

Meeting note

Thursday 29 September 2016
 Centre City Tower, 7 Hill Street, Birmingham B5 4UA
 10.00 am to 3.45 pm

Water resources working group meeting – Third meeting

Attendees	
Tim Charlesworth - Affinity Water	David Daley - Yorkshire Water
Mike Pocock - Affinity Water	Polly Chancellor - The Environment Agency
Dr Illias Karaponos - Affinity Water	Caroline Harris - Natural Resource Wales
Jerry Bryan - Albion Water	Paul Harrison - Welsh Government
Andrew Snelson - Anglian Water	Simon Furse - WICS
Leonie Mackenzie - Bournemouth Water & South West Water	Nathan Richardson - RSPB
Liz Cornwell - Bristol Water	Colin Green - Ofwat
Liz Franks - Dee Valley	David Young (item 2 only) - Ofwat
Daniel Davies - Dŵr Cymru	Freddie Levett - Ofwat
Crawford Winton - Northumbrian Water	Hanif Jetha - Ofwat
Steve Morley - Portsmouth Water	Ian Pemberton - Ofwat
Pat Spain - Severn Trent	Jon Ashley (item 7 only) - Ofwat
Nikki Deeley - Southern Water	Mat Stalker (items 1 – 5) - Ofwat
Nagi Suzuki - South Staffordshire Cambridge	Peter Hetherington - Ofwat
Phillip Dixon - Thames Water	Rob Lee (item 9 only) - Ofwat
Frank Grimshaw - United Utilities	Simon Harrow - Ofwat
Luke Devial - Wessex Water	Ynon Gablinger (item 2 only) - Ofwat

Meeting purpose

Several topics were covered at the meeting:

- How Ofwat could approach cost assessment for water resources at PR19;
- Factors to consider when determining access prices for bilateral markets in England;

- Ofwat provided project updates on licencing, the market information platform and the capacity measure for PR19;
- The abstraction incentive mechanism (AIM) and its future;
- The PR14 water trading incentives and their future; and
- Areas for discussion at future meetings and how these topics would be presented.

Action	By Whom	Deadline
Minutes: Ofwat to circulate the minutes to group members for comment. Comments should be sent to Freddie Levett .	Ofwat, Group members	7 October for comments from group members
Project updates – market information platform: Group members asked to look at slide 24 displaying outputs from the WRMP TAG exercise on information needs and ensure they are comfortable with the ‘must’ ‘should’ ‘could’ classifications.	Group members	14 October for comments from group members
Targeted incentives – water trading incentives: Ofwat will provide an MI/d figure for bulk supply exports to provide context to slide 62. <i>The total volume of water exported in 2013-14 was 619 MI/d, further analysis of the bulk supply register is contained in p48-49 of Water 2020: Regulatory framework for wholesale markets and the 2019 price review, Ofwat December 2015</i>	Ofwat	Closed
Regulatory accounts consultation – water resources boundary: Group members are asked to send their thoughts on the suggested addition to the definition, or alternatives, by Friday 7th October to inform 2016/17 RAG. Please contact Simon Harrow and Peter Hetherington with comments.	Group members	7 October for comments from group members.
Presentations for future working groups: Group members were invited to take the lead on presenting their thoughts on topics to forum to encourage a richer discussion and inclusive debate. Among others topics available include: <ul style="list-style-type: none"> • Form of control; • Demand side utilisation risk; • RCV allocation for water resources; • Regulatory treatment of interconnection; • Risk based review • Market information database • Bid assessment framework; and • Resilience 	Group members	7 October for the November meeting, otherwise ongoing

<p>If you are interested in these or other topics please contact Peter Hetherington.</p>		
<p>Working group feedback: Group members were invited to provide feedback on their experience of group meetings and provide suggestions on how to potentially improve them going forward. Specific questions:</p> <ul style="list-style-type: none"> • Format and content of the meetings; • Frequency, timing and location of meetings. <p>Please contact Peter Hetherington with comments</p>	<p>Group members</p>	<p>14 October so that Ofwat can organise meetings for next year in view of the group's comments</p>

Note of the meeting

1. Welcome and introductions

Ofwat welcomed the attendees and thanked group members for their continued support.

