls for the period from 2025 to 2030.
<b>Procurement Plan</b>	A plan comprised of relevant evidence submitted by an Appointee, which details how they plan to carry out their procurement process.
<b>2019 Price Review or PR19</b>	The price control with Final Determinations issued in December 2019 covering the period 1 April 2020 to 21 March 2025.
<b>2024 Price Review or PR24</b>	The current price control process with final methodology published December 2022 for the period 2025-2030.
<b>RAPID gated process</b>	A process relating to the funding of investigations and development of water resource solutions from April 2020 until March 2024. There are four approval gates in this process.
<b>Regulators</b>	A body that supervises a particular sector or business activity to ensure it is being operated correctly and specifically Ofwat, the Drinking Water Inspectorate, the Environment Agency, and Natural England.



<b>Risk allocation</b>	The appropriate level of risk allocated by the Appointee to the relevant party. This is part of the commercial framework.
<b>Specified Infrastructure Project Regulations (SIPR)</b>	<p>The Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013. The Secretary of State or Ofwat may specify projects for delivery under the Regulations if:</p> <ul style="list-style-type: none"> <li>• the projects are of a size or complexity that threatens the incumbent undertaker's ability to provide services for its customers; and</li> <li>• specifying the infrastructure project is likely to result in better value for money than would be the case if the infrastructure project were not specified.</li> </ul>
<b>Totex</b>	Total expenditure (Totex) is capital and operating expenditure.
<b>Value for Money (VfM)</b>	The economic concept that seeks to ensure benefits (value) from a project are maximised from the incurred cost (money spent).
<b>Weighted Average Cost of Capital (WACC)</b>	A company's average cost of capital across all sources.

## **Appendix 2 – Template ARD**

### **DPC Allowed Revenue Direction**

This DPC Allowed Revenue Direction is issued to [**Insert details of Appointee**] ("**Appointee**") by the Water Services Regulation Authority ("**Ofwat**") under sub-paragraph U6.1 of Condition U of the Appointee's appointment as a water and sewerage undertaker for the purposes of Chapter I of Part II of the Water Industry Act 1991 ("**Appointment**").

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## 1 Definitions and interpretation

1.1 In this DPC Allowed Revenue Direction:

- (a) **ARD Term** has the meaning given to it in paragraph 2.1;
- (b) **CAP Agreement** means the Approved CAP Agreement in the form dated on or around the date of this DPC Allowed Revenue Direction, as amended with the express approval of Ofwat pursuant to this DPC Allowed Revenue Direction or the Appointment (as appropriate);
- (c) **CAP Charges** has the meaning given to it in paragraph 4.15;
- (d) **CAP Documents** means the CAP Agreement, [the Funders' Direct Agreement] and/or any other contract or arrangement between the CAP and the Appointee  
**[Note: to reflect the package of documents for the relevant Project];**
- (e) **CPIH** means the all items Consumer Prices Index including owner occupiers' housing costs, sometimes referred to as the Consumer Prices Index (H);
- (f) **Change Event** means [[●]];
- (g) **Compensation Event** means [[●]];
- (h) **Dispute Resolution** means the process in paragraph 14;
- (i) **DPC Allowed Revenue** has the meaning given to it in paragraph 4.13;
- (j) **DPC Designation** means the **[insert title of designation notice if it references the particular Project]** designation notice issued by Ofwat to the Appointee dated **[insert date];**
- (k) **Draft Revenue Statement** has the meaning given to it in paragraph 4.2;
- (l) **Excluded CAP Charges** has the meaning given to it in paragraph 4.17;
- (m) **Expiry Date** means the date on which the CAP Agreement expires or terminates in accordance with its terms;
- (n) **Final Revenue Statement** means a Draft Revenue Statement settled in accordance with paragraph 4.3, 4.4 or 4.6 (and revised in accordance with paragraph 4.8);
- (o) **Forecast CAP Charges** has the meaning given to it in paragraph 4.14;
- (p) **Included CAP Charges** has the meaning given to it in 4.16;
- (q) **Independent Technical Adviser** means the independent technical adviser appointed in accordance with the CAP Agreement or any replacement from time to time;

- (r) **Independent Technical Adviser Appointment** means the appointment of the Independent Technical Adviser entered into or to be entered into by (i) the CAP; (ii) the Appointee; (iii) Ofwat and (iv) the Independent Technical Adviser (as amended or replaced from time to time);
- (s) **Project** means the [**Insert name or short description of the Project**] as described in the schedule to the DPC Designation;
- (t) **Reconciliation Charge** has the meaning given to it in paragraph 4.18;
- (u) **Recoveries Amount** means an amount falling within the scope of paragraph 5.1 that has been recovered by the Appointee from the CAP by way of the Appointee's right of set-off or counterclaim under the CAP Agreement against any payment to the CAP or otherwise accounted for in the calculation of any payment to the CAP.
- (v) **Revocation Date** means the date on which this DPC Allowed Revenue Direction is revoked by Ofwat in accordance with sub-paragraph U6.4 of Condition U of the Appointment;

1.2 The following terms shall have the meaning given to them in the CAP Agreement:

**Note: To be inserted when Ofwat has had the opportunity to review the CAP Agreement and assess which of its terms require to be reflected in this ARD. Ofwat expects to publish the ARD and a redacted version of the CAP Agreement at financial close**

1.3 The following terms shall have the meaning given to them in the Appointment:

**Approved CAP Agreement**

**Charging Year**

**Interim Determination**

**Periodic Review**

**Regulated Activities**

1.4 Where any amount or sum is expressed to be "**Indexed**", it shall be indexed in accordance with [CPIH]. **Note: if necessary this definition will be amended and/or reconciled with any specific index provisions to be included in the relevant DPC Allowed Revenue formula.**

1.5 Where this Allowed Revenue Direction makes reference to a cost not being recoverable from the CAP, it shall be interpreted as meaning that any claim against the CAP for such cost is likely (on the balance of probabilities) to fail, taking into account any limitations in the CAP Agreement on the CAP's liability and the CAP's financial solvency.

1.6 In this DPC Allowed Revenue Direction:

- (a) **agreed form** means a form agreed separately between the Appointee and Ofwat;

- (b) **including** and similar expressions are to be read without limitation;
- (c) **person** includes a firm and any entity having legal capacity;
- (d) any term importing gender includes any gender;
- (e) any term importing the singular includes the plural and vice versa;
- (f) any reference to any legislation (whether particular legislation or legislation generally) includes any legislation for the time being in force replacing or supplementing such legislation and any subordinate legislation made under any such legislation, and any code of practice or approved document issued or approved under the authority of such legislation; and
- (g) subject to any contrary indication, any reference:
  - (i) to any paragraph or Appendix is to such paragraph or Appendix of this DPC Allowed Revenue Direction; and
  - (ii) to any clause or Schedule is to such clause or Schedule (as applicable) of the CAP Agreement.

## **2 Term**

2.1 This DPC Allowed Revenue Direction shall come into effect on the date upon which the CAP Agreement comes into full force and effect in accordance with its terms and, subject to paragraph 13, continue until the later of:

- (a) the Expiry Date; and
- (b) the Revocation Date,

such period being the "**ARD Term**".

2.2 If Ofwat and the Appointee agree any changes to this DPC Allowed Revenue Direction (including an extension to the ARD Term) in accordance with paragraph 7 below, Ofwat shall issue a duly amended DPC Allowed Revenue Direction to the Appointee.

## **3 Reporting requirements of the Appointee**

The reporting requirements on the Appointee will be set out in the Regulatory Accounting Guidelines issued under Condition F of the Appointment.

**Note: Other reporting requirements not set out in the RAGs (if any) to be inserted here. This may include, for example, any forecast and outturn reporting that the Appointee is required to provide (and the process and Information requirements for such forecasts and outturn reports) in respect of the CAP Charges.**

## **4 DPC Allowed Revenue**

*Revenue Statement*

- 4.1 The Appointee is entitled to collect from customers the DPC Allowed Revenue in each Charging Year in accordance with the relevant Final Revenue Statement.

**Note: Depending on the terms of the Approved CAP Agreement, additional drafting may be included here to set out (or set out a method for determining) the first year in which DPC Allowed Revenue can be recovered.**

- 4.2 By no later than 15 September each year, the Appointee shall submit to the Independent Technical Adviser (copied to Ofwat) a statement of the DPC Allowed Revenue for the following Charging Year calculated in accordance with paragraph 4.13 ("**Draft Revenue Statement**").

