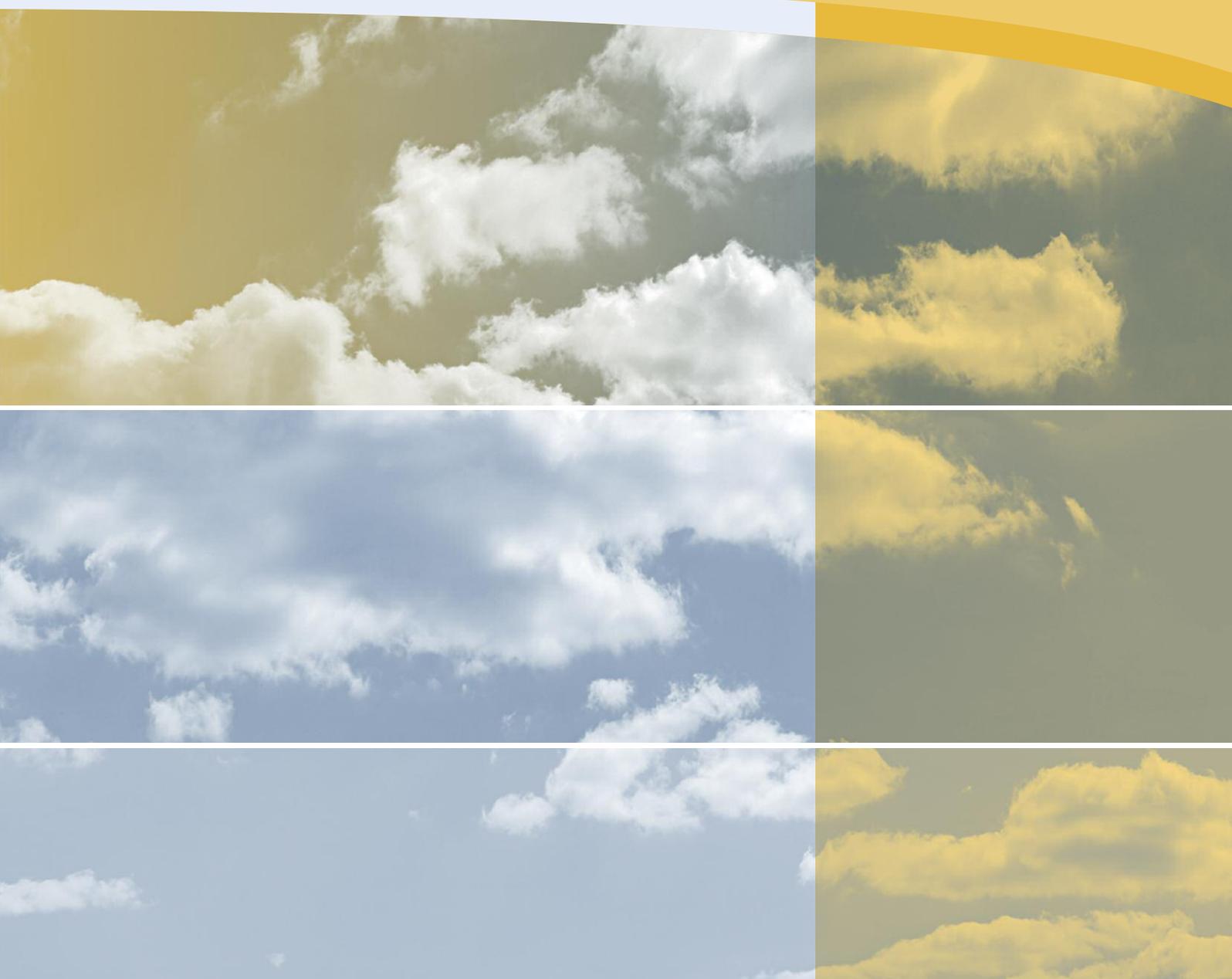


**Setting price controls for 2015-20 – final methodology and expectations for companies' business plans**

**Appendix 3: Trading and procurement codes – requirements and advice on principles to be included**



## **A3.1. Purpose of this document**

At present, water trading is likely to be between two parties that have concentrated market power. Because of this concentration of market power it is important that there is either appropriate ex-ante regulation or reliance is placed on the Competition Act (and the associated powers for ex-post enforcement). On balance we consider a form of ex-ante regulation is needed in the form of a requirement for a company to have a trading and procurement code which is approved by Ofwat. Of course, companies should in any event ensure they, and their codes and practices, are in compliance with competition law.

Therefore, for a water company to obtain an export and (or) import incentive as part of the next price control it will have to submit a trading and procurement code to Ofwat for approval.

A water company must then be able to demonstrate that it has complied with its approved code if it is to obtain an incentive payment. A water company does not have to produce a trading and procurement code if it does not want to claim any water trading incentives. Ofwat would be content for more than one water company to jointly develop a trading and procurement code.

We have concluded that this approach is more proportionate and less intrusive than Ofwat needing to be involved in approving the individual trades that a company will undertake.

This appendix provides water companies with the standard set of requirements that we think need to be covered as a minimum within the trading and procurement code. It is, however, important that companies consider the risks themselves and develop a code that they consider to be fit for purpose.

