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

This is Anglian Water's response to RAPID's consultation on the regulatory and commercial framework for strategic water resource solutions.

We welcome the consultation and largely agree with the points made; we have identified a number of key areas below that we would particularly like to draw attention to, in addition to our detailed responses on the specific consultation questions:

- We see real value the regulatory alignment role RAPID plays and would like to see that continue. We see value in RAPID's role in regulatory decision-making being strengthened and would welcome RAPID taking on more devolved decision making where possible, in order to meet the stated aims of RAPID in helping to accelerate the delivery of essential improvements.
- We are highly supportive of this programme of work and will continue to engage in through the new working group structure, bringing learning from our AMP7 experience of DPC and our longer track record of delivering major infrastructure projects.
- Specifically, with respect to contractual structures and risk allocation, it will be important to take learning from current experiences on DPC schemes, and particularly on ensuring alignment across regulators with respect to managing water quality risks.
- There is a significant potential to deliver additional public and private value through the delivery of the SROs and we very much welcome the positive progress on multi-sector legal and commercial frameworks that the CEPA work has delivered. However, there is further to go to establish a common reference framework for defining best value. Customers and investors (through green finance) are setting clear expectations around the additional value major investments should deliver for both the environment and wider society. Specifically what is considered best value for water company customers and the environment, and gaining agreement on point at which additional public or private funding streams are required over and above water company customer funding, will be critically important.
- It will be important to ensure the commercial arrangements put in place for the SROs accurately reflect the wider consenting process. Water UK is currently working closely with government on a review of the DCO process. RAPID needs to ensure this programme of work incorporates the findings from that review.
- The scale of the challenge in overcoming the environmental barriers should not be



underestimated. Specifically, the proposed changes to abstraction licensing which would see a move to EPR and a 6-year review period for abstraction licences presents a potential major barrier to securing long term investment in major water resources schemes.

- We welcome the acknowledgement that securing investment is key, and the overall balance of risk and return for investors in the sector must be right if this is to be achieved.
- Finally, as this programme of work continues, we would welcome more detailed thinking and discussions on the treatment of SROs in the price review process including: the timeliness and allocation of funding between parties, the regulatory treatment of new solutions, and potential revisions to the price control period (i.e. a 10 year price control) reflecting the long term nature and scale of the investment. We would also stress the importance of early and continued alignment across the regulators to avoid divergence later in the process which could create unnecessary risk and uncertainty in the deliver programmes.

Our detailed response to the questions in the consultation is appended to this letter.

Yours faithfully

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Head of Future Resources Strategy

Chapter 2.1 Planning for long term outcomes/ Best value/aligning incentives

(a) Are there other barriers and challenges to best value planning that have not already been identified in the May consultation on PR24 or that apply differently to the types of solutions being considered by RAPID? What needs to be done to address these issues?

The regional planning process and associated WRMP statutory process is the primary basis for establishing long term best value water resources portfolios and establishing the need for promoting individual SROs.

We wholeheartedly support the development set out by Ofwat in its recent Long Term Delivery Strategy discussion paper of shifting the focus from business planning over a five-year window towards long-term plans and contextualisation of companies' business plans within a long-term delivery strategy. The move towards LTDS and best value planning, builds on our approach we set out in our Strategic Direction Statement in PR19, WRMP19 and how we are developing our WRMP24. We are committed to the concept of best value planning.

The ability to deliver both public and private value as an outcome of the SROs is particularly pertinent to the two reservoir systems being developed in the Anglian region, where there is significant opportunity and established strong partnership working approaches.

We value having a consistent view across the regulators on:

- a) the definition of best value and what water company customers should legitimately be expected to pay for beyond minimum least cost scope and;
- b) the alternative funding routes for delivering additional public value (e.g. biodiversity enhancement, flood mitigation).

There are two additional factors we consider to be barriers to best value planning in relation to the SROs:

- The uncertainty around the future availability of water in the environment i.e. potential changes to abstraction licences, the need for “no deterioration”, future environmental enhancement scenarios. These issues have created significant uncertainty about the availability of water for multi-sector trading, to realise multi-sector benefits (for example the role of abstraction in flood risk management), as well as for long-term security of investments. In addition, the proposed move to EPR and the associated 6 year review of licences could present a potentially significant barrier to investment.
- Another challenge is the lack of consideration of water quality in water resources management and planning. Water quality has become a serious constraint to abstraction and is limiting future options for the development of water resources. These constraints must be recognised by everyone in the sector, including regulators, because they are driving additional costs, higher carbon and customer acceptability concerns.

