

# RAPID Consultation Response

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26<sup>th</sup> January 2022

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

Dear ██████████

We welcome the opportunity to respond to your consultation document and the continued collaborative approach you are adopting in the development of SROs.

Within the document you posed 17 specific questions and we have addressed each of these in our response below.

Chapter	Question and Response
<p><b>2.1 Planning for long term outcomes/ Best value/aligning Incentives</b></p>	<p><b>Q1</b> 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?</p> <p><b>Response:</b></p> <p><i>In our response to Ofwat’s consultation on long term delivery strategies we have highlighted the need to avoid regulatory divergence. It would be our proposal to align the Ofwat common scenarios with those already committed in statutory planning guidelines (such as for the WRMP) and being complied with as part of the regulatory planning cycle for PR24 business plans. Where no set standards currently exist we believe it would be sensible for all regulators to agree the most appropriate standard for companies to build into their planning. This is particularly important to remove uncertainty for transfer schemes that may take up to 15 years to deliver and therefore require a level of commitment in plans at an early stage. Efforts should be made to standardise the use of best value metrics across the planning frameworks to allow comparison of schemes and provide confidence to stakeholders.</i></p> <p><i>The SRO process favours the DPC delivery model. However, there are elements of SROs that will require traditional capital investment within a water companies existing region (e.g. backfilling an existing resource that is diverted for use in an SRO). Because of the planning timelines it may be necessary for an exporting company to require that PR24 allows for delivery of water transfer infrastructure within AMP8 (as an “enhancement” project), before a commercial agreement is in place with an importing company. In this case we believe that no regrets elements of SRO investment, that will benefit water companies and their customers regardless of whether trading progresses, should be split out and progressed separately through PR24 where possible with an adaptive long term plan set out with triggers for further capital investment identified as the needs become established.</i></p>

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

**Q2** 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?

**Response:**

*We think that the option to have a future gated process should be kept open until we have seen the outcome at Gate 2 and how SROs are incorporated into WRMPs. We recommend the continuation of efforts to capture lessons learned and feedback from companies to update the process in future. We have concerns about the misalignment of information between Gate 2 submissions and the draft WRMP which will be published around the same time later this year. We believe this could be resolved in future planning rounds to avoid confusion with stakeholders and minimise the risks to the progression of schemes. It may be appropriate in future to integrate SROs into the WRMP process entirely with a continuation of the regional planning groups to reconcile plans across England and Wales. This would still require provision of sufficient allowance within PR24 and future price controls to enable development of schemes to a suitable level of detail.*

**Q3** 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?

**Response:**

*We suggest that contractual arrangements for the system are kept as simple as possible. We also suggest that a principle should be established whereby the company or companies that are the primary beneficiaries of the assets and investment should be recognised as being best placed to act as promoters of the investment, the primary procurement body and therefore the one through which payments (e.g. to a DPC provider) are made.*

*In a multiparty trade it should be the recipients who ultimately pay the DPC costs, as they are incentivised to balance the efficient use of their water system. However this could either take the form of either (or a combination of) (a) a multi-party contract with the DPC provider, or (b) a single party contract for the primary recipient, who then on-sells the water to other recipient companies. The best arrangement will likely depend of the configuration of the individual supply system being considered.*

*It is an important principle that an exporter should not have a financial stake in assets that it could not otherwise use to supply its own customers. The accountability to pay for supply infrastructure should be for the companies whose customers will benefit from that infrastructure (and will ultimately be paying for it).*

*Supply companies are stakeholders in the overall system and therefore we agree that there should be a coordination agreement between all the parties to ensure suitable engagement so the system operates appropriately. (Please also refer to our response to the system operation question Q12) A joint venture with joint liability will not be appropriate for schemes involving exporting companies whose own customers do not (or could not) significantly benefit from the scheme. In these circumstances a hybrid model may be available to incentivise the collaboration of all parties but the cost liability allocated to the company(s) responsible for funding the infrastructure.*

*We also believe it would be beneficial to the overall market to retain the option for exporting companies to be considered as part of a CAP for the delivery of trading infrastructure and therefore they should not act as promoter unless necessary.*

