RAPID

Enabling new water resources – a consultation on commercial arrangements

Southern Water consultation response

20 March 2024

WATER for LIFE from Southern Water

Contents

1 Summary feedback

This document outlines Southern Water's response to RAPID's "Enabling new water resources – a consultation on commercial arrangements, November 2023." Itemised responses to each of RAPID's 21 questions are enclosed, however in summary Southern has three primary areas of feedback.

1.1 A preferred commercial model

We agree with the principle whereby a default commercial structure is available that can be utilised as a foundation upon which water companies can base their individual SRO commercial models.

Care is required though in the application of such a default standardised model. The SRO-enabled BSA / DPC / SIPR model is still evolving and there is not yet enough evidence to suggest that a single commercial model, anticipated to only require minimal adjustment to allow it to be tailored for individual circumstances, can be successfully applied as a universal model across all water SROs. Southern has a particular interest here as the most fitting commercial model for SESRO may well turn out to be a hybrid lead / multi-party model, but further work will need to be undertaken to confirm this understanding.

Our recommendation would be to use the preferred commercial structure as industry guidance for now whilst further real-world tests are conducted as to how well it works, ensuring deviations resulting from the need to consider specific circumstances are not just permitted by exception, but are embraced as valuable learning insights as to the integrity of the proposed model.

1.2 Fair shares

Any use of a reservoir or other asset which has been constructed in partnership between two or more companies has to be conducted in accordance with the investment contribution proportions between the partners (those proportions being directly reflected in the associated bulk supply agreement). Fair shares clauses, as currently proposed, contravene this principle by reallocating agreed contractual capacity arbitrarily in accordance with drought or other water stress conditions allowing one set of customers to receive potentially inequitable treatment over another set of customers. The issue is exacerbated within the consultation document with the proposal that fair shares arrangements potentially only benefit the exporter and not the importer should their customers face a similar adverse drought scenario.

Shared water assets such as reservoirs present an opportunity. There is the potential for the re-allocation of capacity between partners when one partner is not using or in need of all its allocated capacity and so can re-direct that capacity to a partner who has a short-term demand requirement above that of their normal, defined operational proportion. The use of a partners' water capacity in this manner should be considered a goodwill, mutually beneficial optionality and not a right. If an alternative standalone asset had been built to the same set capacity as an individual company's agreed proportion of the shared asset capacity, then this 'right-to-use' (implied by the current fair shares principles) would not be available. It is the investment by the parties to the agreement that are not the Lead SRO that has created the optionality and their customers should not be unduly penalised. This illustrates how agreed asset share proportions are sacrosanct to any agreement.

It is therefore our position that a bulk water exporter should not be able to supply its own customers with water beyond its standard contractual percentage allocation of the deployable output / investment share agreement at the expense of importing partners when there is unavailable capacity to meet the needs of both sets of customers.

We note that part of the underlying concern in this area is the possible effect of section 37 of the Water Industry Act 1991 and its enforcement by the Secretary of State / Ofwat. We, therefore, request clarification from the Secretary of State and Ofwat that Section 37 of the Water Industry Act 1991 cannot be interpreted in such a way that shared asset water is re-allocated from agreed partner proportions without the partner's consent when there is unavailable capacity to provide all partners with their contracted allocations.

1.3 Economic profit

The proposed approach is to apply economic profit to both the fixed cost component of the charge and the volumetric component. We believe this is a reasonable approach for two reasons:

- Applying economic profit to the fixed cost component incentivises a water exporter to engage in the development of an asset or an enlargement in capacity of a planned asset to which they would potentially be uninterested in doing if they only considered their own needs (at the present time).
- Applying economic profit to the volumetric component compensates the water exporting company and its customers as they have agreed to forgo the opportunity to use those resources if additional water resources are needed to meet their needs.

However, we consider the volumetric component of the economic profit proposal to be invalid and unfit-for-purpose should fair trades clauses be introduced to BSA contracts. By design, the volumetric component of economic profit is intended to compensate the exporter company and its customers for the opportunity cost of not being able to utilise in the future the water now being exported should it be required to meet their own needs. Fair shares clauses as currently drafted in the consultation document conflict with this principle.

