

Regulators' Alliance for Progressing
Infrastructure Development

November 2023



Enabling new water resources – a consultation on commercial arrangements



About this document

RAPID, established in 2019, is the Regulators' Alliance for Progressing Infrastructure Development. We are a partnership of three water regulators: Ofwat, the Environment Agency and the Drinking Water Inspectorate (DWI). Natural Resources Wales (NRW) is involved in an advisory capacity and has a decision-making role for any strategic water resource solutions involving Wales, Welsh policy and legislation.

RAPID provides advice and recommendations on the development of strategic water resource solutions to the partner regulators, Ofwat, the Environment Agency, DWI and to NRW. The responses to this consultation will feed into our advice to partner regulators and to NRW.

This consultation builds on our 2021 consultations¹ on the regulatory and commercial frameworks required to support the development of those strategic water resource solutions.

This consultation sets out our further thinking and assessment of policy options on commercial frameworks, specifically in relation to commercial / contractual models including bulk supply water transfer agreements and associated policy, such as charging.

We welcome views on our proposals and assessment of policy options as set out in this document.

¹ [The Regulatory and Commercial Framework for Strategic Water Resource Solutions – discussion document, June 2021](#); [The Regulatory and Commercial Framework for Strategic Water Resource Solutions – a consultation, December 2021](#); [The Regulatory and Commercial Framework for Strategic Water Resource Solutions – Outcome document, August 2022](#).

Executive summary

Water is a precious resource. Our water resources are coming under increasing pressure from population growth, economic development, and climate change. Society expects that water will be available for users while also protecting and improving the environment we live in. This means that we must act now, and act together, to develop new water resource infrastructure supply solutions which counter these combined risks in the coming years alongside reducing leakage and demand. We are working on a programme of solutions that will provide in total over 2300 mega-litres (MI) a day, or equivalent to the needs of more than 10 million people.

At the 2019 price review (PR19) Ofwat announced a £469 million ring-fenced development fund for companies to investigate and develop strategic water resource solutions that benefit customers, protect, and enhance the environment and benefit wider society. This funding provides companies with the ability and certainty to accelerate the development of solutions to be 'construction ready' for the 2025–2030 period; it encourages joint working, enables additional analysis where required and provides outputs with greater certainty than would be available without it.

Solutions development

Several water companies are developing solutions which will help address the water supply deficits in the coming years. These solutions are described in each water company's Water Resources Management Plan (WRMP)², where more can be seen on the individual justification for each solution and an assessment of potential options. It is through the approval of these plans that the go-ahead will be given for solutions to progress from early development through to planning. Many of the proposed solutions are regional schemes and multi-party in nature, with more than one water company involved in the supply and transfer of water between regions. They range from water reservoirs to water recycling and water transfers and are explained in summary in our October 2022 publication 'Building a resilient future – a guide for investors and the supply chain'³.

Developing regional, potentially multi-party infrastructure of this scale and complexity inevitably leads to challenges and issues for our existing regulatory and commercial frameworks. Historically, the sector has not had to deliver such a significant programme of major infrastructure at one time. This means they may not have the necessary skills or capacity in-house for delivering these projects and there may be opportunities for accessing

² WRMPs set out how water companies (in England and Wales) intend to achieve a secure supply of wholesome water for customers and a protected and enhanced environment both now and in the long term. The duty to prepare and maintain a WRMP is set out in sections 37A to 37D of the Water Industry Act 1991. Plans are produced at least every 5 years and reviewed annually. Within their WRMPs water companies plan for at least the next 25 years. Water companies should take a leading role in a more holistic and integrated approach to water management exploring all opportunities to deliver cross sector mutual benefits, for society and the environment.

³ [Building a resilient future – a guide for investors and the supply chain](#), October 2022

different funding models. As a result, we are of the view that for the RAPID programme of projects, significant benefits could be derived for customers through competitive tendering of major infrastructure projects. This would allow third parties to design, build, finance, and potentially operate and/or maintain major infrastructure. This policy forms part of Ofwat's PR24 methodology as it can result in better value for customers by driving down costs and increasing innovation, while maintaining quality. The PR24 methodology also provides for benefits to customers in areas exporting water: customers receive a 50% share of the economic profit calculated for any trade which therefore benefits those customers for supporting resilience for other companies' supplies.

Commercial frameworks for solutions

The current regulatory and commercial frameworks are not fit for purpose to support the delivery of these solutions. The multi-party nature of solutions, and the use of competitively appointed third parties are new elements which will require adaptations and development of existing regulatory and commercial frameworks. We see a need to provide the sector with information as to how solutions will be regulated and how we expect commercial arrangements to be structured to deliver solutions which are in the best interests of customers, society and the environment. Commercial frameworks include contractual and charging arrangements, as well as operational arrangements.

In December 2021 RAPID consulted on our initial thoughts on how the framework needs to change and published a consultation outcome document in August 2022⁴. Since then, we have been working to develop the policies in more detail.

We are now consulting on our current thinking on:

- Commercial delivery models, including our preferred model for solutions. Based on our own analysis and market engagement, we consider that there are substantial benefits to customers with water companies adopting a broadly common model approach across the portfolio of RAPID solutions. Our proposal is to focus the competitive procurement on delivery of infrastructure and for each solution to be driven by a lead water company, to ensure clear and appropriate allocation of responsibilities and risk; and
- Contractual arrangements for water transfers. We propose producing updated guidance on bulk supply transfer agreements for RAPID solutions which will also consider the standardisation of contract provisions, operation of solutions at times of drought or other operational incident, charging guidance and possible future use of statutory codes and / or charging rules.

⁴ [The Regulatory and Commercial Framework for Strategic Water Resource Solutions – a consultation, December 2021; The Regulatory and Commercial Framework for Strategic Water Resource Solutions – Outcome document, August 2022](#)

We have engaged with all regulators involved in RAPID as we have developed this consultation and engaged also with water companies.

Responding to this consultation

We welcome any comments on this document. Please email them to rapid@ofwat.gov.uk.

The closing date for this consultation is **Thursday 29 February 2024**. If you wish to discuss any aspect of this document, please email us at rapid@ofwat.gov.uk or post them to:

RAPID – Response to Consultation on commercial arrangements
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA.

We intend to publish responses to this consultation on our website at www.ofwat.gov.uk/regulated-companies/rapid. We will also share responses with our partner regulators (Ofwat, the Environment Agency and DWI), and with NRW.

Please note that by providing a response to this consultation you are deemed to consent to its publication on our website.

If you think that any of the information in your response should not be disclosed (for example, because you consider it to be commercially sensitive), an automatic or generalised confidentiality disclaimer will not, of itself, be regarded as sufficient. You should identify specific information and explain in each case why it should not be disclosed and provide a redacted version of your response, which we will consider when deciding what information to publish.

At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons why the contents of those written responses remain confidential. In relation to personal data, you have the right to object to our publication of the personal information that you disclose to us in submitting your response (for example, your name or contact details). If you do not want us to publish specific personal information that would enable you to be identified, our privacy policy explains the basis on which you can object to its processing and provides further information on how we process personal data.

In addition to our ability to disclose information pursuant to the Water Industry Act 1991, information provided in response to this consultation, including personal data, may be published or disclosed in accordance with legislation on access to information – primarily the Freedom of Information Act 2000 (FoIA), the Environmental Information Regulations 2004 (EIR) and applicable data protection laws.

Please be aware that, under the FoIA and the EIR, there are statutory Codes of Practice which deal, among other things, with obligations of confidence. If we receive a request for disclosure of information which you have asked us not to disclose, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

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1. Background

RAPID (Regulators' Alliance for Progressing Infrastructure Development) is a partnership of three water regulators: Ofwat, the Environment Agency and Drinking Water Inspectorate. Natural Resources Wales is involved in an advisory capacity and has a decision-making role for any solution involving Wales and Welsh legislation / policy. We work closely with both governments in England and Wales. The Environment Agency leads our engagement with Natural England.

We are supporting strategically important new water resource infrastructure supply solutions (referred to in this document as 'solutions') to be developed by water companies with funding secured in PR19. Our vision is resilient, timely, high-quality, environmentally beneficial water resources which are acceptable and affordable for customers. We seek to achieve this through regulators working together to promote the development of solutions that are in the best interests of water users, society and the environment. Solutions involving sourcing water from Wales must demonstrate benefit to the economy, people/society, and environment of Wales, and have regard to the interests of Wales, as set out in relevant Welsh policy and legislation, with particular focus on sustainable management of its natural resources and the well-being goals for Wales.

1.1 The strategic water resource solutions

Proposed solutions will form part of the Water Resource Management Planning process. These plans are expected to be finalised early in 2024, subject to approval by the Secretary of State in the Department for Environment, Food and Rural Affairs (for England) or Minister for Climate Change, Welsh Government (for Wales)⁵. These final plans will set out the need for the proposed solutions, enabling them to be taken forward to the statutory planning process. In PR19 Ofwat set aside £469m of funding to explore the development of the potential solutions. Development of these solutions is subject to a formal gated process where decisions are made on key milestone delivery penalties and solution funding progression. The details of gate allowances, activities at each gate and delivery incentives are described in more detail in PR19 final determinations: Strategic regional water resource solutions⁶.

RAPID supports and oversees the development of the solutions through the gated process, the role of which is to assess the progress made in development of each solution and to provide advice and recommendations to Ofwat to enable Ofwat to make decisions on

⁵ See section 37A of the Water Industry Act 1991. Approval in this context means that the Secretary of State or the Welsh Minister, as the case may be, have chosen not to require changes to a draft water resource management plan. The Welsh Minister has this power in relation to companies who operate wholly or mainly in Wales, and the Secretary of State has this power in relation to companies who operate wholly or mainly in England.

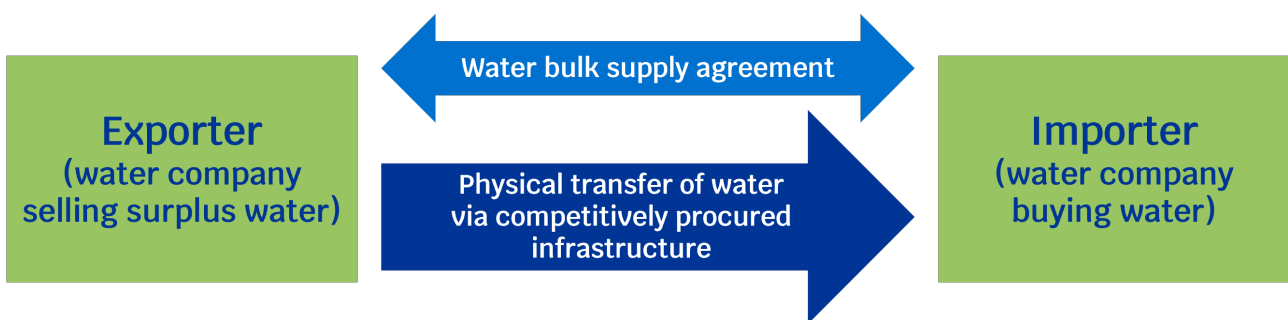
⁶ [PR19 final determinations: Strategic regional water resource solutions, December 2019](#)

continued ringfenced funding for solution progression. The purpose of the gated process is to ensure at each gate that:

- Water companies are progressing strategic water resource solutions that have been allocated funding at PR19 or have subsequently joined the programme;
- costs incurred in doing so are efficient; and
- solutions merit continued investigation and development during the period 2020 to 2025.

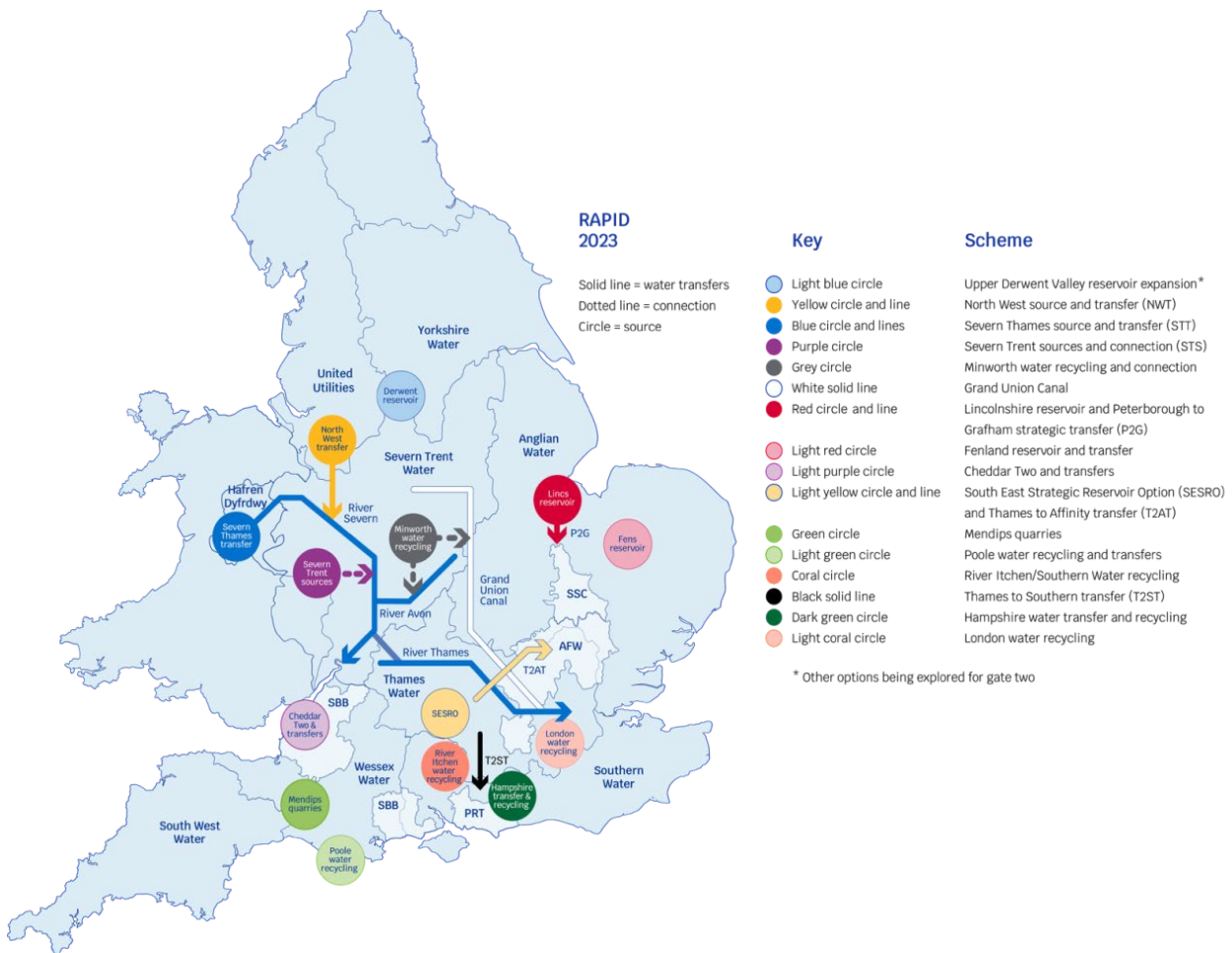
The solutions are regional schemes and multi-party in nature. They range from bilateral (bulk supply) water transfers between two water companies to those with multiple water companies (those selling the water - the exporters and those buying the water - the importers). For some solutions multiple water companies could be providing water to a lead water company who then exports to one or more importing companies. Figure 1 below sets out the high-level parties and process for a bulk supply transfer.

Figure 1 Basic representation of water transfers and parties



There is a programme of 18 projects involving over 2300MI/day, or equivalent to the needs of more than 10 million people. All schemes are from English water companies, although some may involve water transfers from Wales. Figure 2 below is a pictorial representation of the solutions.