**Q4** What is your view on the policy options set out (or any others) to incentivise water trading?

**Response:**

*We support the proposals within the consultation to provide greater regulatory certainty as an incentive to water trading. However, we believe current incentives for exporting companies to*

*participate in water trading are weak because;*

- *Water trading incentives are minor in comparison with the overall cost of providing supply infrastructure and;*
- *For major supply infrastructure, the framework for recovery of the exporter's costs may appear to place too much risk upon the exporter (especially if the supply infrastructure cannot readily be used to supply its own customers).*

*We do not support the NERA proposal to calculate a mark-up for exporting companies based on the next available trade. Aside from the difficulties with calculating such an incentive, it would seem likely to result in arbitrary values, which would not incentivise long term planning for participation.*

*We support the proposal outlined in the consultation that the exporter's customers should not face volume risk. We therefore believe that the approach to cost assessment for supply assets should be re-considered to avoid a secondary impact of volume risk on exporting companies. The approach to assessing the efficient cost of exporter supplies should not be the same as for assets used in incumbent supplies, for which the exporter already have strong incentives to invest. For water trading assets, the main beneficiary is the importer, and hence the exporter should expect greater incentives to participate. However, if exporters face the same risk of cost under-recovery as for its BAU operations, then this will harm incentives to participate. We therefore suggest that exporter investment cost allowances should be at a lower assumed level of efficiency (e.g. average cost rather than upper quartile costs).*

*We also note that the existing water trading incentive and the approach taken to the Havant Thicket investment are somewhat remote, in that the incentives are only recovered once supplies are constructed and in operation, and recovered over the long term. This approach means exporting companies would be investing now, for something that is not for their benefit (or their customers benefit) but then may not receive incentives for another 10-20 years. In our view this is unlikely to provide sufficient encouragement for an exporting company to prioritise development of water trading investment or as being equivalent priority to its activities in delivering services to its own customers. We therefore suggest that higher value, up front incentives for exporters should be considered, for example a premium to the WACC for investment in water trading assets, to supplement the existing "post trading" incentives, which should also be increased in size at a fixed value to provide greater ex ante certainty.*

*Whilst we also support the consultation in suggesting incentives for optimising utilisation of traded supplies, this not a significant issue in comparison with the need to better incentivise participation in water trading as an activity.*

**Q5** 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?

**Response:**

*As set out above, we consider that the key issue to address with incentives is for participation in water trading. Normal regulatory incentives should be adequate to incentivise efficient delivery (as is the case for BAU investment in assets). Similarly, the existing DPC process should be sufficient to identify assets that are suitable for that form of procurement, and the DPC process will itself determine whether DPC or in-house procurement would provide best value for customers.*

*As also noted above, exporting companies should **not** have a financial stake (and hence face stranding risk) for supply assets that could not be repurposed for the benefit of its own*

customers. It would therefore be for the importing company to take the decision as to whether stranding of a strategic water trading asset was preferable, given the wider consideration of its other water supply options.

**Q6** Does the pathway for resolution of environmental barriers meet the requirements of stakeholders and are there other environmental barriers that need to be considered?

**Response:**

We welcome the pathway and wish to emphasise the importance of these timelines being met as earlier versions contained dates that have now slipped. This creates a delivery risk for the programme and can lead to inefficient expenditure.

The advice notes that are due to be published within Gate 2 (i.e. the technical criteria for WFD Reg 19 due in Spring 2022) need to be delivered as soon as possible. Any delay to their publication would mean that it would become very difficult to incorporate any required changes into our Gate 2 submission. Similarly regulatory requirements for the Gated submissions should be clearly defined as early as possible in each Gate. At the time of writing (January 2022) a final guidance document and submission template has not been provided for Gate 2. This increases delivery risk for the submission into the Gate and can lead to inefficient expenditure.

We urge RAPID to ensure that new advice notes issued as part of the SRO process align with other regulatory guidance being issued. For example we recently received contradicting guidance around abstraction licenses and were subsequently informed that WRMP24 supplementary guidance on preventing deterioration takes precedence.

