

RAPID consultation on the regulatory and commercial framework for strategic water resource solutions

Severn Trent Water response

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Executive summary

We welcome the opportunity to comment on RAPID's policy options for the regulatory and commercial framework for strategic resource options (SROs). We support RAPID's vision of resilient, timely, high-quality, environmentally-beneficial water resources which are acceptable and affordable for customers.

The purpose of RAPID is to enable the provision of sufficient water resources for England and Wales in the long term. As a result the sector might need to develop several competing options at the same time in case some do not reach completion, which might be due to planning decisions. The regulatory and commercial framework needs to take account of this.

Our main points on the consultation are:

- We support continuing with the current SRO process and suggest extending it to include a third "decelerated" group of schemes, which would need RAPID to continue. We consider that because some SROs schemes will be large and complex there is a case for ongoing regulatory support.
- We support giving companies and investors more certainty in advance about whether water trading incentives will apply to particular SROs. It is worth being aware that in their water resources planning, water companies are effectively assuming there will be water trading incentives for the exporter equal to 50% of the difference between the average incremental cost (AIC) of the SRO scheme and the AIC of the exporter's next best option.
- We suggest RAPID should be cautious about policy options aimed at optimising the use of SROs during their asset lives in case they have the unintended consequence of having a chilling effect on investment in SROs. However, we consider it is worth investigating options for selling water to a secondary buyer when the primary buyer is not taking it.
- We support the programme of work to review aspects of the environmental regulatory framework to improve clarity and understanding. We would welcome more information on environmental requirements to inform Gate 2 of the SRO process.
- On charging we can see that Option 4, using principles rather than a methodology for setting charges, appears most consistent with the current approach to bulk supply agreements. Option 1, variable and fixed costs, seems the most appropriate for SROs. For information, we and the other companies are assuming scheme prices at the AIC of the seller's next best option in our water resources management plans (WRMPs). This is because we are consulting on our WRMPs in the autumn and need to make an assumption about pricing while the commercial framework process has not yet reached a view.
- We support RAPID developing a more detailed framework for the fair shares approach and looking at mitigations for the drawbacks the sector has identified, such as how we handle the different levels of service customers have paid for in different companies' areas.
- In terms of next steps, we would welcome some clarity on when RAPID will be able to consult on more precise guidance on the regulatory and commercial framework for SROs, given that water companies will be consulting on their draft WRMPs in the autumn.

We do not consider any of the information in this response to be commercially confidential.

Responses to the consultation questions

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

- Section 2.1 Q1 - 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 consider RAPID has identified the main barriers and challenges to best value planning through the reports commissioned, the working groups and the consultations. RAPID has identified having workable approaches for dealing with enhancement costs associated with trading at PR24 as being a key issue.

We consider there are strong benefits of the SRO process in addition to the PR24 process. The SRO process is leading to long-term collaboration between companies and regulators across multiple asset management periods (AMPs) to help deliver resilient water resources for England and Wales. The SRO process is a key mechanism for delivering PR24's focus on the long term.

2.2 Development activities / Other regulatory barriers to investability

- Section 2.2 Q1 - 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 consider that the gated process for SROs has worked well so far. We think it is wise to keep open the gated process for future SROs that are not covered by PR24. The drivers for major national infrastructure improvements, including more SROs look likely to remain in place for many years.

We can see that financial incentives with less regulatory oversight is an alternative option that might work eventually as we learn more from the existing process. However, because some SRO schemes will be large and complex there is a case for ongoing regulatory support.

- Section 2.2 Q2 - 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?

RAPID discusses options for who should competitively tender the solutions. We favour the importing / beneficiary company carrying out the competitive tender because, as the consultation say, they have the most at stake in securing the best outcome. This option also appears to be less complicated from a regulatory perspective than using a joint venture, third party or hybrid option.

However, we recognise that in particular cases some stakeholders might prefer an independent party to carry out the competitive tender, so we support RAPID's approach of not ruling out specific options to allow for the best outcome for customers and the environment in each case.

- Section 2.2 Q3 - What is your view on the policy options set out (or any others) to incentivise water trading?

We support water trading incentives to encourage cross-border trades, including SROs, where they benefit customers and meet all regulatory requirements. We support Ofwat's current view that it is likely to retain water trading incentives as part of PR24.

We should remember the purpose of RAPID is to enable the provision of sufficient water resources for England and Wales in the long term. As a result, there might be a need for incentives for competing

options at the same time, even for those that do not reach completion, which might be due to planning decisions.

It is worth being aware that in their water resources planning, water companies are effectively assuming there will be water trading incentives for the exporter equal to 50% of the difference between the AIC of the SRO scheme and the AIC of the exporter's next best option. The other 50% goes to the exporter's customers. This is because companies need to consult on their WRMPs in the autumn and there is no decision on water trading incentives yet.

