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RAPID: THE REGULATORY AND COMMERCIAL FRAMEWORK FOR STRATEGIC WATER RESOURCES

NWL Consultation Response

January 2022

Northumbrian Water response to RAPID: The regulatory and commercial framework for strategic water resource solutions – a consultation, December 2021

Northumbrian Water response to RAPID: The regulatory and commercial framework for strategic water resource solutions – a consultation, December 2021

Overview

We support the RAPID remit of facilitating the development of strategic resource options which deliver the best outcomes for customers, the environment and wider society now and in the future. We have not yet been involved with the RAPID gated process, but we welcome it as a helpful way of regulating what can be a complex and unpredictable process.

The work of RAPID includes the removal of barriers to water trading and the incentivisation of trading where it is beneficial to customers. As a company, we are both importers and exporters of water, so we are keen to continue to develop the regulatory and market mechanisms to support water trading. It is important that in doing so in-area resource development is considered on an equivalent basis to water trading and strategic solutions. The RAPID remit should not be narrowly interpreted and so ignore or introduce undue bias against in-area resource development, which has met growing customer demand to date and should not be discounted as an option. Instead, water trading and strategic resource options should be considered on a level playing field alongside the development of in-area resources.

Key principles

- Strategic resource options and water trading options should be undertaken where it is economically and environmentally rational to do so.
- They should be assessed on a level playing field with in-area resource development.
- Regulatory policy should thus be targeted at removing any regulatory distortions that prevent an optimal decision being reached.
- Incumbent customers should not subsidise water trading, instead, they should receive a share of the economic benefits of any trading.

All extracts in bold italics are from ‘The regulatory and commercial framework for strategic water resource solutions – a consultation’, RAPID, December 2021.

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

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 Ofwat PR24 consultation broadly supported the RAPID proposals in principle but did not address the more detailed proposals set out in this consultation, for example, in the exclusion of fixed sunk costs from base cost models. This will be an iterative process, so we encourage Ofwat to ensure that these specific RAPID proposals are built into the PR24 Price Review methodology.

We note the PR24 consultation suggested that bilateral markets will not come into consideration until after PR24. This is welcome and confirms that the emerging consensus over efficient procurement and sharing of strategic resources is far more likely to be successful for all stakeholders. We believe that it is critical for all parties to commit to a longer-term co-operative way of working that uses market mechanisms (bid assessment framework, DPC) and flexible, in-period regulation (RAPID gates).

2.2 Development activities/Other regulatory barriers to investability

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2.2.1 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?

NWL has not yet delivered a RAPID scheme and so our first experience of the process will be after 2025. If, following a review, the consensus is that the RAPID gated process has worked, it should be retained with appropriate streamlining.

One significant advantage of the RAPID gated process is that it is more flexible than a 'once in 5 years' Periodic Review Final Determination. It gives time and space for discussions outside the hectic and complex Periodic Review. Providing new strategic resources is becoming increasingly urgent but also necessarily complex and RAPID has proved itself the best way of delivering this to date.

2.2.2 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?

Extract: We see competitive tendering for delivery as being just as applicable to strategic water resource solutions as to a single water company project. We expect that, the major components of these projects that are sufficiently large and separable will be procured by DPC

We agree that competitive tendering is just as applicable for strategic water resource solutions as for single water company projects. Indeed, one of the drivers for strategic water resources is likely to be the economies of scale that would be delivered through collaboration.

Whilst we agree that DPC for large projects should be considered, we note that the PR19 DPC projects have yet to be delivered and appraised. It is in the interest of customers to retain the option of non-DPC delivery should the costs become prohibitive. This is consistent with the more flexible approach as set out by RAPID below:

Extract: Having considered these alternatives, we do not see a particular requirement for the same approach to be taken for all solutions. We therefore propose that the strategic water resource solutions should develop their own proposals for which approach should be taken and expect sponsors to demonstrate why a particular procurement model represents best value based on the nature of the individual solution, considering the implications for risk allocation and management. This flexibility was supported by respondents to our June discussion document.

