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RAPID
Ofwat

By email: rapid@ofwat.gov.uk

20th July 2021

Dear Rapid team

RAPID Regulatory and Commercial Framework: a discussion document

We welcome to opportunity to respond to the discussion document on the regulatory and commercial framework for strategic water resource solutions. Taking the document as a whole, we agree with the approach, which we think has been thoughtfully developed with contributions from the industry working group, that we have been able to contribute towards. We answer the consultation questions as a whole.

One question we had in approaching this topic was whether the framework should be limited to the large and strategic schemes, given our natural instinct that local and smaller schemes should provide great value in terms of systems resilience and flexibility. Having reviewed the discussion document, we agree that you are right to make this distinction, In parallel we think Ofwat should ensure that the importance of third parties to resilient future water trading through bilateral and business retailer activity remains an area of active development.

We agree that a “fair shares” approach to allocating new water resources to supply beneficiaries is likely to be appropriate. The priority is to develop the best value schemes, and commercial and competitive arrangements to develop those schemes should not be blocked by uncertainty as to how incentives or other regulation should affect their future use. Fair shares has precedent within the water sector (e.g. Clywedog Reservoir in the 1960s which supported the River Severn and supplies to Bristol Water), prior to economic regulation, and can compliment the development of new resources today.

Where there are fixed sunk costs, then fixed charges, with variable operating costs is likely to be an appropriate cost allocation / bulk supply pricing methodology. This balances certainty to development with retaining incentives to trade. At its simplest, we think a distinction between the fixed cost will be the cost of developing an SRO (usually through a competitively appointed partner – CAP), with the variable cost of it providing water in practice.

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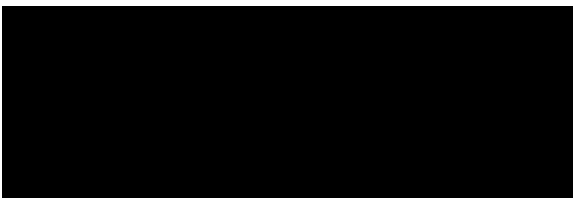
For such costs, the main challenge is to make sure they are directly observable as far as possible, and therefore can be reflected in any pricing approach. Where they are discrete, the volume can also be recorded and shared. Where the system is interconnected, a wholesale minus approach such as used with NAVs, plus the benefit of the scheme net of any trading incentives is generally likely to work best.

We agree that, there is the separate question of how to efficiently develop a major project, and whether multiple water companies should be involved rather than just the incumbent. The decision on this may be on a case by case basis, based on the principle that the design should reflect whatever minimises regulatory and customer risk, which then reduces financing costs. Generally for construction and operating costs, having a single buyer who ultimately operates the bulk of the system is likely to be the option that encourages efficient procurement without risk of misallocating risk once the project is in operation.

We had some concerns about the pricing logic in NERA's review of bulk supply agreements and pricing. We agree with the summary set out in the discussion document, and in particular the initial thinking RAPID set out in Table 1.1 on NERA's recommendations. Based on RAPID's analysis, most strategic schemes are likely to be regulated decisions, based on best value rather than least cost, which means that Long Run Incremental Cost may not yield a useful pricing methodology. We will continue our contribution through the pricing workstream of the working group to illustrate this further, so we agree that this thinking may evolve.

We also agree with the reference to Drinking Water Safety Plans in drinking water quality requirements. Drinking Water Safety Plans can be used to identify hazards and their mitigations (which the DWI monitor through a Risk Assessment Risk Index), which may have the potential to support the management of drinking water risks through water trading.

Yours faithfully



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