



# South West Water

[REDACTED] RAPID

By email ([rapid@ofwat.gov.uk](mailto:rapid@ofwat.gov.uk))

26 January 2022

Dear [REDACTED]

## **RAPID's consultation on the regulatory and commercial framework for strategic water resource solutions**

Thank you for the above consultation. Our response to the questions is given in the Annex attached.

Our response should be read in conjunction with that from the West Country Water Resources Group for which we provided input. For brevity and to prevent duplication, our response is purposefully short.

Our key points are consistent, and in summary are:

**Long-term planning and best value** – the concept of ‘best value’ intrinsically means there is a decision to be made on what is ‘best’ and ‘best’ to whom. That is not straightforward. In the context of the Strategic Resource Options, we think therefore consideration and equal weight should be given in the process to the counterfactual i.e., to evidence that we are confident that the alternative decisions are ‘worse’ from what is proposed to take forward

**Gated process** – the overall concept of the gated process created at PR24 is fully supported for long-term planning. We do think the current process is quite rigid and has a high overhead. Looking ahead we think a more flexible, lower overhead process, would deliver better customer and environmental value for money. The inclusion of Mendip Quarries is a good example of where this has worked well.

**Procurement** – we think the options set out are sensible, however, as some solutions may be cross sector and very long term, a Government backed infrastructure body should be considered for some solutions; or at least decide if this should be rejected.

**Incentives for water trading** – we think it would be helpful to set out what the future regulatory model might look like as a concept and how the RAPID process fits within this. Incentives, bilateral markets and pricing are often used interchangeably but in different contexts. Pricing based on efficiency cost recovery is different from say a pricing model based on the ‘value of water’ in a fully competitive market.



## South West Water

What is critical to the success of water trades is access to the water to trade. With processes such as licence capping and the environmental destination requirement this is reducing water availability. This reduces the opportunity for trades. Overcoming this barrier is important and in the West Country Regional Water Resource Plan and our own Water Resource Plan we are strong advocates for smart water licencing that gives access to water, especially when there is a surplus, such that it can be used where there is a shortage. We believe this regulatory concept is critical to success in the water sector for meeting resilience and being affordable in doing so.

**Risk allocation and co-ordinated operations** – we would recommend that risks should always be allocated to those best placed to manage them. We believe very careful consideration needs to be given to decision making on co-ordinated operations and who carries what risk. This is because more so than management of generation in the energy sector, how water resources are managed over time is critically important to resilience in a drought. Who makes what decision is therefore critical in who carries what risk.

An overarching observation is that in taking this area forward, the water sector needs to ensure a close focus on affordability and the outcomes we are trying to achieve is maintained. We think this is very important as water resources is only part of what customers are being asked to pay for.

Yours sincerely,

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[Redacted]  
**Regulatory Director**



## South West Water

### ANNEX 1 CONSULTATION QUESTION RESPONSES

#### 2.1 Planning for long term outcomes/ best value/aligning incentives

**Q: 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 fully agree with the concept that plans and projects should aim to deliver 'best value' and that they should be set in the context of long-term strategies. However, we also think there is a long way to go until the concept is thoroughly understood and applied by both practitioners and stakeholders.

Barriers and challenges regarding 'best value' include:

1. Ofwat's PR24 consultation in May 2021 included eight occurrences of the phrase 'best value', mostly in the context of the design of the price control and the approach to assessment of enhancement costs. There is a potential barrier or challenge about how enhancement costs are assessed for 'best value' solutions. By definition 'best value' solutions are not 'least cost' and therefore an approach that relies on industry-wide econometric modelling or cost benchmarking will not provide sufficient funding, nor would it consider the specific regional or local best factors that determined best value. An alternative cost assessment method will be necessary such as a deep dive assessment that is a project specific.
2. Ofwat's PR24 May consultation refers to the Environment Agency's guidance for water resource planning. The guidance (included in Appendix A for ease) includes a very long list of factors. Whilst commendable it is hard to see how all these factors can be satisfactorily resolved in a single plan or easily articulated to external stakeholders. The first factor in the list is government policy and regulator expectations, and we welcome the indication that a best value plan can adjust the timing and balance of policy aims against other criteria.
3. We think that best value considerations apply to overall long-term **plans** rather than **schemes**. The PR24 consultation and the EA's water resources planning guidance rightly refer to best value plans. However, on occasion the discussion has been about best value schemes. We consider schemes to be the means to deliver on an overall plan. Also, any plan will always include a mix of schemes, some traditional infrastructure projects, some nature-based solutions etc.
4. Whilst 'best value' is simple in terms of concept, its application is more difficult. At its heart is the concept of 'trade-offs' - 'Best value' to whom, over what timeframe and what measure. From a regulatory perspective we think greater consideration in the



## South West Water

SROs and the development of the plan, is perhaps not what is 'best value' but rather that alternative choices are worse 'in the round'.

