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

26 January 2022

Dear RAPID,

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

Thank you for the opportunity to review and respond to the RAPID proposals for the future regulatory and commercial frameworks for strategic water resource solutions.

As this follows on from RAPID's initial proposals in June 2021 in relation to frameworks that could govern such strategic schemes, we try to build upon our feedback last year.

I append our comments and observations to the questions raised in the consultation at the end of this letter.

Should you have any further questions or require more information please let me know via email at [REDACTED]

Yours sincerely,

[REDACTED]

Regulatory Strategy Manager

## **RAPID – The regulatory and commercial framework for strategic water resource solutions**

### **Yorkshire Water response to consultation questions**

#### **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?**

We have not yet identified any further material barriers or challenges to best value planning that have not been previously identified by RAPID or Ofwat. As Yorkshire Water is not presently leading any water resource schemes presently being taken through the RAPID gated process, we are not aware of how any barriers or challenges may apply differently depending on the type of water resource solution being considered.

We do envisage that this dynamic may become apparent in practice. For example, barriers and challenges may have a different materiality or significance if a solution is considered to be delivered via a DPC route compared to an in-house or JV route. We have no specific examples at this stage. As RAPID has noted in this section and from feedback to its June 2021 consultation, it is vital to recognise and consider the full value to be delivered from a solution option and not simply the lowest cost of delivery.

In terms of the overarching policy areas outlined in the consultation, we believe RAPID has highlighted the right ones when thinking about long term resilience – portfolio of options, best value solutions, optimising operational management.

However, we would question whether those areas require significant further exploration around the water resources planning process. The planning process is highly complex and increasingly sophisticated. There may be a risk of overcomplicating this further with limited additional benefits to be gained.

## 2.2 Development activities/Other regulatory barriers to investability

- **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 welcome the acknowledgement that the current RAPID gated process is resource intensive, and we would support a move to a much more streamlined gated process for new strategic solutions beyond the existing PR19 solutions. Consideration should be given to compressing or combining gate stages where feasible.

As a collaborative representative of our three regulators, RAPID could play a more inclusive role providing assurance of schemes to the regulators, this could alleviate some of the regulatory burden on companies between the decision gateways.

- **Are there other approaches for procurement we should consider, or other pros and cons?**

For procurement (section 2.2.2), we are supportive of a flexible approach given the range of solution options that could be delivered across the programme. Regulators need to be proportionate in the way that they ask for justification of a proposed procurement route approach in reference to the party that leads this key stage. The benefits and disbenefits associated with a particular procurement route may be marginal in some cases and so again it is better to focus on the best way to achieve the end point delivery of enhanced water resources resilience, rather than the owner of a stage in the process of getting to that end point.

We believe the relationship between the lead party and the future solution provider (where this is a commercial provider, such as a CAP via the DPC route), could be more complex than indicated by RAPID in its examples. Where the provider, rather than the beneficiary, takes the lead in the procurement and contracting process, its customers may have little or no benefit from the solution and therefore are not the most appropriate customers to fund the CAP/DPC model. The customers of the beneficiary who benefit from the solution ideally should be the ones who fund the CAP (enabled through modifications to the

beneficiary undertakers' licence). Splitting the responsibilities between parties for licence arrangements from the contractual and performance arrangements could add significant ongoing complexity, risk, and increase costs.

The long-term financial liability of funding the CAP/DPC and managing their performance needs careful consideration in determining which party (or parties) is best placed to contract with the CAP. Even where the 'provider' party is seen as the more suitable 'supplier of last resort' should the CAP wish to end its provision or sell on an asset located in the provider undertaker's region.

- **Do you prefer one approach and if so what and why?**

We do not believe there is a consistent best approach. As we state above, we believe keeping a flexible approach is key to enable the optimal commissioning and contracting model to be determined for the water resource need and solution.

We therefore support your proposal that the sponsors for the strategic water resource solutions should develop their own proposals for which approach should be taken and expect them to demonstrate to RAPID why a particular procurement model represents best value based on the nature of the individual solution, considering the implications for risk allocation and management. We do not believe this will always be best to be led by a single party (provider or beneficiary) or by a hybrid grouping of parties.