Figure 2 Map of strategic water resource solutions



1.2 Delivering new infrastructure through competition

In PR24, Ofwat stated that major new infrastructure should be delivered by competitive delivery models. For all major new infrastructure, water companies need to assess whether they can deliver the scheme by Ofwat's Direct Procurement for Customers (DPC) framework, or where appropriate the Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 (SIPR) model used for Thames Tideway Tunnel (TTT).

DPC is a process whereby companies put major infrastructure projects out to competitive tender for delivery by third parties for all discrete projects above a size threshold of £200m whole life totex⁷. The successful bidders for DPC projects, known as the Competitively Appointed Providers (CAPs), will be responsible for designing, building, financing, maintaining and potentially operating the infrastructure.

⁷ [PR24 Methodology - Appendix 5 - Direct Procurement for Customers, July 2022](#)

Ofwat consulted on and published final guidance on the DPC process in early 2023⁸.

SIPR provides a regulatory process for competitively tendering for large and complex water and wastewater infrastructure. Third party delivery through SIPR may be available where projects meet the required threshold test which is that:

- i. the infrastructure is of a size or complexity that threatens the incumbent undertaker's [water company's] ability to provide services for its customers; and
- ii. specifying the infrastructure project is likely to result in better value for money than would otherwise be the case.

This model requires the infrastructure to be specified by the Secretary of State or Ofwat if in their opinion a project meets this test.

An Infrastructure Provider (IP) appointed under SIPR may be issued with a project licence, therefore being directly regulated by Ofwat. Once licenced, an IP is also regulated under the Water Industry Act 1991, as applied to infrastructure providers by SIPR. The IP is responsible for designing, building, financing, maintaining and potentially operating the infrastructure. SIPR is not available as an option for Welsh projects (although if any part of the infrastructure is in Wales, Welsh Ministers must be consulted prior to the project being specified).

1.3 Regulatory and commercial frameworks

Developing regional, potentially multi-party infrastructure of this scale and complexity inevitably leads to challenges and issues for our existing regulatory and commercial frameworks.

We therefore committed to exploring how we could evolve and adapt frameworks so that emerging aspects, be they opportunities, gaps or barriers, can be addressed. In addition, we recognise that the legislative frameworks in England and Wales differ and therefore cross border solutions may require differing approaches.

There will be a need for commercial and regulatory frameworks to govern the design, build, financing and operation of the infrastructure required to support the solutions, and where there is a transfer of water between an exporting water company (seller) and an importing water company (buyer) there will be a need for agreements to govern that supply. There may also be a need for supplementary agreements where third parties are involved in providing the additional sources and infrastructure (for example entities like the Canal and River Trust).

⁸ [Guidance for Appointees delivering DPC Projects, March 2023](#)

1.4 Commercial structures

Multi-party and third-party contractual arrangements are relatively new for the sector, and the types of contracts needed will depend on the commercial model under which the solutions are delivered and operate, and the commercial risks that flow from those structures. (We discuss models in more detail with diagrams illustrating these arrangements in chapter 2.)

One of the objectives of this consultation is to get views on developing a coherent and standardised framework for the commercial structures which may result in more consistent contracts addressing risks and issues in a similar consistent manner, where appropriate. Development of a consistent framework with common standards is likely to unlock programmatic benefits for the programme of solutions and will result in better value for customers through reducing transaction costs, avoiding first of a kind premium on each project, developing standardised commercial structure and risk allocation which may attract a lower cost of capital, and achieving increased competition through repeatability of the pipeline.

1.5 Guidance on negotiating bulk supply agreements

Most solutions will involve bulk supply water transfers. This is the transfer of a supply of water from one appointed water company to another. Bulk supplies are sometimes referred to as 'water trades' as they are a way for water companies to trade surplus water to other companies which need more – transferring surplus water across geographical areas to those areas that need it more. Water companies can draw up a contract between them (a bulk supply agreement) that sets out the terms and conditions of a bulk supply, including price. Water trades can have economic and environmental benefits, by providing alternative sources of supply that have lower costs or lower environmental impacts.

Transporting the bulk supply from one company to another company involves an 'interconnection' or transfer. To date, these arrangements have either used existing infrastructure or have required small scale interventions to existing systems and infrastructure and have been designed, built, financed, operated, and maintained by the water company selling the water (the exporter).

In 2013 Ofwat published 'Negotiating bulk supplies – a framework'⁹. This was non-statutory guidance for water companies to assist them in negotiating bulk supply agreements and to provide a clear indication of Ofwat's approach if a matter is referred to us under either sections 40 or 40A of the Water Industry Act 1991. Under these provisions, Ofwat can determine the terms of a bulk supply agreement (or vary or terminate a bulk supply agreement), if the parties are unable to agree and one of the parties refers the matter to us.

⁹ [Negotiating Bulk Supplies – A Framework, August 2013](#)

We have reviewed the guidance in the light of the current solutions and their requirements. Developed in 2013, before competitive delivery was required for major infrastructure, the guidance did not need to consider agreements involving multi parties. It also focused on new appointees and assumed that the infrastructure for bulk supplies was either already in place or would be put in place by the exporter. In this consultation we seek views on supplementing that guidance to deal with the characteristics of strategic water resource solutions.

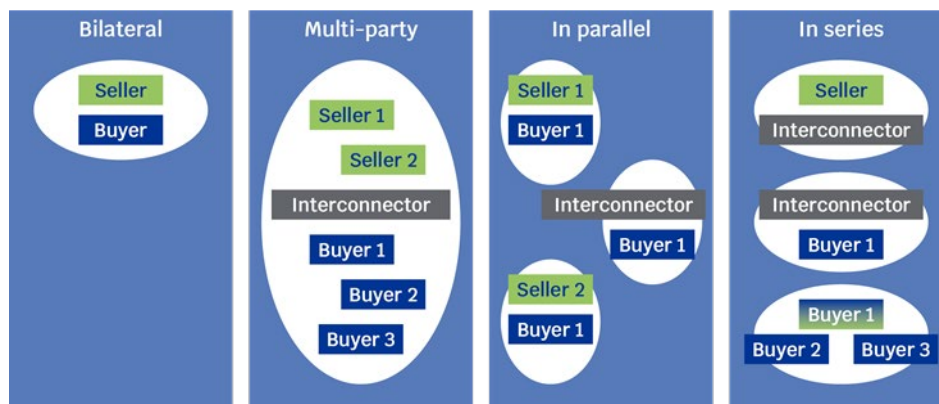
We consider there is a need to develop updated/further guidance on bulk supplies for RAPID projects only. This guidance would not apply retrospectively to any other existing bulk supply agreements. We have also considered whether there is a case for issuing a statutory code and charging rules dealing with bulk supplies. In this consultation we also seek views on developing a statutory code and charging rules in the longer term.

2. Commercial structures – a policy discussion

In our December 2021 consultation on regulatory and commercial frameworks¹⁰, we set out that there would need to be commercial arrangements in place for all aspects of any delivery solution to enable the supply of water between water companies and the development and utilisation of additional infrastructure required to enable such a supply.

The consultation explained that there were options for regulating the solutions and included an assessment of contract types. At its simplest, contract types could be a bilateral contract for supply from one water company (Seller – also known as 'Exporter') to another (Buyer – also known as 'Importer'). For a more complex solution there might be more than one seller, more than one buyer and newly developed infrastructure such as an interconnector or reservoir developed to facilitate the supply. Infrastructure to facilitate a supply may be delivered by a third party financed solution (i.e., a CAP or an IP). There might also be infrastructure delivered directly by an incumbent water company to facilitate the supply. We considered a range of options to bundle or unbundle different elements and to arrange contracts in parallel or series, as demonstrated in Figure 3 below where each white oval represents a separate contract.

Figure 3 Options for contract structure from December 2021 consultation



We received limited comment on these options. We have since developed our thinking on the framework which we consider companies should adopt for commercial models and contractual arrangements. Our further thinking has developed and been tested in conjunction with engagement with companies through our regulatory and commercial steering groups.

¹⁰ [The Regulatory and Commercial Framework for Strategic Water Resource Solutions – discussion document \(June 2021\)](#); [The Regulatory and Commercial Framework for Strategic Water Resource Solutions – a consultation \(December 2021\)](#); [The Regulatory and Commercial Framework for Strategic Water Resource Solutions – Outcome document \(August 2022\)](#)

This consultation therefore sets out how we anticipate the commercial contracts should be broadly structured for most solutions.

More specifically, this chapter sets out the outline contractual and regulatory arrangements where a bulk supply is to be facilitated by the development of significant new infrastructure (i.e., significant new infrastructure is developed either: (a) to create water resilience/ capacity to enable a supply for the benefit of more than one water company); or (b) to facilitate a supply between water companies). This includes what the arrangements should be for the design, construction, finance, maintenance, and operation of the infrastructure; whether bulk supply agreements are needed; how transfers are governed and operated (including during time of drought or other operational events); and charging arrangements.

We note that not all bulk supplies will require new infrastructure and water companies should always test options to find the optimal solution to facilitate any bulk supply.

2.1 Types of commercial structures

As far as possible water companies entering into bulk supply arrangements enabled by new infrastructure should use a common default commercial structure (save where exceptions can be justified on a value basis). RAPID continues to develop its thinking on the detail within the commercial structures, recognising the individuality of the solutions and the different solution types. However, we consider there to be benefits in using a default commercial model.

This will both ensure equity across customers and avoid companies duplicating effort in developing models in isolation.

We consider it will also ensure transparency of contractual approach – assisting with market, investor and supply chain engagement, resulting in better deals from a more engaged and competitive market if there is a common commercial model against which they are bidding for delivery of the solutions.

A common commercial structure will also unlock the programmatic benefits of delivering several large complex infrastructure projects in parallel and should deliver greater value for money than “reinventing the wheel” for each project removing first of a kind premium, creating a more standardised approach to develop similar infrastructure and achieve similar risk profiles and thus lowering the transaction costs and potentially the cost of capital for solutions.

However, we recognise that a “one-size-fits-all” approach may not work in every case. Elements of any project may need to be specifically tailored.

This consultation considers how risk associated with different commercial structures may be allocated between different parties – water companies, third parties (CAP or IP) and customers (see section 2.4.).

2.2 The role of a CAP / IP for solutions

The role of a CAP/IP may differ depending on the solution. However, in the models we have considered, we have primarily focussed on a CAP/IP whose role is confined to infrastructure delivery – namely the role of the CAP/IP is to design, construct, finance, maintain and/or operate the infrastructure that facilitates the bulk supply. In this regard, we have preserved the typical arrangements for a CAP/IP (an infrastructure only approach).

We acknowledge that there is an alternative model (an entire service model). Under this entire service model, the CAP/IP does not just design, build, finance, maintain and operate the infrastructure that facilitates a supply, but takes contractual and regulatory responsibility for some or all of the actual supply. This could potentially include responsibility to one or both water companies for sourcing/abstracting/supplying the water and/or providing the supply of water downstream to the importers (water companies buying the water).

However, our preferred commercial structure (save where exceptions can be justified on a value basis) is infrastructure only. Reasons for this include that the “entire service” model:

- Results in the CAP/IP taking on functions that may be more typically associated with a water company itself.
- Changes the investment proposition typically envisaged in respect of CAPs and IPs. Instead of being ring-fenced special purpose vehicles (SPVs) providing critical infrastructure (typically on an availability basis), they take on a greater service function and broader liabilities and obligations. This may impact the financeability and indeed the cost of finance of a CAP/IP.
- Means that a bulk supply agreement will not be between two water companies but will be from a CAP/IP to two or more water companies. This type of bulk supply agreement does not fall within the statutory bulk supply regime that allows for regulation by Ofwat to protect customers.¹¹

For these reasons, we do not consider an entire service model further here.

However, we do not preclude variants of the infrastructure only model – in particular the scope of an obligation to maintain and operate infrastructure may vary considerably from solution to solution.

¹¹ Sections 40 and 40A of the Water Industry Act 1991 allow Ofwat to set the terms of a bulk supply agreement if the parties to the agreement cannot agree such terms. However, this only applies to a bulk supply agreement between water companies.

2.3 Commercial structures: options

We set out below the two basic infrastructure only commercial structure options which we have considered – a lead party option and a multi-party option. Variations can arise depending on whether the project is delivered under DPC or SIPR.

Lead Party Model

In the Lead Party Model, one water company (“Lead Water Company”) “delivers”¹² the relevant infrastructure that facilitates a multi-water company supply. It develops this infrastructure both on behalf of itself and the other water companies who will benefit from the supply (i.e., the exporters and importers). Actual export and import would remain the responsibility of the Lead Water Company by way of a bulk supply agreement.

More specifically, the Lead Water Company procures and appoints (through competitive tender) a third party provider (an IP or a CAP). The CAP/IP will enter into a contract (or contracts) with that Lead Water Company – these contracts will set out the obligation to provide the infrastructure and provide for payment to the CAP/IP.

Under a Lead Party Model, the CAP/IP may be responsible for the design, construction, completion, maintenance and operation of infrastructure that facilitates a supply (and the financing of those activities). The CAP/IP would enter into subcontracting arrangements for works with one or more contractors.

The role of the CAP/IP relates to the relevant infrastructure. The infrastructure will integrate into the network run by a water company (likely the Lead Water Company¹³). The CAP/IP will not be responsible for the wider “entire service” functions that facilitate a supply (as explained in section 2.2).

To ensure the transfer of water from any exporters to any importers and appropriately allocate both the costs for any water supply and the costs of the infrastructure that facilitates it, there is a bulk supply agreement between the Lead Water Company and the other water companies. In some cases, such as some of the reservoir solutions, we expect the Lead Water Company to be exporting water to other water companies. For other solutions, the Lead Water Company may be the main importer. We also note there may be certain circumstances where two-way transfers are required – for example in respect of transfer assets.

¹² 'Delivers' means the planning and development of the project to tender stage and putting the project out to tender for a CAP/IP.

¹³ There is a working assumption that the lead party is likely to be the party in whose water supply area the asset is constructed. This does not necessarily have to be the case, but additional complexity arises where it is not.

Lead Party Model replicates business-as-usual water practice, whereby water companies hold responsibility for the assets in their own networks (albeit when such assets are to be delivered by a CAP or IP the nature of that responsibility may be altered).

Figure 4 below shows a possible high-level structure for a Lead Party Model both under a DPC and SIPR approach. Key features of this model are set out in table 1 below.