We agree with this statement, which contradicts the earlier statement on DPC being the expected approach. To ensure the best outcome for customers, Ofwat should not prescribe the procurement approach but rather require companies to explain why their approach represented best value.

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

It is important to start with an assumption that a successful water trade creates economic value, through additional income (exporter) and avoided costs (importer). In an unregulated market, this would be sufficient to allow trading and no further incentives would be required.

Regulatory incentives are required though as, at present, the regulatory process captures both the additional revenue and the lower costs due to the trade. To retain an incentive for the trading companies Ofwat and NERA have devised various mechanisms to share profits between customers and companies.

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One key area identified in the consultation is that, for an incentive to work, companies require confidence that it will be applied before construction begins or a trading arrangement is agreed. We support the Havant Thicket approach of an incentive being agreed by Ofwat in advance (under reasonable conditions). This is a significant improvement on the current regime, where companies only find out if Ofwat will allow an incentive several years after trading.

We favour a sharing mechanism that is transparent, flexible and predictable. The 50:50 profit sharing mechanism that Ofwat use for sharing profits on land sales is a tested mechanism that has applied unchanged since privatisation. This would ensure that the incentive flexed according to the scale and profitability of each trade, whilst ensuring that both customers and companies shared in the risk and return on the trades and had sufficient incentives to pursue them. Indeed, this mirrors the cost sharing mechanism that Ofwat currently uses for Periodic Reviews.

We appreciate that NERA and others propose variants of this approach. Whilst they may have the same outcomes, they do not identify the level of mark-up on the trades, whether this would be prescribed or negotiated and how any sharing of this mark-up with customer would be carried out.

The consultation suggests exporter customers should be protected from volume risk. We agree this is desirable but should be addressed through the contractual terms rather than through incentive design. It is preferable that trading parties set their own operational trading incentives in a contract rather than having them imposed on them through a regulator.

2.2.4 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?

Extract: As noted in section 2.1 above, we also note that water companies may face incentives to plan for more investment than is needed (to secure increased allowances and hence revenue through the price control)

We do not agree that there is an incentive to plan for excessive investment. If the cost of capital is set correctly, additional investment is profit neutral. In practice, increases in the RCV from enhancement investment are usually matched by increases in the debt required to finance them, leaving regulatory equity unchanged. Increased revenue is offset by increased operating, depreciation and interest costs, leaving the investment profit neutral (as is designed by Ofwat's building block approach to revenue setting).

We agree that it must be recognised that water resources may be required for resilience purposes (eg the 1 in 500 year drought scenario) and thus may not be utilised in full. This is not an indication of inefficiency or that an incorrect investment decision was made and should not be penalised in any way. We agree with the statement that '[...] at a minimum, it would be helpful to clarify that the relevant test [for water resource requirement] is the resilience standard that companies are required to apply and not the out-turn utilisation in a particular year.'

We agree that the *current policy for DPC provides investors with confidence of cost recovery for the development and delivery of a project*. This policy should logically extend to all investment models (eg

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RCV based ones), to ensure that, as the paper notes, *it would appear better to seek to avoid unintended biases and ensure that companies were agnostic to the delivery model being selected*¹.

The key principle is that regulatory assessment should not be done with the benefit of hindsight, but recognise that the key decisions were based on the best information available at the time. As the paper notes, we agree there should always be incentives for companies *to optimise how their assets are used and minimise the risk of stranding assets/scenarios of low utilisation, which may include reallocation of resources to better balance supply and demand and could even go to investigating new trades*. However, this should be limited to future decisions that recognise the sunk costs of past investments. We therefore do not consider that a retrospective incentive that penalises companies for making investments that were demonstrated to be necessary to manage risk at the point of investment would be constructive or appropriate. Instead, we consider that this risk is best managed by ensuring that there is effective scrutiny of proposals in the lead up to the investment being made. Risk management could be further supported by encouraging the consideration of real options that enable investment decisions to be made incrementally following an adaptive pathway, as discussed in 'PR24 and beyond: Long-term delivery strategies and common reference scenario', Ofwat, November 2021, p.13-19.