Chapter 2.2 Development activities /Other regulatory barriers to investability

(a) Should the option for a future gated process for new strategic resource solutions be kept open at this stage? If additional regulatory intervention is required, which is the preferred option proposed?

We recognise the step change in collaboration that RAPID has delivered both across the regulators and between the regulators and the wider industry. It is important the future regulatory model continues to build on this, and the benefits seen to date.

We agree that the option for a future gated process should be kept open and the decision should be made when the scale of future investment requirements is better understood. There will be value in continuing to collate feedback from the industry on lessons learnt as we move through the remaining gates in AMP7 to ensure the design of a future process addresses any improvements but importantly retains the value that the processes has and continues to deliver. One alternative model to consider is the regulatory oversight model for the Large Onshore Transmission Investments (LOTI), which has the flexibility to allow projects to come to market at different times thus removing some of the pressure on the market.

The alignment of the regional planning processes and planning processes will continue to be important for future periods. One concern, from a procurement perspective, for the current RAPID gated process is that all these schemes will come to market at a similar time, leading to bidders having to choose between different opportunities and ultimately weakening the competitiveness. Further flexibility in with respect to future gate timings would help mitigate this risk.

(b) Are there other approaches for procurement we should consider, or other pros and cons? Do you prefer one approach and if so what and why?

We support the continued flexible approach to procurement options, recognising a one size fits all model is not appropriate. We would welcome a discussion to establish an agreed view on which project characteristics are considered to make a SIPR approach more appropriate over a DPC approach and the associated detailed application of the approach in the context of the SROs.

SIPR was designed only for projects of a size and complexity that threaten an undertaker's ability to provide services for its customers and represents value for money. We are not clear whether Ofwat or RAPID's view of SIPR eligibility criteria has changed.

We would welcome further guidance on the minimum expected level of assessment and completion for each gate with respect to the value for money (VfM) analysis recognising that there are multiple options to be considered (i.e. not just DPC or inhouse), to ensure consistency and ability for RAPID to compare the analysis across the SROs. The VfM analysis to date has only been to compare DPC delivery (factual) vs in-house delivery (counterfactual). With multiple delivery routes this is more than a binary comparison. A further complexity is that these schemes could have various arrangements between the exporting and importing company(ies) with various trading arrangements. The resulting number of configurations increases exponentially when adding each new dimension. Guidance from RAPID would be helpful to ensure comparable and consistent VfM assessments from companies. Otherwise each company may take a varying approach with varying

levels of complexity, detail, options and analysis. We would support this being a focus area for the future working groups to explore.

A further point to note is that it would be helpful to understand how the RAPID submissions or process will integrate with the DPC control point process in particular when assessing the different options or when moving into construction.

Procurement options

The proposed flexible approach to different types of delivery models is something we would welcome. Up until now, it has mainly been the provider or supplier that has had control over the procurement of the asset, but it is not necessarily right that this way is always best. With significant water resource projects, identifying the appropriate vehicle should provide the optimum investment solution.

We agree that those procurement options set out are reasonable and consistent with the options we set out in our gate 1 submission.

We included a couple of additional considerations, which are not considered in the consultation document, outlining how these tender models could work in terms of packaging of projects into multi-procurements depending on revenue streams and how trading arrangements would support the funding of infrastructure.

A key consideration will be how to manage a multi appointee strategic solution where there is a supply agreement and potentially at least one additional water company involved. For example, you may have a situation where company A is signatory to the Competitively Appointed Provider Agreement (CAPA), has a Bulk Supply Agreement (BSA) with company B and company B holds the Allowed Revenue Direction (ARD) as they are the beneficiary. Not only do the current DPC arrangements not allow for that (as the company which enters in the CAPA must also have the ARD) but also the ARD and CAPA must be developed and negotiated together.