**Note: subject to checks against the development of the CAP Agreement, in particular provisions relating to the appointment of the Independent Technical Adviser.**

- 4.3 Within twenty (20) Business Days following receipt of the Draft Revenue Statement (or any amended Draft Revenue Statement pursuant to paragraph 4.7) from the Appointee (or such other time as may be agreed by the Independent Technical Adviser and the Appointee), the Independent Technical Adviser shall notify the Appointee (copied to Ofwat) as to whether:
- (a) it is content that the Draft Revenue Statement complies with this DPC Allowed Revenue Direction, in which case the Draft Revenue Statement shall become the Final Revenue Statement; or
  - (b) it has any concerns that the Draft Revenue Statement does not comply with this DPC Allowed Revenue Direction, in which case the Independent Technical Adviser shall state in what respect the Draft Revenue Statement is non-compliant.
- 4.4 If the Independent Technical Adviser notifies the Appointee (copied to Ofwat) that it has concerns regarding the Draft Revenue Statement in accordance with paragraph 4.3(b), the Appointee and the Independent Technical Adviser shall meet as soon as possible with a view to agreeing the Draft Revenue Statement. If the Independent Technical Adviser has not withdrawn its concerns within fifteen (15) Business Days following its notification pursuant to paragraph 4.3(b) (or such other time as may be agreed by the Independent Technical Adviser and the Appointee), then:
- (a) the matter shall be determined by the Independent Technical Adviser, such determination to be made by 30 November (in that year) and, subject to paragraph 4.5, to be final and binding; and
  - (b) the Draft Revenue Statement as amended to put into effect any such determination shall become the Final Revenue Statement.

- 4.5 A determination of the Independent Technical Adviser shall not be final and binding where the matter has been referred by the Appointee to Ofwat for determination in accordance with this paragraph 4.5. The Appointee may refer any Draft Revenue Statement to Ofwat for determination in any of the following circumstances:



- (a) if the Independent Technical Adviser fails to:
  - (i) notify the Appointee of its position regarding the Draft Revenue Statement in accordance with paragraph 4.3; or
  - (ii) make a determination in accordance with paragraph 4.4(a),
- (b) if the Appointee reasonably anticipates that the Independent Technical Adviser will fail to notify as set out in 4.5(a)(i) or make a determination as set out in 4.5(a)(ii), by reason of the Independent Technical Adviser's insolvency or the termination of the Independent Technical Adviser Appointment; or
- (c) in the case of manifest error or fraud.

4.6 If a Draft Revenue Statement is referred to Ofwat in accordance with paragraph 4.5, Ofwat shall, by 30 November of the relevant year or (if given fewer than twenty (20) Business Days' notice) as soon as reasonably practicable thereafter, either:

- (a) confirm that it is content that the Draft Revenue Statement complies with this DPC Allowed Revenue Direction, in which case the Draft Revenue Statement shall become the Final Revenue Statement; or
- (b) instruct the Appointee to make changes to the Draft Revenue Statement to ensure that it complies with this DPC Allowed Revenue Direction, in which case that Draft Revenue Statement as so amended shall become the Final Revenue Statement,

provided that if Ofwat fails to respond in accordance with this paragraph 4.6, the Draft Revenue Statement referred to Ofwat shall become the Final Revenue Statement.

4.7 At any time before the Draft Revenue Statement becomes the Final Revenue Statement, the Appointee may re-submit the Draft Revenue Statement with any amendments (highlighting such amendments) and paragraph 4.3 shall apply to such Draft Revenue Statement, provided that such process shall have concluded by the date upon which the figure for CPIH is published for the month of November.

4.8 Promptly upon the figure for CPIH being published for the month of November, the Appointee will revise the Final Revenue Statement so as to reflect the actual CPIH figure (the Appointee having relied on its own reasonable forecast for the purposes of preparing the Draft Revenue Statement).

4.9 The charges set out in the Final Revenue Statement, as revised in accordance with paragraph 4.8, shall be included in the Appointee's charging process (in accordance with the Appointment and this Allowed Revenue Direction) on the basis of self-assurance without further reference to Ofwat.

4.10 The Appointee shall levy charges to its customers in respect of each Charging Year in the manner best calculated to collect the DPC Allowed Revenue as stated in the relevant Final Revenue Statement (revised as provided for by paragraph 4.8) in accordance with paragraph 9.1 of Condition B of the Appointment.

- 4.11 The Appointee in levying the charges referred to in paragraph 4.10 shall comply with the requirements of any applicable rules issued by Ofwat under section 143B, section 66E and / or section 117I of the Water Industry Act 1991 applicable in respect of the relevant Charging Year.
- 4.12 The DPC Allowed Revenue does not take account or make allowance for bad debt which will be addressed as part of each Periodic Review (and consistent with any other bad debt in respect of the Appointee's revenues), using the methodology applied by Ofwat at the time of such Periodic Review.

*DPC Allowed Revenue*

- 4.13 The "**DPC Allowed Revenue**" in respect of the Project in each Charging Year (**Y**) shall be calculated in accordance with the following formula:

$$[AR_Y = FCC_Y + (RC_{Y-2} * TVM_Y) + RA_{Y-1}]$$

where:

$AR_Y$  means the DPC Allowed Revenue for the relevant Charging Year;

$FCC_Y$  means the Forecast CAP Charges for the relevant Charging Year;

$RC_{Y-2}$  means the Reconciliation Charge for the Charging Year immediately preceding the Charging Year in which the forecast is being made (Y-1), calculated in accordance with paragraph 4.18; and

$TVM_Y$  means the time value of money adjustment to the Reconciliation Charge, calculated in accordance with paragraph 4.19.

$RA_{Y-1}$  means the Recoveries Amount recovered by the Appointee in the Charging Year prior to the Charging Year concerned

**Note: The DPC Allowed Revenue is expected to be calculated in a manner consistent with the Approved CAP Agreement. The above formula is one option for payment based on a forecast and reconciliation process. For other structures, such as fixed price and performance adjustments, this can be adapted so that the reconciliation manages any such performance adjustments.**

*Forecasts*

- 4.14 The "**Forecast CAP Charges**" shall comprise the Appointee's reasonable expectation (assured by the Independent Technical Adviser) as to the likely CAP Charges which will be payable during the relevant Charging Year. **Note: subject to checks against scope of Independent Technical Adviser Appointment.**

*Meaning of CAP Charges*

- 4.15 The "**CAP Charges**" shall comprise the Included CAP Charges set out in paragraph 4.16 less the Excluded CAP Charges set out in paragraph 4.17.

4.16 The "**Included CAP Charges**" shall comprise:

**Note: this is expected to include monthly charges/capital sums but may need to take into account performance amounts/adjustments, depending on the terms of the Approved CAP Agreement. Certain amounts may require the consent of Ofwat before inclusion and/or may require a report from the ITA.**

*Meaning of Excluded CAP Charges*

4.17 The "**Excluded CAP Charges**" means:

**Note: this term is expected to be developed to be consistent with the Approved CAP Agreement. In some cases this may involve Ofwat's consent being required in relation to the inclusion/exclusion of certain amounts in the Charges. If there are no excluded charges the architecture in paragraph 4.15-4.17 can be simplified.**

*Reconciliation Charges*

4.18 The "**Reconciliation Charge**" for any given Charging Year shall be calculated as follows:

$$RC_Y = CC_Y - FCC_Y$$

where:

$RC_Y$  means the Reconciliation Charge for the given Charging Year;

$CC_Y$  means the actual CAP Charges for the given Charging Year;

$FCC_Y$  means the Forecast CAP Charges for the given Charging Year as set out in the Final Revenue Statement in respect of that year.

*Time Value of Money*

4.19 The time value of money ("**TVM**") shall be calculated in accordance with the following formula:

$$TVM_Y = (1 + WACC_Y)^2 \times CPIH_Y \text{ Adjustment Factor where:}$$

"**WACC<sub>Y</sub>**" means the weighted average cost of capital and shall assume the value of the allowed return on capital (vanilla form) for wholesale controls for the related service from the last relevant Periodic Review; and

"**CPIH<sub>Y</sub> Adjustment Factor**" means one (1) plus the percentage change (expressed as a decimal) in the CPIH between the published CPIH figure for the month of November in year Y-3 and that published for the month of November in year Y-1.

## **5 Recoveries under the CAP Documents, Collateral Agreements or Insurances**

5.1 The Appointee shall be entitled to recover from the CAP any amount(s) that the Appointee is expressly entitled to recover (including by way of any right of set-off or counterclaim) from:

- (a) the CAP under the CAP Documents;
- (b) any of the [Contractors, Service Providers, Consultants, Specified Sub-Subcontractors or Sub-Consultants under a Collateral Agreement] [**Note: relevant third party to be aligned with Approved CAP Agreement**]; and
- (c) any insurers,

in respect of any costs, losses or liabilities of the Appointee, including on account of any activities to which Ofwat provides its consent in accordance with paragraph 12.