We disagree with the suggestion that river augmentation be ruled out completely. We agree that long term widespread use of augmentation is unsustainable but that occasional localised use of river augmentation to allow groundwater abstraction during severe droughts should not be completely ruled out and should be considered on a catchment specific basis.

River regulation is a key element of water transfers such as the Severn to Thames transfer scheme and as such we need to make sure the commercial model is resilient to future changes in environmental policy and regulation. There will need to be suitable provision within the trading contracts to ensure engagement with regulators through the establishment of committees or similar arrangements. It may be even necessary for a new regulatory body to be established specifically to deal with the regulatory input into the ongoing operation of the transfer system.

**2.3 Construction/  
Risk allocation  
between partners**

**Q7** What is the best approach for ensuring regulatory oversight for RAPID solutions beyond gate 5 into the delivery phase?

**Response:**

We support some form of cross regulatory collaboration to oversee the delivery of projects beyond Gate 5 and help to unblock issues as they arise. Regulatory involvement during construction should be limited to monitoring of contractual mechanisms. Those contracts should contain all the incentives necessary to ensure that parties are properly incentivised for delivery performance. Where construction is on assets shared between trading and indigenous customers then the usual regulatory incentives should be adequate. We don't have a strong preference for either option 2 or option 3 as presented in the consultation document. If option 2 was progressed then sufficient resources would need to be made available to support the additional workload required of regulators on top of BAU activities whereas if option 3 was selected it would be important that strong lines of communication were established between the RAPID organisation and its regulatory colleagues. Whatever approach is taken its important that clarity is provided on the objectives of the regulation over and above that

*which they would get for a similar project being delivered as business as usual. We suggest that focus be placed on regulators working collaboratively to support the successful and efficient delivery of the SROs.*

**Q8** 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 look forward to reviewing Ofwat's DPC guidance document when it is published.*

*We believe that water companies can't be expected to commit spending to meet the needs of customers outside their regions without sufficient incentives. This includes the treatment of option investment in backfill costs that are for the benefit of out of region customers. Exporter companies should be protected from the risk of inefficient usage and underutilisation of the scheme whereas importer companies should also be protected from the risk that the inputs to the transfer will be outside of their management control.*

*Risks associated with policy and regulation change during the life of the trade must be borne by the customers as such risks are outside of the management control of the parties in the contract. These risks need to be carefully considered in the contract and may have associated costs that need to be managed such that the use of the transfer is still financially beneficial to the recipient company when compared with alternative in-region options.*

**2.4 Service delivery / Coordinated Operations**

**Q9** What is your view on the areas identified for standardisation of contracts? Are there any other areas that should be considered?

**Response:**

*We agree with the areas highlighted as being suitable for standard approaches, although we would also note that non-delivery provisions should relate to quality parameters as well as to volumetric delivery.*

*We also believe that some standard higher level principles could also be developed around the commercial model and the simplification of contracts for single parties managing multiple system elements as previously stated. Our experience of DPC is that the key areas could be broader recognising other areas such as, but not limited to, compensation, payment mechanisms, refinancing, insurances, change controls etc.*

*Standardisation has been useful in encouraging market participation and reducing costs/complexity of procurement. It is essential however that the standardised elements are aligned to the requirements and risks that the contract is designed to govern. Other sectors have seen standardisation as being particularly supportive to new service providers and new finance parties in providing comfort that common approaches and contractual positions offer improved certainty in considering the resolution of challenges across infrastructure assets. In turn, this is providing the pre-conditions for providers and finance parties to invest in new infrastructure and service delivery platforms.*

*That said, standardisation for its own sake could be counterproductive. Contracts need to recognise the specific circumstances and service requirements that apply to a particular trade.*

*Further work is required to explain what specifications and risks are envisaged across the RAPID systems and therefore how standard terms would differ for each class of project.*

**Q10** Do you agree with the issues and options set out for the treatment of trades in future regulatory periods?

**Response:**

*We agree with sunk trading costs being separated from base costs for both exporter and importer companies.*

However, we disagree with two statements made in relation to the exporter:

