

Trading and procurement codes – consultation on updating our guidance

About this document

Water trading can benefit customers, the environment and the water sector. To encourage water trading our water trading incentives offer greater rewards for exporters and lower costs for importers for new trades. To protect customers and the environment we require water companies¹ that want to claim the incentives to demonstrate that new trades comply with an Ofwat-approved trading and procurement code. The requirement for codes and compliance with them ensures that only economically and environmentally beneficial trades will receive an incentive payment as part of our price review process.

The guidance for trading and procurement codes is now over five years old and no longer reflects the latest market and regulatory developments. This consultation provides an overview of our review of the guidance in light of these developments and should be read alongside '[Trading and procurement codes – draft guidance on requirements and principles](#)'.

We welcome responses to this consultation by close of business on 29 March 2018.

¹ In this document we use the term “water company” to mean a company that holds an appointment as a water and/or sewerage undertaker under the Water Industry Act 1991. This document applies to the 17 largest water companies in England and Wales that are subject to full price control regulation and therefore are able to produce trading and procurement codes to claim water trading incentives.

1. Introduction

Water trading is where a water company responsible for supplying water in an area buys it from a third party provider rather than developing its own water resources. Trades can be for either raw or treated water and are typically agreed as part of the water resources management plan (WRMP) process. Since privatisation, water trading between water companies has remained static at around 4 to 5% of distribution input (water into supply), however at the same time water companies have invested heavily in linking up their networks and trading their water internally.

Greater levels of water trading can benefit:

- customers, as it can improve resilience of supply and allow more expensive investment in developing new resources within an water company's area to be deferred, reducing future upward pressure on bills;
- the environment, by ensuring water is supplied to where it is scarce and there are existing environmental pressures, instead of developing new resources or using unsustainable abstractions; and
- the water sector, by enabling water companies to share in cost savings from trading instead of investing, and providing opportunities for companies to profit and innovate from trades.

At the 2014 price review (PR14) we introduced water trading incentives, for both exports and imports, to help encourage new water trades. We recognised that these incentives, if not designed correctly, could have an adverse impact on customers and the environment. We therefore introduced caps on the level of the reward and required companies to produce and comply with an Ofwat-approved trading and procurement code to claim the incentives.

We published the requirements and principles companies should follow when producing their trading and procurement codes in [appendix 3 of our PR14 final methodology](#). These are designed to ensure a well-functioning water trading market that works in the interests of customers and the environment. For example, the codes help protect the environment as incentives will not be available for any new trades that result in an increase in unsustainable abstractions. Similarly the codes protect customers as incentives will not be available if companies procure supplies on a non-competitive basis or artificially end and restart existing trades. Compliance with codes will be assessed as part of our price reviews, with incentives paid in subsequent periods.

In our [final methodology for the 2019 price review \(PR19\)](#) we confirmed we will maintain water trading incentives for new trades beginning in 2020-25 and maintain the requirement for trading and procurement codes to claim the incentives. We also noted that as the guidance for the codes is now over five years old it would need to be updated to reflect the latest market and regulatory developments through a targeted consultation. This update will provide early clarity on the requirements to claim incentives for new trades that start in 2020-25. Box 1 provides an overview of our policy on water trading incentives.

Box 1 – Our policy on water trading incentives

Water trading incentives, implemented at PR14 and maintained at PR19, are intended to reduce barriers to trading by lowering costs for importers and increasing rewards for exporters.

- **Lowering costs for importers** – qualifying imports will benefit from an import incentive payment of 5% of the costs of water imported under new agreements. 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. The import incentive payments are accrued annually during 2015-20 (2020-25 after PR19), with the cap applying in each year. Companies receive an import incentive payment at the next price review.
- **Increasing rewards for exporters** – for all new qualifying exports that start during 2015-20 (2020-25 after PR19), exporters retain 50% of the lifetime economic profits (that is, the profits over and above the normal return on capital invested). Companies receive an export incentive payment at the next price review. This will be equal to 50% of the full discounted economic profit for the forecast life of the export, with a cap of 100% of the economic profit for the years the export operates in 2015-20 (2020-25 after PR19). Any amount beyond the cap will be rolled forward to the following price control period.

To claim incentives at the relevant price review, companies must submit a report to Ofwat demonstrating their compliance with their trading and procurement code.

2. Overview of consultation

In this section we:

- review our existing guidance (in section 2.1);
- outline our proposed changes to our guidance (section 2.2);
- outline our proposed approach to the approving new codes (section 2.3); and
- set out how we will require updates to approved codes (section 2.4).

2.1 Review of our existing guidance

Our existing guidance provides companies with a standard set of requirements and advice on general principles they need to reflect as a minimum in their trading and procurement code. These requirements and principles are designed to ensure a well-functioning water trading market that works in the interests of customers and the environment. They also ensure consistency with wider water resources planning processes.

The table below provides an overview of our existing guidance. We have reviewed the guidance and consider that the core principles listed in the table remain relevant. For example we still only want the incentives to be available where new trades are economically and environmentally beneficial. We will, though, need to reflect our decision to maintain water trading incentives at PR19.