5.2 Where any amount referred to in paragraph 5.1 is a Recoveries Amount it shall be treated as follows:

- (a) If the Recoveries Amount is recovered at any time during the ARD Term other than the final year of the ARD Term, it shall be added back to the DPC Allowed Revenue in accordance with paragraph 4.13;
- (b) If the Recoveries Amount is recovered in the final year of the ARD Term, it shall be added to the termination amount or the End of Concession Payment.

## 6 Recoveries under Periodic Review or Interim Determination

**Note: The Appointee's project related costs will, in general, be dealt with as business as usual costs, recoverable through the price review and subject to the relevant price review methodology in place at the time. There is therefore no need to deal with these costs in the ARD. However, where it is agreed with Ofwat that the Appointee can recover certain project costs either in full (eg the end of concession payment) or with a specific alternative customer sharing rate (eg we may agree that certain land sales will have a different customer sharing rate), that should be set out in the ARD. Those costs will then be dealt with in a price control, subject to the methodology in place at the time.**

6.1 The Appointee shall be entitled to recover from customers the nominal amount of any of the following costs in its entirety, but in each such case excluding any cost(s) arising from an Excluded Change and provided that any allowance on account of the time value of money, inflation and the cost of capital will be subject to the methodology applied by Ofwat at the time of the relevant Periodic Review or Interim Determination (as applicable):

- (a) **Insert categories of permitted costs (if any)**
- (b) Subject to any disallowance determined by Ofwat pursuant to paragraph 10, any Termination Payments and the End of Concession Payment other than any payment of default interest.

## 7 Change Events and Compensation Events

**Note: Ofwat acknowledges that there may be events for which the CAP will not have been allocated the risk and responsibility for the financial consequences of them and**

**the subsequent occurrence of such events will not have been included in their original bid price. Therefore, the Appointee may want the ARD to provide for recovery of such additional charges which were not included in the normal CAP Charges. Such events would be specified in the CAP Agreement and included in the ARD. These events may be Change Events (e.g. changes to the project) or Compensation Events (e.g. no fault events that result in changes to the Project). Ofwat would expect such events to be managed in accordance with the following provisions (as developed and aligned with the CAP Agreement).**

- 7.1 The Appointee shall provide prior written notice to Ofwat of any proposed suspension (instigated or agreed by the Appointee) of the CAP Agreement for more than one (1) month and/or any proposed extension of the term of the CAP Agreement for more than one (1) month.
- 7.2 Subject to paragraph 7.3, the Appointee agrees that Ofwat's consent is required in respect of each of the following:
- (a) any change to the terms and/or conditions of, or to the works or services required under, the CAP Agreement (whether or not occurring as a result of a Change Event or a Compensation Event) and which would result in:
    - (i) any increase in the prevailing [**insert reference to relevant periodic charge**] of more than [one (1) %]; or
    - (ii) a need for Ofwat to make a consequential change to the DPC Designation;

**[Note: principles to be based on assessment of changes that would be regarded as sufficiently material in the context of the CAP Agreement ]**

- (b) any suspension of the CAP Agreement for more than [three (3) months], if instigated or agreed by the Appointee;
- (a) any extension of the term of the [Project][CAP Agreement] of more than six (6) months;
- (b) any [refinancing - **Note: definition and scope of changes to funding to be aligned with funding structure and potential changes to it**] which (and to the extent that it) requires the Appointee's consent or approval under the CAP Agreement;
- (c) any material change to the terms and/or conditions of the CAP Agreement (other than any change which is set out in paragraph 7.2(a)); **[Note: to be considered alongside paragraph 7.2(a), as it develops]** and
- (d) any agreement between the CAP and the Appointee to settle a Dispute(s) under the CAP Agreement. **Note: Subject to alignment with Dispute Resolution Provisions under the CAP Agreement and agreement on suitable materiality thresholds, for example the settlement amount being materially greater than the**

**amount assessed by the Independent Technical Adviser (if disputes are within the Technical Adviser Appointment).**

- 7.3 Ofwat's consent is not required to or for:
- (a) [any event, circumstance or instruction comprising (or otherwise giving rise to) a Compensation Event not falling within paragraph 7.2(a)];
  - (b) **others to be added based on the CAP Agreement e.g. in relation to certain non-works variations, certain changes in law etc.**
- 7.4 If any action is proposed to which paragraph 7.2 applies, the Appointee shall notify Ofwat in writing of:
- (a) the nature of the proposed action and the reason for instructing or seeking the same;
  - (b) if applicable, an explanation of how the proposed action would impact on the quantum, timing or calculation of the CAP Charges and / or the DPC Allowed Revenue (including what amounts, if any, should be recovered from customers under a Periodic Review);
  - (c) if applicable, an explanation of how the proposed action would impact on the scope of works or services to be provided by the CAP as set out in the DPC Designation; and
  - (d) if applicable, the change to the DPC Designation that it considers is required, providing any relevant supporting information.
- 7.5 [Ofwat shall consider the notice and accompanying information received pursuant to paragraph 7.4 and, [within thirty (30) Business Days] following receipt of such notice and information or such other period as may be reasonable in the circumstances (depending, in particular, on whether or not Ofwat needs to consult on any such changes), shall notify the Appointee as to whether it consents to the proposal.]

**Note: drafting will be developed following review of the CAP Agreement. In some cases it may be possible to align timescales with, for example, dispute mechanisms.**

## **8 Independent Technical Adviser**

- 8.1 Ofwat and the Appointee have entered into or will enter into the Independent Technical Adviser Appointment (with the other parties to it), in the agreed form. **Note: to be revised in accordance with the parties to the relevant Appointment. As set out in Condition U11.1, "the Appointee (whether jointly with the CAP or otherwise) must appoint an Independent Technical Adviser, approved by Ofwat".**
- 8.2 Ofwat's consent is required in respect of any replacement or re-procurement of the Independent Technical Adviser or any person undertaking any of the duties and functions provided for in paragraph U11 of Condition U of the Appointment.

**Note: other provisions requiring reports from the ITA to be inserted when the CAP Agreement is reviewed.**

8.2.1 The Appointee shall procure that the Independent Technical Adviser Appointment shall include an obligation on the Independent Technical Adviser to provide a report each quarter to Ofwat and the Appointee setting out:

(a) **[Insert reference to appropriate cost defined terms that should be included in the report to refer to Outturn costs of the Project];**

(b) [progress against the programme for the Project and completion date;

(c) a (high level) summary of the accepted programme for the Project;

(d) the cumulative value of Compensation Events and Change Events which have arisen; and

(e) **others to be included following review of the CAP Agreement.**

## **9 Termination and expiry of the CAP Agreement**

9.1 Unless already determined in a Periodic Review, by no later than two (2) years before the expiry of the CAP Agreement or as soon as reasonably practicable following notice of termination of the CAP Agreement, the Appointee shall submit to Ofwat its proposals for the future of the Project which may include:

(a) procuring a new CAP Agreement (or similar);

(b) extending the term of the CAP Agreement (if it has not already been terminated);  
or

(c) delivering the Project itself.

9.2 Following submission of such proposals pursuant to paragraph 9.1, Ofwat and the Appointee shall meet to discuss, and use their reasonable endeavours to agree as soon as possible, the future of the Project.

9.3 The Appointee may not terminate the CAP Agreement without Ofwat's consent except where:

(a) the Appointee is entitled to terminate the CAP Agreement due to the CAP's breach or repudiation of the CAP Agreement **[Note: align with termination provisions of the CAP Agreement];** or

(b) Ofwat has revoked this DPC Allowed Revenue Direction and / or the DPC Designation.

## **10 Disallowance of End of Concession Payments and Termination Payments**

**Note: As set out in Ofwat's Guidance, Ofwat is aware that there may be End of Concession Payments and/or Termination Payments under the CAP Agreement**

(although this will not always be the case if the water company chooses to re-tender or extend the service contract). Such payments may be managed as part of any Price Review (if, for example, the asset is added to the RCV and charges recovered in the normal way) or Interim Determination provided that Ofwat is satisfied on a case by case basis that there are suitable handback and defects provisions in the CAP Agreement for a particular Project.

