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By email: rapid@ofwat.gov.uk

25th January 2022

Dear RAPID,

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

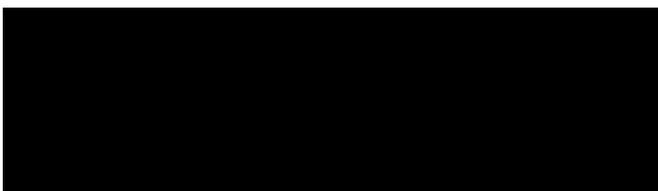
We welcome the opportunity to respond to this consultation and repeat our support from the previous RAPID consultations for the process on how the proposals have been developed, including through the Pricing, Incentives and Risk working group that I was pleased to contribute to. These proposals follow on from the June regulatory and commercial framework discussion document, which as this discussion paper noted was broadly supported by stakeholders, including ourselves.

We have focused our response to our view that we can deal with most of the issues through:

- a) Separating charges for water resources from the activities of an SRO that treat and distribute this water
- b) The pricing thoughts we developed as part of the RAPID pricing working group that identified how fair shares and splitting fixed and variable costs that can be observed can support the pricing and incentive issues identified.
- c) an ongoing role for RAPID to ensure the arrangements apply in practice through regulation, rather than relying solely on contractual and market incentive mechanisms.

We are currently commencing the Water Breakthrough Challenge project we are leading on with Binnies, RWE, Castle Water and University of the West of England. This pilot project will touch on some of the issues considered in this consultation, and therefore we would welcome an early opportunity to explore how we can work together to get the most value out of this exciting pilot project.

Yours faithfully,



Director of Strategy & Regulation



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Response to specific questions

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?

We have not identified any further barriers at this stage. We must assume that the planning process will identify the preferred projects and best value as a concept recognises there is a very long time frame and externalities for water resource projects that the water sector ultimately is responsible for, that are not just related to water resource planning.

Our only concern is that there are a number of overlapping economic regulation processes, including the need to identify adaptive planning trigger points as part of the recent development of the requirement for long-term delivery strategies. Some of this recent consultation implied that the core pathway would be least cost, rather than best value, which we do not believe was intended. Ultimately if the goal is to develop new water supplies as efficiently as possible and in parallel to reducing pressures on demand, then there will need to be sufficient regulatory certainty to minimise the cost of financing these projects.

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 believe that a gated process for new strategic resource solutions should remain open at this stage. It is clear that strategic resource solutions require regulatory support to deliver effectively and efficiently, rather than being left to being planned through market mechanisms or regulatory financial incentives. The risk of reliance on financial incentives may have the perverse incentive of discouraging strategic resource solutions.

The main issue with the existing gated process may be inadequate resources being assumed for scheme development, which ultimately could prove to be a false economy. We think that rather than a cap on development costs, a specific cost sharing rate (perhaps 75% customer: 25% company) may reflect the collaborative and long-term nature of strategic resource planning activity, particularly for early gates.

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?



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There may be an emerging option for multi-sector schemes, that could seek financing through the UK Infrastructure Bank. This could include public and private partnerships (e.g. local authority support for water resource developments given the educational, economic or recreational benefits). This may be a development of the third party option in the consultation which is not apparent to date.

We do not have a set preference for one model over another – as the consultation suggests we think this is case specific.

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

We agree with the pragmatic solution that there should be consistency of trading incentives between different delivery models. We are comfortable with Ofwat's existing trading policy but recognise as the consultation does that it may need to be applied differently for strategic resource schemes. Our view on pricing is that fixed costs should be reflected in fixed "fair shares" charges and separately identifiable variable costs as far as possible should be charged based on volume. Trading incentives can be built into both the fixed cost recovery (to incentivise utilisation) and on variable costs, most simply as a return uplift. This may be a set incentive uplift, rather than the calculated uplift based on the next best resource option that NERA proposed, which is unlikely to have good incentive properties where scheme choice is subject to regulated planning based on best value, not just total cost.