Regarding the calculation of economic profit, the consultation document proposes a move away from a calculation based upon an uplift to the cost of capital to one based on a cost benchmarking. We disagree with the cost benchmarking approach for three reasons:

1. The methodology for the cost benchmarking is excessively complex.
2. The data upon which it is based is open to challenge in accordance with quality and applicability.
3. The approach does not adequately address the issue of risk.

Economic profit is intended as an incentive for water exporters and importers to overcome financial and non-financial barriers. Those barriers are also driven by risk, both real and perceived. An effective economic profit methodology must be able to address not only tangible cost factors, but intangible risk factors.

The consultation document proposes that economic profit be subject to regulatory approval. We agree. We propose that RAPID and Ofwat consult the industry to obtain agreement on commercially acceptable upper and lower limits within which the level of economic profit for individual schemes can be negotiated. This would have the benefit of allowing companies to focus, and potentially shorten, their bilateral negotiations and allows Ofwat a measure of flexibility in adjusting levels of economic profit proportionately in the instance of cost overruns. Future RAPID / Ofwat guidance should specify a regulatory basis as to how economic profit may be adjusted within the agreed upper and lower limits. This solution provides governance, guidance, clarity and flexibility to the calculation and agreement of economic profit for individual schemes.

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?

We agree with the principle whereby a default commercial structure is available that can be utilised as a foundation upon which water companies can base their commercial model.

Care is required though in the application of such a default standardised model. The DPC / SIPR model is still evolving and there is not yet enough evidence to suggest that a single model, anticipated to only require minimal adjustment to allow it to be tailored for individual circumstances, can be successfully applied as a universal model in this instance. The time and cost risk of imposing such a solution is significant if the model ultimately should prove to be unworkable. A premature, rigidly applied default commercial structure also has the potential to stifle the evolution of an alternative as-of-yet undefined industry-generated innovative solution which could naturally emerge with increasing knowledge and experience.

Our recommendation would be to use the preferred commercial structure as industry guidance for now whilst further real-world tests are conducted as to how well it works, ensuring deviations resulting from the need to consider specific circumstances are not just permitted by exception, but are embraced as valuable learning insights as to the integrity of the proposed model. When further learning has been undertaken and there is sufficient evidence to justify the full adoption of the more standardised commercial structure across the industry then a default model could be applied more formally.

A possible way forward to aid the potential adoption of a default commercial structure could be for RAPID to define a process that all new strategic water resource infrastructure supply solutions (SROs) follow. The process could include a set of stepping-stones and criteria with as its basis the premise that the outcome would be the adoption of either the lead party or multi-party model. The process would enable clarity in the determination as to why the chosen model would be the most appropriate. In addition, the process would help confirm the validity of both models. The process could also include the consideration of whether operations and maintenance should be transferred to the potential IP or CAP as part of the commercial proposition (see Q2.2(b) for further discussion of O and M within the preferred commercial structure). This process could be considered for each SRO as part of the gate two or three submission.

Q2.2 (a): Do you agree with the preferred commercial structure being a lead party model?

Yes, in accordance with the caveats described in Question 2.1. There is a possibility that SESRO may be best represented through a hybrid version of the lead or multi-party model, therefore we would recommend the multi-party model continue to be held as an approved alternative.

Q2.2 (b): Do you agree with the preferred commercial structure being an infrastructure only model?

In principle yes, but in accordance with caveats described in Question 2.1.

The consultation defines “Infrastructure Only” as being applicable across the full DBFOM spectrum for SIPR / DPC arrangements. DBF is certainly infrastructure only, however with O and M the line starts to become blurred as to where “Infrastructure only” ends and a “Full-service model” begins. If the preferred commercial structure is to be Infrastructure only then logically DBF should be included by default. However, since the ordination of O and M is less clear-cut, we propose that a flexible approach be taken, with the decision as to where responsibility lies being dependent upon the type of asset and the context of its particular, proposed use.

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

As per our response to Questions 2.1 and 2.2 our recommendation would be to utilise the lead party (infrastructure only) model, with the multi-party model as an approved alternative, on a guidance-only default basis and test how well it performs as the knowledge experience base of the industry evolves. As such we would not want to recommend another approach at this time.

Our expectation is that the lead party (infrastructure only) model whilst having merit (and value) as a default model will require notably more tailoring to individual circumstances than we perceive RAPID currently expects. For example, the lead party model as presented in the latest consultation paper denotes the lead water company as the exporter. Depending upon the individual commercial arrangement, the lead company could well be the water importer, which would consequently change the shape of the model. This is one, of what we anticipate will be a number, of common adjustments to the default model that will emerge as our knowledge and understanding evolves.