Figure 4 Lead Party Model

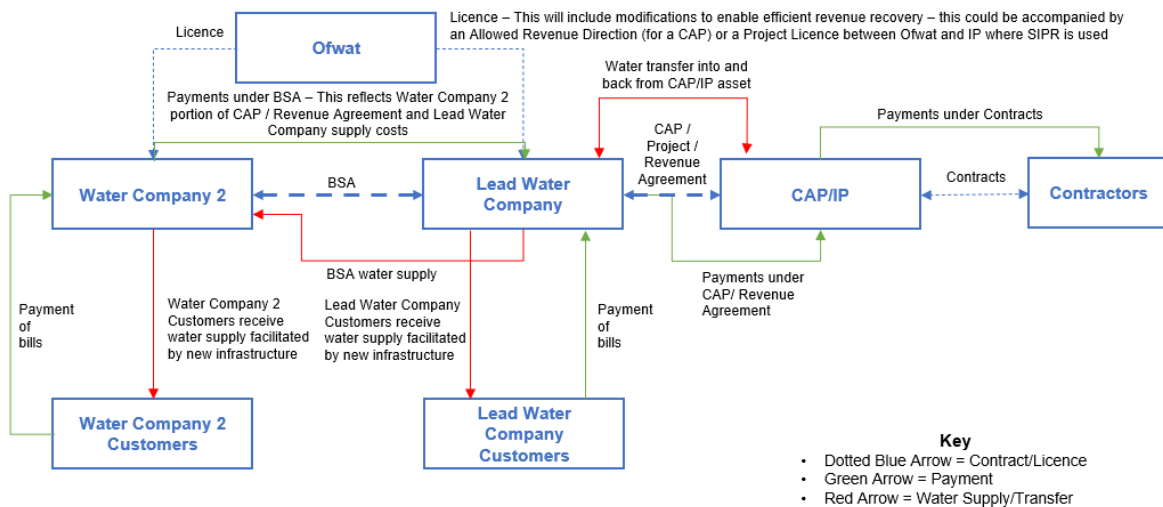


Table 1 Features of Lead Party Model

| FEATURE | LEAD PARTY MODEL |
|--------------------|---|
| Commercial | Ensures supply and flexibility of operations by way of a bulk supply agreement between water companies. |
| | The CAP/IP has a single employer/instructing water company i.e., the Lead Water Company. Water Company 2 may benefit from governance rights to enable it to manage its cost and non-supply risk. These governance rights would be set out in the bulk supply agreement. |
| Financial | The CAP/IP directly relies upon a single counterparty (Lead Water Company) for payment. The CAP/IP role is to provide the relevant infrastructure asset to the Lead Water Company (the scope of any operation and maintenance of the CAP/IP would need to be defined on a value basis). |
| | The Lead Water Company may take a degree of credit counterparty risk on Water Company 2 to make payments under the bulk supply agreement – this facilitates payments to the CAP/IP. |
| Contractual | The Lead Water Company will contract directly for the delivery of the infrastructure asset with the CAP/IP, not Water Company 2. |

| | |
|---------------------------|--|
| | <p>The Lead Water Company and Water Company 2 enter into a bulk supply agreement. The bulk supply agreement will contain obligations on the Lead Water Company to build the infrastructure asset to facilitate the water supply. It will also contain rights for the Lead Water Company to recover certain costs incurred in respect of the infrastructure asset and supply (these should be proportionate to the amount of benefit that Water Company 2 derives from the asset). In addition, the Lead Water Company will have obligations to make supply (this may require assets and processes beyond those controlled by the CAP/IP). In the event of a two-way supply this could also be accommodated under the bulk supply agreement.</p> |
| <p>Operational</p> | <p>Water Company 2 is reliant on the Lead Water Company for its supply. The bulk supply agreement will need to appropriately incentivise the Lead Water Company to supply. Where Water Company 2 has made payments for an infrastructure asset that facilitates the supply there should be very limited circumstances where the Lead Water Company may reduce supply.</p> <p>There will also be an Agreement between the Lead Water Company and the CAP/IP which will cover the scope of any operation and maintenance of the infrastructure asset by the CAP/IP. This Agreement may (amongst other things) set out any compensation that becomes due for any operational failures of the infrastructure asset caused by the CAP/IP.</p> |
| <p>Regulatory</p> | <p>Ofwat will have a role:</p> <ul style="list-style-type: none"> • In the development of the procurement of any: <ul style="list-style-type: none"> • CAP pursuant to Condition U of the Lead Water Company’s licence; and/or • IP pursuant to SIPR. • In approving the Approved Revenue Direction (ARD) related to any CAP or issuing any project licence, specification notice and designation pursuant to SIPR. • In issuing price controls for the Lead Water Company, Water Company 2 and any IP. • Potentially in respect of the bulk supply agreement, if the water companies cannot agree the terms or wish to vary the terms or terminate the arrangement (under sections 40 and 40A of the Water Industry Act 1991). |

Multi-Party Model

In the Multi-Party Model, two (or more) water companies jointly procure and/or appoint a CAP/IP (through competitive tender) for the design, construction, completion, operation and / or maintenance of infrastructure that facilitates a bulk supply and the financing of such activities.

To note that if the Multi-Party model is being used under SIPR, the statutory test for specification would likely have to be met in respect of each water company.

The CAP/IP carries out activities strictly limited to the availability of an infrastructure asset that facilitates a supply.

| | |
|--------------------|---|
| | <p>Dual employer management risk – Both water companies may take an active role in managing and specifying what is to be built by the CAP/IP. Water companies may consider appointment of a managing agent to act collectively on their behalf.</p> |
| Financial | <p>The CAP/IP relies upon both water companies for payment. Detailed consideration of liabilities between water companies would be required in the event of single water company payment default.</p> |
| | <p>Each water company remains exposed to credit risk of the other (albeit indirectly), as functioning of the infrastructure asset that facilitates supply is dependent on both water companies meeting their payment commitments.</p> |
| Contractual | <p>The role of the bulk supply agreement is more limited in a multi-water company scenario. The bulk supply agreement does not govern the infrastructure asset.</p> <p>Where a CAP is used, water companies may need to address what happens upon expiry of the CAP Agreement (if the useful asset life outlasts the CAP Agreement).</p> |
| | <p>Responsibilities and rights of each of the water companies would need to be clear in the event that the CAP Agreement is terminated, or the project is de-specified.</p> |
| Operational | <p>Under a bulk supply agreement, the company buying the water will be reliant on the exporter for the supply and the bulk supply agreement will need to appropriately incentivise the exporter to supply in all scenarios. There should be very limited circumstances where the water company selling the bulk supply can affect any reduction to the supply.</p> |
| | <p>Ownership of the infrastructure asset would need to be considered. Accounting treatment would also require consideration in this regard. Joint ownership of the asset may occur (subject to considerations in respect of ring-fencing), but integration in existing infrastructure of one water undertaker network and location in single supply area may be problematic. Therefore, the asset is most likely to be owned by Water Company 1 (the Exporter). Likely to be inappropriate for assets to be fully owned by the CAP/IP</p> |
| Regulatory | <p>Ofwat will have a role:</p> <ul style="list-style-type: none"> • In the development of the procurement of the: <ul style="list-style-type: none"> • CAP pursuant to Condition U; and/or • IP pursuant to SIPR. • In approving the Approved Revenue Direction (ARD) related to any CAP or issuing any project licence, specification notice and designation pursuant to SIPR. • In issuing price controls for Water Company 1, Water Company 2 and any IP. • Potentially in respect of the bulk supply agreement if the parties cannot agree the terms or wish to vary the terms or terminate the arrangement. |

2.4 Commercial structures: responsibilities and risks

Each of the above commercial structures result in differences in the responsibilities and risks to which the water companies and any CAP/IP are exposed.

In this consultation, we would welcome views as to likely risk allocation in the above commercial structures and the challenges that may result. Such risks and responsibilities should be considered (as a minimum) in the context of: (a) the ability to deliver for customers at best value; (b) the impact on participating water companies' ability to deliver their functions (in both operational and regulatory terms); (c) the impact on the financeability of participating water companies; and (d) the impact on the financeability (and value of finance) of a CAP/IP.

We do not set out all of the possible allocations of risk and responsibilities below. This is for water companies to develop in the context of their specific projects. However, we provide two examples of particularly material risks that would need to be considered:

Example Risk 1 – Financial Risk/Credit Risk

A key difference between the Lead Party Model and the Multi-Party Model is the issue of financial/credit risk. With a Lead Party Model, there is a single counterparty (Lead Water Company) responsible for payment to the CAP (or the IP under SIPR), while under the Multi-Party Model, the CAP/IP would rely on both water companies¹⁴ for payment.

In practice this means that under the Lead Party Model, other water companies would be responsible for payments to the Lead Water Company for onward payment to the CAP or IP, making the Lead Party reliant on payments from those companies. Under the Multi-Party Model, both Water Company 1 and 2 would be responsible for paying the CAP or IP directly for the water they receive. All parties are reliant on one another to make payments to preserve the CAP/IP as a going concern.

Where risks are significant, there are a range of mitigations that may be implemented or considered. For example, relevant payment obligations could be made on a 'pay when paid' basis instead of a 'pay when due' approach. All approaches would need to be justified on a value for money basis.

¹⁴ Contracts between the CAP/IP and water companies do not come within the statutory definition of a bulk supply agreement (for which Ofwat has a statutory function to determine the terms if participating water companies cannot reach agreement on them, and one or both of the companies ask Ofwat to make such a determination on the bulk supply agreement).

Example Risk 2 – Supply Risk

In a Lead Party Model and a Multi-Party Model, Water Company 2 takes supply from Water Company 1. Water Company 1 is reliant on the CAP/IP for supply.

Water Company 1 also needs to be incentivised to supply. This may necessitate liquidated damages where Water Company 1 does not make a supply. Water Company 1 may seek to limit its exposure to damages for non-supply where the non-supply is solely attributable to the CAP/IP.

This is notably different from a potential entire service model, where both parties take supplies directly from the CAP/IP.

These issues and others need to be taken into account in terms of possible commercial implications in any contractual arrangements.

We welcome views on the responsibilities and risks of different models and ways in which they might be mitigated.

2.5 RAPID's preferred model

RAPID continues to develop its thinking on the detail within the commercial structures, recognising the individuality of the solutions and the different assets being provided. However, as explained above, we consider there to be benefits in using a default commercial model (save where exceptions can be justified on a value basis).

Our preferred delivery model is a Lead Party Model, (modified accordingly if a project is delivered under DPC or SIPR), provided on an infrastructure only basis.

We seek your views on this approach in the questions below.

Questions for stakeholders

Chapter 2 – Commercial structures

Q2.1. Do you agree that there should be a default commercial structure across all solutions, with deviations permitted by exception and depending on the specific circumstances of the solution? Please explain your answer.

Q2.2. a) Do you agree with the preferred commercial structure being a lead party model? Please explain your answer. b) Do you agree with the preferred commercial structure being an infrastructure only model? Please explain your answer.

Q2.3. Please provide suggestions for any other commercial structure you consider may be appropriate either as the default approach or for exceptional circumstances.

Q2.4. We welcome your views on the different risks and responsibilities associated with different models. Please provide comments on risks not detailed in the paper which you consider may have a material impact on the choice of commercial structure.

Q2.5. Please provide comment on ways in which risks identified in Q2.4 may be mitigated.

3. Bulk supply agreements – a policy discussion

3.1 Framework for negotiating bulk supplies

A bulk supply agreement is an agreement for a bulk supply of water between two water companies. A bulk supply agreement sets out the terms and conditions of the bulk supply transfer, including how it would operate and the price.

Ofwat has a statutory function to determine the terms of a bulk supply agreement, if the two water companies cannot reach agreement on such terms, and one or both water companies ask Ofwat to make such a determination. Ofwat may also be asked to vary the terms of an existing bulk supply agreement (or terminate such an agreement), if requested to do so by one or both of the parties (sections 40 and 40A of the Water Industry Act 1991 (WIA91)).

In 2013 Ofwat published 'Negotiating bulk supplies – a framework'.¹⁵ This was non-statutory guidance for water companies to assist them in negotiating bulk supply agreements and to provide a clear indication of Ofwat's approach if a matter is referred to us under either sections 40 or 40A of the Water Industry Act 1991.

Ofwat's objective for the 2013 guidance was to facilitate bulk supply negotiations between companies, providing a framework of fourteen provisions (see table 1 below) to include in such agreements.

Table 3 Areas in Ofwat's 2013 bulk supply agreement framework

| | |
|--|--|
| Price and non-price terms | Agreement would consist of both types of terms, for example 'price' could include a minimum charge the recipient of the water pays; a non-price term could include ownership and responsibility for the assets |
| Facilitating the addition of new sites or connections | Bulk supplies for new appointees |
| Ownership of and responsibility for the assets | Agreement should make clear who owns and is responsible for maintaining the assets |
| Measuring the water supplied | Specifications for the standard for the meter or equipment used to measure water being supplied |
| Quality of the water supplied | Bulk supplies could relate to untreated, partially treated and potable (drinking) water and the agreement should define the type being supplied |
| Adjusting prices | Explain how any adjustments may be made to take account of inflation for example |
| Interruptible or firm supply | Level of supply certainty for the transfer |

¹⁵ [Negotiating bulk supplies – a framework, August 2013](#)

| | |
|---|---|
| Interruptions of supply to carry out planned maintenance | So that receiving company knows when it needs to find alternative sources for customers |
| Co-operation in emergency situations | Definition of an 'emergency' and how parties would deal with it |
| Co-operations at times of water shortage | What would happen during time of water shortage |
| Liability for planned and unplanned interruptions | How the recipient would be compensated if there was an interruption in the water transfer |
| Duration | How long the agreement would be in place for |
| Dispute resolution | How either party might resolve a dispute around the transfer |
| Termination | How either party might terminate the agreement if required |

Having been developed in 2013, primarily for the new appointee market, the guidance does not deal with the possibility of there being multi-parties to a bulk supply agreement nor does it deal with the possibility of both parties to the bulk supply agreement paying for new infrastructure to facilitate the bulk supply. We have reviewed the guidance and considered its application to the RAPID solutions. To do this we undertook a gap analysis, referencing a recent bulk supply agreement made between two water companies that was available to us, to assess whether the existing guidance sufficiently covered all of the areas required for the bulk supply transfers being developed through RAPID.

3.1.1 Gap Analysis

In undertaking the gap analysis, we referenced the bulk supply agreement recently agreed for the Havant Thicket Reservoir.¹⁶ The agreement is between Portsmouth Water and Southern Water, and while it does not involve a CAP or IP, the agreement has been a useful reference document because it includes the development costs of new infrastructure that is constructed specifically to facilitate a bulk supply.

Portsmouth Water is planning to construct the Havant Thicket reservoir in its areas of operation for the purpose of facilitating a supply to Southern Water. Portsmouth Water will design, construct, operate and maintain a reservoir of approximately 8,700 mega-litre (Ml) capacity. This will enable Portsmouth Water to provide Southern Water with up to 21 Ml/day from its Gaters Mill water treatment works.

The two companies have entered into a bulk supply agreement. Under the bulk supply agreement charges are payable by Southern Water to Portsmouth Water. These charges include a capacity charge which represents the cost of constructing, operating, maintaining

¹⁶ For more detail on the regulatory framework for delivery of Havant Thicket reservoir, please see our [guidance on Havant Thicket](#).

and financing the reservoir, and a volumetric charge which reflects the incremental operating costs of providing water to Southern Water. The capacity charge will be payable for the duration of the agreement (about 80 years).

This bulk supply agreement reviewed covers all the 14 areas in the Ofwat guidance and has a number of additional provisions.

3.1.2 Conclusion

We consider that when developing bulk supply agreements there is a need to have a consistent approach which would help achieve greater standardisation. Following discussion within RAPID, Ofwat, our partner regulators and with the water industry, our conclusion is that the RAPID solutions require new guidance for negotiating bulk supply agreements.

The new guidance will be specific for RAPID solutions and the existing 2013 guidance will remain in place for other bulk supply agreements, including those between new appointees and incumbent water companies.

To assist with developing new guidance we have drawn on the gap analysis work and developed Appendix 1 (A1), which sets out a summary of some of the key areas that should be covered in bulk supply agreements for RAPID solutions.

We will use this Appendix to form the basis on which we undertake further work to develop the new guidance and to develop standardised approaches to the areas set out in Appendix 1. We invite your views on the areas set out in Appendix 1 and any additional areas to include.

We will take steps to develop this and consult on it by early summer 2024, with the intention of finalising the document by late 2024.

Questions for stakeholders

Chapter 3 - Section 3.1 - Framework for negotiating bulk supplies

Q3.1. Do you agree with our conclusion that the solutions in the RAPID programme require a new guidance framework for negotiating bulk supplies? Please explain your answer.

Q3.2. Please provide your views on the areas likely to be required in bulk supply agreements for RAPID projects as set out in Appendix 1 and please list any areas that you consider are missing from Appendix 1.

