South West Water

Peninsula House, Rydon Lane, Exeter, EX2 7HR
www.southwestwater.co.uk

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RAPID
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

By e-mail: rapid@ofwat.gov.uk

Dear colleagues

Enabling new water resources – a consultation on commercial arrangements

Thank you for the opportunity to respond to the consultation on the future commercial arrangements for new water resources.

Over the coming years, there will major investment in new water resources across the country as the sector responds to population growth, climate change, and meeting new environmental standards. Many of the new investments will go through either the direct procurement for customers (DPC) process, or the special infrastructure projects regulations (SIPR) approach. Both approaches are new to the sector, and require substantial design and development for projects to be successfully delivered.

In addition, many of the new water resource assets being developed will serve multiple parties. While a bulk supply framework exists in the sector (to enable water companies to trade water), the framework was largely developed to facilitate the trades of existing capacity, rather than underpin the development and delivery of major new assets.

We have three strategic resource options (SROs) that may be eligible for the DPC approach, and will involve varying degrees of interactions with other water companies:

- Cheddar 2 – a major reservoir being served by both springs and partially treated water from the River Axe. This could provide an annual average output of 14 megalitres per day (Ml/d) to the benefit of both South West Water and Wessex Water customers. It is planned to be construction ready in 2030 and operational in 2032/33.

- Poole Recycling and Transfer – the scheme will divert final effluent from Wessex Water's Poole waste water treatment works to the river Stour via a new pipeline, water recycling plant and wetland. It will supply an annual average deployable output of 12.5 Ml/d and a peak summer demand deployable output of 25 Ml/d. It is planned to be construction ready by 2030 and operational in 2035.

- Mendip Quarries – the scheme will repurpose quarries to form a new reservoir fed by a combination of groundwater and surface water. This will provide an additional water resource benefit of up to 87 Ml/d. This could provide benefit to Bristol Water, Wessex Water, and Bournemouth Water customers. And potentially to companies in the south east via a raw water transfer to the river Thames. It is planned to be construction ready in the period 2030-35 and operational in 2042.

There has been much progress in the sector in recent years with the establishment of RAPID and the development of the regional planning groups. However, further position statements and guidance in respect of the DPC model would be welcome from Ofwat. Additionally, significant further development is required around the underpinning regulatory treatment of new major assets that use the DPC / SIPR processes and / or have complicated multi-party arrangements.

As such, we welcome this timely consultation, and make a number of proposals as to how to further develop the regulatory framework to support the need for expedient and efficient delivery of major new water resources.

- We consider that there would be benefits from standardisation of aspects of the DPC, SIPR, and BSA frameworks. This could help reduce the costs of projects going through these processes in the long term. While we agree with the standardisation of common competitively appointed provider (CAP) Agreement/ infrastructure provider (IP) Agreement and bulk supply agreement (BSA) terms, such as termination rights, these proposals also need to allow for flexibility and tailoring of the delivery model for each project. Moreover, some projects (for example, Cheddar 2) are required in the short to medium term, and so will need to progress before full agreement on standardisation has been reached. There will also need to remain some flexibility to commercial arrangements to reflect project-specific circumstances.

- Despite the potential benefits, the development of DPC and SIPR projects demands substantial investment in terms of time, resources, and costs by the water companies to navigate these schemes through the competitive process. These costs will require sufficient funding from customers to support the process. Ofwat has a critical role to play in this context, as it needs to carefully consider the value for money offered by these schemes, ensuring that each project genuinely delivers value for customers. The departure from the value for money assessment as part of DPC eligibility assessment raises some concerns. It does not instil confidence that each scheme progressing through the competitive delivery route will indeed bring these benefits. Ofwat should consider if a more tailored assessment of development costs, taking into account the specific circumstances and needs of each project considered.

- In general, we support the proposed lead-party model. However, there may be some specific circumstances where other approaches provide more value. The delivery models should also be considered in the broader context of regional and national planning works, ensuring that interests and objectives are aligned between the undertaker(s) working on DPC/SRO schemes and the wider planning objectives.