A future “standardised” commercial structure may be one that is based upon a default lead party (infrastructure only) model, but which has several listed, known, common adjustments that reflect the need for tailoring to individual circumstances. If the evidence is then compelling that the default model and the listed adjustments do indeed cover almost all circumstances, then the model may be mature enough to support “deviations by exception.”

Q2.4: We welcome your views on the different risks and responsibilities associated with the 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 are aware that Thames considers credit risk within the lead party model (as applied to the potential SESRO bulk supply agreement between Thames, Southern and Affinity) to be a significant commercial risk to which they have put forward alternative proposals. We acknowledge their concerns and recognise that credit risk is inherent within the model, whether the risk sits with the lead water company or the Infrastructure Provider (in the case of SESRO). Considering SESRO as a lead or multi-party hybrid model may prove the best solution to help address Thames’ concerns as under a multi-party model the credit risk associated with the development costs would transfer to the Infrastructure Provider. The credit risk could consequently be considered as part of the SIPR project licence and Project Cost and Risk Envelope (PCRE).

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

A Letter of Credit facility may be an arrangement which mitigates the credit risk within the Lead party model.

3 Bulk supply agreements

General Statements Relating to SROs and Bulk Supply Agreements

It is clear, both from the contents of Section 3 of the Consultation and from Ofwat's previous consultations and existing guidance on BSAs, that the law and regulatory guidance, as currently exists, do not envisage nor deal with the bulk transfer of water between two or more water undertakers other than as a purely commercial, traditional arrangement.

The underlying fundamental assumption is that one water undertaker (subject to its section 37 Water Industry Act 1991 duty) has, or is able to generate, some spare water capacity within its area and substantially within its existing assets, i.e., "surplus water" which could benefit another water undertaker's customers. In order to secure the efficient use of the water resource for all customers, it is expedient for both parties to come to an agreement (or be compelled by Ofwat determination to do so) on the bulk transfer of such water under commercial terms. This, of course, is historical and only required slight review and revision to encompass the NAV market.

SROs are now required to meet present and future challenges of water scarcity for the benefit of water customers generally without regard to water undertakers' geographical boundaries, and be subject to competitive delivery by non-regulated third parties. In order to address these evolving requirements, related bulk supply transfer arrangements for the future need to be substantially different and need to be regulated differently. The complexities and intricacies of both the commercial and regulatory arrangements necessary to enable the bulk supply agreement recently agreed for the Havant Thicket Reservoir (Havant Thicket BSA) make this clear. The Havant Thicket BSA arrangements deal with payment by one undertaker's customers (Southern Water's) to the second undertaker company (Portsmouth Water) of 100% of the Totex for the new infrastructure required to facilitate 100% of the bulk supply to the first's customers.

The existing law, guidance, and principles (and even the Havant Thicket BSA principles) do not envisage or deal with:

- The possibility of there being multi-parties to a bulk supply agreement.
- The possibility of all parties to the bulk supply agreement jointly paying for new infrastructure to facilitate the bulk supply.
- The need for customers of all the water undertaker parties to the bulk supply requiring supply from the same new infrastructure paid for jointly by all and how this accords with, and would operate, given each water undertakers' broad section 37 Water Industry Act 1991 supply duty to their respective customers.
- The potential circumstances in which one water undertaker's customers contribute to the costs of an SRO but the actual water supply is facilitated through another entity (or entities) once or even twice removed.
- One or more of the parties to the transfer potentially being non-regulated entities (both parties to the Havant Thicket BSA being regulated water undertakers).

All these issues and complexities need to be considered and reflected in any new policy framework and regulatory arrangements for these new-type, SRO-enabled agreements for the bulk transfer of water. An update to, or further guidance simply built on the existing framework may not be enough.

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?

We agree that a new guidance framework is required for SRO enabled bulk supplies. Existing law, guidance, and principles (including Havant Thicket BSA principles) do not envisage or address:

- The possibility of all parties to the BSA jointly paying for new infrastructure to facilitate the bulk supply.
- The need for customers of all the water undertaker parties to the SRO requiring bulk supply from the same infrastructure paid for jointly by all.
- One or more of the parties to the transfer potentially being non-regulated entities (both parties to the Havant Thicket BSA being regulated water undertakers).
- How any of these accords with, and would operate, given each water undertakers' broad Section 37 Water Industry Act 1991 supply duty to their respective customers.

