December 2022

Creating tomorrow, together:
Our final methodology for PR24

Appendix 5
Direct procurement for customers

Ofwat

About this document

This appendix sets out further detail on our Direct Procurement for Customers (DPC) policy, expanding on Chapter 3 of our final methodology. It considers the views expressed by respondents on our draft methodology proposals published in July 2022 and sets out our final decisions and reasoning.

Contents

1. Introduction 3

2. Identifying schemes for DPC 4

3. Treatment of DPC projects at PR24 9

1. Introduction

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

DPC was introduced at PR19 with the aim of improving value for customers and the environment from major projects. It does this by promoting innovation, enabling capital and operational cost savings as well as a reduction in financing costs, while maintaining quality.

For PR19, companies (also referred to as 'Appointees') were required to consider DPC for discrete, large-scale enhancement schemes expected to cost over £100 million, based on whole life total expenditure (totex). We are currently working with the sector to progress DPC 'pathfinder projects' in England and Wales.[1]

In September 2022 we published draft guidance on our regulatory and commercial expectations where Appointees are developing projects to be delivered by DPC.[2] Following the consultation, we will publish final guidance in early 2023.

This appendix sets out our PR24 final methodology for DPC:

- we set out the circumstances under which DPC will apply by default in companies' PR24 business plans and how companies should assess the suitability of schemes for DPC (see Section 2); and
- we explain how DPC projects will be treated in the price review (see Section 3).

[1] Ofwat, 'Competition in strategic investment: a high-level stocktake', July 2022, p. 7
[2] Ofwat, 'Draft guidance for Appointees delivering DPC projects', September 2022

2. Identifying schemes for DPC

In this section we set out the circumstances under which DPC will apply by default in companies' business plans and the criteria that should be used to assess the suitability of schemes for DPC.

2.1 Our final methodology policies

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.[3] 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 companies will:

- identify all schemes that are over £200m of whole life totex;
- assess the extent to which these schemes are discrete, using our updated technical guidance;[4] and
- undertake a robust value for money assessment of delivering the project through DPC.

2.2 Changes from our draft methodology

In response to feedback from stakeholders on our draft methodology, we want to clarify that in PR24 submissions:

- companies are not required to assess the suitability of DPC for schemes below the £200m size threshold, however we reserve the right to explore this after business plans are received; and
- if a company identifies delivery under the Specified Infrastructure Projects Regulations (SIPR) may be appropriate and offer best value for money, it should undertake a full assessment against the requirements set out in the legislation.[5]

[3] Whole life totex is the total expenditure of running an asset until the end of its economic life.
[4] We are in the process of reviewing our technical guidance for assessing which schemes are sufficiently discrete for DPC and will make the revised guidance available in early 2023.
[5] The Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 (SI 2013/1582).

2.3 Stakeholder views

Respondents generally supported the use of DPC where it is demonstrably in the best interests of customers. Some companies queried whether DPC by default might preclude very large projects being delivered via the Specified Infrastructure Projects Regulation (SIPR).[6]

Most respondents supported an increase in the size threshold from £100m to £200m whole life totex which they said would better match the appetite of investors and achieve value for money for customers. Some companies stated the threshold should be increased further, suggesting smaller projects may not attract enough interest from potential bidders.

Respondents queried our discretion to explore the use of DPC for projects below the size threshold, suggesting this could place an additional burden on companies. The All Company Working Group (ACWG) asked us to be clear on the circumstances when we might deviate from this threshold as part of the final methodology.

Companies welcomed our forthcoming guidance on assessing discreteness and agreed that discreteness should be a key consideration before schemes are deemed DPC by default. Several companies stated that where there is unambiguous evidence of negative value for money at the pre-procurement stage the project should not proceed with DPC.

2.4 Our final decisions and reasoning

In light of stakeholder feedback, for PR24 DPC will apply by default for all discrete schemes over £200m of whole life totex. This is consistent with the preferred option set out in our draft methodology and applies to all parts of the water and wastewater value chain, apart from bioresources.