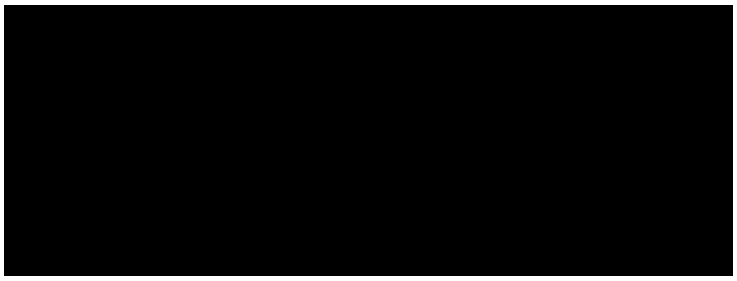
- Regardless of the commercial model used, it is essential that there is clear and transparent regulatory treatment of the long-term remuneration for the capital employed. In recent price reviews, Ofwat has introduced the concept of water resource regulatory capital value (RCV) being ‘at risk’. Such risk for a major water resource project is likely to be too great for any party to be able to reasonably bear. In order to facilitate efficient commercial arrangements, Ofwat will need to provide sufficient regulatory commitment to the remuneration of the asset.

- The ‘fair shares’ proposal appears reasonable in principle. However, there are some challenges in practice, including interaction with existing legislation.

- The bulk supply charging framework would benefit from more guidance from Ofwat. In particular, with regards to the treatment of economic profit.

Our responses to the specific consultation questions are provided in Appendix 1. We hope you find our responses helpful. Please contact me if you would like a further discussion; I would welcome open dialogue between our respective teams to explore our responses in more detail.

Yours faithfully



Appendix 1 – Responses to consultation questions

Commercial Structure

2.1 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.

Adopting a standardised approach across competitively delivered infrastructure projects brings several benefits that contribute to the efficiency, consistency, and successful delivery of projects.

Establishing a standardised commercial structure requires comprehensive research, analysis, and collaboration amongst regulators, industry experts, and stakeholders. Developing a model that accommodates the intricacies of various types of infrastructure projects can be a time-consuming and resource-intensive process.

Despite the initial investment of time and resources, the creation of a standardised model could lead to long-term efficiency benefits. Once developed, the model can serve as a valuable resource for future projects, reducing the need for extensive customization in subsequent regulatory processes.

While we agree that standardisation of common CAP Agreement/IP Agreement and BSA terms could be beneficial, these proposals also need to allow for flexibility. In the case of our Cheddar SRO project and projects of other companies that are expected to be procured in 2025-30 (AMP8), it is not likely that a fully standardised model will be developed in time to meet the projects' timescales. Waiting for the development and implementation of a fully standardised model might not be feasible within the constraints of current project timelines.

While acknowledging the benefits of standardisation, a flexible approach that allows for targeted adjustments to the standardised model to meet the specific needs of individual projects is the preferred option. This would keep an appropriate balance between standardisation and adaptability optimises project delivery and ensures that the commercial structure is tailored to the project specific risks.

In the case of Cheddar SRO, where time is of the essence, it may be more practical to employ a pragmatic approach, adapting existing best practices and lessons learned.

The experience of early schemes will also help to explore whether there should be a single default structure, or a range of models. There may need to be a range of standard models that emerge, particularly where there are multiple parties, where existing assets are involved, and for the management of interconnectors.

2.2 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.

The lead party model is a suitable option for many projects, and it should be considered as a preferred commercial structure for majority of projects delivered under DPC or SIPR (without precluding the ability to use alternative models where appropriate).

The lead party model provides several advantages that align with our SRO projects. For instance, the lead party model provides a clear and streamlined communication channel, as there is a single counterparty responsible for managing all aspects of the project. This simplifies coordination, decision-making, and issue resolution, ensuring greater efficiency and effectiveness.

