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The regulatory and commercial framework for strategic water resource solutions – a discussion document

Dear Paul,

We welcome the opportunity to respond to your consultation document and the continued collaborative approach you are adopting in the development of SROs.

Within the document you posed 4 specific questions and we have addressed each of these in our response below.

Q1 - Which aspects of our initial thinking do you agree with or disagree with? What other approached would you advocate and why?

- **Market Design.** We agree that the established framework of regional identification of need, water companies and others proposing solutions and regional selection of the best value options should continue to be the preferred model. The efficacy of this approach could be enhanced through greater alignment of processes and timeframes to drive more efficient decision making. We also agree that direct analogies to the wholesale markets in energy are neither optimal or practical at present due to the limited connectivity of infrastructure, however this should be reviewed in future following the likely development of 'interconnectors' between regions.
- **Procurement of solutions and tendering.** We agree that Direct Procurement for Customers (DPC) should be assessed as a procurement route for SRO schemes at Gates 1 and 2, culminating in a strategic business case for DPC compared with other procurement routes at Gate 3. However, the timing of procurement activity will be determined by the date the solution is required, which may be beyond the current gated process. Therefore a finalised procurement strategy and possible market engagement would need to be undertaken at the appropriate time, which may not be aligned with the current Gate 4 (2024).

We also agree that further consideration is required regarding the procurement implications of multi-party SROs - especially in relation to DPC – and that this should be addressed through the Pricing, Incentives and Risk Working Group.

Finally, we would propose that procurement of DPC solutions should only progress once there is clarity regarding the regulatory framework for SROs in order to reduce commercial uncertainty and maximise interest from the market.

- **Financing the RAPID solutions.** We agree that proactive engagement with the investor and financing community would be beneficial in both developing the commercial framework and ultimately leading to the efficient delivery of SROs. However, as noted above, the appropriate timing of this engagement with regard to specific SRO opportunities will need to align with the individual programmes of each project to maximise the interest of potential investors.
- **Contract standardisation.** We agree that the standardisation of contracts will ensure consistency, promote best practice and ultimately reduce transaction costs of water trades. We also welcome the proposal to allow some flexibility to diverge from standard terms where necessary. We look forward to supporting this activity through our participation in the Standardisation Working Group. However, we note that some contractual terms may differ between different types of arrangements - e.g. continuous vs. intermittent supplies, or quality clauses (depending on whether it is a raw or treated water trade). However, standardisation could encompass standard options to accommodate these differences in trading arrangements.
- **Drinking water quality.** We agree that water quality should not be compromised as a result of transfers and it is incumbent upon both importing and exporting water companies to work together to ensure any risks are mitigated. We also agree with the NERA proposal that water quality obligations should be enshrined within the proposed standardised contract terms, although these need to consider the water quality implications of transfers involving both river systems and third party interconnectors which are outside the direct control of exporting and importing companies.

We concur with RAPID's observation regarding the need to engage with both the Drinking Water Inspectorate (DWI) and customers to achieve their acceptance of direct reuse SROs, however we believe this engagement is equally applicable to any change in water source which may impact customer perceptions of water quality (such as hardness) as a result of trading.

- **Charges.** We agree with the proposal to manage risk of stranded assets that the efficient fixed costs of investment in a water resource are recovered through charges to the beneficiaries of the strategic transfer in the form of fixed charges, and are payable irrespective of whether the water resource is used.

We agree with the proposal that volumetric charges should be set equal to short run variable costs, in order to give the right signals for utilisation of the water resource. However a contract will also need to consider how to manage the risk of over-utilisation – in this case such volumetric charges would be insufficient. This may be in the form of a contractual penalty, or for volumes above the contract threshold to be charged at a higher volumetric rate (e.g. to ensure recovery of long run-marginal costs).

We would query the proposal that “network costs” should not be de-averaged – that may be appropriate for the underground water network, but may not be appropriate for water treatment costs.

We agree with the principle that where an exporting company is trading surplus water, and is not developing a new source, that an appropriate price would recover an average of the relevant fixed and variable wholesale costs.

We agree with NERA’s proposal that charges should reflect costs plus an appropriate return, and welcome the opportunity to work with RAPID and Ofwat on the development of trading incentives for PR24.

We agree with the 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. We believe a no deterioration approach should be taken to protect customers.

- **Environmental regulation.** We welcome the establishment of the National Appraisal Unit (NAU) to support a consistent environmental assessment of SROs and to provide a national perspective on regional environmental benefits and disbenefits. This will be enhanced by the recent introduction of an Environmental Regulation task & finish group to address policy issues and operational risks.

