



Bilateral markets call for information
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Strategy & Regulation

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6 September 2019

Dear Sir/Madam

CALL FOR INFORMATION – BILATERAL MARKETS

We welcome the opportunity to respond to your call for information (“CFI”) on developing bilateral water resource markets. Thames Water has a long history of using water resource markets to benefit customers in our region and in the wider south east of England, and we continue to explore new opportunities where we can find them.

Given that Defra has yet to commence the provisions enabling the bilateral market within the Water Act 2014, it seems prudent for Ofwat to use this CFI to reengage with stakeholders to gauge their level of interest in the bilateral market.

Thames Water was an active member of Ofwat’s Water 2020 working groups on Water Resources and Access Pricing in 2016 and 2017, which considered in detail the structural and policy issues alluded to in the CFI. We would welcome the chance to take that work forward with Ofwat and other stakeholders. We cannot replicate that detail in this response, but we do set out a range of issues for further consideration. We group these issues around the themes introduced by the questions, which are:

- (1) the principle of bilateral markets;
- (2) how bilateral markets might compare with other markets; and
- (3) the legal framework for bilateral markets.

1. The principle of bilateral markets

The bilateral market encourages wholesale competition, through allowing retailers to choose which wholesaler provides them with water resources. We see benefits in using markets to encourage existing and potential wholesalers to come forward with new water sources, and to incentivise retailers to seek them out, especially if this can complement the existing bidding market.

Our role in a bilateral market would likely be primarily as provider of access services (or “common carriage”) within our own area, although it is possible that retailers active in neighbouring incumbents’ areas may request supplies from us (“secondary supplies”). In providing access services, it follows that some of our water supplies will be displaced by those of the new wholesaler (unless the retailer supplies new customers only).

It is vital that Ofwat is clear about the purpose of the bilateral market when it develops the detailed mechanisms to support it: will the primary aim be to offer choice to retailers, or to encourage wholesalers to help tackle incumbents' supply/demand deficits? Both are valid aims, but different incentives will be created depending on which aim is chosen. For example, focusing on retailer choice could increase operational complexities for incumbents as they manage dynamic, short-term behaviour. Market entry for the sake of creating a market, without clear value for customers risks damaging long-term security of supply. While focusing on reducing deficits could stifle retailer choice in favour of more efficient use of available resources and promoting greater certainty for wholesalers. It will be important to establish how the incentives in a bilateral market would sit alongside those present in the longer-term, strategic bidding market, and which set of incentives would deliver the greater common good.

2. How bilateral markets compare with others

In the working groups in 2016 and 2017, we discussed in depth how potential entrants with water resources (wholesalers), and retailers, might view the available opportunities. There are natural tensions within the bilateral market that require careful thought. For example:

- Retailers are likely to welcome the greater choice in the provision of water resources but will they expect incumbents to be suppliers of last resort ("SOLR") if their preferred wholesaler was unable or unwilling to maintain supply (especially if they are a single-source wholesaler such as a power station)? The SOLR issue underlines the importance of being clear what the purpose of the bilateral market is and what role(s) incumbents will play; and
- Wholesalers and retailers are likely to have different expectations in terms of duration and volumes of supply: wholesalers would want certainty over their investments in the form of long-duration contracts; whereas retailers would prefer flexibility to switch, especially as their own non-household ("NHH") customers would have such flexibility. Retailers would be unlikely to accept 'take or pay' contracts that exposed them to large downside risk.

It may also be instructive to consider whether separate bilateral markets in non-potable and potable water are worth pursuing.

3. The legal and policy framework

Much of the legal framework that would benefit a bilateral market has already been implemented, with the introduction of the water supply licensing provisions and the NHH Retail market. For example, incumbents are under licence obligations to treat entrants fairly and to handle data appropriately; there are also safeguards within primary law against unauthorised physical connections to incumbents' networks that protect water quality (although it may be useful if bilateral markets distinguished between non-potable and potable water). Further protection is in place in the form of incumbents' network Access Codes, which cover vital operational issues, Bid Assessment Frameworks, as well as guidance from Drinking Water Inspectorate. These will need to be reviewed as development of the bilateral market progresses, to ensure the right protection is maintained and the right outcomes can be achieved.