- 10.1 Where a Termination Payment is payable by the Appointee under the CAP Agreement as a result of the Appointee's default or voluntary termination of the CAP Agreement, Ofwat shall be entitled to disallow (pursuant to paragraph 6.1(b)) recovery of an amount equal to up to [twenty (20) %] of such termination payment in accordance with the principle set out in paragraph 10.2, subject to an aggregate limitation on such disallowance of [twenty (20)%] of the Appointee's annual turnover during the immediately preceding financial year (at the time, or the latest time, at which this provision is applied).
- 10.2 Any disallowance determined by Ofwat pursuant to paragraph 10.1 shall reflect the extent to which the Appointee's failure to act as a prudent and efficient appointee contributed to the termination, if at all.
- 10.3 Notwithstanding that compensation will be payable under the CAP Agreement, no disallowance shall be made under paragraph 10.1 if the Appointee terminates the CAP Agreement in accordance with [insert clause references from the CAP Agreement for particular triggers].
- 10.4 Subject to paragraph 10.5, if the Appointee enters into an agreement with the CAP to terminate the CAP Agreement (a "**Consensual Termination Agreement**") and, at or around the date of commencing the negotiations in respect of such agreement until the date such agreement is entered into, circumstances are such that there is no reasonable likelihood of the Appointee terminating or being or becoming entitled to terminate the CAP Agreement as a result of a CAP Event of Default, Force Majeure or [insert others from the CAP Agreement] (even if the relevant circumstances continued), Ofwat may extend the application of paragraph 10.1 to any termination amount payable by the Appointee under the CAP Agreement. Without prejudice to the generality of the foregoing, Ofwat shall not apply paragraph 10.1 to any Consensual Termination Agreement if the Appointee has served valid notice to terminate the CAP Agreement in accordance with its terms.
- 10.5 Ofwat may only extend the application of paragraph 10.1 to a Consensual Termination Agreement in accordance with paragraph 10.4, if either:
- (a) Ofwat advises the Appointee of its intention to do so when giving its consent to the Appointee entering into the Consensual Termination Agreement in accordance with paragraph 9.3; or
  - (b) additional information, which was not known to Ofwat at the time of giving its consent to the Consensual Termination Agreement in accordance with paragraph 9.3, subsequently becomes known to Ofwat, giving Ofwat justifiable cause to do so after (and notwithstanding that) the Consensual Termination Agreement has been entered into, and



in any event, only as part of the Periodic Review or Interim Determination (as applicable) at which the Consensual Termination Agreement is first taken into account.

- 10.6 The Appointee shall promptly provide Ofwat with any and all Information (as defined in this DPC Allowed Revenue Direction) reasonably necessary to enable Ofwat to properly assess whether circumstances are such that there is any reasonable likelihood of the Appointee terminating or being or becoming entitled to terminate the CAP Agreement as a result of a CAP Event of Default, Force Majeure or **[insert others from the CAP Agreement]** in accordance with paragraph 10.3

## 11 Regulatory guidance

Ofwat has issued guidance on how it will take into account certain amounts recoverable by the Appointee in a Periodic Review or Interim Determination (as applicable).

## 12 Confirmations

**Note: Drafting may be inserted here to deal with the interaction between the Appointment, Guidance and the CAP Agreement, if appropriate, for example granting consent to the involvement of Associated Companies under Condition U9 in relation to certain activities or dealing with any funder requirements under Condition U5 which may be a form of assignment in security.**

- 12.1 Ofwat confirms that the references in paragraphs U8.3 and U8.4 of Condition U of the Appointment to revenue that has not already passed on to the relevant CAP:
- (a) do not apply to revenue that is, or is likely to become, due to the CAP in accordance with the provisions of the CAP Agreement; and
  - (b) apply only to revenue collected on account of CAP Charges (as defined in paragraph 4.15).
- 12.2 Ofwat provides its consent, in accordance with sub-paragraph U9.3 of Condition U of the Appointment, to the Appointee:
- (a) supporting the CAP in obtaining all requisite property rights, accessing properties and obtaining Consents in accordance with the CAP Agreement;
  - (b) undertaking the activities that are expressly allocated to the Appointee in clause [ ] of the CAP Agreement as at the date of this DPC Allowed Revenue Direction;
  - (c) administering, enforcing and managing the CAP Agreement and any other Project Documents to which it is a party; and

**Note: others to be based on a review of the CAP Agreement**

## 13 Survival

- 13.1 The following provisions, and the ability of the Appointee to recover amounts from customers on the basis of such provisions, shall survive any revocation or any termination of this DPC Allowed Revenue Direction: [●]. **Note: to be reviewed in relation**

**to the particular CAP Agreement to determine if there are amounts which should be appropriately recovered**

- 13.2 The termination or revocation of this DPC Allowed Revenue Direction shall not affect any rights, remedies, obligations or liabilities of the parties that have accrued up to the Expiry Date or Revocation Date, including the right to claim damages or take other enforcement action in respect of any breach of this DPC Allowed Revenue Direction which existed at or before the Expiry Date or Revocation Date.

## **14 Dispute Resolution**

**Note: generally, matters which are to be determined by Ofwat pursuant to Condition U or this Direction shall be determined in Ofwat's discretion in accordance with the relevant requirements of the regulatory framework, including any rights of referral or appeal. If the interaction of the Independent Technical Adviser needs to interact with procedures under the CAP Agreement, this can be managed in accordance with a process set out in the ARD.**

## Appendix 3: DPC licence provisions

The DPC Licence Conditions are already in the licences of five Appointees. We have reviewed the existing provisions and propose some minor changes to them. The document below sets out the current Condition U provisions and relevant definitions in Condition A and highlights the changes we propose making to them. It also summarises the Condition B provisions and the proposed changes to those provisions. We intend extending these provisions to those companies that will be delivering DPC projects in the period between 2025 – 2030. Deletions are struck out and insertions are underlined, and changes are highlighted in **red text**.

### Condition U: Direct Procurement for Customers (DPC)

#### Introduction

This Condition requires that, where the Appointee plans, procures, manages and carries out activities in respect of a DPC Delivered Project, the Appointee must:

- (1) obtain relevant consents from Ofwat; and
- (2) take appropriate steps to ensure its customers are protected.

#### U1. Designation of a DPC Delivered Project

U1.1 Ofwat may, with the consent of the Appointee, by direction from time to time:

U1.1.1 designate an infrastructure project as a DPC Delivered Project;

U1.1.2 modify the designation of a DPC Delivered Project (designated pursuant to sub- paragraph U1.1.1; and

U1.1.3 revoke the designation of a DPC Delivered Project (designated pursuant to sub- paragraph U1.1.1 or any modified designation of a DPC Delivered Project modified pursuant to sub-paragraph U1.1.2).

U1.2 As part of any direction issued pursuant to sub-paragraphs U1.1.1 and U1.1.2, Ofwat will set out in writing the scope (or, if applicable, the modified scope) of the DPC Delivered Project.

U1.3 In this paragraph U1 “infrastructure” means infrastructure relating to:

- U1.3.1 the provision of a system, or part of a system, of water supply, or the securing of supplies of water; or
- U1.3.2 the provision of a system, or part of a system, of sewers, or the provision of means for emptying, or dealing effectually with the contents of, sewers.

U2. Procuring a DPC Delivered Project

- U2.1 Save to the extent otherwise approved in writing by Ofwat, the Appointee must:
  - U2.1.1 put a DPC Delivered Project (including the financing of such a project) out to tender in accordance with paragraph U4; and
  - U2.1.2 appoint a CAP (or more than one CAP) to undertake a DPC Delivered Project in accordance with sub-paragraph U5.1.

U3. Appointee's Responsibilities

- U3.1 The designation of a DPC Delivered Project, any consent issued by Ofwat (or failure to issue such consent) pursuant to this Condition U and the appointment of a CAP to undertake a DPC Delivered Project does not diminish the responsibilities, obligations or liabilities of the Appointee as a relevant undertaker in respect of the DPC Delivered Project (including, without limitation, pursuant to the Appointment).
- U3.2 The Appointee's procurement of a DPC Delivered Project and its management of any Approved CAP Agreement must ensure that the Appointee is and continues to be able to carry out its functions as a relevant undertaker.

U4. DPC Procurement Process

- U4.1 The Appointee must not, without the prior written consent of Ofwat, commence or undertake any DPC Procurement Process. Any such consent from Ofwat may be issued in stages, with consent issued for a prescribed stage of the DPC Procurement Process only. Further, any such consent may be conditional and, in carrying out a DPC Procurement Process, the Appointee must comply with any conditions imposed by Ofwat in commencing or undertaking any DPC Procurement Process.
- U4.2 Ofwat may withhold consent under sub-paragraph U4.1, including where it considers that a DPC Procurement Process (and any relevant proposed procurement documents, any proposed selection and evaluation criteria, any

proposed procurement plans and the form and provisions of the proposed CAP Agreement to be put out to tender) is not likely to achieve best value for customers.