Table 1 – Overview of our existing trading and procurement code guidance

Advice	Type	More detail
The trade must be agreed in July 2013 or later	Requirement	Water trades that were agreed before the incentives were introduced are not eligible.
The trade must be operating between April 2015 and March 2020	Requirement	Only trades that operate in the PR14 period will be eligible for the incentive.
Trades to be between unrelated parties	Requirement	Water trades between two related entities are not eligible for the incentive because barriers to water trading appear to be between unrelated entities, not within the same group of companies.
Non-discriminatory procurement by importers	Principle	Actual and potential exporters of water need reassurance that importers will procure third party supplies of water on a non-discriminatory basis.
Economic purchasing of water supplies by importers	Principle	Water supplies should be purchased from the most economical sources available, having

		regard to the quality and the quantity of the water supplies, and other relevant aspects.
Use of competitive processes	Principle	Where appropriate an importer should seek to procure water supplies through competitive processes.
Contract lengths	Principle	Contract durations should be reasonable enough to allow for an appropriate level of investment.
Transparency	Principle	Trades should be transparent to ensure a level playing field for market participants and other interested parties. Codes should explain how the company will ensure effective provision of information to demonstrate compliance with the provisions of the Code. This should include appropriate arrangements for auditing compliance with the code, and a report to be sent to Ofwat.
Links to water resources management plans (importers and exporters)	Principle	The approach to agreeing water trading arrangements and selecting options under the company's water resources management plan should be consistent.
Rational economic and environmental flows (importers and exporters)	Principle	There should be processes to ensure that any trades will involve economically and environmentally rational flows and to protect environmentally-sensitive abstraction sites.
No artificial ending of trades (importers and exporters)	Principle	Existing trades should not artificially end and restart to take advantage of changes in incentive arrangements.
Correct assessment of costs (exporters)	Principle	The costs of the export arrangement should be accurately estimated and fully recovered from the export agreement.

2.2 Proposed changes to our guidance

To reflect the latest market and regulatory developments we have identified four additions to our guidance set out in the table below. These new additions will only apply to new trades that start on or after 1 April 2020 and are claimed at PR24. The full detail on these additions is provided in the corresponding guidance document published alongside this consultation.

Table 2 – proposed changes to our guidance

Proposed requirement or principle	Rationale
The trade must be or have been operating between April 2015 and March 2025	This brings our guidance in line with our decision to maintain water trading incentives at PR19. Our expectation is that companies should claim for new trades that operated in 2015-20 at PR19. Only in exceptional circumstances

	would a trade be eligible to be claimed at PR24 which was operating during 2015-20. This replaces the previous requirement relating to trading dates.
Appropriate allocation of incentives between relevant controls	To reflect our introduction of separate controls for water resources and network plus water at PR19, companies should ensure that incentive payments are allocated appropriately between the controls. This ensures consistency with our expectations on how companies will determine this split as set out in appendix 5 of our PR19 final methodology.
Consistency with the company's bid assessment framework	To support the bidding market, where third party providers can bid to provide supply or demand options, at PR19 we will require companies to produce bid assessment frameworks. Our guidance for company bid assessment frameworks (appendix 8 of our PR19 final methodology) has common principles in terms of transparency, non-discrimination and proportionality. The link to bid assessment frameworks will strengthen their implementation and help ensure consistency between the two processes.
Evidence of assurance processes	Assurance is in part already embedded in the requirement for transparency but introducing a separate principle helps formalise this requirement. This recognises the long-term nature of water trading and the importance of clear decision making and company ownership.

Alongside these updates we will also reflect wider developments which may impact trading and procurement codes. When we first published our guidance the Water Act 2014 had not yet become law. Reflecting this our updated guidance says we will ensure consistency with any new arrangements that come into effect. We have also considered how the codes should be approved (see next section).

2.3 Proposed changes to the approval process for new codes

As of February 2018 we have already approved [six trading and procurement codes](#) after a public consultation period for each, and one is currently out for consultation. Across all the consultations only two responses have been received to date, both by large water companies on early codes. This low response rate seems to indicate a need to change the approval process for new codes.

Reflecting on the low response rate we propose to **streamline our current approach**. To reduce the regulatory burden, we propose to shorten the public consultation period to four weeks (from six) and if no comments are received automatically approve codes (rather than have an Ofwat approval process over six weeks). This approach ensures consistency with codes that we have already approved while maintaining transparency and the opportunity for stakeholders to comment on draft codes.

Figure 1: our proposed approach to approving new codes



As an alternative to this option we did consider removing the requirement for a public consultation or alternatively requiring companies to be responsible for consulting on their draft codes. However these options would be inconsistent with our approach to codes we have already approved. No public consultation would also reduce transparency, while transferring ownership for public consultations to companies might not increase the response rate and could be seen as an unreasonable burden.

2.4 Our update process for approved codes

Our existing guidance sets out that Ofwat may conduct an annual review of approved codes and provide further guidance to companies by the end of June each year. Companies would have six weeks to make changes and resubmit the resulting draft code to Ofwat for approval. This consultation and the updated guidance document forms our review of the approved codes and the timeline set out in the table below provides an overview of the planned update process.

Table 3 – Our proposed timeline

Date	Item
15 February 2018	Ofwat publishes this consultation and draft guidance
29 March 2018	Consultation closes after six weeks
April/May 2018	Ofwat publishes new guidance
June 2018	Companies resubmit codes after six weeks
July 2018	Ofwat approves or requests resubmission of updated codes
3 September 2018	Companies submit PR19 business plans (note to claim incentives at PR19, company codes must be approved before business plan submission)

This timeline complements this consultation, enables companies yet to submit codes to incorporate any new principles and provides certainty on the incentive arrangements for new water trades ahead of 2020.

For companies with approved codes, we are also interested in their views on how we could best facilitate the updates to them, for example whether a short workshop would be helpful.

3. Consultation questions

We welcome your responses to this consultation by close of business on 29 March 2018. Please email responses to Water2020@ofwat.gsi.gov.uk or post them to:

Trading and procurement codes guidance review
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory ‘Code of Practice’ which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

Q1: Do you support the new requirements or principles we have set out in section 2.2?

Q2: Do you support our proposed approach to approving new codes, as set out in section 2.3?

Q3: Do you support our proposed approach to updating approved codes, as set out in section 2.4?

Q4: Do you have any other comments on the draft guidance document published alongside this consultation?

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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