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

We are supportive of the trading approach in principle that the exporting company should be incentivised to trade (and hence consider releasing a long-term surplus), and the importing company should at least be able to recover its costs (certainly where the solution is optimal under WRMP options). We agree that this could be relevant for RAPID strategic scale solutions as well as smaller trades.

However, we do have some reservations about the scale of incentives to trade and how they could distort decision making. If a trade is the right thing to do because it offers water resource resilience, then it should be selected through the WRMP options process. There is a risk (currently likely quite small) that transfers

get selected as options because there is an incentive, and not because they are the optimal water resources solution.

Given that trades undertaken through RAPID solutions are likely to be more complex in nature and to be linked to the construction of significant new infrastructure to facilitate the trade, we acknowledge that incentives may be required that differ to the current arrangements, and this may include a trading incentive which incentivises both new and ongoing trades in the context of a co-ordinated system of trading.

We agree with some of the more detailed points RAPID makes, such as an incentives regime should ensure a level playing field for inter-company trades that could apply to all types of trade between companies, not just for RAPID solutions. We also agree that incentives that confer higher regulatory certainty (across multiple price reviews) will be valued by trading companies and that the exporter's customers should be largely protected from volume risk, if not performance risk.

- **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 welcome the recognition by Rapid and Ofwat that there are regulatory issues which may impact on the investability of solutions that need to be addressed moving forwards into PR24 in order to incentivise companies to deliver solutions which are in the best interests of customers.

The treatment of asset investments post-2020 may have been considered an encouragement to third party water resource options, yet we have seen negligible interest in practice and limited theoretical capacity to be somehow released given the purpose of raw water abstractions and the mixed priorities of regulators. As Ofwat has already acknowledged the potential for a bilateral trading market is very distant indeed and the new planning standard for securing supplies against a 1 in 500 year drought will drive requirements for substantial resource solutions (supply side and demand side) before any nascent water bidding market can effectively deliver.

We would be supportive of reducing actual (or perceived) regulatory barriers to investment and ensuring that the required projects are financeable. We note the three policy options presented in the consultation:

1. retain the current policy, perhaps with further clarification of how it would apply for assets to meet the resilience standard
2. find an alternative way to allocate risk appropriately between companies and customers, for example through incentives for best value
3. provide additional assurance of recovery of efficient costs, perhaps on a bespoke basis for particular assets, with more detailed scrutiny in advance and obligations or contractual commitments to continue to optimise the use of the assets

We believe all options may have value for future strategic resource solutions, whilst encouraging companies to explore demand side solutions. We would welcome further discussions with RAPID and Ofwat on how these approaches could be applied to ensure the right balance of risk between companies and customers.

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

The discussion points on environmental regulations and the barriers that require resolution is timely and vital. Transferring water between catchments often brings associated INNS risks that if not resolved can effectively remove a strategic solution from the list of viable resource options. Understanding how such risks are likely to exist and be mitigated should be addressed as early as possible in the RAPID solution review and scrutiny approach. We will review the list of actions to review the regulatory framework and the proposed timetable for delivery further, but it seems to be comprehensive.

We look forward to the findings of the DWI and CCW research into the public perception of water recycling for drinking water use.

We have experienced issues with customer acceptability of water where we have made local and short-term changes to supply sources, so we are familiar with the need to effectively communicate with customers to mitigate the worst effects. We are pleased RAPID and the DWI plan to work together to develop a principles framework that sets out how water companies can mitigate water

acceptability issues and determine how they could be included in the assessment process related to water quality enforcement.

### 2.3 Construction/Risk allocation between partners

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

We are not fully clear of the specific additional value in extending regulatory oversight by RAPID or its partner regulators on RAPID projects beyond Gate 5. As RAPID notes, other regulatory interventions are very likely to be in place for RAPID projects, including:

- monitoring of water quality undertakings.
  - controls on planning and environmental consents.
  - tracking of the company's WRMP progress.
  - oversight by Ofwat of the construction phase of DPC schemes into deliver; and,
  - bespoke performance commitments on delivery outputs and outcomes for significant and highly visible projects.
- **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 have no specific views on the appropriate allocation of risk between parties, but we do have an observation about the early proposal from RAPID. As RAPID is proposing that regulatory intervention is needed from the outset to design appropriate incentives to ensure that the balance of power between water companies and their customers is equal, can we assume that RAPID envisage that the balance in a project will typically be very unequal and one company will be incentivised to force the other company (or companies) to take more risk?

