

Question 1 - A number of stakeholders have previously expressed interest in supplying water resources, either through the bidding market or in a future bilateral market. There are also a large number of WSSL licensees. We are interested in stakeholders' views on:

- a) Whether, in principle, they would be interested in selling water resources via means of a bilateral market;**
- b) Whether, in principle, they would be interested in purchasing water resources via means of a bilateral market; and**
- c) Whether, in principle, they would be interested in playing some other role (such as providing water treatment services or providing other services) to support a bilateral market.**

1.a. and 1.b.

Castle Water would have a strong interest in participating in bilateral water markets. Our interest currently is in selling via these markets. We would expect to also be in a position to purchase water through bilateral markets as markets develop. However, in the absence of further details of how a market would work it is difficult to explore this in further detail.

Castle Water has agreements in place which in principle give access to extensive water resources, which could be used to provide benefits to end-users as well as reducing supply constraints for network owners. These agreements equate to c. 20% of Castle Water's current volumes through CMOS.

1.c.

Castle Water would have an interest in providing services for Network Operation, to procure and balance supply and demand on regional water networks, in regions where Castle Water does not have any conflict of interest (which might arise from participating in bilateral markets).

Question 2 - Owners of water resources currently have an existing route to market through the bidding market, while retailers can contract for water resources with the regional water company. We are interested in stakeholders' views on:

- a) the advantages or disadvantages bilateral markets might have compared with the trading arrangements currently available to them;**
- b) how bilateral markets could complement or conflict with existing mechanisms available for water trading; and**
- c) whether they have any preference between the existing arrangements and bilateral markets (if so, why).**

2.a.

Bilateral markets can reduce the price volatility inherent in current arrangements, enabling long term investment decisions. Published water supply access price can change dramatically year on year. For example, Thames Water has published data on the indicative Combined Supply Discount for the SWOX area for the years 2018 to 2021 ranging from a forecast discount of £0.0723/m³ published in 2017 to £0.2316/m³ published in 2018. This is a change of 320% year on year.

There is no clear methodology on how costs, combined supply discounts, equalisation payments, or average incremental costs are calculated. The value and payment mechanism for any "equalisation payment" is not explicit in terms of price, duration, or the pricing point in the supply chain. The "Average Incremental Cost" (AIC) prices referenced in the PR19 business plan published in the "Market Information Database" is a guide but not the intended unit cost for equalisation payments. A standard approach should be adopted with transparent pricing and supporting cost analysis.

The way new participants can engage in the Bidding in and regional water resource planning is not compatible with price control periods. Project life cycles are likely to exceed and unlikely to coincide with price control cycles.

The methodology for establishing charges using the different network entry and exit points should be codified. The current equalisation charge refers to "network plus costs" which covers both treatment and distribution. A raw water resource that is treated *prior* to delivery into incumbents' network does not fit into this category; a potable water resource should be required only to pay the "Treated Water Distribution Costs". We note the Competition Act requirement for incumbents to allow access to essential facilities, which would involve paying only the "Treated Water Distribution" charges.

2.b.

Existing arrangements for providing pricing and contractual arrangements are insufficient to support the necessary long term investment. The asset life for treatment and transportation to access existing networks are in excess of 20 years. Investment programmes to bring water resources into use require long term stable contracts for access to networks, and pricing methodologies.

Network charging for bilateral markets must be based on clearly set out Short Run Marginal Costs (SRMC), and not place responsibility for network upgrades onto independent providers of water resources. Current pricing is both high and volatile (changing significantly from year to year), and does not incentivise new resources.

Bilateral markets have the potential to bring forward significant new supplies of water. There are a number of different “products” which Castle Water can provide. The most obvious categories are i) long term supply contracts; and ii) single bulk transfers or a series of single transfers to alleviate shortages. Contractual arrangements need to be significantly different in the two different cases.

Trading raw water resources will also encourage the development of 3rd party water treatment facilities within incumbent areas. This could further drive down costs by encouraging competition.

2.c.