An update to, or further guidance simply built on the existing framework is very unlikely to be sufficient.

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.

The consultation (page 51) assumes that:

"*Under this bulk supply agreement both water companies contribute to the cost of and [both] benefit from the new-build infrastructure asset*."

This, of course, is not always the case as is evident from the Havant Thicket Reservoir (non-SRO, so outside of the purview of this consultation) and Severn Trent's role in Grand Union Canal SRO (to be developed further). Whilst the provisions set out do not necessarily reflect this opening statement, it is necessary to distinguish between what could be a "standard" SRO-enabled BSA and what may be necessary for a multi-party BSA or even a "cascade" type BSA (two or more back-to-back BSAs or similar arrangements where obligations in one depend on obligations in another).

That aside, the various areas identified and set out in Appendix 1 are sufficiently encompassing of all the material issues that any standard, SRO-enabled BSA should cover. As with all commercial and quasi-commercial agreements (which is what these BSAs are), a simple formulaic application of these identified areas to every SRO-enabled BSA will not be possible, neither will a standard template form (see: responses and comments under questions 3.3 and 3.4 below).

3.2 Standard bulk supply agreement provisions

Q3.3: Which contract provisions do you believe should be standard to bulk supply agreements?

A few contract terms should be set as standard to all bulk supply agreements. These are generally potential contract terms which either incorporate or reflect standard industry requirements (i.e., legal

or licence obligations which affect all water companies) but are necessary to be set out in the agreement to ensure the parties also have a contractual basis to exercise certain rights. These include:

Water Quality

- Provisions for what is the 'relevant water quality requirements' should be standard and tied to the relevant DWI standard as this should not be subject to debate or negotiation.
- Additional provisions on what would constitute material breaches of water quality requirements which allows a party to shut down the system (supplying or receiving) should also be industry standard and tied to the definition of the relevant water quality requirements, not subject to negotiation.

Measurement of Water Supply

- Provisions for measurement of supply should be industry standard.

Definition of 'Emergency'

- An industry-wide accepted / set definition of what constitutes an emergency sufficient to trigger a no-fault reduction and/or suspension of supply is necessary as experience shows this seemingly minor point can take up significant negotiation time and resources and still result in an unsatisfactory outcome to either or both/ all parties.
- Given our responses on the significant revisions required to the 'fair shares' principles and the unequivocal need to enshrine firm supplies (not necessarily in set quantities, but with agreed percentage outtakes of deployable output), it will also be necessary to tie in this definition with the revised and improved 'fair shares' principles discussed elsewhere in this response as both go hand in hand.

'No-Fault' Termination

- Standard contract terms which clearly define what would constitute a 'no-fault' termination (i.e., termination necessitated without fault of any party) should be agreed at industry level.

Consequences of Termination

- To ensure all customers are protected in what would otherwise be severely constrained commercial circumstances, consequences of termination in specific circumstances where, for example, an SRO-enabled asset or works become genuinely stranded or supply becomes impossible, should be standard.
- These should be minimal and linked to a recourse to Ofwat by any of the parties pursuant to s.40A Water Industry Act 1991, as it may, for example, become necessary for one party to step into the position of another under a regulatory intervention to complete delivery of the project (i.e., enable a regulatory step-in arrangement rather than a contractual step-in), or with regard to a replacement licensed undertaker being appointed to the business of a party, etc.

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

Following revisions precipitated from this consultation, our recommendation would be to update all of Appendix 1 and publish as a "default" framework for guidance purposes. This being on the basis that the framework is utilised as a pilot to help ascertain its effectiveness by applying it to emerging bulk supply agreements. Rather than any adjustments being seen as "deviations permitted by exception," RAPID / Ofwat should engage in dialogue with partner water companies to better

understand why any changes are being proposed. If proposed changes prove superior and adoptable as a standard industry position, we would recommend they be adopted into the guidance. As these "proven" adjustments accumulate in number, a revised iteration of Appendix 1 can be re-published at a later date, incorporating the fully revised standard provisions.