Colin Green introduced himself as the Director leading the design areas of the Water 2020 programme. He noted the need to understand how to maximise the benefit of the working group and consider what changes might be needed for the start of 2017. Group members were encouraged to actively present their thoughts on relevant topics at future meetings to further stimulate the debate.

Update on actions from the last meeting:

- The minutes have been updated with comments from members, the main change is to include the detail from the breakout sessions;
- Two group members have indicated that they will provide comments on the Form of Control spreadsheet calculations shared after the last meeting;
- A paper on raw water transfers prepared by the Canal and River Trusts is now available to group members [here](#), please speak to Darren Leftley if you would like to circulate this further; and
- An update on access pricing is being provided as part of this meeting (item 4).

2. Cost Assessment for water resources

Ofwat gave a presentation to gain initial thoughts from wider stakeholders on potential approaches to cost assessment for water resources at PR19.

Ofwat initiated a discussion on cost drivers that should be considered as part of assessing water resources costs, whether these varied between companies and whether or not these drivers were under management control.

The following key points were raised in discussion:

- Various drivers that impacted operational, maintenance and enhancement costs were suggested by group members. These included geology (mainly for capital enhancement – eg building a reservoir or digging a borehole), topography, geography and inherent raw water quality (which may affect pre-treatment cost, a water resources activity).
- It was commented by the group that there is a great deal of regional variation in these factors—even within catchments—and it would be difficult to find a way to accurately reflect the costs of these factors in an econometric model. Moreover, these factors are not, generally, under management control.
- Other factors seen to be outside of management control include the spatial distribution of customers, land ownership and environmental legislation.
- It was argued that in the short run there is little management control over the asset. The companies work with assets that they inherited at privatisation. However, in the long run there is management control.
- It was suggested that in considering additional cost drivers, Ofwat could revisit Special Cost Factors made at PR14.
- It was suggested that the natural scale variable is the amount of water abstracted. This is largely out of management control as it is driven by population and weather conditions, although companies can affect it through their control of leakage.
- It was suggested that except for power costs, most other operational and maintenance costs were fixed, ie they do not change with output.
- It was argued that small diameter boreholes were more expensive to maintain than large diameter ones – harder to treat blockages.

Smaller groups were then asked to consider four potential approaches for setting efficient water resources expenditure: top-down wholesale, top-down water resources, top-down water resources and treatment, and bottom-up.

The following key points were raised in discussion of these approaches (as set out in slide 9 of the pack):

- **Top down wholesale** – The group noted that this may be the most practical approach. It would be consistent with the Totex approach and avoid the potential complexities of disaggregated modelling. The group noted that the key factor in the success of this approach would be in the allocation of the portion of costs to water resources. It was noted that this could be based on

either industry or company historic spending on water resources, or could be informed by bottom up modelling. The group also noted that a key challenge to the success of such an approach is the ability to develop good estimates of wholesale costs.

- **Top down water resources** –The group noted the potential complexities of this approach driven by the heterogeneity of water resources across companies, the need for a firm definition of water resources was also discussed. The group noted that this approach may not fit the objective of encouraging more trading, as the majority of competitive water trading will likely be in treated water, rather than raw water. The group also discussed the merits of a hybrid approach whereby the top down water resources would be calibrated against a bottom up approach.
- **Top down water resources plus treatment** – The group noted that this approach would help capture the raw water quality overlap with treatment and help encourage the behaviours we would want to drive in the sector. However, the group noted that by combining water resources and treatment you lose the granularity between the functions and this may mean it is more difficult to identify any true efficiencies between the companies in providing the water resource function. The group also noted that this approach ensures that water companies remain incentivised to deal with water quality and will allow for catchment management to be considered as a whole.
- **Bottom up** – the group noted that a disadvantage of the bottom up approach is that it is costly and time consuming. However, the approach addresses the heterogeneity in water resource assets across companies. It was suggested that the approach could be based on a sample of assets, although this could result in an unrepresentative sample and inaccurate assessment of costs. It was suggested that the approach can be used in combination with a top-down approach, a fifth option for Ofwat to consider.