2.4.1 Size threshold

On the basis of the evidence we have seen, we continue to think that the size threshold of £200m whole life totex is appropriate. We expect companies to use this threshold as a trigger for assessing the extent to which DPC schemes are discrete and deliver value for customers against an in-house delivery approach.

Stakeholders agreed with our assessment that the benefits of DPC are likely to be greater and the costs smaller (as a percentage of the size of the project) for larger DPC schemes. Our engagement with the market suggests that larger projects are also more likely to be

[6] Anglian Water and Thames Water

attractive to potential bidders. This underpinned our decision to raise the threshold from £100m to £200m for PR24.

Whilst some companies suggested the size threshold should be increased further, the most reliable information we have from our 'pathfinder projects' suggests that the use of DPC for discrete projects above £200m can yield net benefits of between 6 and 40 per cent of project totex.

Companies asked us to be clear on the circumstances when we would explore the use of DPC below the size threshold. To minimise the burden on companies, we do not require them to assess the suitability of DPC for projects below the size threshold as part of their business plans. We reserve the right to explore this after business plans are received in the following circumstances:

- major projects pose delivery or financeability challenges because they are large compared with the size of the company;
- multiple smaller schemes of a similar nature could be combined into an overarching programme; or
- there is a system which could form a bundled project.

Companies may also elect to use DPC below the revised £200m threshold at PR24 at their discretion.

2.4.2 Discreteness assessment

As part of their business plan, companies must assess the extent to which schemes are discrete using our technical guidance and support this assessment with evidence. This assessment should be undertaken for all schemes above the size threshold of £200m whole life totex. We are in the process of reviewing our technical guidance and will publish the revised guidance in early 2023.

2.4.3 Value for money assessment

Delivering value for money is one of the central drivers for DPC projects, and DPC has the potential to create significant benefits for customers through the competitive exposure of large schemes.

As part of their business plans, companies should present a robust value for money assessment of project delivery through DPC for all eligible schemes.[7] The assessment should

[7] Eligible schemes are discrete projects above a size threshold of £200m whole life totex where DPC will apply by default.

set out the difference in Net Present Value (NPV) of the revenue to be recovered from customers over the whole life of the asset under DPC and under in-house delivery.

When carrying out the modelling we expect companies to:

- model the in-house counterfactual following our PR24 approach to setting expenditure allowances (see Chapter 6);
- assume the asset will transfer back in house at the end of the concession period; and
- provide us with a copy of the model.

We also expect companies to use a standard set of modelling assumptions. We will consult on these assumptions before confirming a final position in Spring 2023.

We agree with respondents that where there is unambiguous evidence of negative value for money at the pre-procurement stage a project should not proceed with DPC. However, at the pre-procurement stage it can be difficult to accurately estimate what represents value for money. Where we consider a negative estimate of value for money is not robust, we may require the company to proceed with DPC until a robust estimate can be determined.

A full value for money assessment will be undertaken at the pre-procurement stage. In line with Condition U of companies' licences (DPC), we will only consent to a project being put out to tender under DPC if it is likely to provide value for money.

2.4.4 Applicability to England and Wales

Our DPC policy applies to companies whose areas are wholly or mainly in England, and to companies whose areas are wholly or mainly in Wales.

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

"We are supportive of you removing new strategic investments from the standard price control process, where appropriate, and opening them up for competition as we believe this enables a stable regulatory environment and gives infrastructure providers the confidence to deliver long-term projects in an innovative and efficient way. For example, Direct Procurement for Customers in the water sector has the potential to create new opportunities for investors, promote innovation, and drive down overall net costs for consumers."[8]

We have carefully considered how our DPC policy addresses the strategic priorities and objectives set out in the Welsh SPS. Delivering best value for customers is one of the central

[8] Department for Business, Energy & Industrial Strategy, 'Strategic priorities and cross-sectoral opportunities for the utilities sectors: open letter to regulators,' January 2022.

drivers for DPC projects and supports the Welsh Government's strategic objective to deliver value for money for customers, communities and the environment. However, the Welsh Government has also stated that it does not support the introduction of competition where this:

- would reduce companies' overall accountability for the delivery of excellent services;
- threatens the integrity and efficiency of the management of the water system; or
- cannot clearly be evidenced that it would be beneficial to customers.