We further agree with the statement that *'In general, we would not expect public water supply customers to carry risk for other sectors unless they are fully compensated for this'*. Water customers should neither subsidise nor be subsidised by other sectors in the usage of multi-sector assets or contracts.

We agree that the policy aims of providing incentives for best value and assurance to investors of recovery of efficient costs are the two balancing principles that will protect customers and incentivise investment. If these are built into obligations and contractual commitments, they should incentivise optimal investment solutions.

2.2.5 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 support the work of the Environmental Regulations task and finish group.

We note and welcome the DWI / CC Water review of the public perception of water recycling for drinking water use. We have an established water recycling scheme in Essex (Langford recycling) that has been accepted by all stakeholders as an important component of water resourcing.

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Table 1

Risk to solution delivery*	Policy/position	Action	By when/who**
 <p>High</p> <p>Low</p>	Water transfers that may impact upon a Habitats Directive site	New advice note confirming role of Regional Groups in safeguarding water for European sites now and in the future. Position on functional linkage of land.	Early 2022 (Natural England/Natural Resources Wales)
	Exemption to meeting RBMP objectives	Develop technical criteria required to meet Regulation 19 tests	Spring 2022 (Environment Agency)
	Approach to capping abstraction licence quantities	Develop new position to clarify approach	November/December 2021 (Environment Agency)
	Requirements of specific Welsh regulations	No changes proposed	n/a
	INNS position statement	No significant changes proposed. Clarification that Regulation 19 cannot be applied to impacts caused by INNS	December 2021 (Environment Agency)
	No transfers that would place a water resource zone in supply deficit	No changes proposed	n/a
	Reserving water for future use	New approach proposed	December 2022 (Environment Agency)
	Augmentation to mitigate abstraction impacts is deemed unsustainable	No significant changes proposed. Clarify position in existing ground water protection position statements.	December 2022 (Environment Agency)

*From solution developers' perspective. ** Note: Most actions only apply to England. NRW indicates when they also apply to Wales.

It is also important that when assessing options, their impacts on wider environmental outcomes such as impacts on the natural environment including biodiversity, net zero, catchment resilience and amenity, access and engagement – as discussed in the 'Water industry national environment programme (WINEP) methodology, Environment Agency, December 2021 (unpublished) p.13-14 – are considered.² These wider impacts should be assessed on a consistent basis across all aspects of the regulatory framework including when considering the relative benefits of water trading, strategic solutions and in-area water resource options.

2.3 Construction/Risk allocation between partners

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

As we do not have any RAPID schemes in the PR19 determination, we are less able than other companies to comment on this directly.

The options appear to be around the level of regulatory oversight of investment delivery. As a broad principle, we can see a role for RAPID in reviewing the progress of the schemes and in intervening where requested in agreeing the regulatory mechanisms that will apply to the schemes. The delivery

² See also '[Draft water industry national environment programme \(WINEP\) methodology](#)' (Environment Agency, Defra, Ofwat, July 2021, p.20-21)

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of these schemes under this approach should be recognised as a learning process for all parties, and so will require interaction and discussions even after delivery has commenced.

We acknowledge that this level of involvement by RAPID may be beyond its current remit and resources, so we would support a proportionate increase in resources should this be agreed necessary.

We agree that a proportionate approach to oversight should be taken, based on the scale of investment and the complexity and risks involved. We agree that this should be assessed at Gate 3 once these factors are clarified.

2.3.2 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?

Extract: We therefore propose that regulatory intervention is needed to design appropriate incentives and ensure that the balance of power is equal and ensure one company doesn't have leverage over the other company to force it to take more risk than it might ordinarily (yellow lines). We also expect to check transfer of risk to customers etc (blue and green lines) as companies may not have incentives to agree fair allocation between different sets of users. We explain in a later section the advantages of standardisation and how it may help with the allocation of risks and ensuring best value outcomes are achieved.

