

Water Redeterminations

The Elsham Scheme – Working Paper

15 January 2021

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Contents

	<i>Page</i>
Introduction	2
Submissions following Provisional Findings	2
Anglian's response to PFs	2
Ofwat's response to PFs	4
Anglian's Reply to PF responses	4
Ofwat's Reply to PF responses	5
Further assessment and updated view.....	6

Introduction

1. Our Provisional Findings on 29 September 2020 considered one specific matter concerned with the Elsham scheme (which provides for additional water transfer, storage and treatment capacity in Anglian's supply area): the potential for it to be unfunded if the Direct Procurement for customers (DPC)¹ results in the contract being delivered in-house by Anglian. We that said that:

Ofwat had confirmed it would consult on this and Anglian confirmed it will engage openly and that, should this provide a workable solution to the problem, the issue need not be dealt with as part of the CMA redetermination. In its hearing, Anglian confirmed this was being discussed with Ofwat and is likely to be resolved, hence we make no provisional determination on this matter.²

2. In its response to PFs, Anglian said that, despite significant efforts, these discussions have not resulted in an agreed position between it and Ofwat, and that without a reduced scope of DPC, Anglian will not be able to meet its obligations during AMP7. Anglian asked that we revise the scope of the Elsham DPC process, such that it only applies to the treatment works at Elsham, and that we include a totex allowance (and associated performance commitments) in the redetermination for the other (transfer and storage) elements of the scheme that Anglian would then deliver as part of its AMP7 programme.
3. This paper summarises the submissions that Anglian and Ofwat have made with respect to this matter and provides our further assessment and updated view. We seek responses to this consultation by 22 January 2021.

Submissions following Provisional Findings

Anglian's response to PFs

4. Anglian noted that three components of the Elsham scheme are subject to the DPC process:³

¹ DPC involves arrangements where a water company competitively tenders for a third party to design, build, finance, operate and maintain infrastructure that would otherwise have been delivered by the incumbent water company. See Ofwat (2017), *Delivering Water 2020: Our final methodology for the 2019 price review*, Chapter 7 and Ofwat (2017), *Delivering Water 2020: Our methodology for the 2019 price review. Appendix 9: Direct procurement for customers* for additional details.

² *Provisional findings report*, paragraph 5.502(e)

³ *Anglian's response to the provisional findings*, paragraph 185

- Elsham to Lincoln transfer;
 - Elsham Transfer and storage from East Lincolnshire; and,
 - New Elsham Water Treatment works.
5. Anglian said that timetable constraints related to the first two of these components would not allow them to be delivered through the DPC process within the timeframe required for it to meet its AMP7 environmental obligations, and ensure security of supply.⁴ Anglian said that these constraints were driven by a number of factors, but in particular by the interface with Network Rail's Basic Asset Protection Agreement (BAPA) process.⁵ Anglian said that - even with optimistic timetable assumptions - its legal obligations could not be met, and that it is necessary to revise the scope of the DPC process so that it only includes the Elsham Water Treatment works.⁶
 6. Anglian said that implementing a reduced DPC scope through Ofwat's emerging DPC IDOK process⁷ would create timetable risks that could prevent Anglian from moving forward as quickly as needed, and pointed to AMP7 water resource pressures as likely to be even greater than had been originally anticipated in its Water Resource Management Plan.⁸ Anglian requested that we reduce the Elsham DPC scope as part of the redetermination as this would resolve matters swiftly and mitigate the risk of its environmental obligations not being met.⁹
 7. Anglian proposed that an additional totex allowance of around £83m be provided for in our redetermination to fund its delivery of the transfer and storage elements of the Elsham scheme: around £87m to fund the costs of delivering the transfer and storage elements, less around £4m to reflect that portion of the allowance for DPC costs (provided for in Ofwat's FD and PFs) that it would no longer need to incur.¹⁰ Anglian proposed associated changes

⁴ [Anglian's response to the provisional findings](#), paragraph 186

⁵ [Anglian's response to the provisional findings](#), paragraph 186

⁶ [Anglian's response to the provisional findings](#), paragraph 186

⁷ An IDOK, or 'Interim Determination of K', is a process by which water companies can request that Ofwat resets their price limits between five-yearly price reviews. In order to do so, certain criteria need to be met around materiality and triviality. Ofwat can also trigger an IDOK based on the same criteria. Ofwat has been consulting on the introduction of a licence change to allow a "DPC Interim Determination" which would facilitate, in specified circumstances, the return of the project to delivery by the company rather than a third party, see Ofwat (2020), [Direct procurement for customers: Statutory consultation on proposed changes to the conditions of appointment of five water and sewerage companies](#).