3. Break

4. Access pricing for bilateral markets in England

Ofwat presented this paper to get further thoughts on how to determine an appropriate access price to facilitate a competitive bilateral market, including understanding what components should be included in contracts between the retailer and water provider for these arrangements. The presentation was focused on England as the Welsh Government has decided not to expand business retail competition at this time, and therefore the bilateral market model will not apply to incumbent companies whose areas are wholly or mainly in Wales.

The following key points were raised in discussion:

- Ofwat noted that this work was being driven by the requirements of the Water Act 2014 which laid the framework for the bilateral market.
- It was questioned why the costs would be different between a business retailer and a NAV? It was explained that though the costs would likely be similar there are differences caused by, for example, the retailer is supplying various business customers across multiple areas, whereas a NAV is focused in single area most likely meaning it will benefit from lower costs.
- It was noted that all incumbents will be potential entrants in the neighbouring areas.
- One group member questioned whether customers benefit from more efficient sources if the compensation payment is set equal to the incumbent's incremental cost? It was explained that customers switching to alternative retailers would benefit as competitive pressure would encourage retailers to pass on some of the cost saving from alternative water resources to attract more customers. Customers that remain with the incumbent benefit insofar as the incumbent delays the most expensive new scheme.
- It was suggested that in order to ensure that the compensation payment does not distort the market that it should be adjusted to reflect changes in the supply/demand balance over time.
- In terms of what should be included in a bilateral market contract, there should be clear insurance and indemnities as with current water trades. This could include DWI rules around quality. Further to this, it could be useful to include a section on who would be to bear the risk of demand fluctuation (the incumbent wholesaler or new entrant). It is possible that a new entrant could provide resource under the retailer's demand to ensure they don't bear the risk of changes in water use. This could leave the incumbent with all of the risk but could be sending good economic signals as it would reduce costs compared with the retailer being supplied solely by the incumbent.
- The potential for reputational damage to companies was noted, this could limit third party interaction, and would suggest that potable trades are likely to primarily be between licenced entities. This may mean that companies may only choose to utilise the bilateral market over the bidding market in niche situations.

5. Ofwat updates

5.1. Licencing

Ofwat provided a brief update on the upcoming licence change consultation, which for water resources is required to enact separate binding price controls and implement the information remedies. The licence change is currently being drafted ahead of a further licencing meeting on 10th October, the drafting of this modification will be shared to attendees involved in the process in advance of this meeting.

5.2. Market information platform

Ofwat provided an update on the market information platform, which will be a key areas of development for the rest of the year. Group members were asked to look at slide 24 displaying outputs from a previous exercise on information needs and ensure they are comfortable with the 'must' 'should' 'could' classifications. The timetable for the market information platform and bid assessment framework was also discussed and it was noted that the bid assessment framework would not go live until WRMP19 was finalised.

Ofwat noted that it would be useful to have company involvement in developing our thinking about whether/how to develop a common platform or format for publishing data.

5.3. Capacity discussions

Ofwat provided an update on the thinking going into defining capacity to be used in water resources control. The components that make up capacity were discussed and an example of how water available for use (WAFU) could be used was for this purpose was shown.

6. Lunch

7. Targeted incentives: The abstraction incentive mechanism (AIM)

Affinity Water gave a presentation to provide a company perspective about how they have approached the AIM, including how they identified trigger points and baseline abstractions. Affinity Water presented the results for their 23 AIM sites in Q1 of 2016-17.

Ofwat then presented on the AIM going forward, looking at reporting for the rest of this AMP and how AIM might be incorporated into PR19. Ofwat highlighted that as the PR19 methodology consultation and the first APRs, which include AIM data, are both being published in July 2017. Ofwat will be engaging with companies (including as part of the consultation on Outcomes in November 2016) ahead of Ofwat's first round of formal AIM reporting (in November 2017) to inform what we propose on the AIM in the methodology consultation – including whether AIM should be compulsory and include financial incentives.

The following key points were raised in discussion:

- The positive results that Affinity Water presented from Q1 of 2016-17 prompted the question of what the main cause of reduced abstraction at the

AIM sites was. Affinity Water explained that reductions can be attributed to a mixture of demand reduction and substitution, but it is difficult to sometimes tell which of these is most responsible.