This section of the consultation also mentions incentives for types of solution. It lists some examples of types of solution. Whether intentionally or not it implies that the examples are bad, whereas we consider that an in-company or in-region solution under the control of one or two companies is the holy grail, because they will be more straightforward to consent and deliver rather than because of any perceived financial incentive.

### 2.2 Development activities /Other regulatory barriers to investability

**Q: 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 agree that the current process has been very beneficial in catalysing a step change in work on strategic water resources and collaboration across the sector. We also agree that the current process has a high overhead burden, and is quite transactional.

We favour a streamlined gated process rather than development of the financial incentives because to us that seems more attainable in the short to medium term. The streamlined process should be less prescriptive, with gateways aligned to the project need and with greater freedom to make decisions as the projects develop and new information becomes available.

**Q: 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 agree that the procurement approach should be designed to suit the needs of the project and its risks and opportunities.

An approach not included which may be worthy of consideration is the use of a standalone government backed infrastructure delivery body. These options are strategic solutions that deliver intergenerational and cross-sector benefits.

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

We are supportive of continued development of water trading incentives. The low take up of new water trades suggests that the strength of the current incentive is not calibrated correctly. Therefore, we support the overall position that any new incentive structure should be designed to work for all water company trades.

We consider it important to recognise that the utilisation of the proposed schemes could be low and highly variable. This is because the predicted water deficits that the schemes are designed to meet are driven by relatively extreme design cases e.g., 1 in 500 year droughts, sustainability reductions that only apply 5% of the time etc. Thus, we agree with the importance placed upon the considerations under the proposed new approach.



## South West Water

We believe at the heart of the issue is how water is valued. For existing water rights, a water transfer increases risk to the donor, but the regulatory regime is not currently based on a market price that reflects that risk. It is effectively priced on cost recovery plus. At the heart of this debate therefore is if in water trading incentives the aim is for 'simulating' a competitive market, or rather is the question on pricing once a regulatory process has completed an allocatively efficient apportionment of water through the planning process and the recovery of efficient costs.

These two concepts are used interchangeably in the report. We think it would therefore be useful to separate out the concept of trading incentives as different from how efficient costs are recovered from new infrastructure (e.g. Havant Thicket). Each can be developed separately.

The greater degree of regulatory certainty, protection for the exporters customers and ongoing adjustments to manage volume risk should all strengthen the overall incentive properties of water trading.

This whole area might benefit from a simple diagram on how the role of pricing and incentives could work in the sector going forward.

**Q: 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?**

If the aspiration is that investment in new water resource capacity will be secured and given the scale of the investment required, we consider that this can only be achieved by dealing with the risk up-front, along the lines of the proposal in the last paragraph on page 21.

There may be some merit in considering different approach for different parts of the strategic resources options (SRO). The most fundamental part of any SRO is the new resource either a new reservoir or new effluent recycling scheme. This is the part that requires regulatory backing and effective management of risk so that the necessary investment is secured.

The transfers of water from the donor region to the importing region generally use technology that is conventional and should be more straightforward to consent and implement.

**Q: 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 understand that resolution of the environmental barriers is complex and does need to be resolved simply and practically.



## South West Water

We see an inherent conflict between on the one hand being asked to prepare 'best value' plans which are required to reflect regulatory policy and expectations and on the other hand a workstream that is seeking to review and potentially revise those policies, and other requirements such as Net Zero also working in tension.

We are pleased to see that work is proposed with the DWI on the principles to be applied. We agree that the issue of customer acceptability can be mitigated by communication with our customers. That is our experience on day-to-day water quality issues. But the timing of the SROs is quite different. Communicating with customers about a change in water quality that is forecast to occur in more than ten years' time (say 2035) may not be very meaningful.

It strikes our region that there are a lot of policies and frameworks but there is a gap in showing how they fit together in the future. We wonder if there is a role for RAPID as a multi-regulator body to help draw out how these could come together and what the overall future model could be in this area.

### 2.3 Construction/ Risk allocation between partners

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

On balance we favour option 2.

The approach should recognise the legal accountabilities of organisations but there is a gap in the cross-regulatory and planning decision making. This is growing as the policy requirements as set out above can often be in tension with one another.

**Q: 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?**

Best practice is to allocate risks to those best placed to manage them. The approach outlined on pages 29 and 30 sounds reasonable.

In addition, we would highlight:

- In major construction projects there are numerous examples where detailed costed risk registers have been developed prior to contract award, only for the actual construction to throw up different risk and cost over-runs. One of the potential downsides is that the purchaser/client ends up paying for both the risks that didn't occur and the newly arising risks.
- Some risks can be classed as on/off i.e., either they happen with large consequences, or they don't happen at all. An example would be a foot and mouth outbreak during construction which prevents traffic movements to the site. These types of risk may need to be treated separately.



## South West Water

- In a drought (or a flood), at the limit customers, the economy and the environment will ultimately carry the risk if there is a failure to provide the necessary protection. As the SROs are long-term solutions, with long lead times there is a ‘timing of decision making’ risk. This is not included in the process and we think this should be included.