3.2 Standard bulk supply agreement provisions

In our December 2021 consultation we explained that we consider there is benefit in some contract provisions being standard for all bulk supply agreements, recognising that some provisions will need to be bespoke to deal with project specific factors. As the anticipated number of bulk transfers increases in the coming years to tackle regional differences in water demand, standardisation of provisions (as with standardisation of commercial arrangements) can aid delivery for the following reasons:

- Economic – standardisation can decrease the time taken to reach agreement, by reducing the issues which must be negotiated, thereby reducing transaction costs and reducing the first of a kind premium where the market gets familiar with standard commercial terms/risk allocation etc.
- Investment – clarity on provisions expected to be included in agreements gives investors (both in water companies and in any CAP/IP) visibility of contract terms increasing their confidence and improving the effectiveness of competition.
- Reducing the need for referrals of disputes to Ofwat – standardisation is likely to reduce disputes over terms thereby reducing matters referred to Ofwat for determination. This in turn could build greater cooperation between companies and thereby build resilience in the sector. Cooperation could produce economies of scale, making more efficient use of surplus water and saving each water company money in the long run.
- Better services and more protection for customers - standardisation can encourage good practice across the industry, ensuring consumer interests are protected and potentially enabling better delivery of services to customers.
- More economic water trades – transparency on the issues included in agreements may reduce barriers to trade and improved consistency may increase the extent to which trading is based on underlying economic value rather than different contractual provisions.

There was majority support in the December 2021 consultation for some conditions of bulk supply contracts to be standardised, recognising also that some details of the individual provisions would need to be bespoke to the solutions. Consultation responses agreed that areas for standard provisions should include:

- defining rights to service
- operating protocols
- payment terms
- termination provisions
- non-delivery provisions
- drinking water quality protocols (to be agreed with Drinking Water Inspectorate)

Building on our gap analysis and the list of potential contract provisions for agreements included in Appendix 1, we are interested in views on any of those or other areas that could

be included as standard. We discuss one area in section 3.3 –Operation of bulk supply transfers during drought or other operational events.

Some respondents to the 2021 consultation were interested in understanding how prescriptive standardisation would be, wishing to ensure that provisions could be bespoke where needed to take account of the individual nature of the solutions, with a suggestion that it may be preferable to have a set of high-level principles for water companies to follow, rather than prescribed terms.

As explained in section 3.1 above, bulk supply agreements are bilateral arrangements between water companies and Ofwat only has a statutory function to determine the terms of a bulk supply agreement if the two water companies cannot reach agreement on such terms, and one or both of the water companies ask Ofwat to make such a determination.

At this stage we are not proposing to issue a statutory code. This is discussed in more detail at section 3.4. Therefore, the provisions would be contained in guidance, and where water companies do not apply the guidance or justify an alternative approach, Ofwat may not approve solutions under the RAPID gated process or under DPC licence provisions.

We seek your views on our assessment that in the longer term it may be appropriate to develop a statutory code to optimise the use of standardised provisions.

Questions for stakeholders

Chapter 3 - Section 3.2 - Standard bulk supply agreement provisions

Q3.3. Which contract provisions do you believe should be standard to bulk supply agreements? Please explain your answer.

Q3.4. Please provide views on how to best achieve standardised provisions.

3.3 Operation of bulk supply transfers during drought or other operational events

Our June and December 2021 consultation documents explained that there would need to be increased clarity around the operation of RAPID solutions and associated bulk supply transfers at times when water supply systems are under stress, such as drought or other operational events.

We laid out the following principles for an approach to allocating water from water trades in the RAPID schemes when water supply systems are under stress:

- there should be good outcomes for customers of both water companies, the exporter, and the importer (or potentially multiple water companies);
- the environment and society should be protected; and
- water companies should be incentivised to plan, manage, and operate their assets effectively.

Consultation responses broadly agreed with these principles, and there was majority support for an approach which we called 'fair shares', which envisaged an agreement that would take into account the circumstances in both the exporter's and the importer's supply areas when providing for the allocation of water, with the aim that customers of the exporter and importer receive a 'fair' (potentially similar or equivalent) level of service. Customers cannot influence the availability of water in their particular geographic location. Where assets are being developed as regional assets or providing benefits across geographical areas, our view is that customers should be treated with equity regardless of which geographic location they are in.

There was a consultation response suggestion that the approach should be a standard contract provision in bulk supply agreements.

We have continued to develop, with the water industry, what a 'fair shares' approach would look like in practice. At a high-level we propose the following principles for forthcoming RAPID projects¹⁷:

- An importing company should continue to be supplied with the water it has contracted for UNLESS to do so would lead to there being insufficient water for the exporting company's customers, which results in the exporters customer's facing a lower level of service than the importer's customers¹⁸.
- If the exporting company has a shortage of water (and temporary use bans), such that it cannot make the supply it has committed to and fully supply its own customers, it can cap the amount it provides to the importer. However, it cannot leave the importing company's customers worse off than the exporter's customers (for example this may mean that both sets of customers may be on temporary use bans). The exporting company will be required to pay compensation for any shortfall in contracted supply (this is likely to be especially relevant, where both water companies have contributed towards the cost of infrastructure to facilitate a supply and then the importer is not provided with water to its contracted levels).
- Prior to imposing any supply cap on the importer below its contracted levels, the exporter must have ensured all reasonable endeavours have been taken to address its own demand shortfall. Water companies may define this standard in the bulk supply

¹⁷ As noted above, we would expect the majority of bulk supplies supported by jointly funded new infrastructure to have very few non-compensated or permissible supply interruptions.

¹⁸ We note that some bulk supplies will be interruptible by their nature and this principle is not designed to undercut interruptible supplies. Rather it is designed to set out key principles where a firm supply is to be provided in accordance with the contract, but the exporting company cannot meet its obligations to its own customers.

agreement and may set out what happens where the exporter fails to supply due to its own poor planning or mismanagement of its resources.

- If the importing company has a shortfall, in water required in its own area, the exporting company is not required to provide more water than it has contracted for, although a separate agreement may be made for more, and a bulk supply agreement may provide that water companies cooperate in mitigating customer detriment.

A 'fair shares' policy is intended to be complementary to other water resource processes that water companies already undertake. For example, each water company has obligations to demonstrate their resilience planning through the Water Resources Management Planning process. The exporting company should include full exports as part of their Water Resources Management Plans to ensure that it is sufficiently resilient to provide supply to the standard expected, with no adjustment for the fair shares policy. It will not be permitted to plan on the basis of not providing the supply it has contracted to deliver. In the event that it is unable to supply despite these plans, then the fair shares policy will apply to reduce the impact on customers of the drought or other operational event and the exporting company will be required to pay compensation for any shortfall.

3.3.1 Defined adjustment to any transfer

The bulk supply agreement would include information about how any defined adjustment to the volume of water being transferred would be determined on the application of a fair shares arrangement. Contractual principles for applying an adjustment could include:

- **Quantifiable level of service:** Quantified by assessing the impact on customers of not providing the water. In circumstances of a shortage, it may not be simple to determine whether one set of customers is suffering greater detriment than another set of customers or to achieve service parity. A mechanism to determine this may need to be set out.
- **Urgency of shortages:** An assessment of this must include the need for water at a given time, as companies may not need temporary use bans at the same time.
- **Number of customers affected:** The number impacted by a potential, or prolonged temporary use ban. Water supplies may support a number of different areas and a clear mechanism for considering how various areas are impacted will need to be considered.
- **Classification under the Environment Agency's / Natural Resources Wales's Standards of Drought:** A key instance where fair shares may arise is in the event of a drought. Droughts and shortages are determined by way of an independent calculation by the Environment Agency / Natural Resources Wales which determines the level of water scarcity in an area. This would need to be built into any fair shares mechanism. It can sometimes be challenging to know whether the exact definition of drought is met in the moment and any bulk supply agreement may need to set out a mechanism for this.

3.3.2 Governance

The contract will need to include a clear process for implementing the fair shares principles. Any adjustment to volumes needs to be determined promptly, while compensation payments can be resolved subsequently, potentially involving an effective dispute resolution process after the event. The initial decision could operate in several ways and will need to be part of the bulk supply agreement:

- **Option 1: Basic contractual arrangement** – a clear and objective method for determining the defined adjustment (for example, a formula for calculating the adjustment).
- **Option 2: Enhanced governance** – a clear set of principles and an established governance panel with representatives from all parties to the agreement meeting regularly when the water availability position starts to change. This could include the environmental regulators. The enhanced governance option must include a deadlock breaking mechanism if the panel cannot agree to an adjustment. Both the panel and the final decision maker will be bound to apply the agreed principles.
- **Option 3: System operator** – an independent third party who will make the final allocation of water based on principles set out in the contract (a form of system operator).

Our preferred option is an enhanced governance model. This allows for real time monitoring of the situation as well as contractual principles for agreeing any adjustment. The option is flexible and adaptable with the panel members being closely involved with the relevant solutions and water companies' needs. A panel approach also allows the frequency of meetings to be adjusted as necessary, for example, holding more frequent meetings during summer months.

However, we do note that in some circumstances for some solutions where there are multiple importers and exporters, there could be a stronger case to move to more of an independent system operator, we will develop this model further in conjunction with solutions where this might add value.

Respondents to the December 2021 consultation also proposed that:

- the agreement could include penalty clauses in the event of non-supply of contracted water (reflected in the proposed approach to charging and the agreement provisions in Appendix 1);
- further work should be undertaken on operating protocols. We are in the process of commissioning engineering expertise to map out various scenarios and the possible operating protocols required;
- further work should be undertaken to consider compensation thresholds for non-supply of contracted water. This point is addressed in Chapter 4 Charging and Water Trades of this document.

We propose including fair shares as a standard provision within a new framework for negotiating bulk supplies for new solutions.

Questions for stakeholders

Chapter 3 – Section 3.3 – Operation of bulk supply transfers during drought or other operational events

Q3.5. Do the high-level principles align with the objectives of this policy? Please explain your answer.

Q3.6. Do you think it is possible to include an objective method in bulk supply agreements for calculating a fair shares adjustment in times of drought / other operational events?

Q3.7. Do you have any comments on whether an enhanced governance model coupled with a dispute resolution procedure could work? Or whether a system operator model may have advantages?

3.4 Guidance or statutory code for bulk supply agreement framework

In deciding on the type of guidance to develop for RAPID projects, we have reflected on the current guidance and the powers Ofwat has in the Water Industry Act 1991 to put in place a statutory code for setting out what provisions must be in a bulk supply agreement (as explained in sections 3.1 and 3.2).

3.4.1 Statutory codes

Since 2014, Ofwat has had the power to issue statutory codes in a number of areas. Under section 40B of the Water Industry Act 1991, Ofwat can make and subsequently revise a statutory code which, amongst other things can make provision about:

- procedures in relation to making, varying or terminating a bulk supply agreement;
- the terms and conditions of a bulk supply agreement;
- principles for determining the terms and conditions that should or should not be incorporated into a bulk supply agreement.

Other statutory codes issued by Ofwat are:

- in the non-household retail market which is governed by the [Wholesale Retail Code](#) issued under sections 66DA and 117F of the Water Industry Act 1991; and

- in relation to the adoption of water and sewerage assets ([Code for Adoption Agreements](#) issued under sections 51CA and 105ZC of the Water Industry Act 1991).

In both these instances, Ofwat worked very closely with the industry to develop the content of the codes. Ofwat may issue a direction for a failure to comply with a statutory code and if a company fails to comply with a direction, Ofwat may take enforcement action.

In considering whether to issue a statutory code for bulk supply agreements, we have also considered the 2018 Ofgem review of the codes in the energy sector¹⁹ which provided valuable insights. The review considered how the codes operated. The codes had been designed at a time when it had yet to see significant growth in low carbon technologies or smarter, more flexible approaches. Many in the industry were critical of the system of codes and code governance, pointing out shortcomings in the system such as it being slow to take decisions due to the code governance process; that it was reactive to existing problems, rather than forward-looking in preparing the energy system for future changes; and that it was overly complex, with the entirety of the codes estimated to run to over 10,000 pages – creating a barrier to new entrants and to innovation.

The review looked at the purpose, content, governance and process of changing the system, and announced proposals for its reform in 2021 after a process of consultation²⁰. The Energy Act 2023, which received Royal Assent on 23 October 2023²¹, enables the reforms to be put into place.

Some key lessons learnt about a statutory code process from the energy sector, are the need for clear governance including for code changes, and the need to ensure codes and the processes around codes do not become overly complex and therefore a barrier to market engagement. Simpler codes provide more flexibility for development and changes in the market.

3.4.2 Assessing guidance and code options

We have undertaken initial engagement with the water industry on the option to use code making powers for bulk supply agreements for the RAPID solutions, instead of non-statutory guidance.

There is support for the use of a code however, there have also been questions about timing in relation to the introduction of a code. Some of the proposed solutions may need to have bulk supply agreements in place in the next 2 years, and there was concern that there may not be sufficient time to introduce a code for those solutions as the sector is still considering

¹⁹ [Ofgem Energy Codes Review 2018](#)

²⁰ [Energy Code Reform – governance framework – July 2021](#)

²¹ [Energy Act 2023](#) (Part 6 – Governance of Gas and Electricity Energy Codes).

appropriate commercial models, and until there is agreement on commercial models, it will be difficult to understand how a code would need to operate.

However, there was also a recognition that a key benefit in moving to a statutory code approach over time could be a reduction in the time needed to conclude commercial negotiations on a bulk supply agreement, as well as increased transparency on agreements more generally.

Our initial assessment of the advantages and disadvantages to guidance and codes is set out in table 4 below.

Table 4 Assessment of Guidance and Statutory Code options

| | Advantages | Disadvantages |
|-----------------|---|--|
| Guidance | <ul style="list-style-type: none"> Flexibility of approach for water companies – allows internal negotiation, and can take account of project specific issues. Existing expertise – sector has expertise in making agreements using guidance. Resources – requires limited resources for water companies once the agreement has been made. Enforcement – although Ofwat cannot enforce the guidance under section 18 of the Water Industry Act 1991, it sends a message to water companies that if they fail to agree terms, any determination by us will be based on the guidance. | <ul style="list-style-type: none"> Voluntary – guidance does not have to be followed/all provisions included although if parties cannot agree they can seek a determination from Ofwat. Enforcement – Ofwat cannot directly enforce the guidance under section 18 of the Water Industry Act 1991. |
| Code | <ul style="list-style-type: none"> Statutory – enabling standard requirements for all solutions. Enforcement – enables route for regulatory compliance and enforcement. More transparency – for investors, simpler/ standardised understanding of contracts for solutions. | <ul style="list-style-type: none"> Resources – more resources likely to be required from both water companies and regulator. Unintended consequences – these may occur depending on prescriptive nature of code. Timing – a code would need to be developed quickly in time for solutions and may be insufficient time to evaluate its possible impact. |

We recognise the benefits of a code in requiring specific terms to be included in agreements, but we are also cautious in moving to a code too quickly, acknowledging that it will require time to develop the correct approach to a statutory code.

Therefore, we have concluded that in the short-term, guidance will provide the most efficient route to a framework for water companies to follow as they develop bulk supply agreements required for the solutions, and as we continue to learn from on-going RAPID projects.

Water companies are aware that if they seek to negotiate terms that differ substantially from the guidance, the other party to the negotiations has the option of referring the matter to us under section 40 of the Water Industry Act 1991 if they do not agree to the approach.

The new guidance for bulk supply agreements for RAPID solutions will also provide an indication of our likely approach to a determination under section 40, and therefore should act as an incentive on water companies to consider the guidance seriously and to engage with us if they propose a different approach. At this stage, we consider that this more engaged approach is preferable to a more formal enforcement approach.

In the medium term, we consider that a code is likely to be required to facilitate greater standardisation, encourage investment by increasing transparency and helping to streamline negotiations between water companies. While a statutory code cannot require a water company to make a bulk supply agreement, but we can, in certain circumstances, order companies to enter into a bulk supply under section 40 of the Water Industry Act 1991.