## **A3.2. Rationale for proposed principles**

A company's trading and procurement code is intended to provide reassurance that any trades it conducts in accordance with its code – and for which it seeks incentive rewards – will deliver net benefits efficiently.

If a company was not to go through a proper procurement process, for example, there is a clear risk that the trade could be challenged as being inefficient. It is also important because of the concentration of market power that all companies are transparent about the trades that they are entering into to allow for appropriate external scrutiny by other market participants and potential entrants.

Our development of trading and procurement codes has drawn on National Grid's Procurement Guidelines and Balancing Principles Statements in the energy sector. For example, National Grid Gas procures system management services subject to its Procurement Guidelines Statement and the company reports on how it has complied with its statement.

The principles in National Grid's Procurement Guidelines Statement include contracting for system management services in a non-discriminatory manner, purchasing from the most economical sources available and procuring via an appropriate competitive process if there is sufficient competition in the provision of a system management service.

### **A3.3. Relationship to the Water Bill**

The Water Bill proposes that Ofwat may issue one or more codes in respect of bulk supply agreements. Should we choose to issue one or more bulk supply codes, if and when the relevant part of the Bill became law, we would ensure consistency between the trading and procurement codes required for the water trading incentives and these new arrangements.

## **A3.4. The standard points to be addressed in a trading and procurement code**

Trading and procurement codes for importers and exporters will need to address different issues. If a company is both an importer and an exporter its code would need to address all relevant issues.

### **A3.4.1. Requirements**

The trading and procurement code should include the following mandatory requirements for an export or import to qualify for an incentive payment.

#### **The trade must be agreed in July 2013 or later**

Exports and imports agreed before the methodology statement was published in July 2013 will not be eligible for the new incentives, but those agreed in July 2013 or later will be eligible. By 'agreed', we mean that the parties have signed a contract in relation to a water trading arrangement.

#### **The trade must be operating between April 2015 and March 2020**

The import or export must be operating in practice and generating revenues during the next price control period: 1 April 2015 to 31 March 2020. The export incentive will not reward revenues accrued before 1 April 2015. The import incentive applies to expenditure during the price control period only. The treatment of water trading arrangements which begin operating after 1 April 2020 will be determined at the 2019 price review.

#### **Trades to be between unrelated parties**

To be consistent with trading and procurement codes then trading must be between unrelated parties. This is because barriers to water trading appear to be between unrelated entities, not within the same group of companies.

### **A3.4.2. Advice on general principles to be included in trading and procurement codes**

It is up to water companies to determine how their trading and procurement codes should best encompass the following principles, and whether they should cover any further principles or issues.

Nothing in trading and procurement codes will preclude any obligations that companies have under competition law.

#### **Non-discriminatory procurement by importers**

The trading and procurement code should provide reassurance to all actual and potential suppliers of bulk water that the procurement of third party supplies of water by the importer will be carried on a non-discriminatory basis.

#### **Economic purchasing by importers**

The trading and procurement code should provide reassurance that in contracting for the provision of water resources the importer will purchase from the most economical sources available, having regard to the quality, quantity and other relevant aspects.

#### **Use of competitive processes by importers**

The trading and procurement code should provide reassurance that where appropriate an importer will seek to secure water supplies through an appropriate competitive process.

#### **Contract lengths**

The trading and procurement code should provide reassurance that fixed length contract durations will be reasonable.

#### **Transparency**

The trading and procurement code should explain how the company will ensure effective provision of information to demonstrate compliance with the provisions of the Code, including appropriate arrangements for audit of compliance with the Code, availability of information including results of audit to Ofwat, and availability of appropriate information to market participants and other interested parties (without compromising the commercial position of any contracting party).

### **Water resources management plans (importers and exporters)**

The trading and procurement code should explain and justify any significant differences between the company's approach to agreeing water trading arrangements and the process for selecting options under its [water resources management planning guidance](#).

### **Rational flows (importers and exporters)**

The trading and procurement code should explain and illustrate the processes that the company has for ensuring that any trades will involve economically and environmentally rational flows. The Code should explain how the company will ensure protection of environmentally-sensitive abstraction sites.

### **No artificial ending of trades (importers and exporters)**

The trading and procurement code should provide reassurance that there has been no artificial ending and restarting of trades to take advantage of changes in incentive arrangements.

### **Correct assessment of costs (exporters)**

The trading and procurement code should provide reassurance that the costs of the export arrangement have been accurately estimated and will be fully recovered from the export agreement.

### **A3.5. Approval process and incentive payments**

The approval process for trading and procurement codes is summarised below.

- a. Companies to provide draft codes to Ofwat.
- b. Ofwat to publish draft codes on its website and allow six weeks for comments.
- c. Ofwat to approve the code or provide reasons for not approving within a further six weeks.
- d. Ofwat may conduct an annual review of approved codes and provide further guidance to companies by the end of June each year.
- e. Companies would have six weeks to make changes and resubmit the resulting draft code to Ofwat for approval.

If a water company wants to claim an export and (or) import incentive it must be operating consistently with and be able to demonstrate compliance with an approved trading and procurement code. Adjustments to price control revenue to take appropriate account of water trading incentives will be made at the 2019 price control review.

**Ofwat** (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide customers with a good quality and efficient service at a fair price.



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