

Trading and Procurement Code

DRAFT

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## Glossary of terms

CAPEX	Capital Expenditure
CDM	Construction Design and Management Regulations
DWI	Drinking Water Inspectorate is the independent organisation that ensures the legal standards for drinking water quality
EA	Environment Agency is the regulator of the natural environment in England
EFG	Environmental Focus Group which comprises members from local planning authorities, statutory bodies, regulatory authorities, environmental nongovernment organisations and local interest groups
HRA	Habitats Regulations Assessment
Ofwat	Ofwat (The Water Services Regulation Authority) is the economic regulator of the water sector for England and Wales
OJEU	Notice within the Official Journal of the European Union
OPEX	Operational Expenditure
SEA	Strategic Environmental Assessment
SEW	South East Water
WFD	Water Framework Directive
WRMP	Water Resources Management Plan is a water company's long term plan for managing supply and demand balance
WRSE	Water Resources in the South East
WRZ	Water Resource Zone
WSL	Water Supply Licencing

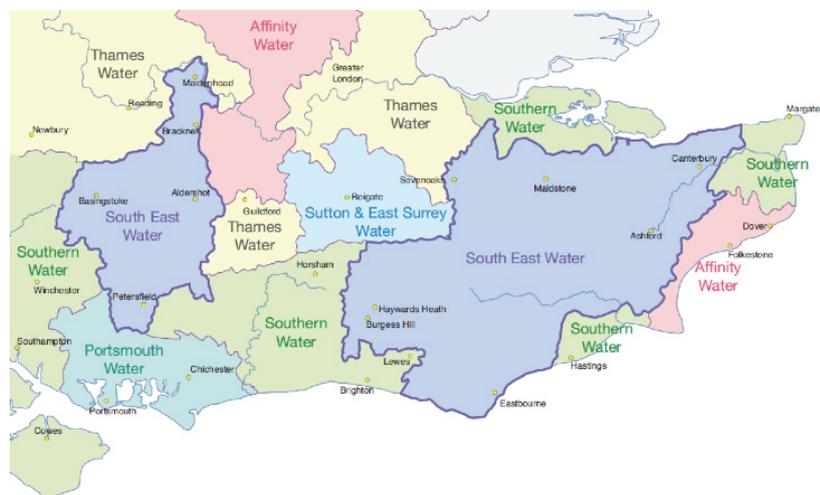
## 1.0 Introduction – the context for water trading

### 1.1 South East Water

South East Water is one of 20 regulated water companies in England and Wales and we supply clean, potable water to around 2.1 million people living in approximately 900,000 properties.

The South East Water supply area is split into western and eastern regions and covers around 5,700km<sup>2</sup> across Kent, Sussex, Surrey, Berkshire and Hampshire. Within our supply area, Southern Water and Thames Water provide a separate service for the removal and treatment of wastewater.

Figure 1 – South East Water Supply Areas



### 1.2 Regulatory framework

We operate under a comprehensive framework of statutory and regulatory obligations and our services are regulated in a number of areas. These are set out in UK and EU legislation, and include but are not limited to the Water Industry Act 1991 (as amended by the Water Act 2003\* and Water Act 2014\*), the Competition Act 1998\*, the Utilities Contracts Regulations 2016; the European Habitats Directive and Water Framework Directive. These obligations set the boundaries for the way we serve our customers, specifying environmental and economic standards which we must meet. South East Water is regulated by:

- **Ofwat** is the economic regulator for all appointed water and wastewater companies and water-only companies in England and Wales. It sets limits on the revenues that these companies can recover for their services every five years through the price review process
- **The Competition and Markets Authority (CMA)** who works to promote competition for the benefit of consumers, both within and outside the UK
- **The Drinking Water Inspectorate (DWI)** is the independent organisation that ensures the legal standards for drinking water quality are met, and oversees the quality of tap water, making sure water is safe to drink when it reaches your home
- **The Environment Agency (EA)** is responsible for regulating how much water we can abstract from the environment, and protecting and improving the quality of rivers, estuaries and coastal waters. It is also responsible for pollution control, flood defence and fisheries

\*Please refer to the link provided on page 14.

### 1.3 Water resources

Around 73 per cent of the water we supply is sourced from over 250 boreholes and wells, with the remainder coming from six river intakes and three surface water reservoirs. Water is pumped from these sources, treated and distributed to our customers through more than 14,500 km of water mains.