The policy framework is less developed than the legal framework and needs to be carefully established to ensure that the right outcomes are sought and achieved for customers. A key risk is that the market is developed without sufficient clarity about what it is meant to

promote or achieve, leading to stakeholders' expectations being unmet and perceptions that the market has somehow failed. In our view, it is a priority to establish at a strategic level, where the bilateral market sits within the options currently available to wholesalers and retailers.

There is clearly much policy detail to be developed in setting up the bilateral market. Many of the issues have been considered in detail by the Ofwat working groups, and it will be worth reviewing and developing what they considered, in the light of responses to the CFI. However, we include some examples of important policy issues here and we would be keen to work with Ofwat and others to develop these more fully.

- **Does the incumbent provide 'supplier of last resort' ("SOLR") services to retailers if their chosen wholesaler is unable to supply?** Section 6.4.3 of Ofwat's Final Methodology for the PR19 says: "*For companies whose areas are wholly or mainly in England, a bilateral market would allow business retailers to procure water resources directly from third parties and to seek ways to meet customers' demand for water more efficiently. Bilateral market entry may, therefore, decrease the investment a company needs to make to provide enough capacity to meet future demand.*" However, this would only be correct if the incumbent was not required to provide a SOLR service, and the resources displaced by the wholesaler's entry could be used to supply other customers' needs;
- **Are the consequences of mixing water sources acceptable to customers and regulators?** Bilateral water trading could involve mixing water from different sources and of different qualities, e.g. surface water being introduced into a network that normally carries groundwater. Mixing different water types can cause pipe corrosion in the network downstream of the injection point, with repercussions for levels of leakage and bursts. Mixing can also cause noticeable changes for customers in how they perceive the taste, smell and appearance of water. Therefore wholesalers will have to make sure their water matches what is already being transported, as well as complying with water quality regulations. If system operation in a bilateral market is not properly governed there could be damaging consequences and significant renewal costs;
- **Who owns the water in the pipes?** There needs to be contractual certainty to delineate ownership and responsibilities in the supply chain. It is not clear whether the wholesaler, the incumbent or the retailer would have ownership rights and responsibilities. In addition, there needs to be clarity about the relationship between parties in the market;
- **Will there be regulatory rules governing the relationship between parties in the market?** It will be important to establish how an incumbent deals with wholesalers that are competing for access to the same asset (pipe or treatment works), if that asset cannot accommodate all bids for access. Will access be granted on a first come first served basis, or by net benefit / value, or some other basis?;
- **Can a retailer in one Water Resource Zone ("WRZ") buy from a wholesaler in another WRZ, when the water cannot physically be delivered by the incumbent?** Incumbents plan their WRMPs and invest and operate on a WRZ basis, which suggests the bilateral market should also operate intra-WRZ not inter-WRZ;

- **Is it acceptable to retailers, wholesalers and regulators for entrants to follow certain operational procedures?** The power station example in the CFI is interesting as it contemplates the wholesaler making decisions around whether to sell the water or use it for its own purposes. We wholly support markets offering this type of choice. In operational terms, there will need to be careful management of the switching on and off of supplies to the retailer (should the wholesaler decide to use water for their own purposes) and how such decisions affect the management of our own water network, as well as investment in new resources. This links closely with the SOLR issue outlined above; and
- **Are access price equalisation payments to be based on the extent to which a wholesaler can reduce the incumbent's supply-demand deficit?** Is the payment based on the average cost of the incumbent's resource or the actual cost of the specific resource displaced?

It is important that these issues (none of which are insurmountable) are carefully considered, to ensure bilateral markets work effectively for all stakeholders and promote efficient outcomes. We are keen to work with Ofwat and stakeholders to achieve this, reprising our role as a member of the working groups if that should be helpful. If you would like to discuss any of the points we raise in this letter, please contact Phillip Dixon in the first instance, on [REDACTED] or by email at [REDACTED].

Yours faithfully

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Nick Fincham
Strategy & Regulation Director