



The Future of Utilities Procurement: Lessons Learned and Challenges Ahead

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Basics

- Generally, the manner in which utilities must procure contracts and evaluate tenders is determined by the Utilities Contracts Regulations 2016 (“**UCRs**”). There are a number of exceptions to this.
- Procurements must also be conducted in accordance with the principles in the Treaty on the Functioning of the European Union. These are now enshrined in the UCRs:
 - **Transparency:** This is not just about disclosure and openness but also the removal of discretion and subjectivity. Procurements must be based on objective criteria that are known to bidders in advance.
 - **Fairness:** Evaluation criteria and the evidence required from bidders must be actually and demonstrably related to the subject matter of the contract and applied proportionately to the stated objectives.
 - **Equal treatment (or non-discrimination):** All bidders and potential bidders must be given the same opportunity, based on the same information and criteria, and evaluated in a non-discriminatory manner.

Four Challenges

Direct Procurement for Customers

The Introduction of DPfC in PR19 could result in fundamental changes to major procurements, including: (i) what is being procured and when it is procured, (ii) how services and works are procured and (iii) even **potentially** a change to the regime under which the works and services are procured.

Financial Status of Market Participants

Recent events in the construction industry have raised concerns about the impact of contractor financial concerns on major projects. Procurement approaches will need to adapt to reflect this.

NDA

Recent procurement case law under the PCRs has raised a number of issues regarding the conduct of a procurement that should also be taken in to account in respect of the UCRs.

Brexit

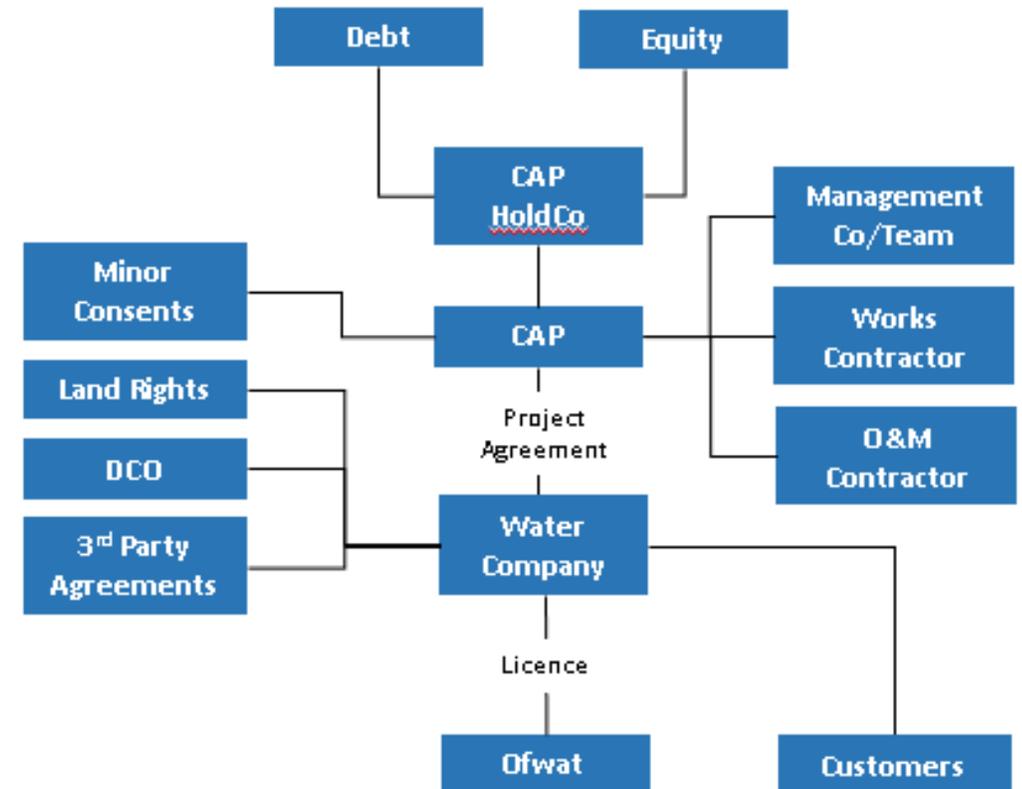
As with other areas of law and regulation, Brexit raises potential issues regarding the application of the UCRs, which utilities should consider and be aware of.

DPfC – What is it?

Key Characteristics

- Ofwat introduced DPfC at PR19.
- A water company competitively tenders for an entity to *design, build, operate, maintain and **finance***:
 - (a) large scale (greater than £100m totex); and
 - (b) discrete, infrastructure projects that would in usual circumstances be delivered directly.
- Primarily seems to be focussed on a contracting as opposed to utility model.
- Revenue stream will be fixed over the contract period.
- Tender process will be run by the incumbent water company.
- Existing water companies will not be able to bid for their own projects.
- The contract duration will generally be for a period of 15-25 years.
- The contractor's revenue entitlement should start on construction completion.