Therefore, our proposal is that we work to develop a code in the medium-term (for projects entering construction by 2030). We will consult on the content of non-statutory guidance in 2024, at which time we will also set out a timeline for introduction of a statutory code.

Questions for stakeholders

Chapter 3 – Section 3.4 – Guidance or statutory code for bulk supply agreement framework

Q3.8. What do you think about the longer-term planning for and development of a statutory code being wider than RAPID projects?

Q3.9. In developing a statutory code, what might we need to consider to avoid any legacy issues resulting from bulk supply agreements considered under non-statutory guidance?

4. Charging and Water Trades

The 2021 consultation set out high-level principles and options for water companies' charges for trades to be specified in bulk supply agreements. The consultation also discussed whether requirements should take the form of principles.

From the responses to the consultation, support was greatest for fixed and variable charges. It was suggested that requirements in the form of principles would allow flexibility as each trade would likely have bespoke pricing arrangements, but existing guidance would need to be enhanced to provide further certainty. It was also recognised that it may be difficult to demonstrate compliance with this approach.

4.1 Proposed charging model

We have continued to develop our proposed approach to charging since the 2021 consultation. We continue to propose that the main components of bulk supply charges (or charges for any similar contractual model) should reflect the costs of the infrastructure, which generally include fixed and variable components. This ensures that those developing the infrastructure have clarity about how their costs are covered in a wide range of operating scenarios, which supports financing the investment.

As noted above in section 1.3, we expect all major infrastructure for the RAPID solutions to be procured through a competitive tender (DPC or SIPR). This should account for the majority of the costs associated with any new supply. Some elements of charges may be fixed in the tender process, but the main part - in particular the fixed charge - will be set through the competition as the price bid by the winning bidder.

Alongside the competitive process, the water company (or companies) leading the development of the project will also incur costs. All of the RAPID schemes have already incurred development costs and further costs will be incurred to take the projects to and through planning consent, running the DPC/SIPR process and managing the resulting contracts. There may also be minor capital costs and ongoing operational costs in facilitating the supply of water beyond the costs of the CAP or IP. While the sum total of all these costs will likely be much less than the costs of the CAP or IP, they will still be material.

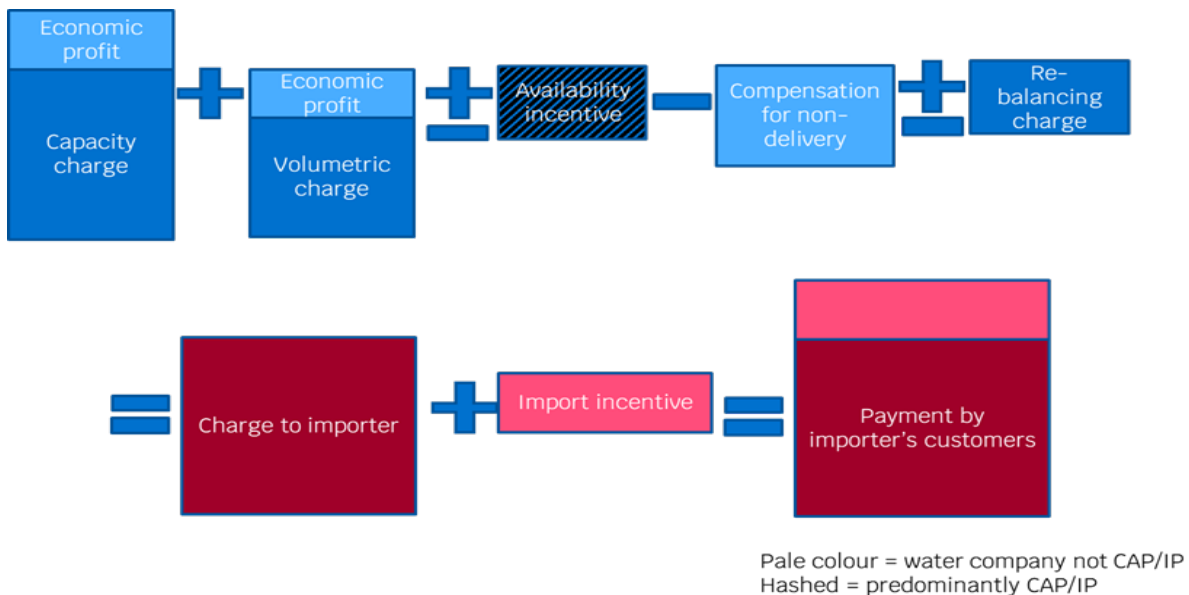
Where these costs are incurred by the eventual beneficiary of the water, they will be paid by the relevant customers and no further adjustments are necessary. However, where they are incurred by a water company that is exporting water (such as if the lead developer from chapter 2 is an exporter), they need to be reflected in the payments by the importer and hence will need to be recovered through the BSA charges where appropriate, so we include them within scope of this chapter. In general, we would expect charges covering the costs of

water companies to reflect allowances set in the relevant price control, with the addition of water trading incentives including a defined adjustment for economic profit.

Where there are multiple importers and exporters of water, the charges will need to be allocated between them. In general, for fixed charges we expect this to be in proportion to the capability provided or reserved by each water company. For the variable charge, each water company will pay based on the volume of water it takes.

In addition to the fixed and variable charges reflecting costs, charges need to provide incentives for the infrastructure to be available when needed, to reflect the water trading incentives applicable (in line with the PR24 final methodology) and to be capable of being rebalanced over time if the parties to the agreement change or reallocate entitlements. These are shown in figure 6 and discussed in sections 4.2 and 4.3 below.

Figure 6 Components of charging model



Questions for stakeholders

Chapter 4 – Section 4.1 – Proposed charging model

Q4.1. Are any other charging elements needed? Please explain your answer.

4.2 Fixed and volumetric charges

We propose that charges take on a fixed and volumetric element. The fixed charge will be paid regardless of asset usage, while the volumetric charge will be paid depending on usage of the asset. Structuring the charges in this manner enables fixed costs to be covered by fixed charges, and variable costs by volumetric charges.

In terms of timing of the charges, we are open to the fixed charge starting on commissioning or earlier during construction.

As noted above, we expect most of the costs to relate to a CAP or IP and the fixed charges to be based on the winning bid in the competitive tender. The volumetric charges may either be specified in advance or also be part of the tender process.

This follows the assumption that the RAPID solutions will meet the criteria for competitive delivery. However, if there was infrastructure being delivered in house then one option would be to follow the Havant Thicket model. With the Havant Thicket project, for which Ofwat set a separate price control with capital expenditure and ongoing opex allowances, the fixed and volumetric charge mirrored the allowances set by the separate price control. Whether RAPID solutions have a separate price control or not, if they have identified cost allowances then the volumetric charge would be based on the opex allowance and the fixed charge on the depreciation and return elements from the RCV based on the capital expenditure.

4.3 Economic profit

To encourage more bulk trading between water companies (and overcome both financial and non-financial barriers evidenced through experience over recent years), exporters and importers each benefit from a separate water trading incentive. Exporters are allowed to charge more than expected costs, with the exporting company retaining half of this excess and the other half flowing to the exporters' customers. This excess is known as Economic Profit. Importers are allowed to recover the import costs from their own customers (as stated in the ²²) plus 5%. The import incentive is 5% of the costs of water imported for all new qualifying trades during 2025–30 and all import incentive payments will be subject to a cap of 0.1% of the importer's wholesale water turnover in each year of the control period. It is proposed that the cap be removed in 2030.

Economic Profit serves two separate purposes. It provides an incentive for the exporter through the 50% retained by the exporter's shareholders. But it also provides a reward for customers of the exporting company ("exporter customers"). This reward is justified because by exporting resources to meet the needs of another water company and its customers, the exporting company and customers forgo the opportunity to use those resources if additional water resources are needed to meet their needs (ie there is an opportunity cost). It may also

²² [PR24 Methodology – Appendix 2 – Water Trading Incentive, July 2022](#)

be justified if the exporting customers have funded development costs of the export scheme, which is not for their benefit in which case they have also taken the risk that the scheme will not go ahead, and their funding of development costs becomes stranded. In this case we would expect the charges to first repay the development costs funded by exporting customers before economic profit is then shared on a 50:50 basis between shareholders and customers. The reward for exporting customers contributes to meeting the need to ensure that exports from Wales benefit Wales, but also applies in England.

Economic Profit will only become payable once the asset is in operation. There will be no Economic Profit payments until this is achieved.

4.3.1 Economic profit for DPC / SIPR

For DPC and SIPR, the structure of charges will be set in the tender process (including the terms of the contract) but the level of charges (at least for the main element such as the fixed charge) will be determined by the competitive tender process and the winning bidder's submission. There is no need to add any element of economic profit on top – the procurement outcome and CAP performance will determine profits. Incentives for the successful delivery of a DPC or SIPR process are considered separately and hence neither the importer nor exporter element of the water trading incentive need apply to these costs.

4.3.2 Setting the level of economic profit

As noted above, we expect the costs incurred directly by exporting water companies (to which economic profit is to be added) to be a relatively small proportion of the total costs of the RAPID solution, with the majority of costs falling to the CAP or IP. Nonetheless, economic profit adds to the costs borne by the customers of the importing company, and we need to ensure that the value of the incentive justifies this additional cost to ensure that the level of economic profit is not set too high. We therefore consider that the level should be subject to regulatory approval.

In principle, the level of economic profit can be higher the more valuable the particular project. For example, if it is much better value than the next best alternative, so that the additional benefit compared to that alternative is shared between the importer and exporter. In practice, we find that it is not generally possible to ascribe a robust valuation to the next best alternative, so we need to find a different approach.

One option could be to apply an uplift to the cost of capital used to derive charges. However, this approach would have a substantial disadvantage that the higher the costs of the scheme were, the greater the economic profit. That is both the opposite to our principled approach and giving greater incentives if costs escalate (over-run) after the decision to proceed. We have therefore developed an alternative approach, which is to base the level of economic

profit on a cost benchmark. Our initial view is that we could base this on the upper (ie most efficient) quartile cost from the sample of all schemes of a particular type included in Water Resources Management Plans. This would give a cost benchmark to which we would need to apply a percentage uplift, then adjust for the share of costs incurred by the water company rather than CAP or IP. Appendix 2 (A2) provides further details of our initial analysis.

4.3.3 Allocating Economic Profit between fixed and variable charges

Allocating the economic profit to either fixed or volumetric charges has opposite advantages and disadvantages as set out in table 5 below:

Table 5 Advantages and Disadvantages of allocating economic profit to either fixed or volumetric charges

| Placing Economic Profits on | Advantages | Disadvantages |
|-----------------------------|---|---|
| Volumetric Costs | Gives the exporter an incentive to improve utilisation of the asset. | Increases marginal costs to the importer, so may discourage use. Makes revenue/profitability less predictable if actual usage diverges from predicted usage. |
| Fixed Costs | Provides a predictable return uplift, consistent with general investments by water companies. Charging the importer “pure” marginal costs sends the right economic signal for usage. | If the importer does not want to use as much water as previously planned, then the exporter has little incentive to find another importer. |

Given these considerations, we are looking to split the economic profit across both the fixed and volumetric charges to minimise the disadvantages. It is important to note that the allocation to fixed and/or volumetric charges is separate from the decision on the amount of economic profit – a high or low value of economic profit can be allocated in any proportion.

Questions for stakeholders

Chapter 4 – Section 4.3 – Economic profit

Q4.2 Do you agree with the proposed approach to calculate economic profit? Please explain your answer.

4.4 Availability and compensation

The RAPID solutions will play a vital role in achieving water resilience for the water companies involved in the solutions. It is therefore important that the solutions are available when needed and can be relied upon, as far as possible, to provide water including at times of water stress.

We split the availability incentives between provision of available infrastructure, such as a reservoir, transfer pipe or treatment plant, and provision of water via that infrastructure. We expect that competitively appointed providers (whether via DPC or SIPR) will generally be responsible for providing infrastructure and not take commodity risk for the availability of water as explained in section 2.2 above. They would therefore be subject to an availability incentive which focussed on whether the infrastructure was available for use, regardless of whether it was actually used. However, for water companies, while a contract for water would generally require them to provide water, there may be circumstances in which this does not happen. In those circumstances we expect the contract to require the exporter to pay compensation.

4.4.1 Proposed approach to availability incentives – a strawman

For a CAP or IP, we expect that they will be measured against making available the necessary infrastructure assets to the specified standard when needed. This measure could be in the form of an incentive on availability. Depending on the circumstances, this may also be appropriate in other situations (e.g., if a water company is providing infrastructure assets to provide water to another water company via in-house delivery).

There are parallels with the OFTO (Offshore Transmission Owners) model in energy, so we are considering whether the availability incentive can be modelled on that used for OFTOs.

Offshore Transmission Owners

Offshore Transmission Owners (OFTO) are obliged to maintain assets to a high standard, to minimise outages and to report on compliance with best practice if longer outages occur, as well as facing a financial incentive.

The financial incentive is based around a target availability of 98%, with a reward or penalty of 5 percentage points of revenue for every 2 percentage points increase or decrease in availability. The maximum penalty in any one year is capped at 10% of revenue to protect cashflows but if availability is lower than this level (94%) then penalties can be carried forward for up to 5 years. Availability can be weighted by month and between planned and unplanned outages.

Where an OFTO bidder expects to achieve a different availability from the target level, they will take the rewards or penalties into account in deciding on the price to bid.

Actual performance in the OFTO regime has typically been of the order of 99% availability, with some exclusions for force majeure events.

For water resources, it may be that the asset would be expected to be available under almost all circumstances. Nonetheless, there are examples of water resources that have not been available when they would have been called upon so we consider that a general availability incentive may address this. We would welcome views on whether something akin to the OFTO model would be appropriate or alternative proposals.

Questions for stakeholders

Chapter 4 – Section 4.4 – Availability and compensation

4.3. Do you agree that the best way to incentivise the infrastructure provider is to set an availability incentive? Do you think the OFTO model could be applied, if not are there other models which should be considered?

4.4.2 Compensation

As described in section 3.3 above, we envisage that water companies that are unable to provide the water that they are contracted to deliver will be required to pay compensation. This is likely to be set out in a bulk supply contract as liquidated damages and/or as a reduction in charges. We envisage a distinction between supply not made under the “fair shares” approach within the contract and a failure to supply under the contract.

The importing company will rely on the bulk supply being available and it is important that they are able to plan on this basis. The exporting company needs to plan on the basis of continuing to supply water and to be resilient to that, able to continue to meet the needs of its customers to the required planning standard. Failure to supply under the fair shares approach is not intended to be an “easy out” – it will only be applied when necessary to best serve the interests of customers as a whole and the compensation that results should take account of the reliance that the importer will have placed on the water being available.

As with the availability incentive, we expect the approach to compensation to be defined in advance in the contract and to reflect a more than proportionate reduction in fixed charges (obviously the volumetric charge will not apply in cases where water is not supplied). One option could be to mirror the availability incentive, with seasonal weighting factors applied. For example, if the weighting for summer was 1.5x, then the compensation payable for a day

of shortfall in July would be approximately 1% of the annual charge.²³ However, given the importance of the transfers for resilience of the system, this may be considered insufficient. In particular, where the supply relies on major assets that are procured via a CAP or IP and charged directly to the importer, the annual charge from the exporting water company may be relatively low compared to the total costs (and more importantly, value to consumers) of the scheme.

We would welcome views on the reasonable costs and other adverse impacts that importing companies may be exposed to in this situation and what level of compensation would be sufficient to reflect this. We could consider applying a further multiplier to the above approach.