While the lead party model is suitable for our SRO projects, where either South West Water or Wessex Water would be the lead company, it might not be universally appropriate for all infrastructure projects delivered under DPC or SIPR. Each project carries unique considerations, and the choice between the lead party model and alternative structures should be carefully evaluated based on project-specific needs.

The infrastructure only model appears particularly well-suited for projects delivered under DPC, given that the water companies are still responsible for the water quality obligations as with other projects delivered in-house.

Regardless of the model used, it is essential that there is clear and transparent regulatory treatment of the long-term remuneration for the capital employed. The undertaker(s) should be sufficiently renumerated to cover the required development and management costs to bring the projects to the tendering stage, as well as overseeing CAPs during the operations period. This will require commitment from both the undertakers and Ofwat.

In recent price reviews, Ofwat has introduced the concept of water resource regulatory capital value (RCV) being 'at risk'. This risk was limited to the water resource 'bidding in' arrangements for new, individual company, assets. Ofwat have, with universal support, not prioritised the development of that market at PR24. Such risk for a major water resource project is likely to be too great for any party to be able to reasonably bear. In order to facilitate efficient commercial arrangements, Ofwat will need to provide sufficient regulatory commitment to the funding of both the asset and its ongoing maintenance and operations.

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

We recognise the importance of exploring and tailoring commercial structures to the unique demands of each project, and the multi-party model for SIPR projects could be a viable alternative to the lead party model. This model accommodates shared ownership and collaborative governance, making it suitable for projects where multiple entities play crucial role in infrastructure development and water supply.

An alternative model could be based on a collection of projects bundled together. The delivery would require a collaborative approach between water companies with interest in different parts of the bundled project, private sector partners, and potentially government agencies. In this model, a CAP/IP could be a consortium that would be formed to jointly undertake the development, construction, and operation of the infrastructure. This model could involve a third party that would take on a system operator role to oversee the operations.

This would be a more complicated model, and therefore may only be appropriate in specific circumstances.

2.4 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.

We recognise that while a standardised commercial model provides a valuable framework, there is a need for detailed consideration regarding which aspects of the model should be left for water companies to decide. These will need to consider a robust list of risks and challenges for each model. In addition to risks identified in the consultation, we believe that Ofwat should consider liquidity and default risks in formulating their proposals.

The lead party model may introduce challenges related to liquidity risks for water companies. The potential scenario of missing payments to the CAP/IP could have broader implications on the other water companies involved. This risk could become more prominent in cases where the lead party encounters financial challenges, leading to the non-payment of one or more payments to the CAP/IP. Other participating companies, often expected to be smaller than the lead party, would still be obliged to meet their financial commitments, potentially imposing a more onerous impact on their financial stability. Financial difficulties leading to a company default could raise additional concerns about the continuity of the CAP/IP funding and the ability of other water companies to fulfil their obligations.

Similarly, the multi-party model may present challenges in terms of liquidity and default risks. If one water company were to miss one or more payments to the CAP/IP, it could disrupt the cash flows of the CAP/IP and its ability to finance obligations. Also, the default of one water company could impact the CAP/IP's ability to receive full revenue required to finance its operations.

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

Ofwat, in collaboration with wider stakeholders, should engage in a comprehensive evaluation to determine the scope of standardisation and the areas that can be subject to water companies' discretion. This process may involve consultation to gather insights from industry experts, regulators, and other relevant stakeholders.

A robust set of risk mitigation strategies will be essential for any delivery model selected by Ofwat. Given the challenges of the lead party model, regulatory oversight can play a critical role to ensure that the proposed economic profit accurately accounts for the mentioned risks and does not compromise the financial stability of the water company due to instability of another water company. In addition, contractual arrangements should clearly include provisions for handling other water company defaults or non-payment to the CAP/IP, specifying action to be taken in such situations.