We agree standardised approaches to contracts can be beneficial and reduce transaction costs and duration of bidding and negotiation stages. We also welcome that Ofwat is due to prepare draft guidance in 2022 on efficient risk allocation for projects that are likely to follow a DPC model. This may help the company taking the lead responsibility for securing construction and/or operation and maintenance partners to ensure they place appropriate risk with those commercial partners (the CAP) in the best interests of customers.

## 2.4 Service delivery / Coordinated Operations

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

The proposals on the priority areas for standardisation in future contracts for RAPID projects appear comprehensive and reasonable. We are supportive of the overall approach and establishment of the Standardisation working group.

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

The consultation helpfully lays out the issues and some options for the treatment of trades in future AMPs in the context of today's low level of trades that do not require significant capital investments to deliver. In future the upfront investment could be very material and although treated as enhancement there is no mention in the consultation proposals confirming a suitable return on that investment appropriate to the risk or the time value of money, beyond a yet to be determined trading incentive. We believe trading incentives should exclude the exporters or importers financing requirements for simplicity.

We acknowledge that where a competitively appointed CAP is not used, the enhancement expenditure of the provider water company should be subject to some regulatory challenge similar to that for other enhancement expenditure in its business plans. However, this challenge should not act as a disincentive to the exporter to progress the proposal with the importer who has evaluated the candidate solution as optimal in their WRMP options.

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

We welcome the points made on how charges could be structured for bulk supply agreements and broadly agree with the pros and cons of each option as explained.

Although the 'wholesale minus' approach as utilised in bulk supply arrangements with NAVs is becoming better understood by incumbents, we do not feel it would be suitable for RAPID projects which may benefit from fixed and variable

charging options similar to DPC schemes. NAVs typically are connecting to the incumbents existing network infrastructure that is funded through regionally averaged wholesale charges and they require relatively stable continuous supplies.

How variable components are charged, and set could be subject to further refinement with peak demand thresholds being a factor, leading to the use of rising or falling block tariffs depending on the position the shared resource and transfer takes within the exporters and importers water resource plans, and how variable pricing can protect relatively efficient demand side solutions from being under-utilised.

- **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 welcome that further work will be taken forward by a working group around compensation thresholds and operating protocols to support them. We also welcome the clarity given on section 37 obligations and how both exporters and importers planning duties should recognise transfers and shared resources even during drought events.

We agree that under normal operation the circumstances in which strategic transfer supplies can be legitimately interrupted or reduced are clearly defined to provide legal certainty and appropriate allocation of risk so that both the exporter and importer are able to plan their investments to ensure they are able to meet their s37 duties. Companies will also need to ensure consistency between fair shares contractual arrangements and their respective drought plans.

- **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 have no specific observations on what is discussed in section 2.4.6 of the consultation around co-ordinated operations, beyond what we fed back to the June 2021 consultation that effective coordination of operations as essential to realise the benefits promised from strategic resource schemes and that

incumbent companies will need to take a leading central role in the development of any such regime.

We look forward to reviewing the findings from the Baringa and Mott MacDonald report in the coming weeks. We also can review the next steps that are expected to be issued by RAPID at that point.

## 2.5 Future Proofing

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

We note the points made by RAPID on the expectations to see changes in how assets may be used over time and the potential for growth in trades and transfers. We have no additional observations to make at this stage and remain open minded to the scale of further collaboration on regional planning and integration.

- **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 feel there remains too much uncertainty to predict when trades and transfer volumes and scale will take off from today's low plateau. We believe the regulatory and legal frameworks which could encourage effective trading need to be fair, straightforward and provide investor certainty over the long term if the RAPID vision of more integrated regional water trading systems is to become a reality.

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

We are sensitive to the potential environmental harm that raw water transfers between catchments could trigger and therefore expect the careful and selective application of destination clauses that effectively preclude re-sale and may preclude some level of transfer within an incumbent's region. We would support the use of such clauses should be overseen by environmental or drinking water quality regulation.

### 3. Next steps

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

We note RAPIDs next steps and the activities of related working groups throughout the consultation, and we have no further additions to propose.

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