

6 September 2019

Bilateral markets call for information
Ofwat
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By email: bilateral.markets@ofwat.gov.uk

Dear colleagues

Bilateral markets – Call for information

We welcome the opportunity to respond to Ofwat's call for information on the development and implementation of a bilateral market in water resources in England.

We believe, that provided the shortcomings noted in our response can be resolved on supply reliability and water quality risk, a bilateral market can act as an additional tool that can complement the bidding market.

Appendix 1 contains our responses to the specific questions raised. We hope you find our comments helpful. Please contact us if you would like further detail.

Yours faithfully



Sally Mills
Regulatory Director

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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.*

Response

- a) Yes
- b) Yes, but only if it was a more efficient solution for customers
- c) Maybe. As an incumbent water supply utility we have the skill base and technical expertise to offer a range of services in such a market. However, our primary focus is on the regulated business and there are no plans at present to operate in such a market.

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).*

Response

- a) Taking the advantages and disadvantages separately:

Advantages

- **Transparency** - in principle it should make the availability of water in a catchment, outside of that used currently for public water supply, more transparent
- **Productive Efficiency** - in principle if there were cheaper sources of water than currently used for public water supply it could lead to cost reductions to customers e.g. if a current incumbent company had water from desalination, but the bilateral market could offset some of that current production, in theory there should be lower costs to the customer. This gives rise to productive efficiency advantages. This may not be visible from the existing arrangement if the "bid" for new water is not made in the first place.

- **Environmental improvement** - in theory if there were new sources of water that had lower environmental impact than current abstraction arrangements the bilateral market could deliver an improved environmental outcome. This may not occur in the current 'bid' arrangement if the bid were not made.

Disadvantages

- **Allocative inefficiency** – whilst water networks are a grid system, it is likely that the water entering the network in a bilateral trade will not be used by the non-household customer itself but more likely a household customer or other customer. As the incumbent water company is required to provide a secure supply to household customers, in a bilateral trade there is a high likelihood that existing sources will therefore need to be maintained and operated in many situations to ensure that the duty to maintain supplies to households is met. This results in allocative inefficiency of supply as it essentially requires the 'doubling up' of source provision. This does not occur in the current bidding market since the source location would be specifically chosen.
- **Environmental degradation** – it could lead to a worse environmental outcome. If there is increased abstraction from a new source it could lead to a deterioration in the environment at that location that relatively is more harmful than the existing abstractions being used. This would not occur in the current bidding market as it would be part of the assessment process. To ensure this does not occur, the environmental 'cost' of abstraction would need to be priced into the charges for any source.
- **Reduced supply security** - compared to existing trading arrangements, the potential introduction of multiple providers into a public water supply system will by definition change the risk to public water supply quality and reliability. For example, if an existing supply is 99% reliable, there is a 1% chance of failure. If a new supply were say, 98% reliable, there will be an increase in risk. As such, checks would be needed to ensure the new source does not increase risk, or if it does, the risk adjusted cost of the supply remains less than the existing source. This is pertinent as the water in a bilateral trade is physically unlikely to be that water which reaches the non-household customer so the risk is being borne by other customers. If not, a move to the bilateral supply would by definition be an inefficient allocation of resource. This disadvantage does not occur in the existing bidding market as it would be part of the assessment process.
- **Increased water quality risk** – without sufficient checks there are increased water quality risks with a bilateral market. For example, if a treated water bilateral trade is made that water is entering directly into the incumbent water supply network. Whilst that water will need to meet DWI and other regulations, by definition it is changing the water quality risk in the water supply network. This does not occur with the existing bidding process since the 'ownership' of the water quality risk fully lies with the decisions made by the incumbent.
- **Increased cost** – bilateral markets will increase costs to manage and monitor operation and increase regulatory complexity since there is greater operational complexity compared to the current bidding framework. For example, if there were no limits on size of a bilateral the same monitoring overhead will occur whereas, in the current bidding framework this could be a filter to ensure efficiency of solution. This does not occur in a bidding market because there will be requirements set out in the bid itself to ensure an efficient solution.

b) There are a number of aspects to consider with regard to complement and conflict of bilateral markets vs. bidding arrangements:

Complement

- **Productive efficiency** – as mentioned above, in theory it could lead to lower production costs. It could also avoid the need for other new water resource investment. However, this would only occur if the costs of the bilateral trade were lower than alternatives or the bidding market.
- **Common checks and balances** – the actions needed to allow water to enter the network safely in theory should be common between a bidding framework and a bilateral trade

Conflicts

- **Who owns the supply and quality risk** – in the bidding framework one would argue that the incumbent company owns the supply risk as it has the choice on whether or not to accept the trade. The bilateral framework is in conflict with this as in theory the incumbent would no longer be responsible for the supply reliability. The same position occurs on water quality. Whilst on raw water the incumbent is responsible for the water quality, where treated water enters the network any failure of their supply on water quality will affect the incumbent company customers. This does not happen in the bidding framework. As such bilateral trades create a conflict on who owns what supply and quality risk.
- **Different planning horizons** – existing water undertakers plan in the long-term and are required to in Statute (Ref: Water Resource Management Plans). In contrast the retail market is more dynamic. As water resources is a long-term planning problem, there is therefore a potential conflict between the different timescales over which the parties in a bilateral market may be making business decisions. The conflict crystallises if the new supply were to fail, in that who owns the supply risk? This doesn't occur in the bidding market since it would be factored into the assessment process.

c) Preference

If one looks at overall supply reliability, the existing arrangement has proved to be successful, since there have been no major shortfalls between supply and demand, or major water quality incidents caused by a failure of a transfer arrangement.

If the public water supply sector is to ensure the delivery of the long-term resilience as needed and set out in 'National Infrastructure Commission – Preparing for a Drier Future' we need to ensure that any bilateral market appropriately addresses the disadvantages on supply reliability and water quality risk that it introduces.

To that end, the existing arrangements, one might argue, deliver the Defra vision more reliably. However, provided the checks and balances needed are performed on a level playing field, in theory there should be no difference between the two market mechanisms. However, that does require the disadvantages on the bilateral market to be addressed.

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?

Response

a) We consider the key policy benefits that need to be captured are

- Quantification of the improvement in supply security
- Quantification of the improvement in the environmental quality
- Quantification of the cost savings (or cost increases) – specifically this should examine what the impact of the long-term reduction in per capita consumption and leakage mean for the avoidance of resource costs that would be offset by bilateral trades. This is because the scale of the savings now are significantly different from past studies and in many cases regions of the country will be in a supply-demand surplus requiring no new additional water resource.

b) We consider the key policy risks that need to be mitigated are

- Who owns water supply reliability risk – since the water into a network may not go to the customer itself, who owns the supply risk if the source of water fails?
- Who owns what water quality risk for treated water – since, once in a water network, the water will affect supplies to households and the incumbent will not be able to control failures on water quality from the bilateral trade
- Protection for the environment – how protection for the environment will be undertaken
- Allocative inefficiency – how the risks of allocative inefficiency due to the need to ensure supply-security can be mitigated (see Question 2 above)

c) Prioritisation

We would suggest prioritising the policy risks first – specifically supply reliability and water quality. Followed by the benefits.

This is because by eliminating the risks first, the feasibility of the trades being successful is improved. This then allows a comparison of the costs and benefits to be made on a level playing field.