- U4.3 The Appointee must notify Ofwat in writing as soon as practicable if it considers it is unable to complete a DPC Procurement Process or intends to suspend or abandon (whether in whole or in part) a DPC Procurement Process. Any suspension or abandonment of a DPC Procurement Process will not automatically result in the revocation of the designation of a DPC Delivered Project.
- U4.4 The Appointee must notify Ofwat in writing as soon as practicable in the event of any legal challenge (or threatened legal challenge) of any nature related to the DPC Procurement Process.

#### U5. CAP Agreement

- U5.1 The Appointee must obtain Ofwat's prior written consent before entering into a CAP Agreement.
- U5.2 The Appointee must:
  - U5.2.1 comply in all material respects with the terms of any Approved CAP Agreement; and
  - U5.2.2 notify Ofwat in writing as soon as practicable of any material breach or non-compliance with any Approved CAP Agreement by the Appointee or the CAP.
- U5.3 For the purposes of sub-paragraph U5.2, a "material breach" or a failure to "comply in all material respects" shall include any instance of payment default or late payment other than an instance of payment default or late payment that is trivial in nature by reference to its significance for the CAP.
- U5.4 In undertaking any action or making any omission related to an Approved CAP Agreement (including undertaking its obligations (or failing to do so) or in exercising (or not exercising) or waiving its rights) thereunder, the Appointee must at all times use all reasonable endeavours to ensure it achieves best value for customers.
- U5.5 The Appointee must not, without the prior written consent of Ofwat, assign, novate or transfer its interest in an Approved CAP Agreement (whether in part or in whole).
- U5.6 Save where Ofwat agrees otherwise, the Appointee must notify Ofwat in writing in the event that an Approved CAP Agreement is (whether in whole or in part):

- U5.6.1 materially amended;
  - U5.6.2 suspended; or
  - U5.6.3 extended.
- U5.7 Any suspension, amendment or extension of an Approved CAP Agreement will not give rise to an automatic increase in DPC Allowed Revenue (except as expressly permitted in accordance with the DPC Allowed Revenue Direction). Where the Appointee seeks an increase in DPC Allowed Revenue as a result of any amendment, suspension or extension of an Approved CAP Agreement, the Appointee will be required to comply with the requirements of the DPC Allowed Revenue Direction, which may include obtaining Ofwat consent.
- U5.8 The Appointee must ensure that any Approved CAP Agreement requires the CAP to give to the Appointee all such information as may be necessary to enable the Appointee to comply with the requirements of the conditions of this Appointment (and any requirements for information related to any DPC Allowed Revenue Direction).
- U5.9 Unless the contrary intention appears, references in this Condition U to an Approved CAP Agreement include any modification of that Approved CAP Agreement.

#### U6. DPC Allowed Revenue Direction

- U6.1 Ofwat, having consulted the Appointee, will issue a direction in relation to an Approved CAP Agreement setting out those amounts that the Appointee can collect from customers (whether related to CAP Charges or certain other amounts (“DPC Allowed Revenue Direction”). Such direction may include, without limitation, those matters described in sub-paragraph U6.2 in relation to an Approved CAP Agreement.
- U6.2 Any DPC Allowed Revenue Direction may (amongst other things) set out:
- U6.2.1 the period of time for which the DPC Allowed Revenue Direction will subsist (and any conditions for extension of that period);
  - U6.2.2 those matters that will require a report from the Independent Technical Adviser;
  - U6.2.3 any forecast and outturn reporting that the Appointee is required to provide (and the process and Information requirements for such forecasts and outturn reports) in respect of the CAP Charges;

- U6.2.4 any adjustment to the DPC Allowed Revenue to reflect the time value of money;
- U6.2.5 the commencement date (and/or the method for determining the commencement date) for the collection of DPC Allowed Revenue;
- U6.2.6 arrangements in respect of any over/under collection of the relevant DPC Allowed Revenue by the Appointee;
- U6.2.7 those categories of CAP Charges (and any other amounts) eligible for inclusion as part of the Appointee's DPC Allowed Revenue;
- U6.2.8 those categories of CAP Charges (and any other amounts) that may be eligible for inclusion as part of the Appointee's DPC Allowed Revenue provided that relevant amounts are approved by Ofwat from time to time (as well as the process that Ofwat will apply when considering such CAP Charges);
- U6.2.9 any Information or evidence (including reports by the Independent Technical Adviser) that Ofwat may require prior to agreeing any amounts as part of the Appointee's DPC Allowed Revenue;
- U6.2.10 those categories of CAP Charges that will not be eligible to be included in the Appointee's DPC Allowed Revenue.
- U6.3 Ofwat may, with the consent of the Appointee, by direction, modify a DPC Allowed Revenue Direction issued pursuant to sub-paragraph U6.1 from time to time. The Appointee's consent will not be required for any decisions Ofwat takes pursuant to and in accordance with a DPC Allowed Revenue Direction.
- U6.4 **Where the period for which a DPC Allowed Revenue Direction is stated to subsist (as set out in a DPC Allowed Revenue Direction) has expired or been revoked,**<sup>14</sup> Ofwat may (having consulted the Appointee and the relevant CAP) by direction, revoke the relevant DPC Allowed Revenue Direction. For the avoidance of doubt, when Ofwat is conducting a Periodic Review the circumstances which are relevant in the light of the principles which apply by virtue of Part I of the Water Industry Act 1991 include, without limitation, any CAP Charges that are payable as a consequence of the termination or expiration of an Approved CAP Agreement to the extent that these CAP Charges have not been

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<sup>14</sup> See definition of the ARD term in the template Allowed Revenue Direction.

included as part of the Appointee's DPC Allowed Revenue.

U7. Ultimate Controller of the CAP

U7.1 The Appointee must maintain and keep up to date and in written form, accurate information about the Ultimate Controller(s) of the CAP.

U7.2 The Appointee must inform Ofwat in writing where it becomes aware that:

U7.2.1 arrangements are in progress or in contemplation which, if carried into effect, may lead to a change to the Ultimate Controller(s) of the CAP; or

U7.2.2 arrangements have been put into effect which might be considered to have led to a change to the Ultimate Controller(s) of the CAP.

U8. Termination of an Approved CAP Agreement

U8.1 The Appointee must notify Ofwat in writing where any Approved CAP Agreement is terminated.

U8.2 The Appointee must notify Ofwat in writing as soon as practicable if any circumstances arise which may reasonably be considered likely to lead to the termination of an Approved CAP Agreement.

U8.3 If an Approved CAP Agreement is terminated for any reason, Ofwat may, having consulted the Appointee and the relevant CAP, direct the Appointee as to the treatment of any revenue collected by the Appointee in accordance with the relevant DPC Allowed Revenue Direction that it has not already passed on to the relevant CAP, and the Appointee must comply with any such direction.

U8.4 The direction given by Ofwat under sub-paragraph U8.3 may relate to all revenue collected by the Appointee in accordance with the relevant DPC Allowed Revenue Direction but not yet passed on to the relevant CAP at the date the relevant Approved CAP Agreement terminates, and any revenues subsequently collected by the Appointee under the DPC Allowed Revenue Direction.

**Note: In paragraph 12.1 of the template Allowed Revenue Direction we clarify the scope of this paragraph U8.4. We propose including that clarification here rather than in the Allowed Revenue Direction.**

U8.5 The termination of any Approved CAP Agreement will not automatically result in a revocation of any designation of a DPC Delivered Project or a DPC Allowed Revenue Direction.



U9. Associated Companies

U9.1 The Appointee must not, without the prior written consent of Ofwat:

- U9.1.1 bid in its own DPC Procurement Process;
- U9.1.2 permit an Associated Company to bid in the Appointee's DPC Procurement Process; or
- U9.1.3 award a CAP Agreement to an Associated Company.

U9.2 For the purposes of sub-paragraph U9.1 to "bid in the Appointee's DPC Procurement Process" includes each of the following:

- U9.2.1 submitting a bid in its own name;
- U9.2.2 being part of any consortium or group of entities submitting a bid; or
- U9.2.3 being named (including as a contractor or sub-contractor of any tier) in any bid as the entity undertaking the DPC Delivered Project (or any part thereof).

U9.3 Save where Ofwat consents in writing to any alternative arrangement, the Appointee must not and must procure that any Associated Company does not undertake any DPC Delivered Project (or any part thereof) as a contractor (or sub-contractor of any tier).

U10. Information

For the purposes of this Condition and Condition M, the definition of "Information" in paragraph 3 of Condition A has effect as if references to information that the Appointee "holds" or "can reasonably obtain" includes all information that any CAP holds or can reasonably obtain, provided that the Appointee shall not be in breach of this paragraph 10 or Condition M (insofar as such sub-paragraph and condition impose obligations that relate to Information held by the CAP or that the CAP can reasonably obtain) where it has used all reasonable endeavours to obtain any Information the CAP holds or can reasonably obtain.