Companies with projects delivered via DPC remain accountable for delivering excellent services to customers and legally responsible for compliance with statutory obligations and licence conditions. For projects in Wales, we will discuss with the Welsh Government on a project by project basis, the extent to which delivery under DPC aligns with their SPS to make sure that a project would not fall in one of the three categories above.

2.4.5 Specified Infrastructure Projects Regulations (SIPR)

In their responses, companies asked us to set out whether SIPR would be considered as an alternative to DPC for very large projects. We remain open to companies exploring the use of SIPR where it may offer benefits to do so. Where a company considers delivery under SIPR is appropriate and could offer best value for money, they should set this out in a full assessment against the requirements in the legislation using our guidance.[9] Where the scheme does not meet the requirements for SIPR, companies should assume the DPC model will be used.

[9] Ofwat, 'Criteria for selecting specified infrastructure projects – Ofwat guidance', May 2015

3. Treatment of DPC projects at PR24

In this section we explain how DPC projects will be treated in the price review. More information on the commercial model applicable to DPC projects and our approval and assurance processes to support DPC projects can be found in our 'Draft Guidance for Appointees delivering DPC projects'.[10] [11]

3.1 Our final methodology policies

For PR24 we will:

- allow the efficient costs for companies 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 schemes; and
- amend the licences of those companies likely to deliver DPC schemes in the next AMP if they do not already have DPC provisions in their licences.

3.2 Changes from our draft methodology

In response to feedback from stakeholders, we have set out more detail on:

- the funding mechanisms for schemes that are deemed unsuitable for delivery via DPC;
- how Appointees will be incentivised to deliver DPC projects; and
- how we will assess appropriate use of DPC in our assessment of business plans (see Chapter 11).

3.3 Stakeholder views

Several companies asked us to clarify the funding mechanism for schemes that are deemed unsuitable for delivery via DPC either at PR24, or subsequently at the procurement stage. Given that DPC will not be a feature of every water companies' PR24 submission, stakeholders suggested that DPC should not be a factor in the assessment of business plans.

Recognising that the number of schemes being delivered via DPC is likely to increase, stakeholders stressed it would be important for the DPC process to be as efficient as possible.

[10] Ofwat, 'Draft guidance for Appointees delivering DPC projects', September 2022
[11] The final version of this guidance will be published in early 2023.

Respondents also want us to make sure that companies are appropriately incentivised and funded to support delivery of competitively tendered projects.

A small number of companies stated that incumbents should be allowed to bid for their own projects and that the exclusion of incumbent company bidding could restrict competition and value for money.[12]

3.4 Our final decisions and reasoning

3.4.1 Cost allowances

For schemes that are delivered via DPC, the costs of the CAP will be recovered from customers outside the price controls in accordance with an Allowed Revenue Direction. As a consequence, we will not include funding for in-house delivery of DPC schemes when we set revenue controls.

Appointees will incur costs for pre-construction activities, as well as running the procurement process for DPC (or SIPR where relevant) and managing the CAP. As with other efficiently incurred costs, Appointees will recover these from their customers as part of totex allowances for PR24. We expect that these costs would be broadly similar to the costs Appointees already incur to develop projects. We have included a separate sheet for DPC and SIPR projects within the data tables for PR24.

In response to queries from companies, we would like to clarify that where there is robust evidence that use of DPC (or SIPR where relevant) is not suitable, a company should propose the project as part of enhancement expenditure in its business plan. In line with our DPC by default policy, the only allowed exceptions are for projects below our size threshold and for projects that are assessed as not being sufficiently discrete for DPC. We will consider the value for money assessment put forward by companies in their business plans for all eligible schemes ahead of our final determination.