In managing liquidity and default risks under the multi-party model, key components of an effective risk mitigation framework include a clear delineation of responsibilities, contingency plans for default scenarios, and transparent communication channels among participating water companies. Ofwat could also consider developing a mechanism where water companies would be required to agree on a contingency fund or risk-sharing agreements, minimising the financial impact on the CAP/IP.

<u>Bulk supply agreements</u>

3.1 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.

Yes, we agree that projects within the RAPID programme would significantly benefit from the development of a new guidance framework for negotiating bulk supply agreements (BSAs).

The intricacies of RAPID projects, which involve multiple parties and varying levels of contributions to infrastructure, highlight the need for a tailored and dynamic approach to guide negotiations effectively. We also recognise the importance of addressing the various commercial models that may arise in the context of projects being delivered under DPC and SIPR.

Given that BSAs typically have a very different use from the proposals set out in the consultation, we propose that the BSA in relation to competitive delivery models should be considered separately in a standalone guidance. Ofwat may consider introducing a new term for such an agreement to limit confusion between the two arrangements.

The guidance should also consider interactions with third-party water resource and service providers. This is particularly relevant in the context of access under section 66D, where the involvement of external entities may play a significant role in the success of RAPID projects. The guidance should provide clarity on how interactions with third parties can be navigated, ensuring that access arrangements are well-defined and adhere to regulatory requirements.

Our Ofwat innovation fund project “Flexible Local Water Supplies” is exploring the commercial model and barriers to third party bulk supply (through combined access). Ofwat have consulted on the wholesale licence application by Castle Water as part of this project, and we will reflect learning points relevant to negotiation of other bulk supplies in our final project report. As part of the project, the report we commissioned by Frontier Economics “Review of Cross Sector Charging Case Studies” has been shared with Ofwat and looks at what the water sector can learn from bulk supply charging arrangements in other sectors.

3.2 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.

We consider that consultation has correctly identified the most material areas likely to be required in a bulk supply agreement.

While the consultation document touches on different aspects of bulk supply agreements, it would be beneficial to delve deeper into risk allocation mechanisms. Clearly defining how risks, such as

unforeseen events or changes in regulatory landscape, will be allocated among parties is essential for ensuring fairness and transparency. This could involve detailing specific provisions for risk-sharing, force majeure clauses, and dispute resolution mechanisms in case of disagreements related to risk allocation.

While advocating for standardisation, it will be critical to recognise the diverse nature of various RAPID projects. The guidance should allow for project-specific variations to accommodate the unique characteristics and requirements of each project. This flexibility ensures that the standard provisions can be tailored to the specific needs of different types of solutions, promoting adaptability within the framework.

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

We agree with the proposed list of indicated provisions recommended for standardisation in BSAs to ensure a consistent and transparent framework for negotiations and operations for RAPID projects.

We note that out of the areas identified, operating protocols may be the most challenging to standardise, as the required protocols may substantially vary depending on the nature of the project.

In addition, there may be benefits from either standardisation, or at least further guidance, on how companies should approach pricing and the treatment of economic profit (see our responses to section 4 of the consultation below).

3.4 Please provide views on how to best achieve standardised provisions.

In considering the development of standardised provisions for BSAs, we support a collaborative and consultative approach that would involve key stakeholders, industry experts, and regulatory bodies. The process should look at developing high level principles, ensuring flexibility where necessary, while maintaining a robust and consistent framework.

Organising industry wide workshops focused on specific aspects of bulk supply agreements can enable detailed discussions. These workshops can provide a platform for in-depth discussions and considerations of critical areas, such as risk allocation or dispute resolution procedures.

Collaboration with water companies will be essential, but Ofwat may consider partnering with industry wide associations, such as the Water UK, that can provide a platform for collective input.

Collaboration with the Drinking Water Inspectorate (DWI) is necessary, especially concerning drinking water quality protocols. The DWI's expertise can contribute to the development of standardised protocols that prioritize the safety and quality of the water supply.

The standard BSA should evolve over time as more projects will be delivered through the RAPID programme.

