

January 2020

# **Bilateral markets – Call for information Summary of responses**

## About this document

In June 2019 we published a [call for information on bilateral markets for water resources](#). This document summarises the responses that we have received to our call for information. Full copies of the non-confidential responses that we received can be found on our [website](#).

Our call for information sought views from interested stakeholders about the development and implementation of bilateral markets in water resources in England (there are currently no plans for such markets in Wales). By “bilateral markets” we mean a third party provider of water resources (such as an out-of-area water company or other holder of an abstraction licence) contracting directly with a retailer to sell water to its business customers.

We noted that we were particularly interested to hear the views of parties who would be open to participating in bilateral markets, such as potential third party suppliers of water resources and retailers or self-suppliers in the business retail market. We want to get a feel for the likelihood of their participation if bilateral markets were implemented. We also sought feedback from stakeholders on their views on the range of policy issues that would need to be addressed in order for bilateral markets to be successfully established, and how such markets could complement, or conflict with, other means of providing water resources.

We received responses from a range of stakeholders, including parties potentially interested in buying and selling water resources and appointed water companies whose networks could be used to treat and transport this water.

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## 1. Summary

In June 2019 we issued a call for information relating to the introduction of bilateral markets in water resources in England.<sup>1</sup> The Water Act 2014 (WA14) includes provisions requiring appointed water companies to provide entry access, subject to certain conditions and exceptions, to holders of wholesale supply licences.<sup>2</sup> These provisions, if fully commenced, would facilitate a “bilateral market” in wholesale water between retailers and providers of water resources other than the appointed water company.

We sought views from stakeholders on a range of policy issues associated with fully commencing the WA14 provisions outlined above and on the best means of addressing such issues. We welcomed views from all interested stakeholders, and in particular from those that considered they might be party to a bilateral contract (as either as a buyer or seller of water resources) and from parties that might have an interest in such trades, such as possible providers of water treatment services. To guide responses we set out 3 questions, but we did not require responses to follow this format.

We received 23 responses to our call for information. One respondent requested that their response remain confidential. Of the non-confidential responses:

- 9 were from appointed water/wastewater companies
- 5 were from holders of WSSL licences
- 1 was from a holder of a NAV licence
- 7 were from various other interested parties.

We are grateful for the feedback provided by stakeholders in response to our call for information. We will take account of the feedback we have received in developing our future work plans.

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<sup>1</sup> The Welsh Government has chosen neither to extend retail competition to all non-household customers, nor to implement the wholesale reforms set out in the WA14 at this time. Therefore the implementation of the WA14 reforms in relation to bilateral markets would only apply in England.

<sup>2</sup> The power to commence the provisions lies with the Secretary of State. We noted that we are working to support Defra to ensure it has good quality information on bilateral markets. We are also working closely with the Environment Agency (EA) and Drinking Water Inspectorate (DWI) on water resources, because of the strong links to both the environment and to public health.

This document provides a summary of the responses that we received, but does not directly address every point raised by respondents. All non-confidential responses are, however, published in full on our website.

In our call for information we asked three prompt questions (each of which had three sub-questions). Chapters 2 to 4 summarise the responses we received to each of the prompt questions. Chapter 5 summarises additional points raised by respondents in their submissions. We set out our next steps in Chapter 6. In the Appendix we provide a full list of respondents.

## 2. Responses to question 1 – interest in participating

Question 1 in our call for information was:

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.<sup>3</sup> 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.

12 of the 23 respondents provided views in response to this question.

### 2.1 Question 1a

Several parties expressed an interest in selling water resources in some way.

A number of parties expressed an interest in selling water as a third party, with some of these indicating that they would only be interested in selling raw water, with others suggesting they would be willing to sell either raw or treated water.<sup>4</sup>

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<sup>3</sup> An up to date list of licensees is maintained on the Ofwat website at <https://www.ofwat.gov.uk/regulated-companies/ofwat-industry-overview/licences/#wssl>

<sup>4</sup> "Raw" water is untreated, and it would be for the WSSL buying the water to make arrangements for its treatment to the required standard. Typically this would be undertaken (and charged for) by the appointed water company into whose network it is being introduced. Issues in relation to water treatment are covered in Chapter 4.

Five appointed water companies expressed potential interest in selling water as a secondary water company (i.e. selling water to a retailer operating outside of the water company's area of appointment). A few appointed water companies noted that they would be unlikely to be in a position to sell water owing to a lack of available resource.

## **2.2 Question 1b**

Four respondents with WSSL licences expressed their potential interest as buyers of water resources.