As a company involved in SROs impacting both England and Wales where possible we would welcome closer alignment between the Environment Agency (EA) and Natural Resources Wales (NRW) to provide a consistent approach to supporting and assessing the development of SROs.

We are pleased that RAPID recognises the critical importance of abstraction licensing in the viability of SROs. Uncertainty around licensing conditions over the medium to long term could undermine the business cases for schemes and could also act as a deterrent to third party involvement in procurement and financing. We hope this issue can be addressed by the task & finish group.

- **Multi-sector solutions.** We support RAPID’s ambition for engagement with other sectors to maximise value and environmental outcomes from SRO solutions. We believe the current market engagement undertaken through both regional planning and company Water Resource Management Plans (WRMPs) facilitates this dialogue and should be fully utilised in the development of SROs.
- **Solution development and delivery beyond 2025.** We believe the establishment of RAPID and the associated gated process has been a positive enabler for the development of SROs. However we recognise that the drivers for major national infrastructure enhancements – such as population growth and climate change – are enduring and therefore consideration needs to be made regarding the promotion, assessment and delivery of SROs beyond the current gated process.

We also believe that the timings of the current gated process (i.e. construction ready in AMP8) may not be applicable to all SROs as the requirement for the water may be beyond that timeframe and therefore we would recommend that the phasing of SROs is reflective of the needs of each scheme rather than a 'one size fits all' approach.

- **Co-ordinated operations.** We believe the optimal use of water will require operational co-ordination across SROs. For example, the STT system could involve a number of exporters and importers in addition to a separate interconnector company. For this type of system to work efficiently there needs to be a 'controlling mind' to optimise the inputs and outputs. We welcome the appointment of the consultants Baringa and Mott MacDonald to explore potential operating models and we look forward to reviewing their findings in the Co-ordinated Operations working group.

However, as noted in the market design section, due to the current discrete nature of supply systems within the sector a national system operator (SO) – an equivalent of the 'National Grid' in the energy sector – may not add value in the short to medium term. In particular, we expect the contractual parties to any water trade to prefer that any system operator to be established under their contract, and for the SO to have a duty of care to each party. The operation of that SO could still be set under national guidance, but it would seem unhelpful for there to be a national SO that acts independently of the contracts that manage local trading arrangements.

Q2 - What have we missed that also needs to be progressed?

We believe that the key themes identified within this discussion paper reflect the current regulatory issues associated with the development of SROs. However, as we progress through the gated process and more detailed analysis is undertaken it is likely that new challenges will emerge which will also need to be addressed at the appropriate time.

One area which we believe may have been overlooked is the need to engage with the wider stakeholder community regarding the requirement to address the challenges of population growth and climate change. Stakeholder support will be critical in progressing SROs through to delivery stage – especially through the planning process – and therefore we believe it is imperative that the case for SROs is outlined at the earliest opportunity to enhance stakeholder understanding and attract third party commercial and financial interest. We believe there is an opportunity for a co-ordinated engagement campaign inclusive of regulators, regional groups and water companies to outline the national water resilience challenges we face and the potential for SROs to mitigate these risks.

This is especially critical with regard to regions who will need to articulate the case for exporting water to support areas in deficit. At present the benefits to exporting companies are not clearly defined and this could inhibit stakeholder support, especially from customers.

Q3 - We welcome views on our proposed next steps, including additional activities that we should be undertaking.

We believe the recent establishment of a number of commercial and environmental working groups is a positive step in providing both focus and pace in defining regulatory frameworks for the development and delivery of SROs. We also welcome the consultative approach being adopted by RAPID in seeking the views of all stakeholders to help shape future regulation.

With respect to the three commercial working groups – Standardisation, Pricing Incentives and Risk, and Co-ordinated Operations – we would welcome clear terms of reference for each to avoid duplication

and/or omissions. Due to the inherent interdependencies between the groups we would also propose that an overarching forum is established to facilitate a coherent strategic direction for the development of a commercial regulatory framework.

Q4 - We welcome views on NERA's recommendations and our initial thinking on them.

We are broadly supportive of the recommendations from the NERA report, the majority of which are identified within the discussion paper (Question 1) and will be further addressed through the recently established commercial working groups.

We hope you find the observations and suggestions outlined in our response to be valuable in contributing to the development of regulatory frameworks and we look forward to continued participation in the debate through the working groups which have been established to address these topics.

Once again, thank you to yourself and the team at RAPID for your continued engagement. If you have any queries regarding our response to this consultation please do not hesitate to contact me.

Yours sincerely,

Tom Allen
Head of National Water Trading