- It was noted that providing transparent information around AIM decision-making as a company is very useful for engaging with stakeholders, particularly river groups, as it helps to build trust. Further, it is important that, given it is a reputational measure, there is transparency with customers and stakeholders around how many potential abstraction sites each company includes in AIM as well as how they are performing at each site.
- Ofwat encouraged companies to consider including more sites in the AIM during this price control period, in consultation with relevant stakeholders.
- An attendee asked if any stakeholders were calling for Affinity to apply the AIM at a higher groundwater level than Q95. Affinity noted that it had made great progress in the area of sustainable abstraction in recent years and making further reductions would be part of the continuing dialogue with stakeholders. It was also highlighted that Q95 is a guide and in some Affinity uses a higher trigger point but this is a catchment specific decision.
- The Environment Agency is interested in seeing the progress and outcome of the AIM, but is primarily focusing on its statutory drivers to ensure sustainable abstraction.

8. Targeted incentives: Water trading incentives

Ofwat presented on the benefits of water trading, provided an overview of the water trading incentives set at PR14 and the situations in which they apply before highlighting the four options it has for these incentives at PR19: (1) have no incentives for water trading, (2) roll over the PR14 incentives to PR19, (3) to consider whether caps are needed and their appropriate levels (4) strengthen the PR14 incentives.

Dŵr Cymru then provided a company perspective on the PR14 water trading incentives setting out its thoughts on how to make the water trading market work more effectively and its views on how Ofwat should set trading incentives at PR19. Dŵr Cymru stressed the need to address the difficulty of understanding what the opportunity cost of water is and suggested that more could be done to facilitate the short or medium-term trades in the market. Dŵr Cymru also highlighted that it is preparing a paper for the marketplace of ideas on this topic.

Thames Water then shared its experiences of the water trading water, focusing on trades that it has negotiated in the past, trades it is looking to do in the present and its approach to the water trading. It noted that there is not much spare water to trade in its region and that where it exists, it needs to be when and where it is needed. It

also suggested other ways (apart from direct financial incentives) to encourage trading.

The following key points were raised in discussion:

- The take up of trading and procurement codes was discussed. Ofwat clarified that companies need to have an approved trading and procurement code in order to apply for the PR14 water trading incentives. This code must be approved before business plan submission (September 2018) in order to claim the incentives at PR19.
- On the incentives themselves it was suggested that incentives serve as a useful prompt for an exporter to consider options to buy and sell rather than consider themselves in isolation. On the other hand, it was suggested that if it is economically efficient then that should be enough of an incentive for a company to trade. Further, it was suggested that Ofwat could potentially adjust incentives to encourage water efficiency more generally instead of specific smaller incentives, making the process easier to understand. It was also noted that companies do not obtain the incentives, or find out if they are available for the specific trade, until the next price review.
- Discussion then focused on barriers to trading which have limited the growth of the market. This focused on security of supply issues, for recipient companies, especially during droughts when a supplying company might refuse (or be unable) to provide water to the recipient. There was discussion of the compatibility of markets and companies' security of supply obligation and alongside this there was a discussion of the cultural barriers to trading. This noted the reputational risks of trading and the discussion touched on whether the scope of contracts was strong enough to counteract this.

9. Regulatory accounts consultation: Water resources boundary

Ofwat presented this paper to discuss the responses to August consultation on the regulatory accounts and introduce a potential further addition to the definition of reservoirs that fall into water resources. This is the addition of the 15 day storage rule to the decision tree set out on slide 87. This is important to ensure consistency and equivalence of the treatment of water resources across companies.

In the discussion it was suggested that all reservoirs irrespective of size could be included instead to make the definition simpler. Ofwat, however, noted that it is important to distinguish between reservoirs being used for balancing purposes and those carrying out a resource function. Ofwat also explained that it had considered whether the use of the statutory reservoir definition would be appropriate. The mechanics of how the 15 day rule would be calculated was also discussed.

Group members are asked to send their thoughts on the suggested addition to the definition, or alternatives, by Friday 7th October to inform 2016/17 RAG by email to [Simon Harrow](#) and [Peter Hetherington](#).

10. Actions and agenda for next meeting

Ofwat thanked the group for its contribution to the day. Group members were reminded that Ofwat was seeking feedback on their experiences to inform how the group could evolve after Christmas to provide greater benefit. Group members were also encouraged to volunteer to lead the presentations on topics for the forthcoming meetings.