Our supply area is divided into eight Water Resource Zones (WRZ), with two zones making up our Western Region and six zones in the Eastern Region. WRZs are the basic framework for planning water resources, managing supply and demand and identifying investment priorities. The boundary of each WRZ describes an area within which the supply and demand for water is largely self-contained, which means that all our customers within a single WRZ share the same level of service and experience the same risk of water supply failure.

Figure 2 – South East Water’s Water Resource Zones



In order to understand if we have sufficient water to meet our customers’ needs, we compare the demand for water with the available supply, taking account of the uncertainties in the forecasts. This assessment produces the “supply demand balances” for each WRZ which show if there is sufficient water to meet customers’ needs or if there is a deficit.

We do this as part of our Water Resources Management Plan (WRMP) every five years to set out what we will need to do, where, and by when, to secure water supplies for today’s and tomorrow’s customers. The overall company level supply demand balances across our supply areas, as published in our WRMP 2014\* are shown below. Details at a WRZ level are available on our website – [southeastwater.co.uk](http://southeastwater.co.uk).

\*Please refer to the link provided on page 14.

Table 1 – Forecast supply demand balance (figures in red are deficits)

	Dry year annual average (Ml/d)				Summer peak period (Ml/d)			
	2015	2020	2030	2040	2015	2020	2030	2040
Deployable output	622.7	612.7	600.9	597.7	727.2	718.3	708.0	705.9
Bulk supplies	56.4	56.4	56.4	56.4	57.3	57.3	57.3	57.3
Process losses	12.3	12.3	12.3	12.3	12.3	12.3	12.3	12.3
Outage	27.4	27.4	27.4	27.4	36.7	36.7	36.7	36.7
<b>Total (WAFU)</b>	<b>639.3</b>	<b>629.3</b>	<b>617.5</b>	<b>614.4</b>	<b>735.5</b>	<b>726.6</b>	<b>716.3</b>	<b>714.2</b>
Demand	574.4	572.2	582.0	604.1	697.5	701.4	730.7	775.8
Target headroom	13.7	26.8	42.1	58.9	15.9	33.4	54.7	75.7
<b>Demand + headroom</b>	<b>588.1</b>	<b>599.0</b>	<b>624.1</b>	<b>663.0</b>	<b>713.4</b>	<b>734.7</b>	<b>785.4</b>	<b>851.4</b>
<b>Supply Demand Balance</b>	<b>51.2</b>	<b>30.3</b>	<b>-6.6</b>	<b>-48.7</b>	<b>22.1</b>	<b>-8.2</b>	<b>-69.1</b>	<b>-137.3</b>

#### 1.4 The challenges

We believe that opportunities for water trading can play an important part in resolving the following challenges that we will face in planning for the future:

##### 1.4.1 Protecting and enhancing the environment

As a water company we are intrinsically linked to our natural environment. Our area is particularly rich in biodiversity, for example Sussex has the highest proportion of ancient woodland of any English county.

We work hard to minimise the environmental impacts of our operations, and in partnership with the Environment Focus Group, regulators and local authorities, look for opportunities to manage catchments better and enhance the natural environment.

All water sources have been and will continue to be monitored to ensure they are sustainable and comply with current and future legislation.

##### 1.4.2 Rainfall and climate change

The whole of the South East of England is classified by the Environment Agency as an area of ‘serious water stress’. This is defined as an area where the demand for water is a high proportion of the water available, which can lead to serious stress on the water environment.

Weather patterns are becoming less predictable. During recent years we have experienced untypically dry and wet weather. The 17 months between October 2010 and February 2012 saw exceptionally low rainfall across the majority of our area. By April 2012, groundwater levels were the lowest since records began in 1904.

Even following a wet winter, the South East of England is only ever 18 months away from the start of a potential drought. This is because we can only store a limited amount of rainfall and much of it flows out to streams, rivers and ultimately the sea.

### 1.4.3 *Population increase*

The environmental challenge is compounded by the fact that South East England as a whole is officially identified as an area for significant population and economic growth. Population and housing within our area of supply is expected to increase by 19 per cent and 32 per cent respectively by 2040.

### 1.5 *Water trading*

South East Water is the highest net importer of drinking water of any water company in England and Wales. Some 8 per cent of supplies, or 56.3 Ml/d, come from water transferred from sources owned and operated by our neighbouring water companies (Southern Water and Affinity Water), under joint rights or bulk supply agreements.

Our membership of the Water Resources in the South East (WRSE) group enables us to fully explore opportunities for sharing existing and new strategic water resources in the most efficient and effective way while maintaining security of supply, protecting the environment and minimising costs to customers. We are one of six regional water companies (Southern Water, South East Water, Portsmouth Water, Affinity Water (formerly Veolia), Thames Water, and Sutton and East Surrey Water) that make up the group, which also includes the Environment Agency and the Consumer Council for Water.