It is important to compare the risk profile of these contracts to the risk profile of the current regulatory regime. For example, due to the revenue cap, the majority of volume risk to revenue in the PR19 determination is allocated to customers (with some volumetric cost risks retained by companies).

Any decision to amend the risk profile to transfer more to companies for example, will require commensurately higher returns. This will be clear in the DPC discussions as the DPC providers will be requiring higher returns for higher contract risks as they occur (or allocation of volume risk to bulk supply importers).

Whilst we agree that, in principle, risk should rest with the party most able to understand and manage it, it must be noted that these allocations will have a commensurate impact on the returns required by investors and are unlikely to relate to the regulatory cost of capital identified as part of PR19 for example.

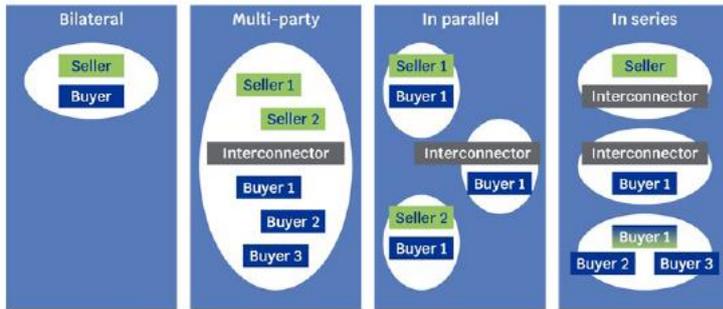
2.4 Service delivery / Coordinated Operations

2.4.1-2 What is your view on the areas identified for standardisation of contracts? Are there any other areas that should be considered?

We have no fixed views on the options for contract structure as set out in figure 2 of the consultation as each of them may have merits depending upon the parties involved and their preferences for control. Indeed, we believe that regulatory policy should be agnostic over these options, leaving the design up to the parties involved. Ideally, regulatory policy would treat all contract structures on an equal basis.

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Figure 2. Options for contract structure



We agree that standard contractual terms on defining rights to service, operating protocols, payment terms, termination provisions, non-delivery provisions and drinking water quality protocols would be very helpful in minimising duplication and transaction costs.

These standard terms should be seen as a helpful guide rather than a requirement however. If all parties agree, then these terms could be varied in a bespoke way.

We do agree that standardising the terminology and structure of contracts will be very helpful to all parties and we support it.

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

Extract: While the sunk costs associated with a trade are already reported on an ongoing basis for the exporter, it may also be proportionate to do so for the importer. **In a price review, for the importer these sunk costs could then be funded similarly to its own sunk enhancement expenditure. This is distinct from the current approach where all the importer's bulk supply charges are funded as base costs.** Separate reporting and funding of enhancement costs would be passed straight through and is consistent with the approach developed for Havant Thicket and has parallels with DPC arrangements.

We welcome this proposal, it addresses the cost assessment disincentive that we identified in our previous submission³. To be precise, to match the importer bulk supply charges to the sunk enhancement expenditure, the bulk supply charge would need to be split between upfront costs (typically capital) and ongoing operating costs (typically opex). The former would represent the annualised enhancement costs that are not part of base costs, the latter would remain as base costs.

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

Extract:(1) fixed and volumetric charges, consistent with the approach for DPC described above
(2) charges calculated with reference to companies' published wholesale charges but adjusted for specific differences in cost (**wholesale minus**). This is the approach used in bulk supply charges for new appointee (**NAV**) water companies
(3) charges set to reflect long run average incremental costs (**LRAIC**), as recommended by NERA, or
(4) requirements take the form of principles. This is the approach that Ofwat uses for some other key water company charges

³ Northumbrian Water response to RAPID regulatory and commercial framework discussion document: July 2021

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. We are however wary about extending this approach to bulk supply pricing more generally, as the calculation of avoided costs has proved complex. NAVs also have the ability to flex their charges to their customers to cover the incumbent bulk supply charges, thus limiting their risk, which would be more difficult for bulk supply importers.