Indicative Structure



DPfC – What is being procured?

What is being procured

- Ofwat has left flexibility as to the extent of services being procured.
- Critically financing will be procured.
- Ofwat describes three core tender models in its PR19 documentation:
- **Early tender** – The water company tenders outcomes and the tender takes place before early design work;
- **Late tender** – Competition focussed on delivering outputs. Tender takes place after planning consents are in place.
- **Very late tender** – Competition is focussed on financing and operations. This occurs where construction is completed (or at least construction procurement).
- Each of these tender models assumes a structure similar to that proposed above i.e. a contractor is appointed by a licensed water company. But... are there other options too?

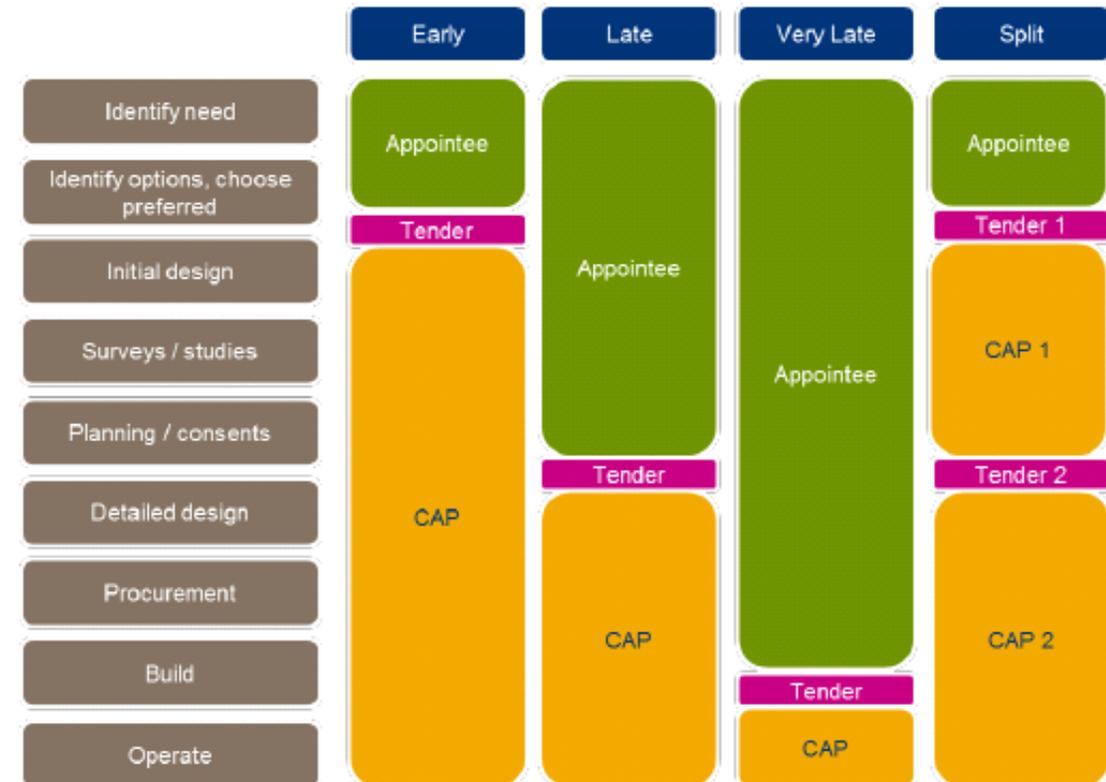


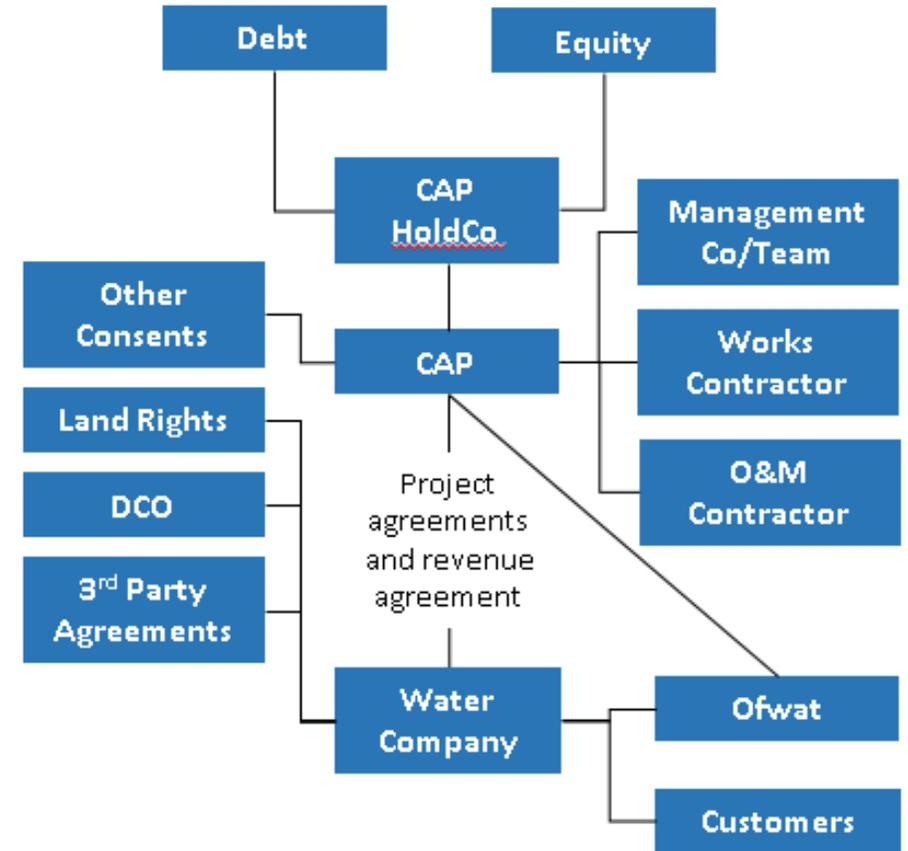
Diagram from Ofwat "Delivering Water 2020: our Methodology for the 2019 price review – Appendix 9: Direct procurement for customers."

DPfC – Alternative 1 (Regulatory Model)

Key Characteristics

- Separately licensed CAP appointed by licensed water company. CAP has licence from Ofwat to design, construct, own, finance, operate and maintain the project asset.
- Water company still carries out preliminary planning, land acquisition and design development.
- Revenues pass through from water company to the CAP.
- Water company's licence is amended to enable it to collect revenues for the CAP's charges due under its licence.
- The CAP is exposed to the risk of water company Special Administration – to solve this it needs (i) cash reserving and (ii) the power in certain circumstances bill customers directly.
- This model is envisaged by Ofwat in PR19 documentation but seems to be secondary to contracting model.

Indicative Structure



DPfC: How is it Being Procured?

- **Planning:** In planning the procurement process, appointees are required to demonstrate VfM to Ofwat. In their guidance Ofwat make reference to the HMG Five Cases Model. They also state the Final Business Case should be prepared in parallel with the procurement process. This raises a question about how VfM is assessed and how this fits with the Price Review process.
- **Process:** Ofwat expects water companies to procure contracts and evaluate tenders is determined by the Utilities Contracts Regulations 2016 (“UCRs”) (where required).