### 1.6 *Contact details*

Any queries in relation to this Trading and Procurement Code, South East Water's Water Resources Management Plan ("WRMP") or in relation to water trading generally should be directed to:

**Lee Dance**

Head of Water Resources

South East Water, Rocfort Road, Snodland, Kent ME6 5AH

Tel: **01634 87 3904**

Mob: **07976 820943**

E-Mail: **Lee.Dance@southeastwater.co.uk**

## 2.0 Purpose and use of the code

This is South East Water's Trading and Procurement Code ("Code"). It sets out the policies, principles and requirements that will apply when appointed water companies and third parties undertake water trades with us.

### 2.1 *Purpose of the code*

At present, water trading is likely to be between two parties that have concentrated market power. To guard against this, Ofwat consider that a form of ex-ante regulation is needed in the form of a requirement for a company to have an approved Trading and Procurement Code\*.

Therefore, for a water company to obtain an export and (or) import incentive as part of the next price control it must be able to demonstrate that it has in place and is complying with a Trading and Procurement Code that is approved by Ofwat\*.

At South East Water we are, in principle, willing to trade with both other water companies and third parties. The code is intended to ensure that in contracting for the provision of water resources we will purchase from the most economical sources available, having regard to the quality, quantity and environmental aspects.

### 2.2 *Use of the code*

We will keep our Ofwat approved Trading and Procurement Code up to date and publicly available, via our website.

This code should be read in conjunction with South East Water's Access Code 2016\*, which sets out in detail the operational and commercial arrangements that govern applications for use of, and supply from, our supply system for the purposes of competition under the WSL provisions. Where we seek to export water, we will base these trades on our Access Code. The latest version of the Access Code is available on the South East Water website.

## 3.0 Principles of the code

Where trades are proposed between other water companies or third parties, and South East Water, we are committed to trading in a transparent, sustainable and responsible manner, and to the benefit of our customers and the natural environment.

In Ofwat's price controls 2015-20 methodology, guidance on the general principles for water companies to include in their code is provided. This guidance is separated in principles that apply to either imports, exports or both.

In the sections below, we have followed the Ofwat guidance to set out how we would approach trades with other parties. It provides the basis for more detailed, commercial negotiations with potential trade parties.

### 3.1 Imports

#### 3.1.1 Non-discriminatory procurement

As part of the process when preparing our WRMP, South East Water is required to consider options to share water with other water companies or third parties. Our WRMP14\* shows the extent to which we have already gone to raise awareness of and interest in water trading with other water companies and third parties. We published a general statement of need, which shows where we might require water resources in the future, across our area.

We are following a more comprehensive and proactive engagement programme for our WRMP19, which includes a website page, industry publication adverts and a formal advert in the Official Journal of the European Union, meeting procurement requirements in accordance with the Utilities Contracts Regulations 2016, all aimed at promoting opportunity for potential trade parties to offer water sharing options.

We have also held specific discussions with neighbouring water companies, within the WRSE group, about the feasibility of water sharing arrangements in the future. We remain willing to discuss potential trades with any third party. We will also apply our internal procurement policy to all future trades and this complies with the EC treaty principles in relation to non-discrimination; transparency and equal treatment when assessing suppliers of all types, either under the EU threshold for procurement or above.

As the above shows, we will not discriminate against or between any potential providers of water to us.

#### 3.1.2 Economic purchasing

Our WRMP14\* includes consideration of potential imports which were assessed against alternative options to identify the most cost effective solutions. We are aware of the need to operate as an efficient company and provide services to our customers as efficiently as possible.

Where we consider options to import water, we assure Ofwat and others that we will follow the same assessment approach to purchase from the most economical sources available, having regard to the quality and quantity of water available, the impact on customers in the donor area and the effect on the natural environment and the operation of our network.

\*Please refer to the link provided on page 14.

### 3.1.3 *Use of competitive processes*

At South East Water we are aware of our obligations under UK and EU competition and procurement law and wholeheartedly supports the use of open and effective competitive processes in seeking to secure new water supplies. Our WRMP, later described, and use of European procurement advertising with OJEU notices\* shows that we are committed to an open, transparent and genuine process for considering potential supplies to us.