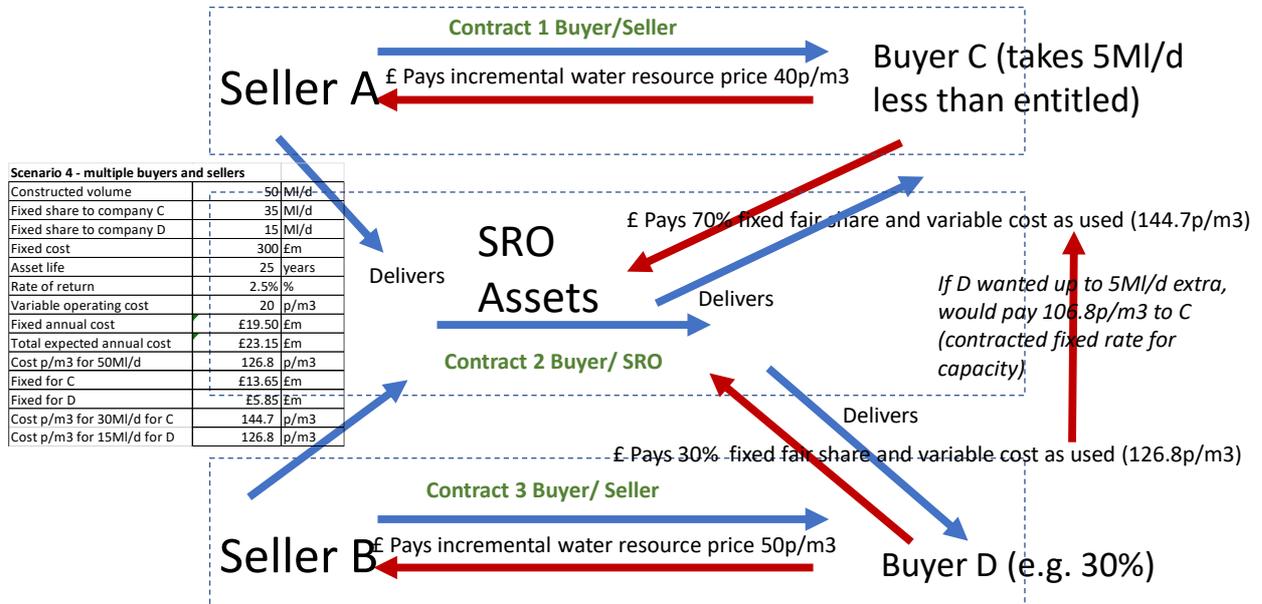
How should we incentivise companies to deliver the optimum solutions in particular how they would support best value outcomes, including any differences for alternative procurement models or multi-sector projects? What incentives should be applied to assets where there may be low utilisation and how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

In our view incentives on low utilisation strategic water resource options should be dealt with through a fair shares approach, and making a clear distinction between fixed and variable cost recovery. By focusing trading incentives on variable usage, this provides an approach to ensure that low utilisation projects have an incentive to be used. The fair shares approach where there can be trading agreed on the fixed share (ie where a company with a 20% share purchases 5% from other users, either trading with an individual user or on a pooled basis where there is shared ownership). An example of how we think these incentives could work that would avoid the risk of a stranded strategic resource option is illustrated below.