It would be helpful to receive further guidance from RAPID when considering multi appointee strategic solutions, on the point raised above and the further points below, such as:

- what would the appointee(s) role(s) be in a multi appointee solution;
- who would be allowed to partake in a SIPR or third party run procurement;
- who would run the tender process if it were a multi appointee solution;
- What additional contracts or arrangements are envisaged to be required as part of either a multi appointee SIPR or DPC

We welcome the upcoming guidance from Ofwat in respect to risk allocation on DPC projects. Consideration of how this will apply if a third party or a Joint Venture is part of the process and who may not be able to have any risk allocated to it, will be important.

(c) What is your view on the policy options set out (or any others) to incentivise water trading?

We are pleased to see a number of options under consideration for incentivising water trading. RAPID recognises the challenge of designing a system that addresses the challenges of complex long term trades, linked to the construction of significant new infrastructure and the challenge of incentivising both new and existing trades. Anglian, currently has no qualifying trades so no direct experience of the existing incentive mechanism.

Having long term certainty about the commercial implications for water trades will be key for:

- investment choices; and
- setting up the commercial, tender and regulatory arrangements for project delivery

The “new approach” appears reasonable. A one-off calculation provides certainty. The exporter’s customers are protected from volume risk which is instead borne by importer i.e. take or pay. On-going adjustments that optimise trading in future price reviews should be limited, otherwise such potential specification risks limit the incentive to adopt or deliver these kinds of solution.

The proposal that exporter’s incentive takes the form of a mark-up calibrated versus next-best-alternative potentially undermines the cost-reflectivity of the trade and means that water becomes a regionalised commodity (rather than a national resource), with customers of companies with a surplus benefitting at the expense of customers of companies with a deficit. The wider socio-economic considerations of such a policy need to be evaluated in terms of the impact on where housing growth is to be focused/targeted. It also risks making the choice of a trading option more marginal compared to the next-best-alternative.

The other factor that will need consideration is how incentives work when the exporting company does not own or operate the asset.

We agree that regulation may provide “potential missing or misaligned incentives to drive the correct behaviours and outcomes”. For example, RAPID identifies that if rights are considered interruptible during times of system stress, recipients of the water cannot rely upon its availability when needed, and that this acts as a disincentive to shared resource development and transfers. The difficulty is that the regulatory financial consequences of an interruption to supply on the supplier’s network can be of such magnitude that it drives risk-averse behaviour. That behaviour may be not to proceed with the collaboration at all, or more subtly in its approach to the consequent allocation of water or the pricing structure, in both cases in the consequent supply agreement. The proposal to allow companies to retain some of the savings made through water trades may mitigate these fears to an extent.

(d) How should we incentivise companies to deliver the optimum solutions whilst securing investment and in particular on how they support best value outcomes, including any differences for alternative procurement models or multi-sector projects? What incentives should be applied to assets where there may be low utilisation and how should stranding risk of strategic water resource options be managed?

It will be important to bring in learning from the DPC projects in AMP7 in designing a system which effectively apportions risks between the appointee and investors. A key consideration in incentivising companies to deliver the optimum solutions is the balance of risk between the parties. In our experience on Middlegate, Ofwat have not yet found a balance for projects being delivered via DPC as it exposes appointees to risk with no commensurate return – ultimately skewing the risk and return balance. The impact would be much greater on the SROs, for the Anglian Water reservoirs, as they are significantly higher value projects.

RAPID also mentions an incentive to companies to continue to optimise how their assets are used but do not consider the balance between a flexible overall system where companies can pick and choose water supply options vs DPC which sets contractual arrangements in stone for ~25 years.

We welcome the concepts presented in the CEPA multi-sector study and recognise the added complexity of effectively allocating risk across multi-party contracts. A benefit of multi-sector assets is that they have the potential to reduce under-utilised/stranded asset risk but this would require a pre-agreed utilisation regime to be implemented during times of water/drought conditions (e.g. prioritisation at the extreme – for example of essential public water supply provision ahead of, say, agricultural irrigation?).

(e) Does the pathway for resolution of environmental barriers meet the requirements of stakeholders and are there other environmental barriers that need to be considered?

We welcome the development of the environmental regulatory risk assessment and associated action plan and timetable and the pathways for resolution appear appropriate. It will be important to keep the timetable and actions under close review and for the outcomes of the actions to be communicated back through the RAPID and All Company Working Group communities in addition to the direct discussions that are ongoing on specific SROs and with companies outside of the SRO process.