- Where the Regulatory model is used the procurement regime is different and is the modified form of the UCRs specified in the Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013.
- Package appropriately - Finance market not used to UCR-type process.
- **Evaluation:** Ofwat states that water companies should allow bidders to comment on draft contracts. The implication is that some competition on legal terms should be used to obtain better pricing.
- Where financing is being tendered additional criteria will need to be considered – including (i) bid price (and other inputs on financial model) and (ii) deliverability (based on compliance with mandated requirements e.g. minimum rating, capital commitment, cash reserving, appropriate leverage and technical/legal compliance).
- VfM is more than just a low price!

DPfC: Challenges for Water Companies

Challenge	Summary
Creating VfM	<ul style="list-style-type: none"> - DPfC will often contain construction risk (unless “Very Late” Tender Model). - 100m Totex is not a large amount - Costs must be less than the current weighted average cost of capital in the water industry (c.2.4%). - DPfC contract principles state that revenue should generally commence after construction completion. - No Tideway type mitigant for exceptional risks (incl. funder of last resort protection).
DPfC Failure Fallback	<ul style="list-style-type: none"> - What happens if a DPfC project fails (either during tender or during term)? - Water company may be exposed to punitive action from the regulator and may inherit a failing project without sufficient funding set at its price review. - Licence condition to use reasonable endeavours to run a process that achieves best value for customers. - Contingency on a case by case basis. Contingency should be part of planning for DPfC.
Development Costs	<ul style="list-style-type: none"> - Development and conduct of the tender processes using DPfC are likely to be bespoke and require considerable resource (particularly in the case of the initial tender processes). - Ofwat has stated costs be similar to current costs to develop a project.
Assets	<ul style="list-style-type: none"> - Asset ownership will need to be considered carefully – consider CAP insolvency.
Accounting	<ul style="list-style-type: none"> - Will structure and licence changes cause challenges for financial covenants?

