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Meeting summary

Tuesday 29 March 2022
12.30pm to 2.00pm

Water Resources workshop

Attendees

Douglas Hunt	Affinity Water
Liv Walton	Affinity Water
Geoff Darch	Anglian Water
Tamsin Kashap	Bristol Water
Iain McGuffog	Bristol Water
James Holman	Dŵr Cymru
Jamie Jones	Portsmouth Water
Jonathan Ashley	Severn Trent
Tim Charlesworth	South East Water
Lee Dance	South East Water
Kevin Wightman	Southern Water
Philip Saynor	South Staffs Water
Colum Goodchild	South West Water
Seb Eyre	Thames Water
Tom Allen	United Utilities
Helen Smith	United Utilities
David Peacock	Wessex Water
Colin Fraser	Yorkshire Water

Ofwat attendees

William Godfrey
Mateo Silos
Graham Knowles
Stephen Topping
Stephen Humphreys
Emily Bulman

Kate Kendall
Peter John

Overview

Industry attendees were welcomed to the workshop and thanked for joining. The agenda covered three topics – investment risk in water resources, Direct Procurement for Customers and water trading incentives.

The aim was to share latest thinking on these topics, allowing Ofwat to reflect on feedback ahead of our consultation on the draft methodology for PR24 in July 2022.

Investment risk in water resources

In PR19 Ofwat set out two circumstances in which water investment after 1/4/2020 might be "at risk" – bilateral market entry and when there was under-utilisation of new assets. The methodology set out how these risks would be addressed.

While water resources investment would continue to be at risk in the event of bilateral market entry, we have already said that we do not expect bilateral markets to come into effect in the next price review period. We will not require companies to propose utilisation risk-sharing mechanisms for large water resource investments at PR24.

To mitigate the risk of companies proposing unnecessary investment in water resource assets, we propose to bring forward into the WRMP process aspects of our PR24 approach to scrutiny of enhancement capex. There would be an additional check on utilisation risk for large water resource investments, to ensure that they represent best value under normal operating conditions. We are also considering how performance in terms of WRMP adaptive planning could feed into PR24 business plan incentives.

In response one company asked whether we would encourage bilateral market entry to help with utilisation of assets; we said there was no plan to do so for the next AMP.

A number of companies asked further questions about bringing forward aspects of PR24 scrutiny of water resource investment. In response we confirmed that this was about ensuring that the two processes – WRMPs and PR24 scrutiny of company plans – were properly aligned, recognising that the draft WRMP process was underway and is ahead of business plans.

It was noted that this would mean finalising draft WRMPs in the Autumn based on the draft methodology. In response we stated that we anticipate that the guidance in the draft methodology would go with the grain of the existing WRMP guidance. We would focus our elevated scrutiny of WRMPs on the need for water resources investment and the selection of demand and supply options, with cost efficiency tested through the PR24 w process.

Direct Procurement for Customers (DPC) for large, separable projects

PR19 introduced DPC for projects that met certain criteria; three Pathfinder projects are already being progressed.

At PR24, we expect DPC to become the default for all projects (with the exception of bioresources projects) above our size threshold. The threshold would be increased, potentially to lifetime totex of £150m-£200m. Decisions to proceed would need to consider evidence on the separability of projects and customer value-for-money (VfM) from using DPC. However, our starting assumption is that DPC will yield VfM for customers.

We anticipate designing our Business Plan Incentives so that companies that attempt to avoid the use of DPC for projects that are eligible would be penalised. We also envisage incentives for doing DPC well, such as for running a good procurement process which delivers on time and creates VfM for customers. We propose to review the DPC licence conditions and are considering adding them to the licences of all companies.

One company asked about using The Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 (SIPR) route as an alternative. We noted that there are current legislative constraints on when it can be used but we are discussing the arrangements with Government. We can see advantages to the wider use of SIPR, so it is not ruled out.

Another company asked how we would take account of feedback from other regulators on DPC proposals. We confirmed that we had been working closely with the Environment Agency and Drinking Water Inspectorate, which are supportive of the DPC framework. We have increased our knowledge and understanding of potential problems and how we would address them; dialogue with other regulators is ongoing and our approach will evolve.

One company confirmed that increasing the size threshold was consistent with its assessment of market expectations for DPC and suggested that the size necessary to generate market interest may be considerably larger. We noted that our market engagement based on Pathfinder projects has given us confidence that the £150m-£200m mark is about right and should enable good competition.