In terms of other environmental barriers that need to be considered, consideration might usefully be given to the ‘land take’ required to develop environmental or social benefits that may not be core to the delivery of the core public water supply project, but might deliver wider public value or other multi-sector aspirations or opportunities (e.g. flood alleviation, wetland development or open channel transfers). The limited application of compulsory acquisition powers under the Development Consent Order Process risks constraining the potential wider public and private value that could be delivered in conjunction with the core public water supply benefits.

Appointees have powers under their licences to purchase land, access land for transfer construction and maintenance which cannot be delegated easily to the CAP. This requires the incumbent to continue undertaking some role and exposes it to some risk which under the existing DPC arrangements it is not remunerated for.

We welcome the proposed development of a principles framework for mitigating water acceptability issues and look forward to reviewing the outputs of the DWI / CCW water recycling study.

Chapter 2.3 Construction/ Risk allocation between partners

(a) What is the best approach for ensuring regulatory oversight for RAPID solutions beyond gate 5 into the delivery phase?

We continue to see the benefits of RAPID acting as a central facilitator for all regulators with a role in successful delivery and operation of the SROs and see there being an important, but evolved role for RAPID into the construction phase. We therefore support the “RAPID-lite” approach outlined as our preference of the three options, provided the benefits and scope of the regulatory role can be clearly justified.

We are pleased to see the proposed flexible approach to levels of regulatory oversight depending on the nature of individual solutions and the risk assessment after Gate 3 would be a sensible way to ensure the oversight is proportionate and adds value.

There is a trade-off between additional costs of monitoring and oversight and the need for additional regulatory engagement for projects which are complex or high risk (e.g. where there could be changes of scope and costs or where there are trigger points which could change scope and costs).

There may be benefits associated with having a forum for engagement with regulators on risks during construction depending on the nature of and risks implied by each project.

Ofwat refers to an oversight role 'to secure best value for customers'. Increased oversight could create additional exposure to ex-post regulatory discretion so we would like to see a clear ex-ante framework to determine scope for regulatory intervention.

That said, enhanced coordination would provide a robust thorough thought through approach from the extensive consultation and coordination resulting in an outcome that is better or more reflective of stakeholder requirements. RAPID lite would continue collaborative working across multiple partners and faster decision making compared to the other two options.

(b) What are the types of incentive and regulation that would result in appropriate allocation of risk between the parties and ensure the right trade-offs are made?

The starting point is allocating risk to the party being able to manage it in line with latest government guidance¹ around infrastructure delivery, in addition to providing ex-ante clarity on what and how the process will work and ensure financeability.

We note that each project regardless of size has implications for financeability i.e., it is important to think about projects and corresponding risks from an incentives and customer perspective on a standalone, project-specific basis.

Ofwat has highlighted that it is in the process of drafting a standardised note on risk allocation within the DPC framework.

It is important to have clarity ex-ante on allocation of risk, which may differ by project. We agree with Ofwat's principle that risks should be allocated to the party best able to manage it. And we also agree with the principle that risk allocation should be proportionate across companies and users. But it is also important that returns and pricing correspond to this risk allocation – and that risk and return allocation and calibration are considered in parallel.

We set out below a list of key considerations for the right framework.

¹ IPA (2021) [Transforming Infrastructure Performance: Roadmap to 2030](#)