The value of compensation could vary depending on whether the lack of supply is due to application of the 'fair shares' model or to a breach of the contractual obligation to supply. We are mindful of the need for substantial compensation to be made in both cases as the importer will be relying on a supply which has not been made. However, the need for a strong incentive to make the supply arguably suggests a greater compensation amount would be appropriate if this is beyond the fair shares adjustment.

Questions for stakeholders

Chapter 4 – Section 4.4 – Availability and compensation

Q4.4. Do you agree that compensation should apply both for fair shares and other failure to supply? What factors should be considered in setting the level of compensation?

Q4.5. Do you agree that seasonality and ratchets depending on the scenario should be developed further? Should compensation be lower if fair shares adjustments are made?

4.5 Multiple importers and exporters

The above discussion was implicitly based on a model with a single importer and single exporter of water, with facilitating assets provided under DPC or SIPR. Some of the RAPID solutions take this form but others involve more than one importer and/or exporter. In this case, we expect the extension of the approach described above to be relatively straightforward. Where there are multiple sellers, each would charge based on their own costs and any economic profit would be based either on their own costs, or if based on a benchmark, this would be allocated between the sellers. Where the arrangement has the nature of a transit (company A providing water to company B, which then provides water to company C), it will be important to avoid layering additional charges (known as "pancaking"), so any uplift for economic profit would only apply to the incremental contribution. Multiple

²³ $1/365 \times 2.5$ (ratio of 5% to 2% from the availability incentive) $\times 1.5$ (seasonal weighting) = 1.03%

importers would need to agree in advance how the supply would be allocated between them. In general, we expect that they would reserve proportions of the capacity (however defined) of the scheme, summing to 100%, and pay fixed charges on that proportion. Nominations to take water would need to be made to a defined timetable (as for a single importer), up to the reserved proportion, and subsequently paid for through the volumetric charge for the volumes taken.

However, there would need to be additional flexibility. In the short term, if one of the importers chose not to take the full volume available to it, consideration is needed as to whether that volume should be available to the other buyer(s). In principle, this flexibility is valuable and could be reflected in payment at the expected opportunity cost to the first buyer. For example, if company B taking additional volumes that company A has chosen not to take has no impact on the future volumes available to company A, then no payment is needed. But if, for example with a reservoir that is constrained, company B taking more now reduces expected future availability for company A then this option may be precluded or subject to a compensatory payment.

In the longer term, bearing in mind the long life of these schemes, we expect there will be occasional examples where either the parties to the scheme want to renegotiate their entitlements or obligations and/or new parties (new importers or exporters) want to join the scheme. As above, we consider that this flexibility has value and should be facilitated. Where there is a potential adverse impact on one of the original parties, this should not preclude change, but may require extensive renegotiation. If the parties cannot agree, we expect that the BSA would be referred to Ofwat for a determination.

Where two importers for example want to reallocate their share of capacity, either temporarily or for the remaining life of the scheme, we would expect adjustments to the share of fixed costs borne by each importer. For this reason, we have included within our charging model provision for rebalancing charges – which would be set to zero initially but could be applied as needed during the life of the project.

Where new importers want to join the scheme, there are alternative mechanisms that could be considered. If the new importer is to join on an equivalent basis to the original importers, this would require a negotiation between all importers to agree the share of the scheme that each receives. We recognise the importance of avoiding incentives for new parties to "free-ride" on all the development work done by the original parties, which may suggest they should pay slightly more than proportionately towards the fixed costs of the scheme. However, we would not want this to create a barrier to new parties joining a scheme where this is mutually beneficial.

Where the original importers are unwilling to give up part of their share to enable a new buyer to join a scheme on the same basis, it may still be possible to join on an "as available" basis – to use water not taken by the original importers. Alternatively, given sufficient notice, it may be possible for the exporter(s) to provide additional water using upgrades to the

original scheme. In this case we would expect the charges to the new exporter to be based on the additional costs. Of course, any such enhancements should be taken forward efficiently which may usually require them to be factored into the initial design whenever possible.

4.6 Guidance or statutory rules on charging

Charges for bulk supply agreements are negotiated between the water companies involved, with the right to refer to Ofwat if there is a disagreement (under sections 40 and 40A of the Water Industry Act 1991).

Section 3.4 above describes Ofwat's legal powers to issue bulk supply codes. Ofwat also has powers under section 40E of the Water Industry Act 1991, to issue rules about charges that may be imposed by a water undertaker under a bulk supply agreement. A failure to comply with rules about charges could lead to Ofwat issuing a direction to comply and a failure to comply could lead to enforcement action against the relevant water company.

To date, Ofwat has relied on non-statutory guidance rather than charging rules for bulk supply charges. If we were to issue charging rules, they could deal with:

- a. the types of charge that may be imposed;
- b. the amount or the maximum amount, or a method for determining the amount or maximum amount, of any type of charge;
- c. principles for determining what types of charge may or may not be imposed;
- d. principles for determining the amount of any charge that may be imposed;
- e. publication of the charges that may be imposed.

We have been considering whether to issue rules as we are concerned that guidance may not give sufficient protection to the interests of customers, as each water company may give primary weight in negotiations to the interests of its shareholders, and the interests of customers and shareholders may not align. For example, we do not consider that there is sufficient constraint on water companies agreeing higher levels of economic profit than is necessary. We therefore expect to provide increased regulatory intervention.

In some areas, where we can set out in advance the approach that should be taken, the most efficient solution is likely to be to provide rules that companies must follow in setting charges. Where there are multiple options and the best approach depends on the particularities of an individual scheme, it may be more useful to provide guidance. In addition, it may be appropriate to start with guidance because this is likely to be quicker to introduce (and hence more useful for early negotiations) and because there may be learning from the initial projects that could be taken into account before fixing rules that are less flexible to change. We therefore propose to start by including charging in guidance and including some aspects of charging in the first phase of our work on defining rules and codes.

Questions for stakeholders

Chapter 4 – Section 4.6 – Guidance or statutory rules on charging

Q4.6. Do you agree with our approach to guidance / rules and charging?

5. Next steps

We welcome responses to this consultation document from all interested parties by Thursday 29 February 2024. We will consider responses with partner regulators and with the water sector as we make our final policy decisions.

We aim to:

1. have finalised policy positions on the areas set out in this consultation by early summer 2024 and will produce a consultation outcome document setting them out.
2. start drafting the new guidance on bulk supply agreements for RAPID solutions from January 2024, taking account of comments received through this consultation process.
3. consult on the draft new guidance on bulk supply agreements for RAPID solutions in summer 2024, before finalising the guidance by late 2024.

We will continue to engage with partner regulators and other stakeholders as we take this work forward.

Questions for stakeholders

Chapter 5 – Next steps

Q5.1. We welcome views on our proposed next steps, including any additional actions you may wish to propose.

6. Summary of questions for stakeholders

| Chapter | Questions for stakeholders |
|--|---|
| <p>2 Commercial structures</p> | <p>Q2.1. Do you agree that there should be a default commercial structure across all solutions, with deviations permitted by exception and depending on the specific circumstances of the solution? Please explain your answer.</p> <p>Q2.2. a) Do you agree with the preferred commercial structure being a lead party model? Please explain your answer. b) Do you agree with the preferred commercial structure being an infrastructure only model? Please explain your answer.</p> <p>Q2.3. Please provide suggestions for any other commercial structure you consider may be appropriate either as the default approach or for exceptional circumstances.</p> <p>Q2.4. We welcome your views on the different risks and responsibilities associated with different models. Please provide comments on risks not detailed in the paper which you consider may have a material impact on the choice of commercial structure.</p> <p>Q2.5. Please provide comment on ways in which risks identified in Q2.4 may be mitigated.</p> |
| <p>3 Bulk supply agreements</p> | <p>Section 3.1 – Framework for negotiating bulk supplies</p> <p>Q3.1. Do you agree with our conclusion that the solutions in the RAPID programme require a new guidance framework for negotiating bulk supplies? Please explain your answer.</p> <p>Q3.2. Please provide your views on the areas likely to be required in bulk supply agreements for RAPID projects as set out in Appendix 1 and please list any areas that you consider are missing from Appendix 1.</p> <p>Section 3.2 – Standard bulk supply agreement provisions</p> <p>Q3.3. Which contract provisions do you believe should be standard to bulk supply agreements? Please explain your answer.</p> <p>Q3.4. Please provide views on how to best achieve standardised provisions.</p> |

| | |
|---|---|
| | <p>Section 3.3 – Operation of bulk supply transfers during drought or other operational events</p> <p>Q3.5: Do the high-level principles align with the objectives of this policy? Please explain your answer.</p> <p>Q3.6. Do you think it is possible to include an objective method in bulk supply agreements for calculating a fair shares adjustment in times of drought or other operational events?</p> <p>Q3.7. Do you have any comments on whether an enhanced governance model coupled with a dispute resolution procedure could work? Or whether a system operator model may have advantages?</p> <p>Section 3.4 Guidance or statutory code for bulk supply agreement framework</p> <p>Q3.8. What do you think about the longer-term planning for and development of a statutory code being wider than RAPID projects?</p> <p>Q3.9. In developing a statutory code, what might we need to consider to avoid any legacy issues resulting from bulk supply agreements considered under non-statutory guidance?</p> |
| <p>4 Charging and water trades</p> | <p>Section 4.1 – Proposed charging model</p> <p>Q4.1. Are any other charging elements needed? Please explain your answer.</p> <p>Section 4.3 – Economic profit</p> <p>4.2. Do you agree with the proposed approach to calculate economic profit? Please explain your answer.</p> <p>Section 4.4 – Availability and compensation</p> <p>Q4.3. Do you agree that the best way to incentivise the infrastructure provider is to set an availability incentive? Do you think the OFTO model could be applied, if not are there other models which should be considered?</p> <p>Q4.4. Do you agree that compensation should apply both for fair shares and other failure to supply? What factors should be considered in setting the level of compensation?</p> |

| | |
|----------------------------|--|
| | <p>Q4.5. Do you agree that seasonality and ratchets depending on the scenario should be developed further? Should compensation be lower if fair shares adjustments are made?</p> <p>Section 4.6 – Guidance or statutory rules on charging</p> <p>Q4.6. Do you agree with our approach to guidance / rules and charging?</p> |
| <p>5 Next steps</p> | <p>Q5.1. We welcome views on our proposed next steps, including any additional actions you may wish to propose</p> |

A1 Draft framework for a standardised bulk supply agreement

NOTE: This Appendix 1 sets out a proposed framework for bulk supply agreements where a bulk supply is facilitated by a new-build infrastructure asset. Under this bulk supply agreement both water companies contribute to the cost of and benefit from the new-build infrastructure asset. This Appendix 1 should be read in conjunction with chapter 3 of the main consultation document.

In this document a **CAP** refers to a Competitively Appointed Provider; an **IP** refers to an infrastructure provider; and **DPC** refers to Direct Procurement for Customers.

Terms and Conditions

General Terms and Conditions

1. Parties

- 1.1 The bulk supply agreement (**Agreement**) needs to set out the parties to the agreement. This will be the water companies participating in the bulk supply.
- 1.2 Parties should also be given appropriate defined terms. This may be as simple as the “supplier” and the “customer”. However, supply may be a two-way arrangement under which both parties make supplies to one another.
- 1.3 There may be more than two parties to any Agreement.

2. Definitions and Interpretation

- 2.1 The Agreement will contain a detailed definitions schedule.
- 2.2 Where appropriate, definitions should align to regulatory documents including the licences of water companies. Alignment to DPC Allowed Revenue Directions and/or a Project Licence (for an IP) may also be required where a CAP/IP is responsible for delivering Assets.

3. Conditions Precedent

- 3.1 There may be conditions precedent to parts of the Agreement coming into effect. These would need to be set on a project-specific basis.
- 3.2 Companies may wish to consider (amongst other things):
 - 3.2.1 Interaction with their own credit ratings and financing documents.
 - 3.2.2 Environmental permits and any other consents required (for example planning permission).

- 3.2.3 Settlement of any amounts due between the parties in respect of costs incurred prior to the date of the Agreement.
- 3.3 The parties should set out a process for satisfaction of conditions precedent and communication as to progress against any conditions precedent.
- 3.4 The Agreement may also have a process for termination (and cost allocation on termination) should conditions precedent not be satisfied by a prescribed longstop date. This may be particularly important where the Agreement is put in place in the development phase of any Assets that facilitate the bulk supply.
- 3.5 Where the Agreement requires Works to be carried out and those Works are to be carried out by a CAP/IP, it may be that there are different phases of the Agreement (and terms and conditions for such phases). Phases may include: (a) the procurement and appointment of the CAP/IP; (b) delivery once the CAP/IP is appointed; (c) supply following completion. Terms and conditions should also govern what happens if a procurement for a CAP/IP is unsuccessful.

4. Commencement and Duration

- 4.1 The Agreement should set out when it commences and when it ends.
- 4.2 Where one party is to benefit from and contribute to an Asset built by another, then the term of the Agreement should reflect that party's contribution to the Asset over its useful economic life.

Works Terms

5. Works and the Assets

- 5.1 The Agreement should make it clear who is responsible for (as between the parties):
 - 5.1.1 delivering and owning relevant works being undertaken to construct any infrastructure asset that facilitates the bulk supply arrangement (e.g. a reservoir or transfer pipe) (**Main Works**);
 - 5.1.2 delivering and owning any other works needed to facilitate the bulk supply arrangement (**Ancillary Works** and, together with the **Main Works**, the **Works**);
 - 5.1.3 maintaining, owning and operating the infrastructure asset (i.e. who is responsible for the operation and maintenance of the constructed and completed Main Works) that is to facilitate the bulk supply (**Asset**); and
 - 5.1.4 maintaining, owning and operating other relevant assets to facilitate the bulk supply (**Ancillary Asset**).
- 5.2 Works may be carried out by one or more of the water companies. Even where a bulk supply is primarily facilitated by the Asset (which is being built by one party),

the Works may still include some Ancillary Works (i.e., connection works) to facilitate the bulk supply between the parties. These Ancillary Works may be carried out by multiple parties.

- 5.3 Where Works or Assets are largely embedded within the network of one of the parties, it will likely be appropriate that the Works and Assets sit within the regulatory ring-fence of one party (this approach may best be facilitated by the Lead Party Model as more fully described in section 2.3 of the consultation document). This arrangement does not mean that both parties cannot contribute to payment and governance of the Works and Assets. Further information on this is provided below.
- 5.4 Subject to certain exceptions (which should be considered on a project-specific basis), the party that owns and is responsible for delivery of the Works and Assets should take responsibility (vis the other party) for the care of and risk of any loss or damage to those Works and Assets.
- 5.5 Where the CAP/IP is responsible for incidents related to the Assets or Works which, in turn, result in water supply outages or losses, then appropriate liabilities between the water companies under the Agreement will need to be considered in detail. Under the Lead Party Model, the lead water company would be responsible for a supply outage. However, these risks may be backed off (whether in full or in part) by the agreements with the IP/CAP to the extent that Works and Assets are the responsibility of any IP/CAP. It may also be possible and appropriate to limit the recourse of the water companies receiving the bulk supply (receiving parties) against the supplying party, where any outage or interruption in supply is solely the result of an IP/CAP failure. Whether or not this is appropriate will depend on the level of involvement and governance that receiving parties have been granted in respect of the appointment of any IP/CAP.

6. The Works

- 6.1 Each water company should be responsible to the other for delivering Works for which they are responsible. The extent of liability between the water companies for delays or defects in Works will need to be addressed in the Agreement – including any adjustment of liabilities where matters arise solely as the result of an IP/CAP (see paragraphs 5.4 and 5.5 above).
- 6.2 In any Lead Party Model (see section 2.3 of consultation document), responsibility for Works may include appointment of an IP/CAP by one water company. If a Multi-Party Model is used this would require a joint appointment of an IP/CAP. The Agreement would need to be amended accordingly.
- 6.3 The scope of Works required to facilitate the bulk supply should be set out in the Agreement. This should include clear requirements and allocation of responsibility

for relevant consenting, planning, design, construction, testing and commissioning of the Works/Asset and bulk supply.