⁸ [Anglian's response to the provisional findings](#), paragraph 25

⁹ [Anglian's response to the provisional findings](#), paragraph 188

¹⁰ [Anglian's response to the provisional findings](#), paragraphs 190-199

that it considered should be made to its interconnector and DPC performance commitments and outcome delivery incentives.¹¹

Ofwat's response to PFs

8. Ofwat said that it supported the approach taken to this issue in PFs, and did not consider that the de-scoping issue needs to be dealt with as a part of the redetermination.¹² Ofwat said it considered that its proposed (DPC IDOK) licence change – which it had consulted on – would adequately address uncertainties related to changes in the delivery route for the scheme.¹³
9. Ofwat said that the proposed de-scoping of the transfer and storage elements of the Elsham scheme would potentially result in significant costs for customers, and so it is considering Anglian's proposals, and technical justification, carefully.¹⁴ Ofwat said its legal advice suggested that a number of the timing issues Anglian had raised should be resolvable through the adoption of a slightly different structure for the process, and that it hadn't been presented with clear arguments as to why the whole Elsham scheme could not be delivered through a DPC process.¹⁵

Anglian's Reply to PF responses

10. Anglian said that the approach taken to Elsham in PFs was linked to the view, expressed at its hearing, that it was actively discussing the scope of DPC with Ofwat and expected the matter to be resolved, and was not based on Ofwat's commitment to consult on licence changes to deal with uncertainties over the managing of changes to delivery routes (including scope).¹⁶ Anglian said that Ofwat had not adequately represented the extensive dialogue that had been undertaken to seek to resolve these issues.¹⁷
11. Anglian said that the advice referred to by Ofwat did not address the timetable concerns Anglian had identified, and that Ofwat's response failed to account for the potential harm to customers and the environment if Anglian could not meet its environmental obligations.¹⁸ Anglian said that any relative benefits for customers under DPC were highly uncertain and relied on the assumption that a Commercially Appointed Provider (CAP) was appointable, and would

¹¹ [Anglian's response to the provisional findings](#), paragraphs 200-209

¹² [Ofwat response to the provisional findings – costs and outcomes](#), p55

¹³ [Ofwat response to the provisional findings – costs and outcomes](#), p55

¹⁴ [Ofwat response to the provisional findings – costs and outcomes](#), p55

¹⁵ [Ofwat response to the provisional findings – costs and outcomes](#), p55

¹⁶ [Anglian's response to the provisional findings](#), paragraphs 16-17

¹⁷ [Anglian's response to the provisional findings](#), paragraph 17

¹⁸ [Anglian's response to the provisional findings](#), paragraphs 19 and 22

deliver at a much lower overall cost than an in-house alternative.¹⁹ Anglian said it had done further work to establish that the treatment works component still represented value for money for customers as a stand-alone DPC project, and had committed to do all it could to ensure the DPC process was successful.²⁰

12. Anglian subsequently provided us with a report it had commissioned from WSP, which reviewed opportunities and constraints with respect to the Elsham DPC. The conclusions of this included that Anglian is right to be concerned that the time necessary to develop and implement the full scope of the Elsham DPC presents an unacceptable business and service risk of failure to meet fixed dated licence reductions, as it would take markedly more time to adequately describe to the market, tender, negotiate and reach financial close than a BAU approach, given the immaturity of the DPC approach and the complexity of the scheme interfaces. The report concluded that the resulting compression of the construction and commissioning programme was likely to leave insufficient time to allow for risks to the programme.

Ofwat's Reply to PF responses

13. Ofwat said that it has a clear process for managing DPC which had been widely consulted upon and aligns with best practice, and that requires water companies and Ofwat to engage throughout and agree the scheme's progression through a number of control points.²¹ Ofwat said that there are mechanisms to allow all or part of a project to revert to in-house delivery if it has determined (based on its assessment at the various control points) that DPC is not appropriate.²² Ofwat said that it expects the development of the project itself to continue in parallel to this process such that the decision on the procurement route should not delay the overall programme.²³
14. Ofwat said that the timetable has been, and still is, fully within management control, and that Anglian has had 16 months in which it could have developed a programme which was achievable.²⁴ Ofwat said it believed that, while it will be challenging to deliver the project within the remaining time after this delay, it is feasible to do so.²⁵ Ofwat said that its external legal advice on the BAPA

¹⁹ [Anglian's reply to responses to the provisional findings](#), paragraph 20

²⁰ [Anglian's reply to responses to the provisional findings](#), paragraph 23

²¹ [Ofwat response to the provisional findings – costs and outcomes](#), paragraph A1.4

²² [Ofwat response to the provisional findings – costs and outcomes](#), paragraph A1.5

²³ [Ofwat response to the provisional findings – costs and outcomes](#), paragraph A1.5

²⁴ [Ofwat response to the provisional findings – costs and outcomes](#), paragraphs A1.9 - A1.10

²⁵ [Ofwat response to the provisional findings – costs and outcomes](#), paragraph A1.10

process had identified a number of alternative approaches that could be taken to reduce the timeline to meet the estimated delivery of March 2025, and that it had communicated its suggested alternative approaches and amendments to Anglian.²⁶ Ofwat said it considered there to be other practical arrangements that could also be put in place to mitigate this risk, but that it is for Anglian to manage the project and manage the risks associated with it.²⁷

15. Ofwat said that any de-scoping of Elsham within the redetermination would undermine the DPC framework, and potentially lead to similar issues (for example, concerned with the BAPA process) being raised in relation to other projects in order to try to avoid the use of the DPC process.²⁸