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

The high-level principles outlined for the fair shares approach appear reasonable. However, it is essential to acknowledge the challenges in translating these principles into operational criteria.

It is crucial to distinguish between the contractual elements, such as the right to supply and the financial implications of different water allocations, and the operational triggers that may necessitate the reallocation of supply. Specifically, if one party has paid another to provide water, and then the water is not supplied (due to fair shares), then there should be a compensation payment to reflect the failure to supply.

It should also be recognised that Section 37 of the Water Industry Act 1991 (WIA91) requires water companies to provide supplies of water to premises in their area – i.e., it could be interpreted as conflicting with the fair shares approach. This may need to be addressed through a change to legislation, or at minimum, explicit assurances from Ofwat that it would not carry out enforcement action on a company that prioritised sharing water over serving its own customers.

Ideally, the approach to operational arrangements should be pre-agreed wherever possible. However, we recognise that defining specific operational criteria, especially related to the long timeframe can be challenging.

Drought conditions, for instance, are inherently variable, with each potentially presenting unique challenges. Attempting to rigidly define the level of service criteria in such circumstances may prove to be impractical, given the diverse weather impacts and customer usage patterns across interconnected water networks. The geographical and network-specific differences further complicate the development of a one-size-fits-all operational framework.

Additionally, during the initial stages it is expected that optimisation and standardisation will be revised on an ongoing basis as stakeholders will gain a better understanding of the new resources. Modelling the yield of these resources, especially in the case of new additions, introduces a degree of uncertainty that necessitates a flexible operational approach.

3.6 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?

In considering this question, it is important to distinguishing between the definition of fair shares as agreed upfront in the contract and the operational mechanisms underpinning bulk supply.

It is essential to establish a clear understanding of what constitutes a fair share at the outset, including assumptions about peak drought scenarios versus normal operational conditions. This upfront agreement will be crucial for incorporating the benefits of the bulk supply into the water resource management plan (WRMP). The incentives embedded in the contract should be structured around ensuring a fair allocation that reflects both operational events and other changes.

Ofwat could consider clarifying the existing requirement in the WIA91, ensuring that it accommodates the dynamics of designated schemes, particularly those identified in strategic WRMPs. This clarity might provide a basis for more efficient and effective bulk supply agreements that align with regional water resource planning.

In the absence of legislative changes, considering a multi-party commercial model as the default for designated schemes, particularly those aligned with WRMPs, may offer a pragmatic solution. This approach would ensure that the complexities of regional water resource planning are adequately addressed and that fair share allocations are managed effectively among multiple parties.

3.7 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?

We recommend a flexible approach that allows for the adaptation of governance models based on the specific characteristics of each project.

In considering the operation of bulk supply transfers during drought or other operational events, the enhanced governance model would be appropriate. However, this model has an underlying challenge, which revolves around ensuring that bulk supplies align with terms agreed within WRMPs and regional WRMPs. While an enhanced governance model provides a mechanism for real-time monitoring and decision making, it may not inherently address the alignment with WRMPs.

We agree that a standard governance model, which is robust and well-defined, should be sufficient to address the day-to-day operation of bulk supply transfers. This model, when adequately structured, can provide clarity on decision-making processes and obligations during operational events.

Alternatively, a system operator model could be considered. This model could be more applicable where there are interconnected schemes. In such complex scenarios, a system operator could play a pivotal role in coordinating and optimising water transfers.

The differences in the appropriate governance model is one of the factors that we consider means that there may be a range of standard models depending on the characteristics of the water supply project, as opposed to a single default.

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

The longer-term planning for and development of a statutory code beyond the RAPID projects is an important consideration that would involve balancing the need for standardisation with the evolving environmental requirements of the water industry. While the immediate focus is on providing tailored guidance for RAPID projects, Ofwat should consider the broader applicability of the standardised provisions in BSAs.

3.9 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?