- The consultation expects a consistent approach to other 3<sup>rd</sup> party revenues, that forecast revenues are required to exceed forecast costs, and any forecast profit would be passed on to the exporter's customers. This implies that the exporter may not profit from a trade, which (considering our response above on incentives) should be permissible. We agree that excess profits may be passed to customers, but not all profits.
- The consultation also states that the enhancement expenditure associated with a trade should be subject to regulatory challenge analogous to that for other enhancement expenditure. Also as stated above, this is not reasonable for two reasons (i) the provision of supplies to the company's own customers is naturally incentivised as part of the overall obligations of the company to its customers – the exporter should not be subject to the same efficiency expectations, in order to support incentives for exporting companies to participate in water trades, and (b) water trades are more discretely for the benefit of the customers of another company. Hence the exporter will not (as much) be able to benefit from the normal "portfolio effect" of managing costs, as would be the case for multiple investments across in the company's own supply network. We support the need for efficient expenditure and suggest that, for large discrete trading projects, this be enabled through challenge from the importing company to the exporter to keep costs low and incentivised through ex post cost sharing. Customers of the buyer are therefore protected by the negotiation by the buyer to get a more efficient option (whereby the seller agrees with that delivery cost), and ensures that customers are getting a more efficient option. The seller may also have an ex post incentive to deliver even more efficiently, once a price is agreed.

**Q11** Do you agree with the options set out for charges associated with bulk supply agreements? Are there any other options that should be considered?

**Response:**

In general, we support the proposals that payments should be predominantly fixed in nature, and that variable charges should only relate to variable costs. This is particularly necessary for (a) recovery of costs for assets that are bespoke and for dedicated use within the water trade, and (b) intermittent (non-continuous) resilience supplies, whereby the supply is often not being utilised (and therefore the exporter would need to recover sunk costs from largely fixed charges). It is possible that continuous supplies could be charged on more of a volumetric basis, but that would need to be on the expectation of a minimum level of utilisation of the supply.

For DPC delivered infrastructure, it is likely that CAPs would also have a strong preference (and even a requirement) for payments to be largely fixed in nature.

We comment on the suitability of the other proposals below:

- Wholesale minus – this approach is suitable for NAVs as the NAV area is largely supplied by, and surrounded by the incumbent's existing supply system. This approach may be suitable (recognising the need for pricing to reflect the full value of trade costs, and not to reflect the existing RCV discount inherent within base wholesale tariffs), but only in a minority of cases – i.e. lower volume trades that do not require significant new infrastructure – but would not be suitable for the SRO trades.
- LRAIC – this approach would only really be feasible if there was many future water trades, against which such future costs could be averaged over. We do not consider that the likely level of trading activity justifies the use of such a complex method for calculating charges.
- Charging principles – we agree that this would likely be the most appropriate approach, with the recognition that each trade will likely have individual bespoke

*pricing arrangements. However, we recognise that existing guidance needs to be enhanced to provide a greater degree of certainty. We don't think that it will be feasible to publish standardised bulk supply tariffs, as each trade will most likely need to reflect to specific investment requirements for each trade.*

*In addition to base prices, we also consider that bulk pricing methodologies should also reflect how to manage pricing of unexpected levels of utilisation of the supply by the importer(s), and whether that is manageable within charges or would need to be managed via penalty clauses within the supply contracts.*

**Q12** 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?

**Response:**

*Whilst we broadly agree with fair shares, we suggest that other options such as interruptible supplies should remain in consideration as taking a single approach may prevent companies agreeing commercial terms on transfers where a lower level of service may be acceptable to both exporting and importing parties.*

*We agree that it is important for levels of service to be clearly defined within supply agreements setting out the circumstances when supply may be interrupted both during normal conditions and during a drought. Where possible the levels of service should be defined with legal contracts. However, we recognise that this may not provide sufficient cover for all scenarios and independent arbitration may be required. Any fair share provisions and the essential nature of resilient infrastructure needs to be properly appropriately financed and the providers themselves be resilient [and allowed to maintain this resilience] from underlying financial pressures exacerbated by a lack of full cost recovery and related capital servicing.*

*Regardless of the contractual terms, public messaging will be critical to maintaining support to the industry in the case where restrictions are simultaneously imposed on both importing and exporting customers.*

*There will be a requirement for transfer agreements to be aligned and incorporated into company resource plans and drought plans. We recommend testing scenarios between potential parties to fully bring to life the opportunity, risks and concerns.*

**Q13** Do you agree with the proposed next steps for co-ordinated operations? Are there specific barriers to regional co-ordination that should be considered?