Should more than one supplier bid to supply us with water we would be committed to using a structured and competitive process to determine the successful supplier. This process would include an initial assessment of each option against the following criteria:

- **Environmental & social acceptability** – an objectives led approach for conducting an assessment of SEA, HRA and WFD
- **Promotability** – acceptability to customers, local planning and regulators as well as synergies with other WRZ's and water companies
- **Deliverability** – experience in delivering similar solutions, constructability, CDM, operability, dependencies on existing assets and the quality of data being used. In addition, the lead time and phasing of delivery and the adaptability and ramp-up time once built will be assessed
- **Resilience** – the vulnerability due to outages, financial uncertainty, regulatory changes, drought and climate change
- **Cost** – an assessment of CAPEX, OPEX, carbon and environmental and social costs

Feasible options would then be subject to further assessment using a process known as the Economics of Balancing Supply and Demand (EBSA) to establish the preferred options for each WRZ.

## 3.2 *Exports*

### 3.2.1 *Correct assessment of costs*

We will approach the costing of a potential water trade in the same manner consistent with the water resource planning process, and as set out in the WRMP guidance. This will ensure that the costs of any export arrangement have been accurately estimated and will be fully recovered from the export agreement.

In Section 7 of our WRMP14 we explain the approach we use for the economic evaluation and assessment of options which include potential water trades. The methods we use include:

- **UKWIR and Environment Agency's 2002 guidance** "The Economics of Balancing Supply and Demand" – This provides a detailed guide to assessing options and choosing a preferred solution. It focuses particularly on the economic assessment of individual options and combination of options
- **Environment Agency 2012 "Benefit Assessment Guidance"** – This guidance sets out a structured approach for assessing and valuing a range of environmental and social impacts associated with water resource schemes. It is a decision making tool based on the principles of cost-benefit analysis, enabling a consistent comparison of the costs and benefits of an option in monetary terms

For the purposes of calculating export charges, we do not have standard tariffs in place. Therefore, the charges will be calculated based on the costs of supplying the trade, including the actual maintenance and operation costs of specific infrastructure in place to supply the export and an apportionment of the cost of abstraction, storage and transmission pumping costs to the supply. Where appropriate export charges may use wholesale charges as a basis of the calculation. Where possible we will use existing infrastructure to minimise the costs of a trade.

### **3.3 Exports and imports**

#### **3.3.1 Assignment**

A trading partner is prohibited from assigning a qualifying trade agreement to any other party without consent from South East Water.

#### **3.3.2 Commencement**

A qualifying trade must have been agreed in July 2013 or later.

#### **3.3.3 Qualifying period**

A qualifying trade must be operating in practice and generating revenues during the period 1st April 2015 to 31st March 2020. The treatment of water trading arrangements which begin operating after 1st April 2020 will be determined at the 2019 price review.

#### **3.3.4 Contract lengths**

We are committed to negotiating fair and reasonable trading arrangements that meet the needs of both parties. Arrangements will be guided by the framework set out by Ofwat in their "Negotiating Bulk Supplies"\* publication.

When setting contract lengths, we will choose a reasonable duration, appropriate to the nature of the supply and other case-specific factors.

For exports, the contract length should take into account any potential risks to existing customers. This includes the payback duration of any infrastructure needed to supply the water. The volume offered should not put any WRZ into deficit within the contract duration and if the supply is related to a specific source, the length of contract should be within the abstraction licence period of consent.

For imports, we will consider short-term and long-term trades, and the contract duration will depend on the circumstances of the specific trade being discussed. As a general rule, where we seek to import water, we need to ensure water is available over a long-enough period to represent a meaningful and secure contribution to deployable output. Taking account of the cycle of water resources management plans and associated planning regimes, in most cases we would prefer a contract term of at least 20 years with long duration notice periods linked to the time we would need to find alternative sources of water.

#### **3.3.5 Transparency**

Information about our water resources position is set out in our WRMP14 and publicly available on our company website\*. As part of the WRMP, we follow a fully transparent process for option selection and appraisal which includes stakeholder engagement and public consultation. We engage with stakeholders and third parties on a quarterly basis as part of our Environmental Focus Group (EFG) meetings to provide regular updates on our proposals for future investment and to give an opportunity for their input and scrutiny into our programme of work.

We also share information with other companies about water availability and potential trading opportunities as part of our work with the Water Resources in the South East (WRSE) group.

We are also subject to the Environmental Information Regulations 2004 and where requests are made for environmental information we ensure that these are responded to and the information provided.

For all qualifying trade proposals that are successfully completed we will carry out an internal audit of the process and provide that report to Ofwat. The audit report will examine the processes followed during the trade negotiations, and demonstrate that we have complied with all aspects of this code. We would provide this report as part of our Business Plan submission.