DPfC: Three Key Messages

Get Creative - Ofwat has presented a huge opportunity to create value and re-risk major projects. Challenge is how best to deliver it. Ofwat has provided flexibility. A DPfC approach needs active consideration and detailed planning.

Protect Yourself – Contingency planning is a legitimate part of Value for Money and any company proposing to use DPfC should also be planning fallback and protections.

Don't Forget the How – How a DPfC tender is conducted is almost as important as what is being tendered.

Financial Status of Market Participants

The recent collapse of Carillion shows that even established market participants can fail. The result is that procuring utilities need to consider resilience in their procurement strategy. Resilience needs to be two fold – dealing with the Issue pre-emptively during a tender process and in the event of insolvency after contract award.

During Tender Process

- Robust SQ financial checks etc. Use appropriate measures – not just turnover but also relevant financial ratios (such as gearing, interest cover and liquidity). **[Note: Restrictions on use of turnover]**
- Consider package size and whether lots may be more appropriate – consider “win one only” option.
- Requirement for joint and several execution of the contract by JV partners.
- Due diligence prior to award – Consider ECI. Use MEAT - including qualitative price award criteria that considers adequacy of pricing submission and assumptions.
- Abnormally Low Tenders.

Risk of Contractor Insolvency

- Ensure financial security – is actually put in place. Also ensure the instruments are appropriate – e.g. robust PCGs and other financial instruments etc.
- Allow for Step-in in the event of insolvency – can utility manage directly? **This approach may only be viable where the majority of the works are subcontracted (consider funding)**
- If you have used lots, consider resilience of having other contractors step-in in the event of failure of another.
- Be an active employer. Knowing contractual risks will enable more realistic remedy.
- Consider funding contingency (particularly re DPfC).

Lessons Learned from the NDA Case

- **Avoid Over Complication:** The NDA had over 700 individual elements to evaluate which meant the claimant had lots of targets to attack. The scores were so close that overturning just a couple of the marks meant the outcome could be overturned on a challenge. The evaluation process was also so complicated it gave the evaluators an almost impossible task and plenty of room to trip up. Consistency of approach across the various evaluation teams also become an issue.
- **Avoid use of ‘cliff edge’ pass/fail and minimum scores:** Another lessons learned from the NDA and other procurements is that these devices should be used sparingly and only where failure to achieve the minimum standard would genuinely make a PQQ/bid unacceptable. It is not safe either to state that we “may” reject for failure to achieve a standard without explaining on what basis you would exercise that discretion. In the NDA case, the NDA had a considerable number of pass/fails and the claimant was able to show that the winning bid failed at least one of these and should have been disqualified. The reality was that the pass/fail issues used by NDA were relatively trivial in the context of the overall bid.
- **Avoid using overly prescriptive marking schemes:** The assessment/evaluation guidance or score descriptors need to be clear so that they can be readily understood in the same way by candidates/tenderers but should also leave some judgment to the assessors, otherwise the evaluation becomes a tick box exercise that can leave little room for evaluators to exercise professional judgment/discretion which might lead to an inflexible and rigid process and to errors that can be overturned on a challenge.
- **Importance of comprehensive record keeping and retaining records.**

Last but not Least... Brexit

- UK procurement law (including the UCRs) is based on EU directives. Therefore Brexit may result in future changes to utilities procurement rules.
- As of today all EU and UK procurement law remains unchanged.
- The UCRs are set out within national legislation so they will not be immediately repealed or amended by Article 50 or the Leave Vote.
- There is no reason to think the UCRs or PCRs will be repealed or amended in the short term following the Article 50 trigger date or by the EU (Withdrawal) Bill.

However, Brexit is unlikely to be business as usual....

- Brexit does raise some interesting procurement issues nonetheless – for example:
 - The case law that informs our understanding of the UCRs may no longer be binding on English courts.
 - It is not clear what arrangements will be in place to allow UK public authorities to publish notices in the OJEU after Brexit.
- In the long-term the UK may look to amend procurement law. Whether or not this is possible may be an output of any trade deal agreed between the UK and the EU.
- It is expected that the Houses of Parliament will continue to develop the EU (Withdrawal) Bill this year. Watch this space for further developments.

Caveats

- The material is in summary form and does not cover all aspects of the relevant procurement rules and case law.
- It is provided for information only and does not constitute legal advice.
- If you have any questions on the update or wish to contact Sharpe Pritchard to assist with any assessment of DPfC schemes please contact sgummer@sharpepritchard.co.uk