

Making greater use of direct procurement

The proposals relating to tendering are driven by Ofwat's objective to protect customers by ensuring that every pound of expenditure reflects efficient costs. We are therefore very supportive of Ofwat proposal that companies should make greater use of tendering to deliver cost efficiencies associated with the construction of new assets.

During the current control period we have increased the use of tendering for large schemes and large blocks of schemes. We see this as a way to leverage more innovation, expertise and ultimately deliver value for our customers through lower costs. We are therefore very supportive of the principle behind Ofwat's proposal.

Below we set out our thoughts on the benefits and costs of tendering under different scenarios. This has helped inform how we think requirements for tendering should be applied in the water sector. This assumes a similar size eligibility threshold as proposed in the consultation (£100m), although it's possible that different size thresholds could be applied to different companies.

Benefits of tendering

As Ofwat has noted, tendering can be implemented in a number of ways – narrowly (construction tendering focused on cost efficiencies) or broadly (construction and finance tendering focused on cost and finance efficiencies). To understand what form of tendering is best suited to the different types of assets in the sector we have looked at tendering models in other sectors.

Based on our assessment of the energy and water regulatory frameworks, the underlying asset will inform the suitability of what is being tendered (i.e. finance and/or construction). In particular:

- Construction and finance tendering is best suited to:
 - large discrete assets that can be constructed on a stand-alone basis before being connected to a network (e.g. offshore transmission, or new reservoirs in the case of water) – this is because the bidders are not exposed to significant construction or operational risk and hence can bid in a low WACC;
 - extremely large assets that have some on-going EA/DWI interaction and operational risk, but where the size is so large that the added risk (and cost) is more than offset by the size of the potential efficiencies (e.g. Tideway).
- Construction tendering is best suited to assets that are already connected to the network and cannot be shut-down (at least for significant periods); and the operation of these assets requires on-going interactions with other regulators such as the DWI and EA (e.g. distribution assets and treatment works). For these assets the significant operational and system risk is best allocated to incumbents.

In the water sector the vast majority of (enhancement) capex relates to assets that are already connected to the network and involve significant coordination with existing operations and the other regulators to build/upgrade.

This suggests that Ofwat should give companies the flexibility to consider what form of tendering is best suited to qualifying assets. This will give greater scope as to what could be sensibly tendered and maximise benefits to customers.

For construction tendering this approach would have the advantage of reducing the reliance on econometric modelling for large enhancement spend, which is technically challenging. Tendering could be used as part of the cost evidence for the exclusions from the modelled costs providing a more robust view of costs, reducing risk for companies and customers.

We think further consideration will be needed on how the tender process and resulting costs can be practically integrated into the price review timetable. Currently most tendering takes place after the price review process is concluded. Whilst it's possible some tendering could be brought forward, it would be challenging given the customer engagement and optioneering that needs to occur before hand.

Costs of tendering

In assessing what form of tendering should be applied to different assets Ofwat and companies also need to consider the costs. These include:

- Setting up the framework;
- Establishing a new boundary;

Setting up the framework

The establishment of the tendering framework – which includes the contractual framework and where applicable changes to the legal/regulatory framework – could take significant resource and time to develop (if never applied before). This is particularly relevant under a broad definition which includes finance tendering because the legal and regulatory framework may need to be modified to transfer risks away from the bidder to other parties (such as the Government or customers).

The costs associated with the broad definition of tendering can be illustrated by the TTT and OFTO framework, for example:

- Under the TTT and OFTO each market framework examined is governed by a bespoke license which sets out the detailed terms governing the new licensee's operation, its obligations and its revenue stream and future regulation.
- The bespoke licence requires the establishment of a new legal and regulatory framework with specific rules that apply to the winning bidder. For water this meant that Ofwat was unable to apply its PR14 framework and instead needed to develop a new set of rules that applied to the single party.
- In terms of time, the OFTO generator build was first consulted on in 2005 and the first tender occurred 4 years later in 2009.
- For TTT the first consultation on phase 1 by Thames Water occurred in 2010. IP tender process began 2015, a gap of 5 years. Although we note that Ofwat was discussing options for the regulatory framework for the TTT as early as 2005.

In contrast under a narrow definition of procurement, the additional costs are likely to be significantly lower. This is because:

- some companies will be able to modify existing frameworks to tender schemes, therefore the incremental costs will be quite low; and
- Ofwat would not need to establish a bespoke regulatory framework that could be applied to the new schemes. This is because risks are not being transferred away from the incumbent and revenue uncertainties are not being changed. Instead Ofwat would apply its PR19 framework to the incumbent.

Overall we think there are likely to be significant differences in tendering costs depending on what is being tendered. Therefore consideration of the approach should take into account both (i) the asset characteristics; and (ii) what costs would be incurred to deliver benefits to customers.

A new boundary will create externalities

Depending on the form of tendering, it's possible that it could reduce the scope for network optimisation if it resulted in the introduction of separate ownership or management.

For example where ownership is tendered, the direct provider will have less incentive to go further than the defined scope of the scheme as it will not own the benefits from any remedial or incremental investment. In contrast the incumbent is incentivised to deliver benefits throughout the whole value chain. Theoretically any externalities could be internalised through commercial mechanisms and frameworks but in practise this could be very complicated, difficult to achieve and add costs for both parties.

Another consideration is whether a third party has the financial headroom to absorb financial shocks in construction of new assets. A single asset owner does not have the scope to dissipate shocks across a broader investment programme whereas an incumbent provider is better placed to absorb cost shock such as a considerable overspend on a specific scheme as it can recover this across the wider investment programme.

Considering these issues as part of the benefits cases for identifying large direct procurement schemes could limit the number of schemes where the costs outweigh the benefits of direct procurement by a third party.

Conclusion

We agree with Ofwat that tendering has the potential deliver significant benefits to customers in the form of lower bills. The form of tendering that should be applied will be dependent on the characteristics of the assets and associated costs with setting up the tendering framework.

We think Ofwat should give companies flexibility to choose the form of tendering that is best suited to the applicable assets (ie, those above the qualifying threshold). This will allow the benefits of tendering to be maximised whilst minimising the costs.