The terms proposed (under question 3.3 above) for adoption as industry standards could be set out within the same guidance but marked specifically as regulatory requirements, deviation from which requires Ofwat approval / sign-off. These should also be subject to regular review and updating as may be necessary.

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?

We welcome the proposed high-level principles and agree wholly with Ofwat's view that a 'fair shares' approach based on clear principles is essential for bulk supply arrangements between water companies to ensure clarity of obligations and responsibilities during times when water supply systems are under stress. We have adopted and use a similar set of provisions and operating principles (although under a different terminology – 'Pain Share') across all our modern bulk supply agreements, whether as exporter or importer, where the basis of the bulk transfer is the availability of surplus water. We would have no objections to such an industry-wide agreed approach and set of principles being adopted as a standard contract provision in bulk supply agreements in these specific circumstances.

We also agree broadly with Ofwat's position that where new strategic water resource infrastructure is being developed as regional assets or for providing benefits across undertakers' geographical areas, customers should be treated with equity regardless of which geographic location they are in, or which water undertaker serves that location.

However, we do not believe the 'fair shares' principles as currently proposed for forthcoming SROs would be fair and equitable for customers given all the likely circumstances of the bulk transfer that will be enabled by these SROs as these are still fundamentally linked to the traditional bulk supply arrangements. New principles are required to address the emerging requirements of forthcoming SRO-enabled bulk supplies.

We have referenced many of the relevant circumstances in the introductory section to this Section 3 (above) and reiterate here that these issues need to be considered and reflected in any new policy framework and regulatory arrangements for agreements for the bulk transfer of water between water undertakers, including in respect of any 'fair shares' approach and principles.

Given that the objective of the new policy is to address the shortfall of existing policies against the requirements of forthcoming SROs, we do not believe the high-level principles are wholly appropriate or adequate (as already noted above). Further and additional principles are, at the least, required to be clearly articulated:

- To ensure that a water undertaker's customers who have paid for new supply infrastructure (wholly or in part) can be confident that in times of water stress they will receive a fair and

equitable proportion of the available water commensurate to the proportion of their contribution to the Totex costs of the new supply infrastructure and in accordance with the relevant undertaker's section 37 duty.

- To ensure, as a corollary to the above, that a water undertaker who has failed or neglected to adequately prepare to meet its section 37 duty should not be in a position to unduly benefit from the diligence of the other undertaker and at the expense of the more diligent water undertaker's customers.
- To deal with the legal position an exporting undertaker could find itself in with regard to its section 37 duty to its own customers where it is obliged by contract to provide a supply to the importer whilst its own customers are without water. **This needs either Licence change or statutory code to clarify with regard to SRO based BSAs as simple guidance would not be sufficient to override the statutory duty.**
- To ensure 'fair shares' applies notwithstanding the above where there is an actual emergency situation which requires, in the national and general public interest, that the fair and equitable thing to do is to share available water *pari passu* across all customers, e.g in proportion to customers served, rather than contractually agreed portions. There would need to be a clear definition of what circumstances would constitute such an emergency.

Why these additional/further principles are necessary may be gleaned from examining one of the currently proposed high-level principles:

"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 customers."

How would this proposed high-level principle apply where, for example:

1. Undertaker A's customers have funded the supply infrastructure 100% and contracted for supply from Undertaker B of 100% of the available water?
2. Undertaker A and B's customers have paid 50/50 for the assets and share the water supply 50/50, and due to a developing drought situation, Undertaker B has taken all its allocated 50% of the available water, but Undertaker A is saving up its own share for use over the remaining period of the developing drought. In the meantime, Undertaker B's customers start to suffer a deteriorating service compared to Undertaker A's customers.

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?

Given the comments made above generally under Section 3, and, in particular, in response to questions 3.4 and 3.5 about what 'fair shares' should be, no. It is possible to establish an objective method of determining a fair shares apportionment between water undertakers of available water in times of water stress, but it is unlikely this can be simply set out in a bulk supply agreement. In our response to this question, we draw on our particular interest as a partner in the forthcoming bulk supply arrangements for the Thames-Southern-Affinity SRO, SESRO.

