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Trust in water

# Trading and procurement codes – guidance on requirements and principles

## About this document

This document sets out our final guidance on the requirements and principles that must be addressed in trading and procurement codes for water companies<sup>1</sup> to claim water trading incentives for new trades. This guidance reflects our consideration of the responses received to our [consultation](#) on our proposed updates to this guidance published in February 2018. It replaces [appendix 3 of our PR14 final methodology](#) and should be read alongside our [Trading and procurement codes consultation – response document](#).

Water trading can benefit customers, the environment, and water companies. To encourage water trading, our water trading incentives offer greater rewards for exporters and lower costs for importers for new water trades. To protect customers and the environment we require water companies that want to claim the incentives to demonstrate that new trades comply with an Ofwat-approved trading and procurement code. This ensures only trades that align with the interests of customers, water companies, and the environment receive incentive payments.

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<sup>1</sup> 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 water companies in England and Wales that are subject to full price control regulation (currently the 17 largest water companies), and therefore are able to produce trading and procurement codes in order to claim water trading incentives.

## 1. Rationale for proposed principles

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.

Our water trading incentives are designed to unlock these benefits. These are complemented by trading and procurement codes. The codes are intended to ensure a well-functioning water trading market that works in the interests of customers and the environment. The codes also provide reassurance to potential market participants when agreeing new trades and ensure consistency with wider water resources planning processes.

The codes help protect the environment as incentives will not be paid for 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<sup>2</sup>.

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<sup>2</sup> This includes changes or modifications to a trade, or group of trades, that do not benefit customers and the environment, but would otherwise provide financial rewards to shareholders of one or more companies.

Compliance with codes will be assessed as part of our price reviews, with incentives paid in subsequent periods. This is a proportionate approach as it means that we are not required to approve new trades as they are agreed.

When we developed our guidance on trading and procurement codes at PR14 we drew on best practice in the energy sector, such as the National Grid's Procurement Guidelines Statement. In 2018 we updated this guidance to ensure consistency with policy and market developments since the guidance was first published in 2013 and reflect the continuation of the incentives in 2020-25.

## **2. Relationship to changes made by the Water Act 2014 and wider wholesale market architecture**

The Water Act 2014 amends the Water Industry Act 1991 to give Ofwat the ability to issue one or more codes in respect of bulk supply agreements that could make provision about the procedures for making, varying or ending bulk supply agreements and/or their terms and conditions<sup>3</sup>. Should we issue one or more bulk supply codes we will ensure consistency between trading and procurement codes and these new arrangements.

In terms of wider wholesale market architecture, the Water Act 2014 also includes other provisions that would, for example, allow licensed third party providers to supply water directly to retailers<sup>4</sup> (the bilateral market) in the English non-household retail market. The implementation of these provisions is a decision for Defra. We will ensure consistency between trading and procurement codes and any new market developments.

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<sup>3</sup> This power is set out in section 40B of the Water Industry Act 1991 (inserted by section 8 of the Water Act 2014). This section is not yet in force for all purposes. Since 1 April 2018, we have been able to issue codes about bulk supply agreements between water companies whose areas are wholly or mainly in England. We will be able to issue codes about bulk supply agreements between water companies whose areas are wholly or mainly in Wales from 1 April 2019. It is for the Department for the Environment, Food and Rural Affairs (Defra) and the Welsh Government to decide when we will be able to issue codes about bulk supply agreements between water companies whose areas are wholly or mainly in England and water companies whose areas are wholly or mainly in Wales.

<sup>4</sup> In this document we use the term “retailer” to mean a water supply licensee with a retail authorisation.

### **3. 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.

#### **3.1 Requirements**

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

##### **Requirement 1: 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.

##### **Requirement 2: The trade must be or have been operating between April 2015 and March 2025**

The import or export must be operating in practice and generating revenues during the 2015-20 price control period (1 April 2015 to 31 March 2020) or the 2020-25 price control period (1 April 2020 to 31 March 2025). The export incentive will not reward revenues accrued before 1 April 2015. The import incentive applies to expenditure during the relevant price control period only.

Our expectation is that companies should claim for new trades that operate in 2015-20 at PR19 and new trades that operate in 2020-25 at PR24. Only in exceptional circumstances would a trade be eligible to be claimed at PR24 which was operating during 2015-20. Please note this does not affect the balance of a PR19 incentive claim being paid at future price reviews. This could be necessary due to the payment cap within a price control period.

##### **Requirement 3: Trades to be between unrelated parties**

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.

## **3.2 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. Principles 10 to 12 were added as part of our update to this guidance in 2018.

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

### **Principle 1: 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 out on a non-discriminatory basis.

### **Principle 2: 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.

### **Principle 3: 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.

### **Principle 4: Contract lengths**

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

### **Principle 5: 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 auditing compliance with the Code, availability of information including audit results to Ofwat, and availability of appropriate information to market participants and other interested parties (without compromising the commercial position of any contracting party).

**Principle 6: Link to 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 plan.

**Principle 7: Rational economic and environmental 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.

**Principle 8: 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.

**Principle 9: 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.

**Principle 10: Appropriate allocation of incentives between relevant controls**

The trading and procurement code should provide reassurance on the approach taken to allocate any incentives payments for each trade between the relevant wholesale controls.

**Principle 11: Consistency with the company's bid assessment framework**

The trading and procurement code should provide reassurance that it is consistent with the company's bid assessment framework which is to be introduced at PR19.



The requirements for the bid assessment framework are set out in appendix 8 of our PR19 final methodology.

**Principle 12: Evidence of assurance processes**

The trading and procurement code should explain and illustrate the assurance processes that the company has in place for agreeing trades. It should explain how decisions are made and how they take into account the long-term nature of water trading and supply-demand balances.

## **4. Approval process and incentive payments**

### **4.1 Approval process**

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

- a. Companies to provide draft codes to Ofwat for initial review and comment
- b. Once agreed Ofwat to publish draft codes on its website and allow four weeks for comments.
- c. If no responses are received the code will be automatically approved. If comments are received Ofwat will have 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. Unless stated otherwise companies would then have six weeks to make changes and resubmit the resulting draft code to Ofwat for approval. We will not be consulting on revised codes.

If a water company wants to claim an export or import incentive it must demonstrate compliance with its approved trading and procurement code. Adjustments to price control revenue to take appropriate account of water trading incentives are made at the next price review.

### **4.2 Applicability of requirements and principles**

To claim incentives at price reviews we require companies to submit an audit of compliance with their code:

- To claim at PR19, this must at a minimum show compliance with requirements 1 to 3 and principles 1 to 9 (that is, the new principles introduced in 2018 will not apply); and
- To claim at PR24, this must at a minimum show compliance with requirements 1 to 3 and principles 1 to 12.

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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