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Multiple separate buyers and sellers – C takes 5MI/d less than fair share



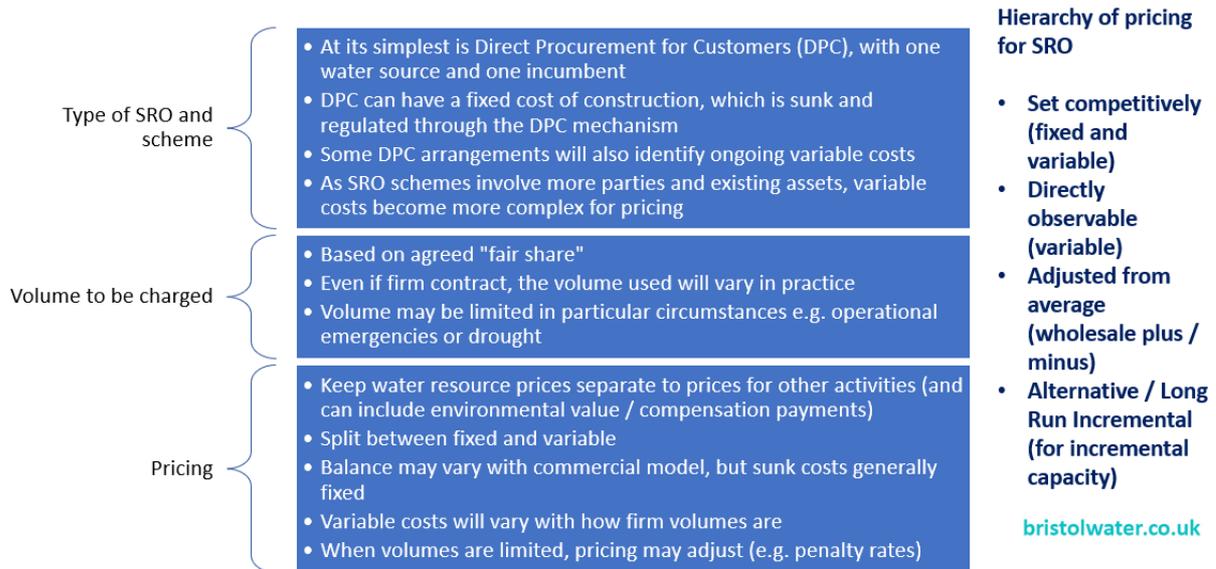
The principles developed here was there was a separate transaction for the water resource between buyer and seller from the Strategic Resource Operation (SRO) who was moving and treating water as necessary. This allows the incentives for water resource trading to be separate from the return and operation of the SRO itself.

Having reviewed the consultation, with the exception of use of existing networks for transit, the pricing principles we identified as part of the thinking for the RAPID pricing sub-group appear to remain relevant.



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Pricing for SROs



The bidding in approach / compensation payment in place at PR19 should still be able to operate – the potential for an alternative scheme to emerge that displaces the SRO in full or part should be available, but only at the marginal cost of water resources and variable cost of the remaining scheme, assuming a sunk fair shares approach to fixed scheme costs are taken.

However bilateral trades extend beyond this, to the other issue of access to existing distribution networks. This is an important access of introducing treated water so business retailers could supply to business customers, to provide greater margin to encourage water efficiency and also consider interruptible tariffs so more water was available at the peak. Such a project is being piloted with support of the Ofwat Water Breakthrough Challenge – the Flexible local supply systems project based on the multi-use abstraction licence owned by RWE at Didcot. This project will need Ofwat and RAPIDs engagement to identify the bulk pricing approach, with some initial work on the pricing options from other sectors commencing shortly.



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One solution could be to limit SRO risk from bidding in but allow for third party access, by allowing distribution costs at short run marginal cost to prevent entry being foreclosed. This would leave the incumbent with the incentive to find an alternative purchaser of their fixed cost fair share, which may include loss of their trading incentive element. This may be preferred to on-going resource use efficiency assessments, which ultimately would need the equivalent of a systems operator. All water resources will have resilience benefits but may not be tested until there is a drought – and all droughts are different. Placing risk on the usage of these assets may not be in the public interest.

In terms of project ownership, we do not believe this should be location based, and that a single lead owner should be mandated. There are assets (eg Purton TW) outside of areas of supply and reservoirs owned by different companies to where the bulk of the water is used (e.g. Elan Valley).