Although no respondents with WSSL licenses indicated that they were not interested, one noted that, in its view, the business retail market was still in its formative stages and would need to mature further before buying alternative water resources became a priority for it.

## **2.3 Question 1c**

Several appointed water companies noted that they would be interested in providing (or would consider providing if requested) treatment and distribution services to support a bilateral market, although most noted that there were a range of issues that would need to be addressed prior to this occurring (these issues are summarised in Chapter 4).

One respondent noted that the bilateral market could create a need for a market maker<sup>5</sup> and noted that this role had been fulfilled by third parties in other markets.

## **2.4 Other points raised**

A small number of water companies that responded noted that they would be interested in an additional market for buying water resources, but acknowledged that

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<sup>5</sup> In this context a market maker would be a party that provided a service (such as a trading platform) that allowed participants to advertise the availability or need for water resources as a pre-cursor to initiating a trade.

the arrangements set out in the WA14 for bilateral markets might not provide a suitable route to achieve this.

### 3. Responses to question 2 – options for trading

Question 2 in our call for information was:

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).

13 of the 23 respondents provided answers in response to this question.

#### 3.1 Questions 2a and 2b

Most respondents gave combined answers to the first two sub-questions.

A number of respondents agreed with our summary of the relative advantages and disadvantages of bilateral markets compared with existing bidding markets and the ways in which they could complement and conflict with one another. Additional advantages identified by one or more respondents included:

- The scope that bilateral markets had to separately trade either treated or raw water products, as opposed to bidding markets which focused purely on raw water resources.
- The opportunities bilateral markets could bring in allowing for a more joined-up approach to energy and water resources policy through drawing more explicit links to the most efficient use of both resources.

Some appointed water companies suggested that one potential disadvantage of bilateral markets was that it might promote inefficient entry because the interests of

retailers and resource providers would not necessarily be aligned with those of incumbents and that each group would have different levels of risk appetite.

A number of respondents observed that it was as yet unclear what role, if any, intermittent supplies of water might play in a bilateral market. In particular respondents noted that it was not clear what range of products might be suited to bilateral markets beyond a baseload supply type of product. Examples of other potential products include resilience-type products, and the provision of back-up supplies to support non-firm resources sold through a bilateral market contract (in effect the provision of a temporary supply of last resort until the non-firm supply could come back on-line). It was observed that it was not clear whether retailers would be appropriately motivated to buy such alternative products. It was also suggested that incumbents were not correctly incentivised in the bidding market to assess such products against the development of their own potential resources.

### **3.2 Question 2c**

Only a few respondents indicated whether they had a strong preference for either the bidding market or bilateral markets, and we observed preferences for both markets across respondents. The majority of respondents either offered no view or noted that it was desirable for potential water resource providers to have multiple routes to market available.

Two appointed water companies expressed the view that existing bidding markets appeared to be making a good start in allowing third parties a route to market and should be allowed to mature before other interventions, such as the introduction of bilateral markets, were considered.

One respondent indicated that it felt in its circumstances bilateral markets offered a significant advantage over the current bidding market arrangements (which align to a degree with the 5 yearly water resource management plan cycle) owing to the greater flexibility it afforded in terms of aligning with project timescales and the terms of access which might be available.

### **3.3 Other points raised**

Two respondents raised concerns around the practical barriers to implementation. In particular, they drew attention to the potential complexities and costs based on the experiences of implementing the business retail market. It was highlighted that regulatory engagement over issues in the business retail market is still on-going and

therefore it may not be practical for retailers to fully engage with further regulatory issues at this time.

One respondent noted that in terms of the development of potential new water resources options there did not appear to be a level playing field, since incumbent water companies (whether for their own resources or for transfers) were able to access development funding through the price control regime, while third parties could not.

## 4. Responses to question 3 – consequential changes

Question 3 in our call for information was:

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?

19 of the 23 respondents provided views in response to this question.

### 4.1 Question 3a

In the call for information we identified a number of benefits and opportunities in relation to bilateral markets, including the increase in opportunities to trade for owners of water resources, an increase in innovation and the potential for increased efficiency in the provision of water resources. Most respondents did not identify any further benefits and opportunities beyond these.

Two respondents suggested that with an appropriate supporting policy framework, a bilateral market trading mechanism would pave the way for more localised short-term trading networks that could see short-term flexible trading of water resources and water rights amongst multiple parties.