If a project is designated for delivery via DPC at PR24 and there is a subsequent decision that it should be delivered in-house, the new DPC licence provisions allow the Appointee to bring an application for a bespoke DPC interim determination. This is set out in paragraph 15A of Condition B for those companies that have DPC provisions in their licences.[13]

[12] Affinity Water and Thames Water
[13] The licence provisions are also set out in an annex to our Draft Guidance for Appointees delivering DPC projects.

3.4.2 Assessment of business plans

As part of the quality assessment of business plans, we will assess whether companies have proposed the use of DPC for all eligible schemes, in line with Section 2 of this Appendix. See Chapter 11 for more detail on our approach to assessing business plans.

We recognise the concerns raised by companies who are unlikely to have schemes that meet the size threshold. Our assessment will be based on how companies have applied the criteria set out in Section 2 of this Appendix, not on whether their plans contain schemes that meet the criteria for DPC.

3.4.3 Incentives for companies to deliver DPC well

Once a project has been designated for delivery via DPC, we need to make sure that the Appointee procures and manages the DPC project and the CAP Agreement well.

We may set Price Control Deliverables (PCDs) for projects designated for DPC delivery, to protect customers by clawing back funding if companies 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.

Through PR24 and the Allowed Revenue Direction we also plan to implement a focused package of DPC incentives for Appointees. The appropriate incentive package will be decided on a project-by-project basis recognising the risks inherent in the project and the potential value obtainable from the procurement process.

We are currently consulting on the suite of incentives that we will consider when agreeing the incentive package for a DPC project.[14] Some of the DPC incentives being considered in the consultation are:

- providing a financial reward for the successful award of a CAP Agreement;
- financial penalties for delays to the submission of DPC business cases; and
- allowing Appointees to keep a share of the incremental value for money created for customers by its approach to procurement.

3.4.4 Incumbent bidding

In our PR24 May 2021 discussion document, we said that we would consider whether conflicts of interest in the tender process could be sufficiently mitigated to allow the incumbent company to submit competing bids fairly. While some companies expressed support for

[14] Ofwat, 'Draft Guidance for Appointees delivering DPC projects', September 2022, pp. 36-37.

allowing the incumbent company to bid, questions were also raised about how companies would be able to run a fair process in this scenario. We concluded that the conflicts of interest that would exist in such a scenario would be likely to undermine fair competition, and hence we did not include this policy change within our draft methodology.

We have not seen any compelling evidence in companies' responses to our draft methodology that would justify allowing the incumbent or their associated companies to compete for DPC projects.[15] The restriction on incumbent bidding is needed in order to maximise competition (and therefore benefits to customers in terms of innovation, financing and other costs). Potential bidders must not be deterred on the basis that they perceive that competition is subject to distortion through a perception of the incumbent company having an advantage that would disincentivise other bidders. Appointees must also be in a position to effectively manage their relationship with the CAP over the duration and at the end of the contract, in the interests of customers. Appointees (and their associated companies) can compete for the DPC projects of other water companies as part of their non-appointed (unregulated) business.

3.4.5 Licence conditions

DPC licence conditions are already in the licences of five Appointees. As part of our draft DPC guidance we have reviewed the existing provisions and proposed some minor changes to make sure that they are still fit-for-purpose.[16] We plan to extend these provisions to the licences of companies likely to deliver DPC schemes in the next AMP if they do not already have DPC provisions in their licences.

[15] By 'associated company' we mean an 'Associated Company' as defined in Condition A (Interpretation and Construction) of an appointee's licence.
[16] Ofwat, '[Draft Guidance for Appointees delivering DPC projects](#)', September 2022, Appendix 3: DPC licence provisions, pp. 66-77.

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

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA
Phone: 0121 644 7500

This document is also available from our website at www.ofwat.gov.uk.

Any enquiries regarding this publication should be sent to mailbox@ofwat.gov.uk.