### 2.4 Service delivery / Coordinated Operations

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

We are content with the approaches proposed and agree that having some flexibility within a framework is a reasonable approach.

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

We think that the proposals set out here are appropriate. The change in reporting of the importer's costs would align a water trading approach to a counterfactual where they developed new resources themselves with traditional enhancement expenditure. This should in theory remove any in-house bias towards minimising 'base' expenditure.

We think that to maintain the legitimacy of sector it is critical that ongoing efficiency is challenged, and any savings shared with customers. Therefore, as long as the incentive properties of the water trading incentive are calibrated correctly and ringfenced, we are supportive of sharing any additional profit with customers.

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

For new discrete infrastructure we think the certainty provided by fixed charges, irrespective of use, are essential to provide companies the certainty that is required to undertake upfront capital investment. The proposal for volumetric charges follows logically.

For other trades, we think that a similar approach in principle should be used. This could take the form of a wholesale minus approach, but then considering RCV run off, returns, and a portion of fast money as the “fixed charge” with the remaining fast money recovered through a volumetric charge (akin to the bioresources volumetric adjustment). This approach retains consistency across water trading and consistency with other bulk supplies. We would then expect them to have a similar level of prescription as the bulk charges for NAVs and so do not necessarily have to be integrated into the charging rules.

As highlighted above on incentives, the starting point that it would be helpful to set out is what the overall regulatory charging ethos is for a bilateral market. Is it to be based on a



'market value' (akin to a LRAIC) or efficient cost recovery (like Havant Thicket) as this choice in part determines the charging approach?

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

The meeting with Baringa/Mott MacDonald scheduled for the 21<sup>st</sup> January 2022 was cancelled. We will be able to comment more on this at or after the rescheduled meeting.

Notwithstanding this the critical question in our opinion is who carries what risk and who has accountability to make what decision. Currently it is clear that the failure of a water supply system to meet a drought will be the body responsible for service. However, in co-ordinated operations the decision making may be split and the implication of a decision may not land on that party.

This is particularly important in water resources because how well water supply systems manage drought events depends on decisions often taken over several months on how sources are operated. So, this is materially different to say energy system operation.

## 2.5 Future Proofing

**Q: How significantly might the optimal use of assets vary over their lifetime?**

We agree it is more than likely that the use of the proposed assets will change over their design lifetime i.e., over the 60 years after commissioning, almost up to 2100. It would be premature and futile to try to design a single multilateral operating model now for a situation that may occur in 2050. Review clauses or break clauses with notice periods are quite normal.

We agree that destination clauses would best be avoided.

**Q: 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 don't envisage dozens of trades in the region mainly due to a long-term lack of water to trade driven by environmental needs. With the West country there is already sharing of resources with Wimbleball reservoir being used by both South West Water and Wessex Water and through a bulk import to Wessex Water from Bristol Water and a transfer between Bournemouth Water and Wessex Water.

Whilst the regional plan forecasts significant deficits in the region the number of trades is limited to strategic links:

1. Between South West Water and Wessex Water
2. Between Wessex Water and Bournemouth Water (South West Water) (possibly bi-directional)
3. Between Bristol Water and Wessex Water (existing/modified)  
+ potentially



## South West Water

4. From Severn Trent Water to Bristol Water
5. Wessex Water to Southern Water.

Therefore, the maximum number of trades is unlikely to exceed five, and some of these will be enhancements on existing agreements. We consider that these are best managed between the relevant companies.

### **Q: Are there any other circumstances where destination clauses would be appropriate?**

We agree that the destination clauses should be avoided if possible to ensure maximum flexibility in the future. We can see a situation where they would be required on environmental grounds, but this can equally be covered through the discharge permits or operating agreement. An example is the plan to divert effluent from Poole sewage treatment works to the River Stour in order facilitate abstraction downstream.

### **3. Next steps**

#### **Q: We welcome views on our proposed next steps, including additional activities that we should be undertaking**

Our response to the discussion document in July 2021 highlighted a few other issues that don't seem to be covered in this consultation:

- Affordability. We would still like to see some work done on the affordability of the proposals and plans. We note that there is a project proposed with CCW and DWI on water quality. Is there a similar workstream to consider the total cost and bill impact of the National Framework requirements?
- Outcomes. We are still surprised how little outcomes are mentioned. In the WCWRG we set have set out the three outcomes that our plan is seeking to achieve: Improving the environment, ensuring water supply resilience and delivering societal benefit.
- Overall framework. There is a lot of focus on water resources however it is not clear how all the various policies and workstreams fit together. It would be helpful to have a simple diagram on what the overall operating model for the sector could be and where the various projects fit into that landscape.
- Smarter water licencing. To meet the future needs we think the sector needs a stronger push on smarter water licences. This gives access to water when there is a surplus to use when there is a shortage. We would value RAPID taking a strong interest in this as it is a cross regulatory issue.