Our comments on the policy options in the consultation are:

- We support Ofwat confirming to companies whether the water trading incentives will apply to specific bulk supplies in advance. This would provide companies with more certainty and would increase the power of the incentives to encourage companies to take forward water trades.
 - If Ofwat moves to assessing whether the water trading incentives apply in advance we can see a good case for removing the requirement for Ofwat-approved trading and procurement codes, which would reduce the administrative burden for all parties.
 - We can see advantages from some front-loading of the water trading incentives in the contract period to encourage current management teams to enter into a long-term bulk supply agreement.
 - NERA's idea of the exporter incentive taking the form of a mark-up on the costs of the trade seems worth considering further, even if the calculation of the mark-up might be complex.
 - We recognise there can be benefits from the ongoing optimising of trading to manage volume risk. The consultation suggests that adjustments could be made to the trading incentives at each price review for this. To avoid creating too much uncertainty and discouraging further trades it will be important, as the consultation says, to put clear limits on the extent to which the trading incentives could be re-specified at each price review.
- Section 2.2 Q4 - 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?

We are concerned that RAPID seems to be moving away from the principle in its June 2021 consultation document that:

“We think in principle [exporting] companies should have a similar level of confidence about the recovery of these costs as if they were developing the resource entirely for their own customers.”

We recognise that water resource assets have long lives and there is a case for optimising how they are used and minimising the risk of stranded assets or scenarios of low utilisation. This could be done by mutually-agreed amendments to the bulk supply agreements, allowing the companies involved to retain confidence over the recovery of their costs. We consider it is also worth investigating options for selling water to a secondary buyer when the primary buyer is not taking it.

- Section 2.2 Q5 - 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 programme of work to review aspects of the regulatory framework, which the Environmental Regulations task and finish group has identified. This should improve clarity, understanding and enhance opportunities to deliver RAPID solutions whilst maintaining existing environmental protections and ambition. However, we are concerned that the outcome of this work might be too late to inform companies' submissions at Gate 2 of the SRO process.

Our experience is that environmental requirements can have a considerable impact on SRO scheme costs. In addition, changes in environmental standards can affect whether an SRO remains the best option for customers. Unknown future environmental changes, such as changes in abstraction licence conditions, can create considerable risk for potential third-party investors in SROs as well as water companies.

In relation to drinking water quality standards, we welcome that RAPID and DWI plan to develop a principles framework that sets out how water companies can mitigate water acceptability issues that might result from water trades.

2.3 Construction/ Risk allocation between partners

- Section 2.3 Q1 - What is the best approach for ensuring regulatory oversight for RAPID solutions beyond gate 5 into the delivery phase?

We can see a case for continued closer coordination between the RAPID regulators, whether through a continuation of RAPID or more informally.

We agree with the consultation that the regulatory support required will vary by the complexity and procurement strategy for an SRO. The SRO process is new and some infrastructure is likely to go through the new DPC route, with a new CAP (competitively appointed provider). As a result we can see more of a role for continued regulatory support for some SROs than would be the case for a single company, experienced in the water regulatory framework, constructing its own assets. As the consultation mentions regulatory support with securing planning and environmental permits would be helpful to progress SRO schemes.

As the consultation says, RAPID does not have to take the decision now about how the regulators will organise themselves in future, but can refine its thoughts as the SROs go through further gates.

- Section 2.3 Q2 - 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?

We consider the consultation has identified the main parties affected by the risk allocation in the diagram on page 29, although it would become more complicated with more companies (and their customers) involved and a CAP. It is worth being aware that the exporting company and its customers have aligned interests to some extent in that both would prefer to take on less risk, and the same is true of the importing company and its customers.

We look forward to seeing Ofwat's DPC guidance document in early 2022 and its proposals on standardisation. For DPC to work well for customers investors will need reassurance about a long-term regulatory commitment to SROs, a pipeline of projects, and the risks associated with the rates of return. We expect DPC investors will want more clarity regarding the regulatory framework for SROs than is available at present.

We are not sure that more regulatory intervention is needed to ensure the balance of power is equal between water companies (when they are appointed undertakers) given that there are existing rules

to refer disagreements to Ofwat. Companies can ask Ofwat under sections 40 and 40A of the Water Industry Act 1991 (WIA91) to determine some or all of the contractual terms of a bulk supply if they cannot reach agreement.

2.4 Service delivery / Coordinated Operations

- Section 2.4 Q1 - What is your view on the areas identified for standardisation of contracts? Are there any other areas that should be considered?

We recognise the benefits of standardising contracts such as reducing transaction costs and sharing best practice. The key issue is that current SROs are very varied in nature and the standardised contracts terms should not be so prescriptive as to prevent water undertakers from tailoring contracts to the specific circumstances of their SROs.

