

## WATER PROJECTS: A BITE SIZE GUIDE TO DPC, REGULATORY DEVELOPMENTS AND NEW OPPORTUNITIES IN THE SECTOR

6 APRIL 2023 • ARTICLE



As the economic regulator in the water sector in England and Wales, Ofwat is responsible for ensuring that water companies provide customers with a 'good quality, efficient service at a fair price'.<sup>1</sup> As part of that commitment, Ofwat sets limits on the prices that water companies can charge their customers in price reviews every five years.

"Under the DPC scheme, with Ofwat's approval, water companies will put major projects out to competitive tender for delivery by third parties."

In recent years, these reviews have introduced and developed the concept of Direct Procurement for Customers ("DPC"), which is a competitive tender process through which water companies instruct third-party competitively appointed providers (a "CAP") to design, build, finance, operate and maintain infrastructure. The aim of DPC is to achieve efficiencies in the development and operation of water infrastructure projects, which can ultimately be passed on to customers in the form of lower prices.

In March 2023, Ofwat published a paper which provides guidance to water companies delivering DPC projects. The period for commenting on that report closed on 10 March 2023. The results of the report will feed into the 2024 price review

("PR24") which will introduce DPC by default for all discrete projects above a size threshold of £200m whole life total expenditure ("Totex").

## BACKGROUND TO THE DPC SCHEME

Ofwat's 2019 Price Review ("PR19") set prices for the period 2020-2025 and identified three key themes against which water companies were expected to deliver services to customers: securing long-term resilience, protecting customers and making markets work. Under PR19, DPC was introduced as something that should be considered by water companies for projects over £100m in cost, where it was expected that it would 'deliver the greatest value for customers'.

In February 2020, Ofwat published the first of three consultations on DPC – being a non-statutory consultation on the proposed amendments to the licence conditions for DPC, and the introduction of a new condition which would enable Ofwat to regulate DPC projects. Stakeholders were invited to comment on the proposals made.

**"The aim of DPC is to achieve efficiencies in the development and operation of water infrastructure projects, which can ultimately be passed on to customers in the form of lower prices."**

In July 2020, a further non-statutory consultation was published which provided updated proposals based on the results of the first consultation and set out how it is expected the 'Allowed Revenue Direction' will work, a mechanism through which water companies will be allowed to collect charges payable to the CAP from customers.

This was followed by a statutory consultation in November 2020 which resulted in amendments to five water companies' licence conditions. These changes form the basis of the wider DPC scheme that will be rolled out to all water companies seeking to implement DPC projects over the coming years.

## KEY FEATURES OF DPC

Under the DPC scheme, with Ofwat's approval, water companies will put major projects out to competitive tender for delivery by third parties. Successful bidders (the CAPs referred to above) will be responsible for designing, building, financing and potentially operating and/or maintaining the infrastructure. Ofwat must provide their approval before the CAP is appointed, and water companies are not permitted to bid for their own tenders, or have an ownership interest in the CAP.

There will be a £200m threshold for projects, above which DPC will apply by default, and Ofwat reserve the right to explore the use of DPC for major projects below this threshold. Water companies will be required to (1) identify projects with Totex over £200m, (2) assess the extent to which the project is 'discrete' and (3) undertake a robust value for money assessment of delivering the project through DPC.

In order to assess discreteness under limb (2) above, water companies will be required to consider Ofwat's technical discreteness guidance, issued in early 2023. This guidance introduced three tests: (i) the Programme Scalability Test; (ii) the Construction Risk Test; and (iii) the Operations and Maintenance Risk Test. The basic idea is that the more separation there is between a project and a company's existing networks and operations, the more suitable it is to be designed, built, maintained and operated by a third-party CAP.

**"The more separation there is between a project and a company's existing networks and operations, the more suitable it is to be designed, built, maintained and operated by a third-party CAP."**

The water company must then carry out an assessment of the value for money that a project will achieve under limb (3) above, which will be based on the difference in Net Present Value ("NPV") of the revenue (in real terms) to be recovered from customers over the lifecycle of the asset under DPC as opposed to in-house delivery. Water companies will be required to submit a fully modelled assessment to Ofwat before entry into a CAP Agreement is approved by the regulator.

The DPC regime is set out in 'Condition U' of the relevant water company's licence, which sets out the company's obligations insofar as putting projects out to tender, the negotiation and execution of the CAP Agreement, the Allowed Revenue Direction and appointment of an Independent Technical Adviser.

Each DPC project is required to have an Independent Technical Adviser (“ITA”), appointed by the water company and pre-approved by Ofwat. The role of the ITA is to obtain assurance around the costs and delivery of a DPC project and they could be involved at any stage.

Once a project has been designated as a DPC project, Ofwat will issue an ‘Allowed Revenue Direction’ (“ARD”) in relation to the approved CAP Agreement, which sets out the proportion of CAP charges that the water company can collect from customers. Condition U sets out Ofwat’s powers in the granting of any water company’s ARD, Ofwat will require a written report from the ITA to enable them to assess the level of charges that should be redeemable under the ARD.