**Response:**

*We look forward to the release of the Baringa document and will be able to provide a more fulsome response once we have reviewed the proposals.*

**2.5 Future Proofing**

**Q14** How significantly might the optimal use of assets vary over their lifetime?

**Response:**

*This depends on several factors including operational complexity, customer preference and climate. Schemes such as the Severn to Thames Transfer offer a large amount of flexibility and scalability allowing for additional exporters and importers to potentially join at later stages. It is important to find a balance to allow for flexibility of use while also protecting those parties who incur the initial investment risk and sunk costs and recognises future change of use and obsolescence risk. For example, the aim should be to achieve the following:*

- 1. Appropriate Change Mechanisms to deal with issues such as future investment and demand requirements and where appropriate compensation provisions to protect all funding parties. This will be necessary where new external finance parties enter such new trading arrangements and markets and where in other markets, compensation is a pre-requisite to making an investment decision.*
- 2. A commitment to 'take or pay' and/or the inclusion of minimum base case usage [cap/collar or an input floor] over the contract term. As referenced under 1) above, if*

*the asset becomes redundant in the operational period, or buyer chooses to make alternative provision then the provider and funder of assets should expect to get fully recompensed – subject to risk appetite and source of finance e.g. external lenders are providing secured loan finance at capped returns so require higher protections than say unsecured equity providers with uncapped returns and who would expect a lower level of protection and compensation.*

3. *Environmental conditions that change so that the asset cannot fulfil its function should lead to full compensation termination of the contract funded by customers/taxpayers. This is likely to be a material consideration in the medium to long-term e.g. provision for climatic change as force majeure (more than simply one-off weather events).*

**Q15** 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?

**Response:**

*It may be realistic to expect such a system to be in place by 2040 allowing sufficient time for the development and delivery of infrastructure. However, this will depend on there being sufficient incentives for participation and confidence in the process.*

*At present the number of viable trading options appears low. However, as the regional planning process matures and the first schemes are developed this may pave the way for additional options to be developed. Much also depends on the success of the industry to deliver the ambitious demand management programmes. If demands cannot be reduced as quickly as hoped then there will be an increased need for additional water sources including transfers.*

**Q16** Are there any other circumstances where destination clauses would be appropriate?

**Response:**

*Importer companies may require certainty and security of supply to incentivise investment in the infrastructure. This would be especially true where external funding has been sourced in relation to infrastructure investment – such external funding parties will require contractual comfort that supply can be maintained at acceptable price to customers.*

*Further, alongside the examples provided for environmental and drinking water quality requirements, due consideration should be given to the parties purchasing or acquiring water supply where they do not plan to use supply for the original intended purpose. Otherwise, to enable water companies to manage their own reputational risk, significant regulations would need to be put in place so as to mitigate and prevent water supply contracts being provided to parties who would not meet any reasonable 'fit and proper' tests e.g. fail to meet minimum security compliance type requirements.*

**3. Next steps**

**Q17** We welcome views on our proposed next steps, including additional activities that we should be undertaking

**Response:**

*We support the refresh of the RAPID working groups that were previously established to address the issues highlighted in the consultation. We also support the creation of an overarching steering group to make sure that cross-cutting issues are dealt with centrally. We believe that progress in these areas needs to be accelerated to avoid delays and uncertainty as the schemes approach critical decision points. This may be achieved by seconding in resources to a central team dedicated to resolving the issues rather than relying on part time input from subject matter experts in individual water companies.*

We hope you find the observations and suggestions valuable in contributing to the development of regulatory frameworks and we look forward to continued participation in the debate through the working groups established to address these topics.

Once again, thank you to yourself and the team at RAPID for your continued engagement. If you have any queries regarding our response to this consultation please do not hesitate to contact me.

Yours sincerely,

A redacted signature consisting of a yellow horizontal line above a black rectangular box.

Head of National Water Trading

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**Water for the North West**