Any use of a reservoir which has been constructed in partnership between two or more companies has to be conducted in accordance with the investment contribution proportions between the partners (those proportions being directly reflected in the associated bulk supply agreement). These

proportions must be respected and sacrosanct as otherwise the operational basis and understanding between the parties can be brought into disrepute. It is important to mention that there must be legal certainty, to the maximum extent possible, about the obligations and liabilities of water undertakers in implementing fair shares and, potentially, allocating water to another undertaker's customers that would otherwise be available to its own customers given the exporting undertaker's section 37 duty.

Such legal certainty has previously been achieved with regard to the apportionment of water between Southern Water and South East Water in respect of the River Medway (Bewl Reservoir) scheme – see: Medway Water (Bewl Bridge Reservoir) Act 1968, which leaves both parties in no doubt as to what proportion of the deployable output of the scheme they are entitled. This has not unduly hindered the companies agreeing from time to time how best to cooperate and assist each other in times of water stress to achieve a balanced allocation that benefits customers in the region notwithstanding which undertaker supplies them water.

This agreement stipulates that whatever the conditions, whether the reservoir is operating at full capacity or partial capacity (e.g., during drought conditions), the proportion that each company is entitled to remains fixed. This must be the basis for SESRO in order to have a fair and equitable foundation for its operation. If anything, this requirement has now become even more important because in accordance with our WRMP supply/demand modelling, SESRO is intended as a core, not a peripheral contributor to our water supply.

Shared reservoirs do however present an opportunity. There is the potential for the re-allocation of capacity between partners when one partner is not using all their available capacity and so can re-direct that capacity to a partner who has a short-term demand requirement above that of their normal, defined operational proportion. The use of a partner's reservoir capacity in this manner should be considered a goodwill, mutually beneficial optionality and **not a right**. If an alternative standalone asset had been built to the same set capacity as an individual company's agreed share of reservoir capacity this optionality **would not be available**. This demonstrates how the agreed proportions are sacrosanct to any agreement.

Fair shares clauses contravene this principle by reallocating agreed contractual capacity arbitrarily in accordance with drought conditions by allowing one set of customers to receive unequal contractual treatment over another area's customers. The issue is exacerbated within the consultation document with the proposal that "fair shares" arrangements only benefit the exporter and not the importer should their customers face a similar adverse drought scenario. It is therefore our position that a bulk water exporter should not be able to supply its own customers with water beyond its standard contractual percentage allocation of the deployable output / investment share agreement at the expense of importing partners **when there is unavailable capacity to meet the needs of both sets of customers.**

The addressing of this potential requires two components:

- Firstly, the inclusion of relevant commercial clauses (potentially standardised as referred to in our response to Question 3.3)
- Secondly, clarification around the potential application of Section 37 of the Water Industry Act 1991. An exporter company could interpret Section 37 as requiring them to re-allocate water from agreed partner proportions when there is unavailable capacity to meet the needs of both sets of customers. Across differing possible scenarios, this has the potential to put

every partner's customers into potential supply / demand deficit through no fault of their own water company.

Clarification is therefore required from the Secretary of state and Ofwat that Section 37 cannot be interpreted in such a way that reservoir water is re-allocated from agreed partner proportions when there is unavailable capacity to meet the needs of both sets of customers.

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?

Our preference would be for an enhanced governance model (assuming the clarity required regarding fair shares is achieved), with ultimate reference to Ofwat (as regulator). This preference being for two reasons:

- A third-party system operator could potentially introduce duplicate dispute resolution complexities without the advantage of final regulatory determination in time for critical decision making.
- A system operator's decisions may be unlikely to overcome other regulatory commitments such as supply PCs and ODIs.

Given the need for a clearer, more regulatory based approach to dealing with fair shares we have described above, it is possible, especially for multi-party bulk supply agreements such as SESRO, to conceive of a hybrid model that combines enhanced governance arrangements as one layer of dispute resolution within the clearer, firmer, and more equitable fair shares principles, with only specific technical issues being able to be referred to a systems operator.

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?

In the short to medium term, we are keen to see continuation in the development of non-statutory guidance for RAPID solutions. As we articulated in our response to Question 2.1, this allows water companies the potential to develop innovative solutions that could subsequently be applied across the industry if their effectiveness can be demonstrably proven. We believe clear, well thought-through guidance has the necessary scope to enable Ofwat and RAPID to capably manage the evolving nature of SRO-enabled bulk supply agreements without the need for a statutory code.