We agree with Ofwat's proposals on the use of non-statutory guidance rather than an immediate transition to a statutory code for BSAs. The industry's complexities, particularly in the context of RAPID projects, demand a nuanced and adaptable approach allowing for lessons learnt on the first projects to be reflected in the guidance.

It may be advisable for codes to apply only to new BSAs, rather than unpicking existing ones.

Charging and water trades

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

The proposed charging model appears to include the key components of BSA charging. However, more details describing and articulating the economic profit proposals are required.

Recognising the likelihood of diverse economic profit levels to mirror distinct risk levels is imperative. We would expect Ofwat to provide details of the approach to calibrating the economic profit. This is especially relevant where projects may carry different risk profiles. Clarification on how these variations would be factored into the standardised model would be welcomed, in addition to any analysis and work done by Ofwat on the charging model

We suggest incorporating flexibility into the model to accommodate unforeseen circumstances or changes in project dynamics, particularly considering the long-term nature of such projects. For instance, as projects progress, various aspects such as scope, timelines, or stakeholder dynamics may evolve. The model should be capable of adapting to these changes without significant disruptions or negative impacts on the project's financial structure.

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

The cost benchmarking based on the upper quartile cost from the sample of schemes in WRMPs may provide a clear and tangible metric for determining economic profit. This aligns with the principles of transparency and fairness in the charging model.

However, it should be noted that different projects should be expected to have varying levels of economic profit to account for specific project risks. This should be reflected in the calibration of economic profit.

It would be useful for Ofwat to set out further guidance on how companies should assess the appropriate level of economic profit (and how to structure it between the capacity and volumetric charge). Having ex ante guidance will help enable companies come to informed decisions on the likely overall risk / return profile of the project prior to Ofwat approving (or otherwise) the economic profit proposals.

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?

The OFTO model, with a target availability and corresponding reward or penalty mechanism, may be applicable, subject to the project specific characteristics. Further analysis is needed to establish the suitability of this model for the projects in question.

In the case of water resources projects, availability can be inherently different from energy infrastructure projects (such as OFTOs) by being intricately tied to the variability in abstraction capabilities, making the measurement and assessment of availability more complex. While traditional models often focus on consistent availability, water resources projects need to consider the dynamic nature of water sources.

Measuring availability in the water sector may present challenges in incentivising optimal asset use. Unlike other infrastructure assets where continuous availability is the general expectation, the cyclical and often unpredictable nature of water abstraction makes the operational requirement more nuanced.

Under the DPC model, it could be considered that the CAP should be incentivised to deliver services through well-defined contractual terms. Ofwat may consider whether incentive measures would be more suitable for SIPR rather than DPC projects. Addressing this challenge requires a thoughtful approach to proving availability precisely during critical periods and would involve developing robust methodologies and measurement criteria that capture the unique demands of water resources during high-stress periods.

4.4 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?

If one party has paid another to provide water, and then the water is not supplied (due to fair shares), then there should be a compensation payment to reflect the failure to supply. Otherwise, the customers of the importing company will have paid for an asset they have not received the benefit from.

4.5 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?

We generally support the principle of the proposed approach. However, seasonality may be a poor predictor of the importance of the water supply (for example, a dry winter may present a more challenging situation than a dried summer).

Having compensation ratchets linked to some form of scarcity could help drive increased resilience at critical times. We consider that it would be useful to consider options for scarcity indicators on a project-by-project basis.

4.6 Do you agree with our approach to guidance / rules and charging?

We agree with the proposed approach to develop guidance as an initial step, with the potential evolution into more defined rules and codes, based on practical experience. This staggered approach aligns with the evolving nature of DPC and SIPR projects and allows for flexibility in adapting regulatory frameworks to the evolving changes to the BSAs.

As DPC and SIPR projects unfold and stakeholders gain valuable experience, the transition from guidance to more structured rules and codes would become a logical progression, ensuring that regulatory frameworks remain responsive and effective in safeguarding the interests of customers.