U11. Independent Technical Adviser

U11.1 In relation to each DPC Delivered Project the Appointee (whether jointly with the CAP or otherwise) must appoint an Independent Technical Adviser, approved by Ofwat.

- U11.2 Any Information furnished to Ofwat in connection with a DPC Allowed Revenue Direction must, if Ofwat so requires, be accompanied by a written report from the Independent Technical Adviser verifying the Information.
- U11.3 The report referred to in sub-paragraph U11.2 must be in such form and address such substance as may be specified by Ofwat and must be consistent with any guidelines issued by Ofwat.
- U11.4 The Appointee must enter into a written contract of engagement with the Independent Technical Adviser which must:
- U11.4.1 set out that the responsibility for the costs associated with any services provided by the Independent Technical Adviser must be paid by the Appointee and/or the CAP;
  - U11.4.2 set out that the Independent Technical Adviser has a duty of care to Ofwat (such right must be directly enforceable by Ofwat);
  - U11.4.3 include a term that the Independent Technical Adviser will act in accordance with good industry practice;
  - U11.4.4 subject to reasonable exceptions set out in the contract of engagement, require the Independent Technical Adviser, its employees and agents to keep confidential and not to disclose, except to Ofwat, the Appointee and the CAP or as required by law, any information which the Independent Technical Adviser obtains in the course of preparing its report;
  - U11.4.5 where required by Ofwat under sub-paragraph U11.2, require the Independent Technical Adviser to submit reports to Ofwat; and
  - U11.4.6 include a term that the Independent Technical Adviser will provide such further Information, explanation or clarification in respect of any report furnished to Ofwat, as Ofwat may reasonably require.
- U11.5 The Appointee must (and must include a requirement in any Approved CAP Agreement that the CAP must) co-operate fully with the Independent Technical Adviser to enable it to prepare any report, including without limitation, so far as is necessary for that purpose:
- U11.5.1 subject to reasonable prior notice, giving to the Independent Technical Adviser access at reasonable hours to any assets and to any premises occupied by the Appointee (or the CAP) in

relation to the DPC Delivered Project; and

U11.5.2 subject to reasonable prior notice, allowing the Independent Technical Adviser at reasonable hours:

- (a) to inspect and make copies of, and take extracts from, any books and records of the Appointee (or the CAP) maintained in relation to the DPC Delivered Project;
- (b) to carry out inspections, measurements and tests on or in relation to any such premises or assets; and
- (c) to take on to such premises or on to or in to any assets such other persons and such equipment as may be necessary for the purposes of preparing and completing their report.

U11.6 Nothing in paragraph U11.5 will require the Appointee or the CAP:

U11.6.1 to do anything which is outside its reasonable control; or

U11.6.2 to allow the Independent Technical Adviser to do anything which would materially disrupt the Appointee's (or CAP's) business or the DPC Delivered Project (unless it is essential that that thing be done to enable the Independent Technical Adviser to prepare its report).

## An extract from Condition A: Interpretation and Construction showing only DPC related definitions

Unless the context otherwise requires, in these Conditions:

**“Approved CAP Agreement”** means a CAP Agreement that has been consented to by Ofwat in accordance with sub-paragraph U5.1 of Condition U;

**“CAP”** means a limited company who has been competitively appointed to be the provider in accordance with a DPC Procurement Process in respect of a DPC Delivered Project;

**“CAP Agreement”** means an agreement between the Appointee and a CAP in respect of a DPC Delivered Project;

**“CAP Charges”** means all those sums that become due to a CAP from the Appointee pursuant to an Approved CAP Agreement;

**“DPC Allowed Revenue”** means, in relation to any Charging Year, the total of the CAP Charges due to be paid to one or more CAPs by the Appointee in that Charging Year (and any such other amounts) that are recoverable in accordance with a DPC Allowed Revenue Direction;

**“DPC Allowed Revenue Direction”** has the meaning set out in sub-paragraph U6.1 of Condition U;

**“DPC Delivered Project”** means such project and associated activities that are so designated from time to time by Ofwat in accordance with paragraph U1 of Condition U and which designation has not been revoked in accordance with sub-paragraph U1.1.3 of Condition U;

**“DPC Procurement Process”** means a procurement process undertaken by the Appointee - the intended result of which is the award of one or more CAP Agreements;

**“Independent Technical Adviser”** means the person appointed pursuant to sub-paragraph U11.1 of Condition U;

**“Ultimate Controller of the CAP”** means any person who, whether alone or jointly and whether directly or indirectly, is in a position to control or in a position to materially influence the policy or affairs of the CAP or any Holding Company of the CAP;

## Summary of Condition B provisions relevant to the regulation of DPC projects<sup>15</sup>

We describe the DPC Licence Conditions in Condition B below indicating where an amendment is proposed.

### Paragraph 1.7

This is an introductory provision that says that one of the purposes of Condition B is to permit the Appointee to levy charges for the purpose of collecting any DPC Allowed Revenue.

### Paragraph 9.1(2)<sup>16</sup>

This imposes a requirement on Appointees to levy charges in a way best calculated to collect any DPC Allowed Revenue (which shall not be included in the Price Control or Price Controls).

Sub-paragraph 1.7 is explanatory only. Sub-paragraph 9.1(2) provides assurance to CAPs by requiring the Appointee to collect DPC Allowed Revenue from customers.

### Paragraph 9.4(1)

This excludes from wholesale Price Controls, those activities that constitute a DPC Delivered Project to the extent that CAP Charges are recoverable in accordance with an ARD.

We propose amending this to make it clearer that what is excluded from price controls are all activities in relation to which the Appointee can, or will be able to, recover revenue in accordance with a DPC Allowed Revenue Direction. In other words, an Appointee's project related costs are regarded as business as usual, and are subject to normal price control mechanisms, unless they are collected from customers under an Allowed Revenue Direction as 'other amounts'.

### Paragraph 10.2

The Appointee may be required to publish charges to show how it is collecting DPC Allowed Revenue.

### Paragraph 14.2 (3)(i)(E)

This excludes "any costs, receipts or savings that are associated with a DPC Delivered Project" from Ofwat's consideration of materiality in the context of a standard Interim Determination.

This exclusion applies in a number of different contexts. Paragraph 14 deals with standard interim determinations. However, the questions in sub-paragraphs 14.2(1) to 14.2(7) are incorporated by reference, with some modifications, into the provisions dealing with substantial adverse/favourable effects (sub-paragraph 14.3) and into the provisions setting out the bespoke DPC interim determination process (paragraph 15A).

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<sup>15</sup> The full provisions can be seen in the licence conditions of Anglian Water, United Utilities, Welsh Water, Affinity Water and Southern Water.

<sup>16</sup> The numbering of paragraphs in Condition B is not the same for all water companies. In this document we use the paragraph numbering for all WaSCs except HDD. To get the equivalent paragraph number for all WoCs and HDD please deduct 1 from any paragraph number higher than 3.

The exclusion in sub-paragraph 14.2(3)(i)(E) applies for the purpose of calculating whether an adverse/favourable effect is substantial but is currently ignored for the purpose of calculating whether a DPC Event will have a relevant effect on the Appointed Business.

The effect of the cross reference on a substantial adverse/favourable effect application is that this exclusion applies when determining whether an adverse/favourable effect meets the 20% of turnover materiality threshold to be considered substantial (para 14.3 (2)(ii)). The words 'associated with a DPC Delivered Project' are broad enough to include the Appointee's own development and other project costs which are consequently excluded from a determination of materiality.

We propose an amendment to Condition B so that any of the Appointee's project costs that are not recoverable via the Allowed Revenue Direction, will be considered 'Business as Usual' and will be taken into account in determining materiality for a substantial adverse or favourable effects application.

### **15A Interim determinations relation to DPC Delivered Projects**

This paragraph sets out specific triggers (DPC Events) for a bespoke DPC interim determination. These are:

- a failed procurement;
- the modification or revocation of a Designation Notice;
- the revocation of the ARD; or
- the termination or expiration of the ARD.

The drafting cross refers to the questions that must be answered to determine materiality in relation to the standard interim determination but with a different materiality threshold and after ignoring the exclusion dealt with above (14.2(3)(i)(E)). The materiality threshold for a DPC interim determination is an amount equal to or exceeding the lesser of £10 million or two per cent of the turnover attributable to the Appointed Business in the latest financial year.