We consider that a move to statutory code would be premature at this time, whether that be for RAPID projects or other projects currently outside of RAPID parameters. However we recognise that statutory code may become a consideration when the market is more mature.

We acknowledge, however, that as regards certain industry standard terms (ref. Q3.3 above) that should be made standard for all SRO-enabled bulk supply agreements, it may be necessary for Ofwat to consider how best to enable these as enforceable baseline requirements across the industry.

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?

If a statutory code was to be introduced, our recommendation would be to apply it from an agreed date and have it applicable on a forward-looking basis only. Existing agreements should be considered legacy and exempt from any new statutory framework.

4 Charging and water trades

4.1 Proposed charging model

Q4.1: Are any other charging elements needed?

We believe no additional charging components need to be considered within the BSA charging model.

4.2 Economic profit

Q4.2: Do you agree with the proposed approach to calculate economic profit?

Economic profit has been envisaged to act as an incentive for water exporters and importers so as to overcome financial and non-financial barriers that have become apparent over recent years. The extract below from the consultation document is helpful in clarifying the intention:

"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 (i.e. there is an opportunity cost)"

The proposed approach is to apply economic profit to both the **fixed cost** component of the charge and the **volumetric** component. We believe this is a reasonable approach for two reasons:

- Applying economic profit to the fixed cost component incentivises a water exporter to engage in the development of an asset or an enlargement in capacity of a planned asset to which they would potentially be uninterested in doing if they only considered their own needs (at the present time).
- Applying economic profit to the volumetric component compensates the water exporting company and its customers as they have agreed to forgo the opportunity to use those resources if additional water resources are needed to meet their needs.

However, if an interpretation of fair shares (either contractually or through Section 37 of the Water Industry Act 1991) drives a re-allocation of agreed partner water proportions of a shared asset when there is unavailable capacity to meet the needs of both sets of customers (see our response to Question 3.6) then the application of **volumetric applied** economic profit becomes **invalid and unfit-for-purpose**. By design, the volumetric component of economic profit is intended to compensate the exporter company and its customers for the opportunity cost of not being able to utilise in the future the water now being exported should it be required to meet their own needs. Fair shares clauses as currently drafted in the consultation document conflict with this principle.

Regarding the calculation of economic profit, the consultation document proposes a move away from a calculation based upon an uplift to the cost of capital to one based on a cost benchmarking. The reasoning being that the higher the costs of the scheme, the greater the economic profit. This introduces the potential to reward cost over-runs, as the over-run will be reflected in the economic profit calculations. We recognise this potential however we disagree with the cost benchmarking approach for three reasons:

1. The methodology is excessively complex. Cost benchmarking introduces a two-stage approach to the calculation of economic profit. The cost benchmarking "weighting" is applied first followed by an uplift loading. Since it is highly likely the uplift loading will ultimately have to be calculated on a qualitative basis in accordance with the specific dynamics of an individual project then the value of the initial quantitative based cost benchmark component becomes questionable. Any adverse result either high or low in the cost benchmarking phase can be compensated for with a proportionate adjustment to the uplift loading. This leads to the conclusion that a single, uplift loading applied in accordance with the specific dynamics of an individual project may be best.
2. The data upon which cost benchmarking is based is likely to be open to challenge in accordance with quality and applicability.
3. The approach does not adequately address the issue of risk. Appendix 2 of the consultation document illustrates that a higher cost project is likely to be adjusted down with the application of the cost benchmarking methodology. This would imply that the risk associated with higher cost projects is less than lower cost projects as the cost benchmarking methodology is being utilised to lower the subsequent amount of economic profit. However, this should not be assumed. Higher cost projects may well contain a much greater level of systemic risk and so should either receive a similar level of economic profit or a potentially higher proportionate percentage. The reasonable level of economic profit for a particular project is likely to only be possible to determine on a case by case basis by taking into account how challenging associated factors such as geography, technology, demand, demographics are along with what potential alternatives are available.

Economic profit is intended as an incentive for water exporters and importers to overcome financial and non-financial barriers. Those barriers are also driven by risk, both real and perceived. An effective economic profit methodology must be able to address not only tangible cost factors, but intangible risk factors.