Does the pathway for resolution of environmental barriers meet the requirements of stakeholders and are there other environmental or water quality issues that need to be considered?

We believe water companies should follow a full Drinking Water Safety Plan approach, in assessing risks which include the successful operation of water quality issues that might arise from water trades. Generally environmental issues are dealt with through the abstraction licence approval and monitoring approach, and as part of Water Resource Management Planning.

These are topics which we will be considering through the Flexible water supply systems Water Breakthrough Challenge pilot project.

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

We believe that option 3, RAPID lite, is likely to be the best approach. The additional cost is likely to be minimal compared to the overall project cost. We agree that this should be considered at gate 3.

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?



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As we set out earlier, we think that risk is best management by separating the fixed construction cost of the SRO from the ongoing variable cost, and by keeping payments for water resources separate from distribution and treatment. This allows for visibility and a clear set of rules, potentially with a fast track route for issues to be resolved by parties where they can't be resolved between the parties.

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

We first provide views on the structure of contracts which was not a specific question in the consultation.

In our view the structure of contracts should be standardised to multi-party (as shown in figure 2) where the activities are separable from existing networks, and bilateral where the activity is incremental (eg a transit network). The distinction between the CAP arrangements for interconnectors and resource schemes then is not an issue if the separate transaction for water resources from the distribution and treatment activities was followed, as we suggest earlier.

We hope that standardisation in water quality expectations can evolve, but currently companies take a range of approaches to hazard assessment and monitoring for Drinking Water Safety Plans.

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

In our view as bulk supplies increase, particularly where there are shared assets, there is a case for bulk supply income and costs to be brought within the regulatory control, with only the trading incentive and water resource market bidding in adjustments being considered as outside of the price control. Accounting separation means that appropriate cost risk sharing and revenue adjustments could form part of the price control.

This option may depend on some of the other options set out in the consultation, and we have not had time to illustrate a worked example of the potential alternative options at this stage.

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



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We do not believe that option (3) as suggested by NERA of using LRAIC is likely to work in practice, as it would provide scope for dispute about schemes other than the one that is directly being observed (ie it relies on costing other schemes, not just the one concerned with the transaction). We think that option (1) will work for Strategic Resource Schemes where the fixed and variable cost can be separately identified and option (2) for the use of the existing network, perhaps in combination with (4) pricing principles for interconnections and transit networks. We show an illustration earlier in the consultation of how we believe option (1) could work in practice.

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?

We think a fair shares approach will need an arbitration process, which could be an ongoing role for RAPID. This will allow some flexibility in how the service level is defined, including some principles that allow the specific environmental and customer impact of a drought to be agreed. As the consultation sets out, we do not see s. 37 WIA91 as a barrier to bulk supplies. We have thought carefully whether contractual penalty clauses or other incentives are needed to support this in practice, but other than the standard pricing approach believe that transparency of the use of the resource and the reputational consequence of a dispute between parties may, with regulatory oversight, be the best approach.

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 do not feel able to comment at this stage without sight of the Baringa and Mott MacDonald report referred to in the consultation, which has yet to be published.

**How significantly might the optimal use of assets vary over their lifetime?
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?
Are there any other circumstances where destination clauses would be appropriate?**

We are of the view that even with multiple trades, water will remain a regulated market. We therefore assume that parties should be engaged in the market with the assumption that it will continue to be regulated. This is likely to minimise cost and risk for both investors and customers.



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We do not believe there are circumstances that warrant the use of destination clauses. The water quality and environmental clauses should be a feature of the regulation of the user – the DWI responsibilities extend that far and destination clauses can be a feature of abstraction licences (more often purpose clauses, or limitations in drought situations).

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

We agree with the proposed next steps. We would like to explore further with Ofwat and RAPID how we can obtain the maximum value out of the Flexible Water Supply Systems project we are leading on, and would suggest engagement on this project at an early stage to support this.