- Section 2.4 Q2 - Do you agree with the issues and options set out for the treatment of trades in future regulatory periods?

We consider the consultation's proposal about removing any profit over and above the water trading incentive from the exporter and giving it to the exporter's customers might damage cost reduction incentives. If the exporter reduces its costs by, say, £100k and that is all given to its customers the exporter has no incentive to reduce its costs in the first place. Applying a sharing factor is a tried-and-tested solution to this issue and would, in our view, deliver benefit for customers.

- Section 2.4 Q3 - Do you agree with the options set out for charges associated with bulk supply agreements? Are there any other options that should be considered?

For information, we and the other companies are assuming scheme prices at the AIC of the seller's next best option in our water resources management plans (WRMPs). This is because we are consulting on our WRMPs in the autumn and need to make an assumption about pricing, while the commercial framework process has not yet reached a view.

Option 4, using principles rather than a methodology for setting charges, appears most consistent with the current approach to bulk supply agreements. It would allow for the variable and fixed costs option (Option 1), which seems the most appropriate for SROs, while providing sufficient flexibility to reflect the idiosyncrasies of individual SROs.

The wholesale minus approach (Option 2) seems more appropriate for NAVs, who take a wholesale supply from an established network, rather than for SROs where a large piece of new infrastructure is involved. If we started with a wholesale price for an SRO we think we would have to make a lot of adjustments (such as the specific costs of providing the bulk supply, the local cost of water in the zone providing the transfer, differences in ODI payments and other regulatory incentives between companies) which would make the calculation of the wholesale price and the minus element complex. In practice the adjustments would move us closer to Option 1 or Option 3.

We are also finding in the WRMP process that supply option costs can change (e.g. due to environmental concerns) and demand requirements can change too (e.g. due to abstraction licence revocations) meaning that the prices for schemes can change. This implies some flexibility might be needed before parties finalise their prices for specific schemes.

- Section 2.4 Q4 - 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 support RAPID developing a more detailed framework for the fair shares approach, including addressing some of the concerns raised, such as how you handle the different levels of service customers have paid for in different companies' areas.

We support RAPID's proposal that the development of the specific parameters and mechanisms of the fair shares approach would be for the companies involved, with the back stop of an Ofwat determination if they cannot agree.

- Section 2.4 Q5 - 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 look forward to seeing the Baringa and Mott MacDonald study on regional coordination in the water sector when it is published.

2.5 Future Proofing

- Section 2.5 Q1 - How significantly might the optimal use of assets vary over their lifetime?

Given SROs involve long-lived assets and that demand and other supply options change over time it is possible that the optimal use of the SRO assets might vary over time.

The consultation considers encouraging unbundling of contracts where practical and enabling third party access to SRO assets. The risk with these options is that it might have a chilling effect on investment in the SRO assets. This would be the case for both appointed water companies and CAPs. Investors in DPC schemes might require a higher cost of capital in a competitive tendering process if there was a risk the contract could be unbundled or that its revenues were not guaranteed to be coming from an appointed water company.

However, we consider it is worth investigating options for selling water to a secondary buyer when the primary buyer is not taking it.

- Section 2.5 Q2 - 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?

Our view is that is best to see how the water trading system develops at a regional level over time and allow the institutions that support it develop organically. We agree with the consultation that it would be premature to consider introducing a single multilateral model until there has been a considerable increase in trading volumes. At present it is not clear how many SROs will be approved through Gate 5 and when the successful schemes will begin construction.

- Section 2.5 Q3 - Are there any other circumstances where destination clauses would be appropriate?

Destination clauses are typically used in various sectors of the economy by customers to ensure security of supply and by producers to guarantee the financing of large initial investments. We consider they could be helpful in the water sector for SROs to support security of supply for the importer and provide certainty for the exporter, CAP and third-party investors.

We consider destination clauses might effectively be required by the exporter's abstraction licence because abstraction licences usually define what use the abstracted water will have.

Having a destination clause might make implementing the fair shares approach easier because there would be more certainty over who the water was going to.

3. Next steps

- Section 3 Q1 - We welcome views on our proposed next steps, including additional activities that we should be undertaking

We would welcome some clarity on when RAPID considers it will be able to consult on more precise guidance on the regulatory and commercial framework for SROs. Regional groups are already consulting on their initial water resource plans and water companies will be consulting on their draft WRMPs in the autumn. We will only be able to consult on the basis of whatever stage the regulatory and commercial framework has reached at those times, making assumptions on areas where the framework has not been decided.

We support developing the consultation's proposals to fit with the timetable for Ofwat's PR24 draft methodology in summer 2022.