The consultation document proposes that economic profit be subject to regulatory approval. We agree. We propose that RAPID and Ofwat consult the industry to obtain agreement on commercially acceptable upper and lower limits within which the level of economic profit for individual schemes can be negotiated. This would have the benefit of allowing companies to focus, and potentially shorten, their bilateral negotiations and allows Ofwat a measure of flexibility in adjusting levels of economic profit proportionately in the instance of cost overruns. Future RAPID / Ofwat guidance should specify a regulatory basis as to how economic profit may be adjusted within the agreed upper and lower limits. This solution provides governance, guidance, clarity and flexibility to the calculation and agreement of economic profit for individual schemes.

We would like to highlight that any economic profit fixed figure or percentage agreed between bulk supply parties will be heavily influenced by whether the importing company or companies have invested a proportion of investment costs commensurate with the anticipated water supply from the asset. Any agreed upper and lower limits may need to discern between whether an importer has or has not participated and invested in proportionate development costs.

The consultation states:

"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."

We agree to the removal of the cap and this regulation. Since most, if not all RAPID schemes will not be operational by 2030 this constraint would appear to be unnecessary.

4.3 Availability and compensation

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?

We are unconvinced that the availability incentive is always the best way to incentivise an infrastructure provider:

- If the preferred model is infrastructure only, why does there need to be an availability incentive for the infrastructure provider? The infrastructure provider may not provide operations or maintenance responsibilities (refer our response to Q 2.2(b)) so would have little scope for influencing availability.
- Where the main purpose of an asset is expected to be drought resilience, then an availability payment may be appropriate, as the assets may operate very infrequently, so costs need to be recovered via fixed not volumetric charges. It would also give incentives for the operator to schedule planned maintenance outside periods when being is use is more likely. If the asset operates only rarely, there would be an advantage in an availability test that periodically demonstrates ability to operate at maximum capacity, with regular payments being conditional on having passed the most recent test.
- Modelling of some SROs (T2ST is an example) show there are scenarios when the assets will be on at high volumes very frequently, not only in droughts. Where water is flowing and being paid for, availability is already demonstrated by the flow of water, and an additional availability incentive would not appear to add anything. Instead, non-provision of water would cause reduced payments to the CAP / water company, giving a direct financial incentive to ensure availability.
- The availability incentive would appear to be based upon the premise that the shared bulk supply asset is a peripheral asset that needs to be kept in a state of readiness should it be needed. Where this is not the case, other arrangements would be more suitable.
- Where it is appropriate to apply an availability incentive, then we would consider its place potentially better suited to the infrastructure provider contract rather than the bulk supply agreement.

There are no alternative models we would like to suggest in this context.

We consider that there is certainly validity in the consideration of the OFTO model and its applicability to the water industry. However as mentioned above we have doubts concerning the appropriateness of an availability incentive when we envisage the assets associated with our bulk supply agreements are likely to be in constant use.

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?

Full compensation should cover two components:

- Compensation itself, that is the full financial cost to the importer of not receiving the water.
- Potential punitive damages depending upon the issue causing the disruption in supply (a loading or ratchet applied to the pure compensation)

Care needs to be taken to ensure that compensation arrangements are not so onerous that they make a bulk supply agreement non-viable. It may be appropriate to calibrate compensation payments to a level that they provide a sufficiently strong incentive for the exporting company to supply water, without jeopardising financeability.

Fair shares interventions should trigger significant punitive damages as they are intrinsically unfair and unequitable to all contract parties (refer response to Question 3.6).

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?

As mentioned above in our response to Question 4.4, we support the further investigation of ratchets dependent upon individual scenarios. Seasonality may not be the most appropriate consideration as it is a poor proxy for water availability.

Fair shares interventions should trigger significant damages as they are a departure from contractually agreed terms. However, in some circumstances fair shares compensation could be lower. If fair shares is defined as the share contractually agreed being applied to the volumes of water physically available, then both water volumes and potentially payments for them will reduce pro rata, and careful definition would be needed of what additional compensation was being paid and why. In the circumstances of an appropriately defined emergency as discussed in 3.5, it is possible that compensation would no longer apply.

4.4 Guidance or statutory rules on charging

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

We agree with RAPID / Ofwat's approach to develop guidance in the short to medium term whilst the bulk supply agreement market continues to mature and then consider the effectiveness of statutory code only in the longer-term.

5 Next steps

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

We do not have additional actions to propose but repeat our cautions about matching the pace at which mandatory guidance is developed to learning that is derived from the progression of individual SRO schemes.