- 6.4 Parties should have to supply information regarding all relevant Works to one another on an open-book basis. Where one water company is reliant on supply from another, information that may impact availability of the bulk supply or costs due between water companies should be shared fully and transparently.
- 6.5 The minimum specification for Works should be set out in the Agreement. This should not be subject to material change without agreement of the parties. This creates certainty to allow one or more water companies to appoint a CAP/IP. It also provides protection for any water company not directly responsible for instructing the Works. Restrictions on changes in the Agreement would need to be reflected in any agreement with a CAP/IP.

7. Rules for awarding Works and contracts

- 7.1 Each party undertaking Works may need to competitively procure services, goods and works agreements. This may also include a requirement for the procurement of finance by way of appointment of a CAP/IP (such contracts for services, goods, works and/or an IP/CAP being “**Contracts**”).
- 7.2 The Agreement may set out key terms and conditions for the Contracts which cannot be changed other than by way of agreement between the parties. This creates certainty to allow one or more water companies to enter into Contracts. It also provides protection for any water company not directly responsible for instructing the works.
- 7.3 The Parties may also implement key sign-off points in respect of procurement of Contracts at which each party’s consent is required. For example, this may include all parties signing-off the tender documents and the final contracts for any CAP or IP.
- 7.4 The parties may include a term that allows each party to obtain and use the copyright for the Assets and the Works. This may include sub-licensing arrangements to ensure each party is entitled to relevant rights.

8. Changes to Contracts

- 8.1 The Agreement must set out rules for changes to Contracts i.e., certain changes may require the consent of all parties to the Agreement.

9. Access and Inspection

- 9.1 All parties may require access to the site where the Works are being undertaken from time to time. Obviously, the party that is the contracting counterparty to the

CAP/IP/relevant contractor (as applicable) will have such rights, but other parties may require these rights to inspect the progress of the project.

9.2 Site rules and conditions of access would also be required in such scenarios.

10. Rules for Design and Completion of Works

10.1 The Agreement may include certain points where all parties to the Agreement have to sign-off the developing design and the completion of any Works. Such sign-off would need to interface with any agreement with a CAP/IP. In the Lead Party Model, it may be that the lead water company has a checkpoint in its agreements with the IP/CAP and there is a parallel right as between the water companies under the Agreement.

10.2 Any sign-off rights would need to be consistent with the relevant Contracts under which Works were undertaken including any agreements with a CAP/IP.

Water Supply Terms

11. Point of Supply

11.1 The Agreement should clearly specify a physical point at which supply is made from one party to another.

11.2 It is not necessarily the case that the Asset would itself be the point of supply – although this may be the case. In the Lead Party Model, it is not envisaged that any supply would be made by the CAP/IP.

12. Water Supply Service Term

12.1 The Agreement should set out the term during which water supply will be made. This will likely be different from the term of the Agreement itself (as the supply may be contingent on the completion and commissioning of the Works).

12.2 Provisions may be included for the extension of the water supply service term to reflect that one party to the Agreement may have contributed to the costs of shared infrastructure and should be entitled to benefit from that infrastructure over its useful life.

12.3 Provision may need to be made for what happens if the actual asset life exceeds the forecast economic life of the asset (i.e., the period over which it is fully depreciated).

12.4 Where there is provision for the future extension of the water supply service term, parties need to consider the role of Ofwat pursuant to s. 40A of the Water Industry Act 1991. Under this provision Ofwat has the power to modify the Agreement in certain circumstances.

- 12.5 Where the duration of the Agreement is set over a lengthy period, the Agreement will need to allow appropriate mechanisms for change. Water asset lives can span 80 or 120 years and operating mechanisms will likely change considerably in that period.
- 13. Water Supply Commencement Date**
- 13.1 The Agreement should set out a “**Water Supply Commencement Date**”. This is the date when the water supply service term should commence.
- 13.2 Typically, the Water Supply Commencement Date should be a fixed date. It may be subject to extension for certain events that may delay Works. For example, *force majeure*, changes in law, and breaches by a party (for example, where a party fails to carry out its Works).
- 13.3 In certain scenarios, liquidated damages may be payable for any delay to completion of Works. The approach under the Agreement to liquidated damages may mirror the approach under the Contracts. For example, parties may want to apportion delay liquidated damages available under relevant Contracts.
- 13.4 Alternatively, liquidated damages may not become payable at all for delays to the Water Supply Commencement Date. Rather the relevant supply obligations may simply commence regardless of whether Works are completed. This may still result in damages becoming due where the supplying party fails to make a supply. Any lead water company would need to consider how best to back this risk off where any delay was caused by a CAP/IP.
- 14. Water Supply Key Details and Requirements**
- 14.1 The Agreement should set out obligations to make supply and accept supply. Supply obligations may be firm or variable or both, depending on stipulated circumstances. However, where all water companies have contributed to the costs of infrastructure to facilitate a supply, there is a general expectation that there would be a firm supply.
- 14.2 Title to and risk in any water supply may pass from one party to another at the point of supply. The Agreement should clearly specify this.
- 14.3 The Agreement should include provisions dealing with the allocation of water in times of drought or other operational shortage events. There is an expectation that the regime described in section 3.3 in the consultation document would apply.
- 15. Quantity of Water Supply**
- 15.1 The maximum quantity of the water supply that a party should be entitled to over a period should be set out. In general, access to water supply should mirror the payment arrangements and the contributions to any Assets constructed solely for the purposes of the bulk supply.

- 15.2 The parties may agree a process for setting out how much water supply is to be made on any given day during the Water Supply Service Term.
 - 15.3 The parties should agree flow rates for any water supply to be made.
 - 15.4 The parties should agree arrangement for timing of supply within any day.
 - 15.5 A process for delivery of water supply may include:
 - 15.5.1 a process for requesting a supply up to the maximum quantity of supply;
 - 15.5.2 a process for varying any request;
 - 15.5.3 minimum time periods for requests;
 - 15.5.4 notification requirements where any request cannot be met;
 - 15.5.5 requirements for minimum amounts of water supply in order to maintain a sweetening flow.
 - 15.6 Arrangements may also be made that deal with:
 - 15.6.1 any logistics of providing and receiving the water supply;
 - 15.6.2 arrangements in respect of planned outages of any Assets or Ancillary Assets, including a schedule of planned maintenance;
 - 15.6.3 measures for testing and flushing following any supply interruption;
 - 15.6.4 any interaction with any other bulk supplies between the parties;
 - 15.6.5 arrangements under which additional supply beyond the maximum supply can be made;
 - 15.6.6 arrangements under which a supply from the receiving party could be made (if a two-way supply);
 - 15.6.7 appropriate means of communication between operational level personnel (including for emergencies or any breach of water quality requirements); and
 - 15.6.8 detailed arrangements to allow each party to carry out routine and emergency maintenance, operations and repairs on its assets and equipment.
 - 15.7 Where any CAP/IP has a role in operating or maintaining the Assets that facilitate the bulk supply, this will need to be reflected in the Agreement and in agreements with the CAP/IP.
- 16. Quality of Water Supply**
- 16.1 The supplying party may have to meet relevant water quality requirements. The Agreement should specify any such requirements. For example, there may be requirements that the water is:
 - 16.1.1 Wholesome – as defined in the Water Supply (Water Quality) Regulations 2016 (note this may not be the case if the supply is not a potable supply);
 - 16.1.2 compliant with the Water Industry Act 1991 requirements and any applicable standards established by DEFRA and the DWI; and

- 16.1.3 compliant with certain prescribed technical standards (e.g., in respect of the chlorine; turbidity; and the phosphoric acid content).
- 16.2 A procedure should be in place to shut down supply and for immediate notice where there are material breaches of quality requirements.
- 16.3 Parties should include details about who is responsible for the consequences of a breach – for example is the supplying company responsible for what goes to the customers of the receiving company? Are there indemnities for fines etc.
- 16.4 Parties should make arrangements to test water quality compliance.
- 16.5 Where water quality requirements are not met, the Agreement should state whether this constitutes an interruption and whether this is a supply which the receiving party must pay for.
- 16.6 Where any CAP/IP has a role in operating or maintaining the Assets that facilitate the bulk supply, this will need to be reflected in the Agreement and in agreements with the CAP/IP.
- 17. Measurement of Water Supply**
- 17.1 The Agreement should contain provisions for measuring water supply at the point of supply.
- 17.2 There should be clear provisions about who is responsible for maintaining the meters and to what standard and margin of error.
- 17.3 There should be provisions allowing for a party to require an independent test of the meter. There should also be provisions detailing who is responsible for costs should the independent tester find (or not find) any issues with the meter.
- 18. Maintaining Supply Assets**
- 18.1 The Agreement may impose obligations on both parties to maintain their systems in and around the point of supply so as to be able to accept and provide supply in accordance with the Agreement and not damage the equipment of the other. This does not necessarily apply to the Asset itself – which may (or may not) be situated at the point of supply.
- 19. Water Supply Interruption**
- 19.1 Provision should be made for the supplying party to notify the receiving party as soon as possible where it cannot make a supply required by the Agreement.
- 19.2 Notice may be required to include information in respect of the:
- 19.2.1 cause of the interruption;

- 19.2.2 date of the interruption; and
- 19.2.3 duration of the interruption.

- 19.3 Parties should be required to rectify any interruption as soon as possible.
- 19.4 Where the supply to be made is a firm supply, the Agreement should set out the circumstances in which interruptions of requested supply will be permissible. These may include:
 - 19.4.1 planned outages – these may be capped on an annual basis and subject to notice requirements;
 - 19.4.2 certain water shortage events – these may be subject to objectively verifiable measures and subject to issuance of drought orders/temporary use bans;
 - 19.4.3 *force majeure* impacting either the Asset or (if different) relevant supply infrastructure;
 - 19.4.4 certain breaches by one party or the other of the Agreement – it should be considered whether all breaches reasonably justify supply outages; and
 - 19.4.5 certain changes in law – for example these could be changes in law that effect the Asset but could also be certain losses of abstraction licences or environmental permits or other legislative changes that may fundamentally impact an ability to supply.
- 19.5 Where a firm supply is given, relief from supply obligations should be limited in nature. Where relief for non-supply is given this should comply with Ofwat's guidance (see section 4.4 of the consultation document (Compensation)).

20. Remedies for Interruptions

- 20.1 Interruptions in firm supply may result in payment of damages by the supplying party.
- 20.2 Parties should set out liquidated damages for non-supply. This will cap losses for a supplier but also prevent the receiving party from having to ascertain loss. A balance will need to be struck between the cost impact of an interruption on the receiving party (which may be significant) and the ability of the supplying party to pay.
- 20.3 Where liquidated damages are payable for interruptions there may be:
 - 20.3.1 liquidated damages due on a volumetric basis (i.e., £ per ML not provided) and/or on a fixed charge basis (i.e., a fixed sum for any failure to supply).
 - 20.3.2 a *de minimis* supply failure amount to allow for margins of error before damages are due.
 - 20.3.3 a cap on relevant liquidated damages.
 - 20.3.4 increases or decreases in rates of liquidated damages depending on conditions (i.e., in drought conditions).
- 20.4 Where a CAP or IP operates an Asset and this causes any interruption then this should be taken into account in the supplying party's liabilities under the Agreement. In such circumstances, it may be appropriate that liquidated damages due to the receiving

party may be capped at the level of recovery from the CAP or IP on a pass-through basis. This will only be appropriate to the extent that other companies receiving a supply have governance rights in respect of the IP/CAP arrangements.

21. Emergency

- 21.1 Provisions in the Agreement should deal with cooperation between the parties in any emergency or in instances of severe drought. The Agreement may set out express arrangements or may simply set out a collaboration protocol.

Care of the Asset and Rules for the Asset

22. Responsibility for Care and Maintenance of the Asset

- 22.1 Where the Asset itself is not the direct means of supply, separate provisions may be made for the Asset as distinct from the supply. The Agreement may set out which party is responsible for, takes care of and maintains the Asset (including cost risk). This is most likely to be the party in whose network the Asset sits and who owns the Asset. In practice, some of this responsibility may fall to a CAP/IP, depending on relevant agreements. The Agreement would also need to clearly allocate responsibility for any regulatory requirements arising in respect of an Asset (it may not always be possible to allocate these in accordance with the preference of the parties as certain regulatory requirements are a function of law).

23. Maintenance and Material Engineering Alterations

- 23.1 Where the parties share the cost risk and/or reliance on the Asset for the water supply there may be restrictions about what maintenance and amendments to the Asset can be made by the party that owns it without consent of the other party.
- 23.2 The party that owns the Asset will always need to be able to make certain changes to comply with law, regulation and good practice.
- 23.3 Where a CAP/IP operates/maintains an Asset, the requirements here would need to be reflected in any CAP Agreement or Project Agreement.

24. Taking the Asset Out of Service

- 24.1 Where the parties share the cost risk and/or reliance on the Asset for the water supply there may be rules about when the Asset can be taken out of service. For example, with a reservoir it may not be appropriate to the Asset out of service during a drought period.
- 24.2 Where a CAP/IP operates/maintains an Asset, the requirements here would need to be reflected in any CAP Agreement or Project Agreement.

25. Use of Water/Asset

- 25.1 Where the parties share the cost risk or reliance on the Asset for the water supply there may be rules and restrictions on the use of the Asset or indeed the water in it/from it.
- 25.2 Where a CAP/IP operates/maintains an Asset, the requirements here would need to be reflected in any CAP Agreement or Project Agreement.

26. Rules to Facilitate Assets

- 26.1 The supplying party may agree to operate other parts of its network and assets (i.e., other than the Asset) in a prescribed way. For example, it may be required to fill a reservoir, or it may be required to send water to process in a desalination plant.
- 26.2 Each company will have to consider their respective regulatory obligations when committing to operate their assets in any specific way.

Governance

27. Governance

- 27.1 The Agreement should set out governance arrangements for the Works, Asset and the water supply as between the parties.
- 27.2 Governance may need to be greater where one party has all meaningful ownership and operational control of the Asset that facilitates the supply but obtains a level of cost recovery from the other party in respect of that Asset. The reason for this is to ensure that the other party is not overcharged and has the means to scrutinise costs. For example, in the Lead Party Model, it is the lead water company that has the direct relationship with the CAP/IP.

28. Governance Committee

- 28.1 The parties may wish to set up a governance committee in respect of the project. This could be a senior committee to resolve any issues and provide expert scrutiny.

29. Party Reserved Matters

- 29.1 Certain matters may be reserved for agreement between the parties themselves.
- 29.2 The extent of such rights should be considered carefully where one party is delivering a project (or managing a CAP/IP to deliver an Asset) for the benefit of itself and another party. A balance should be struck between: (a) the need to afford the non-delivering party rights sufficient to manage its cost and supply risk and (b) allowing the delivering party to deliver the project.
- 29.3 Where a CAP/IP operates an Asset or carries out the Works, the requirements here would need to be reflected in any CAP Agreement or Project Agreement.