## Appendix 4 – Project Incentives: commercial and regulatory arrangements

### 1. Commercial arrangements

#### Construction and Delivery incentives

Incentive	Purpose	Less complex projects	More complex projects
<b>Capital Cost</b>	Incentivise efficient delivery of asset	Fixed price contract subject to limited reopeners, compensation events.	<p><b>Target cost incentives:</b> with sharing of under- and over-spend between the CAP, contractors, and customers.</p> <p>We expect the level of share between the CAP, its construction sub-contractors and customers to be fixed at a specified level.</p> <p><b>Compensation events:</b> we expect the CAP Agreement to include an incentive on the CAP to provide comfort that compensation events are being properly raised and costed. Particularly where the customer bears some or all the risk of funding compensation events.</p> <p><b>Alliancing incentive:</b> in some cases, it may be appropriate to include an incentive to drive collaboration between the CAP, contractors, and Appointee. We would expect such incentives to be self-funded. For example, where post procurement, the CAP, contractors, and Appointee can agree an alternative approach which reduces the target cost below the bid level – the three parties may retain the full benefit of that outperformance if it is achieved.</p>
<b>Time</b>	Incentivise on time delivery of asset	<p>Revenue commences on acceptance of asset.</p> <p>Long-stop date specified in contract allowing termination on failure to meet date.</p> <p>Early completion may be incentivised where a need is demonstrated and that it would be value for money. Otherwise, we would only expect companies to allow the revenue period to commence early while maintaining the set revenue period.</p>	<p>Revenue commences on acceptance of the asset, except where an alternative approach is demonstrated to deliver better value for money for customers.</p> <p>Where revenue commences prior to acceptance, the contract should include: (1) penalties for delay beyond the required delivery date, e.g., a defined reduction to returns, and (2) a long-stop date specified in contract allowing termination on failure to meet date.</p> <p>Early completion may be incentivised where a need is demonstrated and that it would be value for money. Otherwise, we would only expect companies to allow the revenue period to commence early while maintaining the set revenue period.</p>

## Operations and maintenance

Incentive	Purpose	Less complex and more complex projects
<b>Operational Costs</b>	Incentivise efficient delivery of operational services.	Use of value testing, benchmarking, and market testing to ensure the CAP's cost are in line with the market throughout the project term.
<b>Performance</b>	<b>Availability</b> – to incentivise the CAP to maintain the assets and service in use for the duration of the project.	Use of an availability mechanism that requires the CAP to maintain an asset and the associated services in use with penalties for an asset being unavailable for use.
	<b>Efficiency</b> – to incentivise the CAP to operate and maintain the assets or deliver the services in an efficient way.	Specific measure to optimise the efficiency of an asset and the associated services across the life of the project. This may support variable use patterns, the outputs of the asset or the operational costs.
	<b>Condition of asset</b> – to incentivise the CAP to deliver and maintain the assets to the required standard for the duration of the project.	Specific measures to allow the condition of the asset to be measured and if necessary remedial action to be required by the CAP (or the Appointee) during the lifetime of the project.
	<b>Quality</b> – to incentivise the delivery of assets and services over the life of the project to required performance standards	Specific measures to allow the Appointee to specify the quality requirements for the development of the assets and the delivery of the services including the required performance and quality measures with mechanisms to incentivise performance if the required standards are not met.

## Financing incentives

Incentive	Purpose	Less complex projects	More, complex projects
<b>Funding requirement</b>	To share the risk of significant variations in the funding require for a project where there is either a VfM reason or a benefit in securing finance from a particular source.	Fixed price contract subject to limited reopeners, compensation events.	<b>Threshold outturn cost</b> to manage the risk of significant cost overruns for the CAP, the Appointee, and the funder. Cost overruns beyond the threshold will be passed back to customers.



<b>Financing costs</b>	To share the risk of the cost of financing where there is either a VfM reason or a benefit in securing finance from a particular source.	Fixed WACC	Market cost of debt adjustment at the end of the construction period
<b>Refinancing</b>	To share any benefit to the project arising from a change in the cost of finance post contract award.	Appointee can require a refinancing throughout the term  The benefit of any refinancing is shared between the CAP and the customer.	Appointee can require a refinancing throughout the term  The benefit of any refinancing is shared between the CAP and the customer.

## 2. Regulatory arrangements

### Allowed Revenue Direction: Additional guidance on Ofwat's approach to disallowing an agreed proportion of an early Termination Payment

The Allowed Revenue Direction will set out the circumstances in which Ofwat may not allow full recovery by an Appointee of a Termination Payment.

In exercising our discretion when considering the appropriateness as to whether to disallow any amount of the Termination Payment, we will consider the prevailing circumstances and relevant factors which gave rise to the early termination. We set out below some factors that are likely to be relevant to our determination as to whether any disallowance is appropriate, and if so whether the upper bounds of the disallowance (towards the top of the agreed proportion) would apply or whether the lower bounds, where little or no disallowance would arise, would apply. This list is provided as a guide and is not exhaustive and any decision we make will depend on the specific circumstances giving rise to the termination.

#### For events where the upper bound (of up to the top of the agreed proportion) may apply:

**Responsibilities under the CAP Agreement** – an Appointee has acted, failed to act, or behaved in a manner which, when considered together with its responsibilities under the CAP Agreement, is determined to have contributed to the wider failings in the delivery of the DPC project up to the point of termination.

**Relationship management with CAP** – an Appointee has intentionally either frustrated the efforts of the CAP in discharging its responsibilities under the CAP Agreement or acted in a way that did not promote collaboration and mutual trust between the parties.

**Relationship with Relevant Independent Adviser (RIA)** – an Appointee did not fully cooperate with the RIA including (but not limited to) withholding of relevant information, being misleading in the presentation of information, failing to comply with reasonable requests for information and clarifications.

**Management and assurance systems** – an Appointee has failed to adequately establish both management systems and assurance systems to support the information being disclosed to Ofwat evidencing the progress of the DPC project

(including all relevant technical documentation), the costs for delivering the DPC project and any forecasts as could be expected to be reasonably in place.

**Consideration of impact of termination** – an Appointee failing to provide to Ofwat a convincing impact assessment based on best practice at the time for the termination of the project.

**For events where the lower bound towards zero may apply:**

**Voluntary Termination** – where an event of Voluntary Termination occurs as defined in the CAP Agreement.

**Consent of the CAP** – where the CAP and the Appointee have, having considered all other options, based on supporting evidence, agreed and that Ofwat also agrees, that it is in the best interests of the project to terminate the CAP Agreement and transfer the project back to the Appointee.

**Customer interests** – where an Appointee has demonstrated that termination of the CAP Agreement is in the best interests of the Appointees' customers and that there are credible alternatives for the delivery of the DPC project which reveal potentially better value for money for the Appointee's customers.

**Confirmation of the Appointee's conduct** – where the Appointee behaves in a manner which, when considered together with its responsibilities under the CAP Agreement, is determined to have not contributed to the wider failings in the delivery of the DPC project up to the point of termination, and nor acted in such way that wilfully undermined the project as being delivered through DPC.

Other factors we are likely to consider in our determination are:

- whether the event was of a trivial nature;
- whether an Appointee's action or failure to act has damaged the interests of customers, including whether any increased costs are incurred by customers;
- whether the Appointee has gained, financially or otherwise;
- whether, because of an Appointee's actions or failure to act, there has been a direct or consequential impact to the environment;
- whether the consequences of an Appointee's action or failure to act would have been apparent to a diligent undertaker.

## Appendix 5 – Supporting contract principles

### Development and Construction

Contract Principle	Explanatory Note
<b>Clearly specify construction requirements, milestones, completion, and commissioning dates</b>	<p>These should be specified as part of the tender process, to make sure bidders can provide appropriate proposals. The completion date in some cases may act as the trigger for the CAP's revenue. This should therefore be clearly reflected in the CAP Agreement, along with any provisions which could change this date.</p> <p>Construction specifications should be drafted to clearly specify in output terms the Appointee's requirements. This would include requirements to comply with law and regulation including the requirements of the Regulators. The Appointee should also specify any requirements to reflect <u>Ofwat's public value principles</u> and any other current guidance on public value, net zero commitments, best practice requirements for the management of contractors and the supply chain and the engagement of SMEs in the delivery of services.</p>
<b>Clearly outline the acceptance requirements for assets to trigger formal 'completion'</b>	Where there are requirements related to completion (for the purpose of triggering payment), these will need to be clearly set out in the contract to provide clarity for the CAP and the Appointee.
<b>Provisions for liquidated damages (paid either to the CAP or to the Appointee) in the event of late delivery resulting from circumstances within either party's control.</b>	Where used, these should be proportionate and capped. Non-delivery may have implications for Appointees in terms of meeting obligations and providing a service for customers. Therefore, some flexibility to include liquidated damages provisions in contracts may be appropriate. Generally, however, bidders will price liquidated damages costs into their submissions, which may not be in the best interests of customers. Appointees must be able to clearly demonstrate why liquidated damages are necessary as part of a CAP contract.
<b>The security requirements to be provided by CAPs to protect the Appointee against late delivery of or failure to deliver assets</b>	This provision should be sized appropriately to cover relevant costs to the Appointee, considering the potential impact on the CAP's costs if this is set too high. Appointees face potential costs in the event of a CAP failing – including retendering or taking the project back in-house. These costs should not be borne by customers. Therefore, CAPs may need to post some form of security. However, high levels of security will increase a CAP's costs, which is not in customers' interests. Any security package should be commensurate with the risk it is designed to mitigate.