- a. the underlying sources of business and regulatory risks which jointly determine overall cashflow risk associated with a given project, and (2) whether these risk factors should be priced into equity returns based on standard corporate finance principles.
- b. The primary risk implied by DPC / RAPID for the incumbent water company such as:
 - a. **Cost risk**, covering the underlying volatility in Totex risk, regulatory discretion risk and input price risk;
 - b. **Performance risk**, associated with objectives, outputs and licence requirements;
 - c. **Financing risk**, i.e., risk associated with uncertain market interest rates; and
 - d. **Regulatory risk**, including political and wider societal influences on regulatory judgments and application of its discretion
 - e. **Reputational Risk**, we are always accountable for our works, in the public eye. We cannot transfer this risk to the supply chain
 - f. **Market Reputational Risk** developed over many years, on a jointly incentivised, risk sharing model. Any damage to this reputation will have wider commercial impact.
 - g. **Cyber Security Risk** – The challenge of managing the risk to critical national infrastructure must be considered in the context of an integrated strategic networks.
- c. Classification of each of the identified risks into one (or more) of the following three categories which affect expected returns, based on standard corporate finance principles and theory
 - a. **Systematic risks**, typically priced through observed betas
 - b. **Asymmetric risks**, requiring adjustments to the cost of equity to compensate investors for downside risks that have an expected loss, which can be incorporated via an explicit uplift to the allowed return; and
 - c. **Real options**, the value to investors from holding the ‘real option’ of delaying investments in the presence of uncertainty, as is the case in the present context in light of lack of clarity around risk allocation which is not priced. Real options affect systematic risk exposure
- d. Pricing of any incentivisation which creates an asymmetric downside risk exposure unless solely reputational. There is not a rational investor that would take on a project where they are exposed to risk of loss, without being able to earn a corresponding upside return, as this would be a violation of the ‘fair bet’ principle in regulation.
- e. Finally, to the extent that incentives are also subject to regulatory discretion, this creates additional risks which would need to be adequately funded/or priced.

Chapter 2.4 Service delivery / Co-ordinated Operations

(a) What is your view on the areas identified for standardisation of contracts? Are there any other areas that should be considered?

We broadly agree that the contract standardisation is a good idea. It can provide investor confidence, creates recognised best-practice and reduces bidder costs by reducing bespoke contracts. The design principles work with ACWG is a good example. The balance between standardisations and flexibility to manage complexities and nuances for specific projects will be important.

The consultation jumps in to the more complex and detailed provisions for standardisation but first we should look to standardise the “boilerplate” clauses (e.g. severance, jurisdiction, ADR, FM).

RAPID’s emerging thinking on key areas for standardisation seems reasonable, but it should be subject to each company’s internal governance (such as restrictions placed on contracting by securitisation) so there ought to be an ability to move away from standard terms on those occasions or where the complexities/nuances of a particular scheme/project dictate a different approach.

Standardisation should not be seen as the production of a set of terms and conditions and left at that; it needs to be an ongoing process to ensure that lessons are learnt so we would recommend a review period is built in where the group review the terms and conditions at least annually and are updated when necessary.

With regards to standardisation in the DPC market we believe it is not mature enough to consider currently, we would want a few different types of DPC scheme to be completed and be operational before being able to agree standard DPC contracts. After a few schemes are up and running that would be the time to look at standardisation when some lessons can be learnt.

(b) Do you agree with the issues and options set out for the treatment of trades in future regulatory periods?

We recognise the need for further thinking and detail on the treatment of trades in future price reviews. The issues and options that are set out are reasonable but we would like to see RAPID go further in considering the treatment of the SROs in the round within price reviews, and not just the trading element. One option could be to have the SROs under a separate price control to other enhancement expenditure, similar to the treatment of Havant Thicket. It will be important that the treatment of costs within the price review process is flexible enough to manage different CAP / delivery arrangements and how trades and associated costs might be managed over the lifespan of those contracts.

(c) Do you agree with the options set out for charges associated with bulk supply agreements? Are there any other options that should be considered?

We agree with the regime of fixed and volumetric charges; and is akin to the “reservation” and “take” charging regime used for our current cost-sharing agreements with Affinity and Severn Trent.

However, careful consideration needs to be given to the liquidated damages for service outages etc. given the multiple reasons that a service outage could occur.

We welcome the reference to the consideration of new charging rules to govern bulk supplies between incumbents.

The options for consideration seem reasonable except to note two issues:

- cost reflectivity is an important consideration to ensure that charging is not disruptive in a contestable market, which may have implications - depending on the materiality/nature of the trade - for a regionally averaged “wholesale minus” approach; and
- how would new rules apply to existing bulk supply agreements between incumbents.

The comment “to the extent that revenues exceeded costs, they would benefit the customers of the exporter in the form of lower water bills” suggests some form of revenue control around bulk supplies. Currently an ex-ante view exists in the Price Review process as to the forecast of bulk supply revenue as a building block in the revenue requirement. The comment would suggest some form of e- post calculation.

(d) Do you agree with our next steps for the development of a fair shares approach for the allocation of water during drought and operational events?