## 4.2 Question 3b

### 4.2.1 Water quality

A significant number of respondents raised points around water quality issues. Many respondents noted that any regulatory framework would need to ensure that existing standards could be maintained. Two respondents noted that the current regulatory framework already places obligations on retailers and suggested that this already provided a level of risk mitigation.

One went on to suggest that the framework should ensure that a suitably regulated company should have responsibility for ensuring an appropriate standard of water quality at the point of network entry. It argued that where a dispute over standards arose with the appointed company whose network was receiving the water (for example if the receiving network operated its system to a standard in excess of the minimum required standard), that a technical third party should provide arbitration.

Several respondents noted that new water sources being introduced to a network could cause issues in respect of customer acceptability.<sup>6</sup> To illustrate the potential impacts this can have, one appointed water company provided a case study citing an example where it had introduced its own new water resource into its network leading to an increase in customer complaints arising from the changed taste of the water.

### 4.2.2 Resilience of networks

Several respondents expressed concerns about the potential impact of bilateral markets on the resilience of water resource zones. A number of respondents noted that it was unclear how water companies should account for third party supplies within their water resource management plans. It was suggested that the potential entry of third party water resources would make it difficult for incumbents to make an assessment of how firm the supply of water would be and how much headroom should be allowed in their plans to account for this.

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<sup>6</sup> In such cases while the water itself is of a safe drinking standard, customers may object to a change to the odour or taste of their drinking water which may have occurred as a result of a new water source being introduced.

A number of respondents took a positive view of the resilience impact of supplies coming online through bilateral markets. They noted that such supplies could increase levels of resilience and that benefits could arise through increasing the diversity of supply sources. They argued that current resilience assessments should be revised to account for this and that resilience should be assessed at a network level, rather than assessing the resilience of individual sources of supply. It was suggested that there would be benefits from assessments being less risk-averse and making better use of the headroom allowance.

### **4.2.3 Supplier of last resort**

Some respondents suggested that clarification was required over arrangements for the supplier of last resort in a bilateral market. In this context, the supplier of last resort refers to the party that is required to provide water resources if a third party or secondary water company is unable to fulfil its contractual obligations to input water resources into the network. A number of appointed water companies either expressed the assumption that it would be the role of the incumbent to provide this service, or indicated that it was a service that they would be able to provide. However, it was noted that it was not clear how this would be valued and charged for, and how this should be reflected contractually.

### **4.2.4 Standardised codes and contracts**

A range of respondents, including appointed water companies and retailers, noted that there might be benefits from some degree of standardisation to the interactions between market participants. Two appointed water companies noted the role played by the Wholesale Retail Code in governing interactions between industry participants in the business retail market. It was suggested that either an equivalent to this code, or an extension of the current code, might be required to govern bilateral market interactions.

A number of respondents also observed that there might be benefits from a standardised bilateral market contract or standardised Section 66D agreement<sup>7</sup> that market participants could use to facilitate the striking of trades.

#### **4.2.5 Stranded investment and long-term financial security**

Some bilateral markets trades could require appointed water companies to undertake some capital investment in order to connect the new supplies to networks or to reinforce networks in order to receive the supplies (for example by expanding the capacity of a water treatment works to enable it to process a higher volume of water). Some appointed water companies queried how such costs might be dealt with to ensure that customers were protected from inefficient investment in the case where a trade failed before the costs of reinforcement had been recovered. A number of suggestions were advanced in this area, including placing conditions on the relevant wholesaler responsible for introducing the water and ring-fencing the relevant assets.

On the other hand, one respondent argued that the investment of a third party supplier might also be at risk in the case where a trade failed as a result of the actions of the retailer counterparty. In such a scenario the third party might be exposed to stranded investment costs. It proposed locking-in a fixed period of 25 years for the equalisation payment in order to ensure the investment was protected, and that the payment should go directly to the third party supplier of the water resources rather than to the wholesale licensee which legally introduced the water into the network (which might, for example, be the retailer).

#### **4.2.6 Other considerations**

Respondents raised a range of other points for further consideration in the development of the policy framework for bilateral markets.

These suggestions included:

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<sup>7</sup> A section 66D agreement refers to the agreement between a WSSL licensee and the incumbent water company for the terms of accessing and use of the network to introduce and deliver water to customers.