30. Access to Project Information and Reporting

- 30.1 Provisions should clearly set out information and reporting requirements.
- 30.2 The parties may also agree to a joint information database to which relevant information is uploaded.
- 30.3 Regular reporting will be essential and may include details on:
 - 30.3.1 the Works costs;
 - 30.3.2 any forecast cost overruns;
 - 30.3.3 progress towards schedule;
 - 30.3.4 any new significant risks or material changes to the remaining significant risks;
 - 30.3.5 issues in respect of necessary consents; and
 - 30.3.6 any issues which may have a material impact on the trigger for any project Enhanced Governance rights (as below).
- 31. Enhanced Governance**
- 31.1 The Agreement may set out enhanced governance rights.
- 31.2 The extent of such rights should be considered carefully where one party is delivering a project for the benefit of itself and another party (and such other party is bearing part of the cost of the project).
- 31.3 Enhanced governance rights should only be exercised in remote scenarios where the lead water company is failing to deliver the project – for example they may occur where the project is over budget or materially delayed. Enhanced governance rights may also apply in situations of extreme water shortage.
- 31.4 A clear procedure for enhanced governance rights should be set out. This should include notification of key issues and establish rectification plans.
- 31.5 Possible enhanced governance rights may include requirements to change contractors or consultants. It may also include rights to directly step in to deliver Works or fix an Asset. The extent to which this will be possible where an Asset is part of the network of one party will need to be considered in respect of relevant regulatory obligations.
- 31.6 Where a CAP/IP operates an Asset or carries out the Works, the requirements here would need to be reflected in any CAP Agreement or Project Agreement. Also, certain enhanced governance rights may be less practical where a privately financed CAP or Infrastructure Provider is to deliver the project. Ability to step-in in such circumstances will necessarily be limited.

32. Independent Technical Advisor

Parties may agree to appoint an independent technical advisor at any time to resolve relevant issues or verify relevant information.

Payments

33. Charges and Payment

33.1 A provision should be included for the payment of charges as between the parties.

33.2 Charges may include:

33.2.1 A Capacity Charge – The purpose of this charge is to recover an appropriate proportion of the efficient capital costs of the Asset. It may also recover the capital costs of any other Ancillary Assets. This may include financing costs, construction costs and certain operating costs. In the Lead Party Model, where an IP or CAP is appointed, then a proportion of the efficient costs of the IP/CAP should be reflected in this charge (but see paragraph 33.3 below on what constitutes an efficient charge in these contexts). This charge should reflect the relative benefit of each party from the Asset. A Capacity Charge reflecting IP/CAP costs would not be appropriate in the Multi-Party Model, where all parties made payments to the IP/CAP directly.

33.2.2 A Volumetric Charge – This may reflect the efficient incremental operating and maintenance costs of the Asset and supply.

33.2.3 Where permissible, amounts in respect of economic profit.

33.3 Any pricing approach will need to work alongside the regulatory regime. For example, the efficient costs of a CAP Agreement will be those allowed in any DPC Allowed Revenue Direction. The efficient costs of any IP will be those IP allowed revenues permitted by a Project Licence.

33.4 Where economic profit is permitted, regulatory treatment of this will need to be considered in line with Appendix 2 of the Final Methodology for PR24.

33.5 Payment provisions may also include interest for late payments and a dispute resolution clause.

34. Change

34.1 Certain agreed events may give rise to changes in charges/costs. By way of example this may include:

34.1.1 certain changes in law or legal requirements with a material cost impact;

34.1.2 certain events that have a significant adverse or favourable effect on assets, liabilities, financial position or profits of the parties and relate to the bulk supply may also cause a change.

Liabilities and Remedies

35. Indemnities

- 35.1 It may be appropriate that parties may indemnify one another in respect of certain liabilities, costs (including associated taxes), losses, charges, costs and expenses (including legal costs and expenses) arising out of or in connection with development of the Assets or supply.
- 35.2 Where indemnities arise there may be a requirement to take reasonable mitigating steps.
- 35.3 Indemnities may not be appropriate in all circumstances and breach of contract may suffice. Where indemnities arise conduct of claims arrangements should be included. Where any CAP/IP is appointed the liability regime under the CAP Agreement/Project Agreement will need to be considered when any indemnities are to be implemented under the Agreement.

36. Liability

- 36.1 Parties may agree provisions in respect of their liability including liability caps and exclusions of certain liabilities i.e. consequential losses.
- 36.2 Where the Agreement is a long-term Agreement it may be necessary to make express provision for what happens if a liability cap is exceeded. Where any CAP/IP is appointed the liability regime under the CAP Agreement/Project Agreement will need to be considered when any indemnities are to be implemented under the Agreement.

37. Insurances

- 37.1 Parties may be required to take out certain insurances in respect of the water supply and Works. Provisions may also deal with uninsurability, payment of premia and joint insurance arrangements.

Termination

38. Termination Events

- 38.1 The Agreement should set out material instances of default that may lead to termination.
- 38.2 Relevant events of default may include:
- 38.2.1 instances of sustained non-provision of validly requested water supply and exceeding the cap on liquidated damages (including any extension thereof);
 - 38.2.2 failure of any critical development activity including any IP/CAP procurement and/or failure to achieve planning permission;
 - 38.2.3 non-payment of material sums;
 - 38.2.4 failure to complete and commission the Asset by a prescribed longstop date;

- 38.2.5 a party abandons the Assets or Works;
 - 38.2.6 an insolvency event occurs in respect of a party (this should not necessarily include where that party is placed in special administration);
 - 38.2.6 sustained *force majeure* preventing supply; and
 - 38.2.7 a replacement event occurs in respect of a party (this is an event where that party is replaced as the water company for its supply area, but the Agreement is not transferred to the new water company).
- 38.3 Relevant events should not include “hair trigger” recourse to termination. Rather, termination should be a measure of last resort. There should be clear opportunities for rectification.
- 38.4 Where a CAP/IP Infrastructure Provider operates an Asset or carries out the Works, the requirements here would need to reflect any arrangements and termination compensation in any CAP Agreement or Project Agreement.
- 38.5 The remedies for the parties should be set out. Where an Asset or the Works become genuinely stranded or supply is prevented recourse to Ofwat may be required pursuant to s.40A Water Industry Act 1991.

39. Effects of Termination

- 39.1 Where compensation on termination arises, the Agreement should make it clear:
- 39.1.1 What compensation is due.
 - 39.1.1 How breakage costs, tax liabilities and gross up are treated.
 - 39.1.2 What regulatory amendments may be required.
 - 39.1.3 Whether any residual liabilities arise.
- 39.2 The approach for compensation will need to reflect any compensation due for early termination or other compensation in respect of any CAP or IP arrangements.

Other

40. Necessary Consents

- 40.1 Each party may be required to maintain and comply with certain consents and permits for the project. This may include consents and authorisations from regulatory bodies such as the DWI. It may include planning permission. It may include land rights and consents of third-party owners. The Agreement should clearly set out responsibility and the implications for non-compliance as well as the relevant consents.
- 40.2 Where consents include positive obligations – for example payment a s.106 Agreement under planning law, then the Agreement should allocate this cost as between the parties.
- 40.3 Where necessary consents are not granted or are revoked then there may be obligations to escalate and utilise relevant appeal processes.
- 40.4 There may be restrictions as to when relevant necessary consents can be amended.

41. General – Boilerplate

Provisions may be included in respect of:

- Disputes.
- *Force Majeure*.
- Variations.
- Representations and Warranties.
- Confidentiality.
- Data Protection.
- Environmental Information Regulations 2004 .
- Marketing and Publicity.
- Transfer and Sub-Contracting.
- Conflict.
- Notices.
- Law and Jurisdiction.
- Third Party Rights.
- Waiver.
- Severance.
- Survival.
- Entire Agreement.
- No Partnership or Agency.
- Counterparts.

A2 Economic profit benchmarking

We have been investigating setting a benchmark to the level of Economic Profit and we have found that Water Resources Management Plan (WRMP) data helps to fulfil this purpose. Economic Profit would be set to this benchmark for different schemes and different option types will have a different benchmark. This essentially sets a cap to the level of economic profit. Using WRMP data we have been able to generate the following tables that illustrate the Net Present Cost of RAPID solutions and how they compare to the median/upper quartile of relevant WRMP solutions. Not all RAPID solutions have been included in the present version of these tables as not all solutions have a preferred option as of RAPID Gate 2. RAPID solutions are explained in summary in our October 2022 publication 'Building a resilient future – a guide for investors and the supply chain'²⁴.

| | Internal Potable Transfer (£m/MI/d) |
|---|--|
| Peterborough to Grafham Transfer | 2.0 |
| Draft WRMP Median | 1.9 |
| Draft WRMP Upper Quartile | 0.8 |

| | External raw water bulk supply/transfer (£m/MI/d) |
|---|--|
| Grand Union Canal Strategic Transfer | 5.1 |
| Minworth (Grand Union Canal Element) | 3.1 |
| Minworth (Severn to Thames Transfer Element) | 5.0 |
| Severn Trent Sources | 6.3 |
| Severn to Thames Transfer (Interconnector) | 3.5 |
| Severn to Trent Transfer (Vyrnwy Bypass) | 1.0 |
| Thames to Affinity Transfer | 4.6 |
| Draft WRMP Median | 8.4 |
| Draft WRMP Upper Quartile | 6.5 |

| | New Reservoir (£m/MI/d) |
|---|--------------------------------|
| Cheddar 2 Source and Transfer | 17.1 |
| Fens Reservoir | 20.5 |
| Mendip Quarries | 7.7 |
| South East Strategic Resource Option | 5.4 |
| Lincolnshire Reservoir | 11.0 |

²⁴ [Building a resilient future - a guide for investors and the supply chain](#), October 2022

| | |
|----------------------------------|------|
| Draft WRMP Median | 10.6 |
| Draft WRMP Upper Quartile | 7.1 |

| | New surface water (£m/MI/d) |
|--|------------------------------------|
| London Water Recycling (Teddington) | 4.6 |
| Draft WRMP Median | 9.7 |
| Draft WRMP Upper Quartile | 6.2 |

| | Water Reuse (£m/MI/d) |
|---|------------------------------|
| London Water Recycling (Beckton) | 14.3 |
| London Water Recycling (Mogden) | 11.1 |
| Poole Effluent Recycling and Transfers | 9.25 |
| Draft WRMP Median | 14.6 |
| Draft WRMP Upper Quartile | 10.0 |

In total against these option types, we have 696 comparators that we have been able to use from draft WRMP submissions. Outliers were removed from the dataset using the interquartile range (IQR) method whereby the upper and lower quartiles are calculated, as well as the IQR, and then all figures that fall out of the range ($Q \pm 1.5^* IQR$) are removed. We were then able to calculate a median and upper quartile from the remaining data. We currently propose to use the upper quartile as the benchmark.

To understand how this benchmarking could potentially work we have laid out the following examples: the draft WRMP Upper Quartile for New Reservoirs is set at 7.0 £m/MI/d (NPC – Net Present Costs) so the Economic Profit for all New Reservoirs would be based on this level. If a water company's SRO is more efficient than the benchmark, then the Economic Profit could either be based on the upper quartile or the projected £m/MI/d of the solution. This applies to all option types. In either case, the value would be fixed at the decision to proceed and not updated for over or underspend.

As a generic example, if we have a reservoir that costs £200m (NPC) with a benefit of 20MI/d, this provides a figure of 10.0 £m/MI/d. However, the benchmark for New Reservoirs is 7.1 (Upper Quartile) and so the total cost that Economic Profit applies to will be £142m.

This benchmark could be set as it is currently presented (by option type) or we could create an overall benchmark by combining all relevant option types together from the WRMPs. In this scenario Economic Profit would be the same per £m/MI/d for all option types. We are currently investigating what would serve a better outcome in terms of customer benefit.

Setting the level of Economic Profit


Alongside the total cost figure, we need to consider the level of uplift on the cost of capital that would be appropriate.

As a comparison, we have considered the potential upside from incentives for PR24, the maximum potential upside from totex outperformance in PR24 and possible ODI outperformance, as well as regulatory precedents from other sectors. It is important to remember that despite this comparison, Economic Profit will be applied to a smaller capital base (ie the company's cost of the SRO rather than its entire RCV). We have not yet come to a view on the appropriate uplift and would welcome proposals for how this should be set.

A3 Glossary

| Term | Description |
|---|---|
| Bulk supply agreement or BSA | A bilateral contract for supply from an exporter to an importer which sets out the terms and conditions of a bulk supply, including price. |
| Bulk supply water transfer | The transfer of a supply of water from one appointed water company to another. |
| Commercial structures or Commercial models | Arrangements for the design, construction, finance, maintenance, operation of solutions, bulk supply transfers and charging arrangements. These will include arrangements involving water companies and third parties. |
| Competitively Appointed Providers (CAPs) | The successful bidders of the DPC process and will be responsible for designing, building, financing and potentially operating and/or maintaining the infrastructure. |
| Direct Procurement for Customers or DPC | The process whereby companies put major infrastructure projects out to competitive tender for delivery by third parties. |
| DWI | Drinking Water Inspectorate – formed in 1990 to provide independent reassurance that public water supplies in England and Wales are safe and drinking water quality is acceptable to consumers. |
| Economic profit | Water companies who export water to other companies can charge higher than their expected costs which results in an excess which is economic profit. |
| Environment Agency (EA) | The environmental regulator for England. |
| Exporter | The water company who is exporting the bulk supply of water transferred to another appointed company. |
| Fair shares | A proposed policy approach which would apply to the operation of bulk supply transfers at times of drought / other operational events. |
| Fixed charge | A charge set in proportion to the fixed costs associated with the capability provided or reserved by each water company. The charge is paid regardless of asset usage and is determined based on the winning bid in the competitive tender. |
| Importer | The water company who is importing the bulk supply of water transferred from another appointed company. |
| Infrastructure Providers (IPs) | The successful bidder of a SIPR project who are responsible for designing, building, financing, and potentially operating and/or maintaining the infrastructure. |
| Interconnection | Transporting the bulk supply from one company to another, often in the form of a pipe designed, built, financed, operated, and maintained by the water company selling the water (the exporter). |
| NAVs | New appointments and variations referring to new, small water companies known as New Appointees. |
| NRW | Natural Resources Wales – the environmental regulator for Wales. |

| | |
|--|--|
| OFTO – Offshore Transmission Owners | In the energy sector, OFTOs design, build, operate and maintain the transmission assets; or others build the transmission assets and then transfer them to OFTOs at construction completion. |
| Ofwat | Ofwat The Water Services Regulation Authority, known as Ofwat, is the economic regulator of the water and wastewater sector in England and Wales. |
| Outcome delivery incentives (ODI) | The financial or reputational (non-financial) incentives for companies to outperform and avoid underperformance against each of their performance commitments. |
| RAPID | The Regulator's Alliance for Progressing Infrastructure Development (RAPID) is a partnership made up of the three water regulators – Ofwat, the Environment Agency (EA) and the Drinking Water Inspectorate (DWI). Established in 2019. |
| RCV (Regulatory Capital Value) | A component of how price limits are calculated and represents a measure of the capital base of a company when setting price limits. It reflects the allowed expenditure to be recovered from future customers. |
| ROCE – Return on capital employed | Represents the returns made by the providers of both debt and equity finance. |
| SIPR – The Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013) | These Regulations are made under the Water Act 1991 and provide the regulatory process for competitively tendering for large and complex water and wastewater infrastructure. |
| Temporary Use Bans (TUBs) | A ban imposed on customers for using water for specified purposes during times of high demand or low supply. Previously synonymous with a hosepipe ban. |
| Totex | Total expenditure (totex) is capital expenditure and operating expenditure. |
| Volumetric charge | A variable charge based on the opex allowance. The charge is paid depending on the usage of the asset. |
| WACC (Weighted average cost of capital) | WACC is calculated as the cost of equity multiplied by the percentage of equity assumed for the notional company plus the cost of debt multiplied by the percentage of debt assumed for the notional company. It represents the allowed return for the providers of equity and debt finance. |
| Water company / undertaker | A company which has statutory powers and duties to supply water and/or sewerage services to premises within an appointed geographical area under the Water Industry Act 1991. |
| Water Resource Management Plans (WRMPs) | These plans set out how water companies (in England and Wales) intend to achieve a secure supply of wholesome water for customers and a protected and enhanced environment both now and in the long term. |
| Water Trade | A way for water companies to trade surplus water with other companies which need more water for supply or as a resilience measure. |



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