\*Please refer to the link provided on page 14.

### 3.3.6 *Water Resources Management Plan*

Water trades are already considered in our assessment of supply demand balance options in our WRMP. Our work with the WRSE has enabled us to explore opportunities to share water resources. It has provided us with information about regional water transfer options to be included in WRSE option modelling and available for our own modelling work. Our final WRMP14 sets out, in Table 9.4, six “in principle” agreement trades with neighbouring water companies which have been taken forward to our preferred programme of investment.

For WRMP19, we are following a more comprehensive and proactive engagement programme which includes a website page, industry publication adverts and an OJEU notice\* all aimed at promoting opportunity for potential trade parties to offer water sharing options. On 7th May 2016, an OJEU notice\* was published for large scale supply side options to identify services for – *The supply and/or delivery of raw or treated water in bulk to South East Water*. The OJEU notice\* will be re-published annually and used as an open market place to generate ideas throughout the planning timetable for WRMP19. We would approach a water trade in a manner fully consistent with the water resource planning process, as set out in the WRMP guidance.

### 3.3.7 *Environmental and economic rationality*

We have a statutory duty to develop a WRMP to manage water resources within our area and to include a clear and transparent explanation of the decision making process used to arrive at the preferred plan. The plan is tested taking on board our customers’ and key stakeholders’ preferences, as well as economic and environmental rational.

The economic rationality of any new water trade agreement is supported by our economic modelling and assessment process which considers a range of costs and benefits, including initial construction costs; environmental and social costs and benefits (including carbon); capital maintenance costs; and, operational costs. This cost assessment process will be reported in the audit report that we would prepare once a trade was agreed.

The environmental rationality of any new trade agreement is supported by the fact that we will not compromise our statutory duties related to both UK and European legislation. One example related to this being that all new water resource options must be assessed to ensure that they do not cause deterioration in Water Framework Directive (WFD) terms. In relation to WFD before entering a trade agreement a sustainability assessment of the new source must be provided to enable the option to be considered as part of our WRMP.

As part of the WRMP, we are required to undertake a Strategic Environmental Assessment (SEA) of our plan. SEA is a process for identifying the overall environmental impact of a plan or programme; to ensure that the environmental effects are taken into account and the environmental implications are appropriately reported and consulted on. We would ask all third parties to provide sufficient environmental information regarding a water trade option to inform our assessments in this area.

### 3.3.8 *Protecting environmentally sensitive sites*

We are committed to serving our customers in an environmentally-responsible way. We support the greater use of water trades to help allocate scarce resources more effectively and the provision of financial incentives is welcome. We already work closely with the Environment Agency and other interested stakeholders to manage our abstractions carefully, including reducing the volumes licensed for abstraction under the Environment Agency's sustainability reductions programme. We are working with Ofwat and the Environment Agency to develop and implement the Abstraction Incentive Mechanism (AIM) framework. The AIM will help to protect sources where there is a perceived marginal adverse environmental impact and alternative water sources or some other realistic means of reducing abstraction from the source are available that will not cause detrimental environmental impacts.

We assure Ofwat, the Environment Agency and others that we will only agree water trades where we are satisfied there is no undue adverse effect on the natural environment. We expect offers of water to us to include similar evidence of regard to environmental protection.

### 3.3.9 *Ending trades*

At South East Water we have several current imports and exports with other water companies. Ofwat is already aware of these transfers through information we have submitted.

We are aware of the Ofwat requirement for qualifying trades to be new trades beginning in or after July 2013. We can assure Ofwat and others that we have no intention of manipulating any of our current trades in order to exploit the financial incentives for trading. We would expect all of our trading partners to take a similar approach to the maintenance of existing trade agreements.

If we agreed a new trade, the audit report that we would prepare as part of the compliance process would include evidence to show that the trade was new, not one that had been artificially ended and restarted.

### 3.3.10 *Trading partner*

A qualifying trade must be between wholly-unrelated companies.

The table below provides internet hyperlinks to the documents and guidance relevant to this code:

<b>Ref</b>	<b>Document / Guidance</b>
1	Water Act 2014
2	Water Industry Act 1991 (as amended by the Water Act 2003)
3	Competition Act 1998
4	Ofwat – Guidance on Trading and Procurement Codes
5	South East Water’s WRMP14
6	South East Water’s 2016 OJEU Notice
7	South East Water’s Access Code 2016
8	South East Water’s Water Resources – “Your Ideas Welcome” website page
9	Ofwat – Negotiating Bulk Supplies – A Framework