We would be able to participate in bilateral markets with clear long term pricing methodology and contractual frameworks.

The current arrangements do not provide the necessary framework to allow new investment in bringing water resources to market:

- They lack a clear pricing structure/methodology;
- They do not provide a contractual framework providing access to networks;
- They allow volatile and uncertain pricing for network access;
- They do not properly provide pricing for different products (long term supplies vs peak supplies);
- There is no network operator independent of the network owner.

Incumbents in some water stressed areas can secure staged funding through PR19 investment plans to develop projects through to securing planning rights in 2025. New entrants do not have access to this level of development funding and will be placed at a disadvantage at PR24 assessment stage, as both time and resources will enable the incumbent’s projects to reduce programme and price risk.

Question 3. The legal framework allows for a number of consequential changes to regulatory instruments (such as licences and codes) to effectively implement bilateral markets. We welcome views from stakeholders on:

- a) The key policy benefits that they consider need to be captured and the best means of doing this;**
- b) The key policy risks that need to be mitigated, and the best means of doing this; and**
- c) Whether there is a degree of prioritisation to the risks and benefits, and if so what needs to be captured as a priority and what might be better left for a more informed decision once some bilateral trading has become established?**

3.a.

In order to facilitate Bilateral markets, the following need to be in place:

- Network pricing transparency, i.e. via an auditable calculation methodology;
- Contractual terms including SLAs around network access and contracts;
- Clarity around licence requirements, and the requirements of the water quality regulators.

It will also be essential to publish acceptable standard form contracts.

The key benefits of Bilateral markets which should be captured include:

- Independent sourcing of water supplies which operate separately from operation of the water network.
- Aggregation of small scale local resources.
- Improved economic management of water in supply-restricted areas.
- Price-testing resource proposals from network owners.

3.b.

The major implementation risks we see, and their mitigation, are as follows:

- **Lack of coordination in severe events**, e.g. weather events - permit a “Water Emergency” to be declared and to be operated;
- **Inefficient market** arising from rights not being exercised - contractual rights fall away if they are allowed to lapse for a defined period;
- **Inertia from network owners** – separate network operation from ownership

3.c.

The immediate priorities relate to:

- transparent pricing methodology;
- a standard form of contract for network access;
- clarity over arrangements and responsibilities for water quality;
- there will be a need for a Network Operator(s) to ensure that water networks are optimised, and that responsibility for decisions on resourcing is separate from network ownership.

To allow a bilateral market to be established there are a number of priority areas that need to be clarified:

Pricing: there needs to be a clear pricing formula for the costs of transporting water through monopoly networks. This should be based on Short Run Marginal Costs, given that network owners have existing obligations to supply all customers.

Priority of access: contractual terms need to be set out for network access. Long term investment will require in most cases “firm” (or guaranteed) access, with interruptibility in only clearly defined and limited circumstances.

Tradable: the rights of the provider need to be clearly set out, including for sale/assignment. This then can also provide a mechanism for network owners to repurchase network capacity, and ensure that network access contracts do not become moribund.

Transportation Costs: currently indicative treated wholesale water pricing is based on the cost to supply for the whole water resource zone, inclusive of all water resource assets, raw water acquisition, storage, movement, treatment, treated water storage, distribution, etc. This whole company approach is not an efficient or realistic method to calculate the actual costs to the wholesaler for raw water, treated and transported only a few miles on their network to its end point of use with the customer. A clear charging methodology is needed, similar to charging for new connections. This must be based on SRMC principles, to ensure that new sources of water are not charged for maintaining and upgrading extended parts of water networks.

Licence requirements relating to water quality: access to water networks is dependent upon conforming with water quality requirements. This requires specifications being available to licensees, and a clear compliance framework. A licensed retailer or licenced wholesaler should be permitted to deliver water into an incumbent’s network, as they are already required to meet DWI standards and Public Health requirements. In order to ensure water quality reaches the required standard, whether potable or raw, it should be tested at the entry point of the incumbent’s network.