Further assessment and updated view

16. The limited consideration given to the Elsham scheme in our Provisional Findings reflected the fact that the scheme was being taken forward through the DPC process. In its Statement of Case, Anglian raised a particular concern over the funding arrangements that would apply if the scheme was to be ultimately delivered by Anglian itself:

Anglian accepted Ofwat's proposal for the Elsham scheme to be carried out using a direct procurement process. The c.£122 million expenditure for this project was, therefore, removed from Anglian's requested allowance. However, if the in-house solution proves better value for money than any bidder proposal, or if there is no appetite in the market to bid for the Elsham scheme, Anglian will have to construct and pay for the scheme itself. It will have no cost allowance to do so, nor...any mechanism for future recovery.²⁹

17. Anglian said (in its SOC) that the obvious and straightforward way to deal with this issue was through a workable reimbursement mechanism.³⁰ The comments in our Provisional Findings on Elsham focused on this specific funding issue, and we said that:

With regard to the potential for the wider Elsham scheme to be unfunded if the Direct Procurement for customers results in the contract being delivered in-house by Anglian: Ofwat had confirmed it would consult on this and Anglian confirmed it will

²⁶ [Ofwat response to the provisional findings – costs and outcomes](#), paragraph A1.11

²⁷ [Ofwat response to the provisional findings – costs and outcomes](#), paragraph A1.11

²⁸ [Ofwat response to the provisional findings – costs and outcomes](#), paragraph A1.7

²⁹ [Anglian SoC](#), paragraph 120

³⁰ [Anglian SoC](#), paragraph 123

engage openly and that, should this provide a workable solution to the problem, the issue need not be dealt with as part of the CMA redetermination. In its hearing, Anglian confirmed this was being discussed with Ofwat and is likely to be resolved, hence we make no provisional determination on this matter (emphasis added).³¹

18. Ofwat's emerging DPC IDOK appears likely to address this funding gap issue in an adequate manner, and we consider that Anglian's concern in this regard has been resolved. While Anglian has said that the DPC IDOK process would create timetable risks that could prevent Anglian from moving forward as quickly as needed,³² this view can be contrasted with Anglian's comments in its SOC that a workable reimbursement mechanism would be straightforward to provide for as there would be an external, verifiable cause determining whether the expenditure should take place.³³ Anglian's submissions following PFs relate primarily to the determination of whether in-house expenditure should take place (given the programme timescale risks Anglian has identified), rather than to how that expenditure would be funded.
19. The primary matter that we need to address now is whether the redetermination should adjust the scope of the Elsham DPC. Our updated view is that it should not, and therefore that no consequential adjustments to totex allowances, performance commitments or ODIs are needed.
20. We consider it important that the assessment of the case for de-scoping, and of the risks of not doing so, are currently being reviewed as part of the ongoing DPC process that has been established. Ofwat told us that it expects Anglian to make its final submission of its Strategic Outline Case for the Elsham DPC (for the first key milestone in the DPC process) by the end of December, with Ofwat then expected to provide its decision in early February. Ofwat said that its ongoing review of Anglian's submissions as part of this process includes detailed consideration of a range of matters, including evidence on the extent and implications of the timing pressures Anglian faces (and, in particular, its assessment of its 2025 supply-demand need case, its response options, and its preferred commercial delivery approach). We note that there may be significant risks to customers associated with us, at this late stage in the redetermination process, seeking to assess and conclude on the range of detailed issues that Anglian's de-scoping proposal raises (for

³¹ [Provisional findings report](#), paragraph 5.502(e)

³² [Anglian response to PFs](#), paragraph 25

³³ [Anglian Statement of Case](#), paragraph 515

example, by unduly increasing the costs that customers will bear for delivery of scheme).

21. There is an existing and ongoing DPC process, which Ofwat noted was established after wide consultation,³⁴ that provides a mechanism through which an assessment of relevant risks is already both provided for, and underway. Further, as noted above, should Anglian consider that further funding is required at the conclusion of this process (or of a relevant milestone within it)³⁵ in order for it to meet its statutory obligations, it can seek this funding through the IDOK process. We therefore see no need within the context of the present redetermination for us to take a view on the appropriate scoping of the DPC. Further, we agree with Ofwat that our doing so would risk undermining the DPC process,³⁶ in a context where there will be significant management control over project timetables, and where companies may face incentives to delay undertaking steps, such as market testing, so as to increase the likelihood of delivery being brought in-house as a result of a subsequent assessment of time pressures.
22. In line with the above comments, our updated view is that the redetermination should not revise the scope of the Elsham DPC, and that no consequential adjustments to totex allowances, performance commitments or ODIs are needed.
23. We welcome submissions from interested parties in relation to these updated views which we will consider prior to reporting on our final determination. Submissions should be made no later than 22 January 2021.

³⁴ [Ofwat's reply to responses to the provisional findings – costs & outcomes](#), paragraph A1.4

³⁵ We note that, under Ofwat's DPC process, conclusions relevant to the scope of DPC may be reached at a number of different points as the project develops.

³⁶ [Ofwat's reply to responses to the provisional findings – costs & outcomes](#), paragraph A1.7