

## **Northumbrian Water response to RAPID regulatory and commercial framework discussion document: July 2021**

We support the RAPID programme, in particular the promotion of efficient bulk trading. We see the work of RAPID relating to the removal of barriers to water trading and the incentivisation of trading where beneficial to customers. As a company, we are both importers and exporters of water, so we are keen on developing an efficient process for water trading with a level playing field between in-area and out-of-area resource procurement.

### **Standardisation**

We support the standardisation of contractual terms where appropriate, with the provision that there could be bespoke changes required where specific circumstances required. We particularly support the intention to include key areas such as arrangements during drought and other times of operational stress, force majeure, dispute resolution and contract termination.

One example of a bespoke contractual arrangement would be where the disinfection of water varied between importer and exporter – ie chlorination and chloramination. A standard contract would need to allow for specific alignment costs to be recovered before water could be imported. The contract may require conditions on leakage for example.

### **Charges**

#### **Averaged or Deaveraged Charges**

Pricing decisions for bulk supplies must start with a choice over whether to take an averaged or deaveraged approach.

Averaged approaches, such as using published wholesale tariffs, work well for smaller cross border supplies where the assets used have already been built and incorporated into the average price control building blocks. They keep the charging regime simple and allow for such supplies to be made in perpetuity with transparent pricing. This approach also applies largely for NAV supplies, which start with published wholesale charges before deducting avoided costs. This minimises complexity for NAVs and allows them to predict their charges in advance of contracting with developers.

For RAPID schemes, where large new asset for supply is required, there is a case for de-averaged bulk charging, based on the costs of the asset. Where a bulk supply uses up capacity in an existing resource such that the timing of a new resource is advanced, a long run incremental cost approach would seem appropriate.

#### **Fixed & Variable Charging**

We agree with the proposal to recover fixed costs through the fixed charge. We describe such a charge as a reservation fee, as it will cover the capital costs of the assets being reserved by the importer and is thus payable even if water is not actually taken. This will ensure that customers of the exporting company are rewarded for the use or reservation of the assets they have paid for. We have such an arrangement in place for our largest bulk export supply and it works well for all parties.

If a fixed reservation charge is being made, then when water is actually taken, the volumetric rate should reflect the variable costs.

#### **Water Trading Incentives**

We agree that efficient water trading should be incentivised. There are four parties involved in any bulk supply if we include the customers of the importer and exporter:

<b>Interested Party</b>	<b>Customers</b>	<b>Company</b>
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<b>Importer</b>	Share of savings	Share of savings
<b>Exporter</b>	Share of profits	Share of profits

The importing company will save money on the import compared to its next best alternative. These savings should be automatically shared with customers through the cost sharing mechanism.

The exporting company should be able to make a profit from the export (likely to be a negotiated share of the importers savings). The profit will need to be shared between its customers (who have paid for the assets) and the company (as an incentive to investigate and arrange the trade). This is where the exporter trading incentive is required, as the standard regulatory approach would simply capture all the profits for the exporter customers.

Any regulatory incentive for trading should be aiming to ensure that all four parties are no worse off due to the trade and ideally have some share of the gains from the trade.

Finally, we note that the trading incentive sharing for Havant Thicket was agreed upfront. This is a significant improvement on the current trading incentive, which companies only discover they receive several years AFTER they have agreed the trade, which undermines the power of the incentive. We recommend that Ofwat confirm upfront incentive qualification alongside regulatory funding decisions to give the incentive more impact in negotiations.

### **Allocation and pricing of water during drought and operational events**

We support the ‘fair shares’ approach as set out in the consultation:

*Fair shares approach – the agreement would provide for allocation of water so as to take into account the circumstances in both the exporter’s supply area and the importer’s supply area with the aim that the customers of the exporter and importer receive a fair (potentially similar or equivalent) level of service.*

This is very similar to the contractual terms of the Essex-Thames bulk supplies (both the original Chigwell TMS-ESW supply and the newer ESW-TMS 2015 bulk supply).

Whilst operational events are likely to be supply-specific, droughts are more likely to span both importers and exporters areas. In those circumstances, a non-preferential approach by the exporter is required, to match the circumstances that would have been in place had the importer developed their own resource.

In extreme circumstances, an exporter may in a position where it faces breaching a Section 37 obligation or a contract to an importer. It is critical that the penalties for breach of contract to an importer are the same as a Section 37 failure, so we support the importer options for legal redress such as damages and interim injunctions to supply.

### **Environmental regulation**

We note that transfers of water will be subject to legislation governing water abstraction and discharge, including operating agreements. Likewise, we agree that transfers should be reviewed as part of regional groups and water company WRMP options appraisal processes. Indeed, we are working closely with Water Resources North and Water Resources East on potential PR24 raw and treated water transfer options.

Our Kielder Water Resource Zone is nationally considered to be a donor zone. However, we would like to highlight that providing resilience to a drought with a 1 in 500 year return period under a high

emissions climate change scenario, is likely to significantly reduce our deployable output and therefore our ability to support any exports. We have informally shared this concern with the Environment Agency and plan to report this in the Water Resource North August submission.

We note the need for all transfers to be subject to full environmental assessments. As with all regional group and WRMP options, we will ensure transfers are subject to integrated environmental assessments covering among other aspects, designated sites and Invasive non-native species. Maintaining target river flows could be a constraint to some transfer options. For example, the Environment Agency has expressed concern over increasing summer transfers in the River Tyne when lower natural flows would be preferential. These concerns will continue to be assessment via our WINEP and through WRMP options appraisal.

We note that the Environment Agency, Natural England and RAPID are setting up a dedicated Environmental Regulation task and finish group. We support this and are keen to sit on this group.

### **Multi-sector solutions**

We support any regulatory reforms that remove barriers to multi-sector solutions, joint ventures or DPC schemes for resource provision.

It would be helpful for Ofwat and the industry to review whether there are economies of scale in resource provision. The growth in the RAPID programme and the multi party, multi sector approach to new schemes would suggest that there are, but the evidence base has not been reviewed and published as yet. Such evidence would be important for policy decisions around water resource planning and other areas. Assuming there are economies of scale, this should give added impetus to removing the barriers for multi party, multi sector schemes.

We have one technical concern about a cost assessment disincentive that we believe needs addressing, we give a simple example below:

Company A builds an in-area resource. The resource requires large upfront capital investment, which, assuming it is efficient, is added to the company RCV and charged to customers with annual depreciation costs that are outside the cost assessment model. It then pays relatively low annual operating costs. In future cost assessment models, only the operating cost will be part of modelled costs, so Company A will appear efficient.

Company B pays a bulk supply charge to an exporter (could be any third party). The bulk supply charge will reflect both the capital costs (spread over time) and the operating costs. In future cost assessment models, BOTH the annualised capital and operating costs are part of modelled costs, making Company B appear less efficient than Company A.

This is essentially a cost assessment version of the 'capex bias' that Ofwat and the industry is trying to prevent. There is a relatively simple solution we believe, where Company B splits its bulk supply costs between capital and operating costs and allocates the capital part to unmodelled costs (or a cost adjustment claim). Such a separation would rebalance the choices of in area and importation of resources.