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 (LRAIC) approach would seem appropriate. This is consistent with the approach taken for assessing the economic value of the resource options.

Fixed and Variable Charging

We support the principles of fixed and variable charges. The fixed charges should represent the fixed costs of the solution, which we would expect to be primarily the sunk costs of construction. There may need to be three charges components – fixed capital cost recovery, fixed operating costs (such as business rates, legal and administration costs) and variable volumetric costs (ie they would be zero if no water was taken). Maintenance costs would also need to be recovered, probably as part of fixed capital costs.

We have found it helpful to refer to the fixed charge as a reservation charge. This matches the contractual allocation of the resource to the payment required. Reserving capacity is an opportunity cost for the provider and should be reflected in the charging arrangements.

2.4.5 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 agree that a fair shares approach is an important one to ensure there is no risk of bias towards in-area resources. Our current bulk trading contracts include 'fair share' clauses in the event of drought and operational events. It would be helpful for the industry to draw up 'standard' fair shares contract terms that would provide a starting point for specific bespoke contractual negotiations.

2.4.6 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 work ongoing on co-ordinated operations and we look forward to commenting on the report in early 2022. We presume it will be presented as a consultation with proposals and options set out. Resourcing of both RAPID and the Water Resource Regional Groups continues to be a barrier. In their PR19 Final Determination, Ofwat disallowed a request for a small amount of funding of the Water Resource North Group, citing the lack of specific solutions for 2020-25. We believe this was a

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short-term approach as the funding would have allowed an early start on additional work on solutions for beyond 2025.

In their representations, NES.DD.CA12 and YKY.DD.CA13, Northumbrian Water and Yorkshire Water request £0.583m enhancement expenditure to contribute to Water Resources North strategic studies. We consider that the activities relating to regional water resource planning identified by the companies in this component are adequately funded through the base allowance. No specific solutions are identified that would pass through the associated gated process with the aim of being construction ready in 2020-25. The companies have not demonstrated any unique or company specific circumstances that justify an allowance for this component.⁴

2.5 Future Proofing 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?

We agree that it is too early to seek to impose a multilateral model and we are not convinced that such a model will ever be required. For example, water companies currently have their own regional tariffs and special agreements set for their customers, with no requirement or expectation that these are integrated with other regions. There is no reason for all bulk supplies to be priced in the same way for example.

The main constraint on water supply in the future is likely to be the availability of water resources in aggregate, not just the ability to distribute it across or between regions. For example, the whole of the Water Resources South and East regions are water stressed, and every company in those regions seems likely to have a supply deficit in their forthcoming WRMP, making trading through regional transfers reliant on increasing aggregate resource development (with associated trading arrangements and connections for strategic resources).

For larger water resource zones, it may be that a small number of larger connections can still facilitate regular trading, as the flow can be turned up or down within the physical capacity of the pipe. As an example, our most recent water trade with Thames was delivered through this offset approach. We used an existing connecting main and relied on the interconnections and displacement within the single Essex Resource zone to minimise the costs of effectively ‘connecting’ Abberton reservoir to London (approx. 40 miles apart) to deliver the supply.

It may be that, as new strategic resources are built ‘out of area’ that trades to use this water will increase over time. These trades will be contractually based and are likely to be long term in nature. Water companies are ‘forced buyers’ of water resources (they have statutory obligation to constantly supply customers). As such, they will wish to procure reliable sources of water over the long term and are unlikely to wish to rely on a short-term market. As such, we do not see the need for a system operator at this stage.

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

We agree that destination clauses seem unnecessary, once water is traded, the seller should have no interest or involvement in how the water is used or re-traded.

⁴ Ofwat PR19 Strategic Regional Water Resource solutions model, deep dive

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