On other questions that were raised we confirmed that we intend to publish a framework document for DPC around the same time as the draft methodology. We also recognised that the construction periods for these projects may stretch over multiple AMPs.

Water trading incentives

Water trading brings significant benefits for customers and the environment, hence the incentives. Trading has been slow but strategic resources options coming through RAPID imply an increase in the future. We're reviewing future incentives given the limited trades at present and the likelihood that water available to trade may increase in the future with the development of schemes through RAPID.

The review of water trading incentives will address three issues: is there still a role for an incentive; if so, do we need to adapt it to work for large scale RAPID type solutions; if incentives are being adapted what is the optimal timing for implementation.

Three options were put to the workshop for discussion: 1) maintain current incentives as at PR19; 2) adjust current trading incentives to account for time-lags from new infrastructure build; 3) move to an incentive based on the exporter's long-run average incremental cost (LRAIC) plus a mark-up, with the mark-up calculated as a proportion of economic rent from the trade. We explained that we were likely to consult on more than one option and were seeking initial feedback from the workshop ahead of our draft methodology.

Two workshop attendees had been invited in advance to provide their initial response to the options.

The first respondent agreed that option 2 was worthy of full consultation. The respondent supported giving approval to a trade when capital expenditure was approved, rather than when the trade becomes operational; given that, were the procurement and trading codes still needed? The respondent didn't think proposals for revenue reporting would be an additional reporting burden. The option would remove the front loading of incentives but hopefully management teams could look beyond that time horizon. It was noted that there were a lot of checks on market power already, so there is not an issue if the incentive doesn't address that. Further consideration would be needed on multi-party trades.

Another attendee wondered whether there was still a role for water trading incentives, suggesting that the regional planning framework may render them redundant. In response it was pointed out that originally the incentive was focused on identifying uses of marginal sources; going forward, DPC may help in driving water trades and lead to additional supply opportunities. One attendee felt that any trade involves a degree of risk (compared with own development) so there was still a case for an incentive.

The workshop discussed the role of risk in water trading. One person noted that in a typical price control you don't have this type of risk. By pricing it in, there was the potential that super-normal profits may arise. Given that trading was a new area of activity and fundamentally different, the incentive needed to reflect the price of risk.

One attendee noted that as a water exporter, your primary obligation is to your own customers; therefore, any export brings risk, particularly given timescales. For that

reason, incentives were needed and we should consider how costs are treated if an asset is underutilised.

From the importers' perspective it was noted that there was an asymmetry of information. The need for additional resource would be captured in a WRMP. If your preferred option requires something to be built, once the build goes ahead costs may start to rise and you may be locked in. Option 2 doesn't address this issue. Therefore, asymmetry of information may prevent trades.

In response it was noted that market testing may help and that the risk of cost creep arose in other circumstances, as well as in an import scenario.

Option 3 was set out, explaining that it built on an approach proposed by NERA. It recommends allowing a mark-up in pricing of bulk supply contracts above cost of supply, rather than through a separate water-trading incentive. Price of trades would be based on long-run average incremental cost plus a mark-up to reflect a proportion of the economic rent.

In response one attendee commented that both forms of Option 3 (NERA's original and the variant presented by Ofwat) could be worth consulting on. It was felt that we were potentially overstating the significance of risk of inflated charges, although there was agreement that it could create uncertainty.

It was suggested that Option 3 appears to assume that long-run costs are stable, but that may not be the case in practice. And that as it was not always easy to identify the costs it was unclear how much certainty would underpin the calculations. It was also felt that the model is possibly too formulaic – e.g. in assessing the cost difference between projects. One attendee noted that cost efficiency isn't the "be all and end all"; security of supply for example is important. The better water resources option in the long term may not always be clearly the most efficient.

In response we agreed that assessing costs may not be easy and that security of supply is important. We want to see trading both for resilience purposes and to foster efficiency.

One attended commented that Option 3 provides the best incentives for most efficient trades. It was the best option in a world of perfect information; but given real world uncertainties, it introduces potential incentives to game the system. Another option would be a central assessment of risks and the costs that attach to them, which would simplify the process of identifying LRAIC.

The meeting concluded with a thanks to all those who had attended. The contributions were very welcome and further contributions by e-mail were invited if points were not sufficiently covered on the day. The Ofwat team will reflect on all the feedback as they develop the draft methodology which will be published in July.