### Operations and maintenance

Contract Principle	Explanatory Note
<b>Service Specifications and performance commitments</b>	The CAP Agreement should clearly specify any operational requirements, including any performance commitments the CAP must fulfil. To make sure the Appointee receives the required level of service, contracts should specify any service specifications or operational requirements. This would include requirements to comply with law and regulation including the requirements of the Regulators. This will ensure a robust framework for the Appointee to manage the CAP's performance over the contract period. The Appointee should also specify any requirements to reflect <u>Ofwat's public value principles</u> and any other current guidance on public value, net zero commitments, best

	<p>practice requirements for the management of contractors and the supply chain and the engagement of SMEs in the delivery of services.</p>
<b>Fixed Operational costs</b>	<p>The CAP should bear the risk of variations in the operational costs of DPC projects. There may be circumstances where a better VfM solution is appropriate. For example, power costs will be affected by the demand for the asset, the work's energy efficiency, as well as market prices. We expect Appointees to consider material cost items (such as power) and what contractual arrangements can be put in place to incentivise efficiency, while also recognising some factors might be outside the CAP's control and therefore may not be value for money to ask bidders to price upfront as part of bids.</p> <p>Appointees can seek solutions that deliver better value for money by, for example, requiring the Appointee to purchase power on behalf of the CAP, to allow it access to preferential prices, and allow it as a cost pass through to customers. In this situation, we would expect the Appointee to consider how through the procurement process and the CAP agreement it will: (a) incentivise bidders to design an asset that is energy efficient and (b) incentivise energy efficiency during operations.</p>
<b>Accommodating Appointee Changes</b>	<p>To facilitate Appointee changes and variations to the scope of the CAP Agreement, an Appointee will need to consider any new requirements as part of their normal capital investment programme. This will include an assessment of whether alternative solutions (for example upstream of the works) are better value for money for consumers than increased investment in the DPC Project. Where additional investment in the DPC Project is appropriate, costs may be recovered from customers through the unitary charge.</p>
<b>Value Testing</b>	<p>The guidance expects that operational costs, in general, should be fixed for the duration of a contract. But contracts may provide for variations in operating expenditure (opex) at periodic intervals, where this is likely to drive value for customers. Where this option exists, Appointees should make this clear to bidders at the start of the procurement process.</p> <p>There are potential customer benefits in maximising the scope of costs that can be fixed during the tender process for the duration of the CAP Agreement. This makes sure customers are not exposed to cost variations and mitigates the risk of bidders submitting unrealistic cost estimates to win the tender, then looking to increase these later. However, there may be factors that materially change opex costs over a long contract period. This may apply to some project types more than others. As such, some flexibility around opex may be beneficial to customers. Each opex element would need to be assessed on its merits.</p> <p>The guidance requires Appointees to consider benchmarking and market testing arrangements for DPC projects to produce best value for money. The CAP Agreement can include contractual mechanisms reflecting the standard form UK project finance models which manage benchmarking and market testing of service costs.</p>
<b>Information and record keeping</b>	<p>The guidance expects that the CAP Agreement should include terms that enable Appointees to fulfil any ongoing reporting or information requirements (in particular, those required for the Appointee to fulfil any statutory or regulatory monitoring and reporting).</p> <p>The Appointee will need the CAP to provide it with information. This could include information needed to fulfil statutory or regulatory monitoring and reporting requirements. Contracts need to include terms that allow Appointees to request this information. Good asset management is</p>

	<p>imperative for both Appointees and CAPs. CAPs should provide Appointees with reports on any asset condition requirements outlined in the contract.</p>
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## Termination and Step in

Contract Principle	Explanatory Note
<b>Step in rights</b>	<p>The guidance requires the CAP Agreement to specify the circumstances under which the Appointee can step in to take responsibility for the delivery of the CAP's outcomes. These should be limited to material breaches (e.g., regulatory non-compliance).</p> <p>Given the critical nature of these assets, the Appointee may need to step in – for example, to ensure continuation of supply or compliance with relevant regulatory obligations. This should be reflected in the contract, though such rights should be limited to events with a significant impact on customers, where the CAP is unable to provide a satisfactory remedy.</p> <p>The guidance expects the CAP Agreement to include contractual mechanisms which manage the process of step in and step out and the financial consequences of those rights.</p>
<b>Expiry of Term</b>	<p>The guidance requires the CAP Agreement to specify a contractual end date. It should also specify what happens to the assets at the end of the contract.</p> <p>It is important to give certainty about how the end of a contract will be managed. At the end of a contract, the assets may still have a useful life, in which case the Appointee may retender the assets or bring them back inhouse. This would be agreed with Ofwat (or the relevant regulatory authority) at the time. Where the assets will no longer be required after the contract has terminated, the assets (or liabilities, as they may be at this point) may either remain with the CAP or be returned to the Appointee.</p>
<b>Handback requirements</b>	<p>The guidance requires the CAP Agreement to specify the required asset specification at the contract end date.</p> <p>Good asset management is of fundamental importance to the water sector. CAPs should put in place robust systems, policies, and procedures to ensure assets are managed effectively over the contract period, and that assets are in an appropriate condition when the contract ends. These requirements will link to the Handback requirements.</p>
<b>Asset residual value</b>	<p>The guidance require that the CAP Agreement specifies the residual (or terminal) asset values at the contract end date, associated with a prescribed condition of the asset. It should set out how this will be paid to the CAP.</p> <p>To raise debt finance for the whole capital expenditure (capex) value of a project, funders will require certainty over any residual value they would receive at the end of the contract. The contract should clearly indicate this value and how it will be paid. This will mitigate the potential credit risk around residual value and lead to improved pricing terms for the project's finance. The Appointee would need to pay the CAP any non-depreciated capex (residual value), equivalent to an RCV figure, at the contract end date.</p> <p>These requirements will link to the Handback requirements referred to above.</p>
<b>Early Termination</b>	<p>The guidance requires the CAP Agreement to set out the circumstances in which it can be terminated early. This should include Appointee Events of Defaults, CAP Events of Default, Corrupt Gifts Event of Default, Appointee Voluntary Termination, and no-fault termination grounds (including force majeure). The guidance would expect the Appointee default to</p>

	<p>be limited to insolvency and non-payment only in line with standard form UK project finance models.</p>
<p><b>Termination Compensation</b></p>	<p>The guidance also requires the CAP Agreement to set out the compensation payable to the CAP and its funders in the different scenarios. In line with standard form UK project finance models, CAP Events of Default will assume a retendering exercise is undertaken to pass the remaining contract term onto a new provider.</p> <p>The guidance expects the CAP Agreement to include contractual mechanisms reflecting the standard form UK project finance models which manage the process of describing the categories of termination and the termination compensation mechanisms payable in the different circumstances and to provide the funders protections mechanisms that are usual in the case of a CAP default.</p>
<p><b>Payment of termination compensation amounts by the Appointee</b></p>	<p>Where a termination payment is made, it will be recoverable from customers via either a future Price review or an Interim Determination. We are unable to set out the applicable methodology by which the termination payments made by an Appointee will be recovered through future price reviews or Interim Determinations. This is because the methodology may change over time, but we expect that the recovery of any amounts in respect of Termination Payments will be consistent with our policy position on recovery of future wholesale capital expenditure at the time.</p>
<p><b>Force majeure</b></p>	<p>The guidance requires the CAP Agreement to include provisions for force majeure events (with impacts on both costs and timetables). These should be clearly defined and strictly limited, in line with good industry practice and standard models of UK private finance.</p> <p>Wherever a contract provides the CAP relief (i.e., passes risks up to the Appointee and potentially back onto customers), the circumstances should be tightly defined. This gives all parties clarity over the allocation of risks and mitigates the potential risk of spurious claims by CAPs after contracts are awarded.</p> <p>The CAP Agreement should also clearly identify the termination trigger for Force Majeure Events and the financial consequences of that event.</p>

**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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