Under the new licence conditions, a water company can request that the price control applicable to it in any five-year period be reset by Interim Determination. Ofwat will consider any requests and may grant such a determination if ‘certain events occur which significantly affect revenues or costs’. These include a failed procurement process, the modification or revocation of a Designation Notice, the revocation of an ARD or the termination or expiration of an ARD.

**"There is clearly an opportunity to gain new investment from institutional investors and funders who derive comfort from a regulated return."**

Under PR24, Ofwat will introduce a focused incentive package for water companies, which aims to ensure that the water company procures and manages the tender process and CAP Agreement effectively, so that DPC schemes are delivered efficiently and achieve the intended goal of lower costs for customers. The incentive seeks to ensure that, if efficient for customers, DPC is always put forward by the water company and selected over in-house delivery.

## FINANCIAL IMPLICATIONS FOR WATER COMPANIES

Under Condition F of the relevant water company’s licence, the company will have certain obligations to keep appropriate accounting records (in a form approved by Ofwat).

Under Condition P, the water company is required to ensure that it maintains sufficient financial and management resources to enable it to carry out its functions in a sustainable manner. This includes meeting the Board Leadership, Transparency and Governance objective, set out in Condition P3 and complying with its obligations under the Water Industry Act 1991.

There are no new implications under the DPC scheme for water companies that lose investment grade status or are nationalised or privatised. Accordingly, we must look to the Water Industry Act 1999 and the Water Industry (Special Administration) Rules 2009 enacted thereunder. The rules set out the special administration process that must be followed if an application is made by the Secretary of State or Ofwat. In short, this regime allows for the appointment of Special Administrators by Court Order to oversee the management of the relevant company. The purpose of the Special Administration Regime is to ensure that services to customers are not disrupted by transferring the company’s business as a going concern and carry out the essential functions of the company in the interim.

## WHAT DOES THIS MEAN FOR INVESTORS?

The aim of Ofwat’s DPC scheme is to increase competition in the market and thereby increase innovation and performance in the delivery of major water infrastructure projects – which will have a knock-on effect for customers, in the form of lower prices.

# WATSON FARLEY & WILLIAMS

While increased competition is a laudable aim, this could have ramifications for the financial stability of the parties delivering major infrastructure. There is clearly an opportunity to gain new investment from institutional investors and funders who derive comfort from a regulated return.

Parallels might be drawn to other regimes that have tried to introduce competition in the provision of infrastructure – such as OFTOs and CATOs.<sup>2</sup> Our analysis of the OFTO regime and what it has delivered can be found [here](#).

*London trainee Ellen Mackie also contributed to this article.*

[1] <https://www.gov.uk/government/organisations/the-water-services-regulation-authority>

[2] <https://www.ofgem.gov.uk/publications/quick-guide-cato-regime-november-2016>

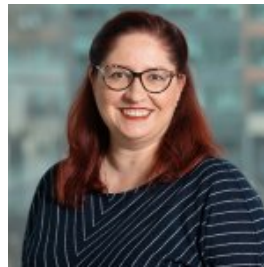
## KEY CONTACTS



**JENNIFER CHARLES**  
PARTNER • LONDON

T: +44 20 7814 8241

[jcharles@wfw.com](mailto:jcharles@wfw.com)



**MARIANNE ANTON**  
COUNSEL • LONDON

T: +44 20 3314 6330

[manton@wfw.com](mailto:manton@wfw.com)

### DISCLAIMER

Watson Farley & Williams is a sector specialist international law firm with a focus on the energy, infrastructure and transport sectors. With offices in Athens, Bangkok, Dubai, Dusseldorf, Frankfurt, Hamburg, Hanoi, Hong Kong, London, Madrid, Milan, Munich, New York, Paris, Rome, Seoul, Singapore, Sydney and Tokyo our 700+ lawyers work as integrated teams to provide practical, commercially focussed advice to our clients around the world.

All references to 'Watson Farley & Williams', 'WFW' and 'the firm' in this document mean Watson Farley & Williams LLP and/or its affiliated entities. Any reference to a 'partner' means a member of Watson Farley & Williams LLP, or a member, partner, employee or consultant with equivalent standing and qualification in WFW Affiliated Entities. A list of members of Watson Farley & Williams LLP and their professional qualifications is open to inspection on request.

Watson Farley & Williams LLP is a limited liability partnership registered in England and Wales with registered number OC312252. It is authorised and regulated by the Solicitors Regulation Authority and its members are solicitors or registered foreign lawyers.

The information provided in this publication (the "Information") is for general and illustrative purposes only and it is not intended to provide advice whether that advice is financial, legal, accounting, tax or any other type of advice, and should not be relied upon in that regard. While every reasonable effort is made to ensure that the Information provided is accurate at the time of publication, no representation or warranty, express or implied, is made as to the accuracy, timeliness, completeness, validity or currency of the Information and WFW assume no responsibility to you or any third party for the consequences of any errors or omissions. To the maximum extent permitted by law, WFW shall not be liable for indirect or consequential loss or damage, including without limitation any loss or damage whatsoever arising from any use of this publication or the Information.

This publication constitutes attorney advertising.