In general, the “fair shares” approach seems sensible. However, there are some specific areas that require further consideration:

- The approach only really applies to an incumbent-incumbent trade; a DPC scheme that only supplies to one incumbent would be expected to perform under a “guaranteed rights” basis; further, in a multi-sector scenario, it would be expected that some sort of preference would be allocated to PWS supplies, consistent with the prioritisation of abstraction in dry weather / drought under the WRA and WIA.
- A “fair shares” agreement could be quite complex if it is to reflect differences between incumbents; for example the recipient may have a higher relative dependency on the import compared to other sources, it may have different levels of service or different historical investment in demand management measures; furthermore, in a drought the risks each incumbent are facing may be different. These are important practical, economic and political considerations that merit attention before an event.
- A “fair shares” agreement would also need to ensure that the exporting organisation had met its duties to properly maintain and service the relevant infrastructure, so that “operational events” were genuinely those that were beyond the reasonable expectations of the organisation.

(e) Do you agree with the proposed next steps for co-ordinated operations? Are there specific barriers to regional co-ordination that should be considered?

We support the progress RAPID has made in this area and agree co-ordination is essential. The co-ordination should reflect the specific geographical needs and be proportionate taking into account the complexity and integration of areas. There should be special consideration given to multi-sector coordination, especially given the different needs and approaches to managing water resources across different sectors. The role of regulation under co-ordinated operations needs to be considered; this should include *inter alia* licensing arrangements, compliance and flexibility

For smaller schemes we suggest one company is nominated to operate under SLA; for larger schemes you could create a water company JV, or CAP (under DPC). Under multi-sector asset, creation of expert CAP with SLAs in place.

Consideration should be given to some form of forum (if not already set up) for companies to set out their contractual, commercial, regulatory and procurement approaches to project delivery from an operational perspective to share learning. The companies developing these schemes are going to be at the forefront of their development. This could take the form of a working group under the existing All Company Working Group, or under the proposed new steering / working group arrangements led by RAPID.

A final observation regards Coordinated Operations – there is no mention of cyber security potentially the challenge of having/or managing integrated strategic networks. The management of the risk to critical national infrastructure is a must consideration going forward.

Chapter 2.5 Future Proofing

(a) How significantly might the optimal use of assets vary over their lifetime?

This depends somewhat on how “optimal” might be defined, for example in terms of the UK economy, the original PWS purpose, or in managing levels of service or drought resilience.

Assets with long lives, e.g. reservoirs, could see significant changes e.g. a switch to greater agricultural support under high levels of global warming later in the twenty-first century.

However, most assets, especially those with shorter lives, will be dominated by their originally intended purpose, in much the same way that older water resources assets are today.

(b) Over what timescale is it realistic to see a fully integrated water trading system at a regional level, with dozens of trades? How should these developments best be managed?

We support the proposed flexibility to allow the commercial arrangements to flex as the water resources systems evolve over the longer term. We are of the view that much wider changes to legislation would be required to deliver a fully integrated regional trading system as envisioned, and this may not be a priority in the context of other environmental and wider social issues. We would support a focus on sub-regional, catchment scale initiatives where there are already high levels of engagement from stakeholders and examples of innovative multi-party trading arrangements emerging in the East of England.

An example of this may include the Ruthamford-Ouse-Nene system, where WRE, Anglian Water, RWE and the Middle Level Commissioners have undertaken a pilot study and where some informal trading already occurs. Furthermore the Water for Tomorrow project (Rivers Trust, Environment Agency, WRE) in East Anglia is exploring new catchment system models for sharing water including governance.

(c) Are there any other circumstances where destination clauses would be appropriate?

It is important to note that abstraction licences effectively prescribe a destination clause, in that licences are related to a specific purpose such as PWS, energy generation or spray irrigation

Chapter 3 Next Steps

(a) We welcome views on our proposed next steps, including additional activities that we should be undertaking

Establishing the new steering and working group structure will be important for the future success of the programme. We have highlighted in our introduction a number of areas we would like to see further progress on and will reiterate just the key ones here:

- The development of a framework for best value planning that the regulators and water companies can all support;
- RAPID strengthening its ability to delivery alignment across the regulators by being able to demonstrate more autonomy; and
- The detail of the treatment of the SROs within price reviews.