- The requirement to develop settlement arrangements to address the potential daily imbalance between water put into the network by third party suppliers or secondary water companies and the volume taken off the network by customers of retailers;
- The development of a central trading platform (or the adaptation of an existing platform) would be beneficial in terms of promoting market transparency and efficiency;
- It would be necessary to define the terms which incumbent water companies would be able to refuse third parties or secondary water companies to connect to their networks. The wording in the WA14 refers to the circumstances in which the incumbent water company being able to do this being as a result of it being required to incur “excessive costs” or the new supply compromising its “ability to meet its own obligations”;
- There would be a need to consider whether it would be appropriate to maintain the current link between the level of wholesale charges that retailers pay currently and the revenue which they are able to obtain from certain classes of customer. It was argued that the benefits for retailers of obtaining cheaper sources of water might be offset by a reduction in the revenue which they can receive.
- One way of minimising the environmental risks that might arise through water transfers would be to prohibit the transfer of raw water and instead require that water should be treated prior to transfer;
- The variable input of water into a network by parties other than the incumbent might cause practical day-to-day network management issues (such as, for example, in the impact the variable supply has on levels of network pressurisation). It was also noted that the actions of these third parties might also directly influence the incumbent’s performance against its output delivery incentive mechanisms and performance commitment measures. This in turn could impact the level of both the incumbent’s revenues and the level of service that its customers’ received.

### 4.3 Question 3c

Respondents identified a number of areas that they considered should be a priority to address when considering the introduction of bilateral markets.

A wide range of stakeholders, including potential sellers, buyers and incumbents, suggested that an early focus of work should be around terms of access and charging for use of services. A number of respondents put forward quite detailed views, suggestions and examples for consideration in this area.

Several stakeholders, including a significant number of appointed water companies, noted that it would be important to provide clarity over the roles and responsibilities each party would have in the market. This included areas such as responsibility and accountability for the quality of water being put into the network. The industry body, Water UK, suggested that a code of practice might be a means of providing clarity in this area.

There was some division among stakeholders on the best approach to opening the market. A number of appointed water companies argued for a phased opening of the market, with an initial phase of only allowing raw water to be traded to be followed later with the market opening to treated water. A number of other stakeholders instead advocated the benefits of running an initial pilot scheme from which lessons could inform a full opening of the market.

#### **4.4 Other points raised**

Four respondents suggested that changes were required to the broader legislative framework around abstraction licensing. They suggested that certain reforms in this area would better facilitate water resource trading. Such reforms would go beyond the scope of the changes to the WA14 concerning bilateral markets under consideration in this call for information exercise. We have shared these responses with Defra and the Environment Agency, which are the bodies which oversee this area.

## 5. Additional points raised

A number of respondents raised additional points beyond areas covered by our prompt questions.

Two respondents highlighted the importance of ensuring that work on bilateral markets should be closely aligned with work being undertaken by RAPID, and should be consistent with the twin track approach (of focussing on an efficient balance between new water resources and demand side measures such as leakage reduction and water efficiency measures).

Amongst other points raised were:

- Water trading and water transfers could lead to greater levels of abstraction in the round and that this could potentially lead to negative environmental impacts;
- It would be desirable to update the impact assessment on upstream reforms undertaken prior to the passing of the WA14;
- It would be useful for a mapping exercise to be undertaken that identified all the potentially available water resources that could be subject to trading;
- It would be useful to clarify the purpose that bilateral markets would serve;
- It would be helpful to have clarification over which parties would be permitted to hold a wholesale authorisation which allowed them to input water into a primary water company's network;
- Good communication with customers would be essential in determining how bilateral markets would be perceived; and
- One respondent expressed general support for the stance outlined in the call for information.

## 6. Next steps

We will reflect on the points that respondents have raised in response to our call for information and will look to engage further with stakeholders in 2020. We will continue to liaise closely with Defra, the Environment Agency and the Drinking Water Inspectorate to ensure that the approach we take to the development of bilateral markets remains aligned. We also intend to work closely with RAPID to ensure that the approach to bilateral markets is consistent with broader work on water transfers, in particular around issues such as water quality and environmental impacts.

We intend to engage with stakeholders in a variety of ways. This may include the publication or circulation of discussion papers, follow-up meetings with particular stakeholders or groups of stakeholders, and workshops. We will provide details of our stakeholder engagement activities on our dedicated [bilateral markets](#) page on the Ofwat website.

Later in 2020, following our engagement with stakeholders, we will publish a policy document setting out our views on ways in which the various policy issues we have identified could be addressed and our thoughts on the appropriate timeframe for action.

## Appendix: Full list of respondents

A full list of respondents who provided non-confidential responses is set out in the table below, with hyperlinks to each response on our website.

Respondents	
<a href="#">Affinity Water</a>	<a href="#">Severn Trent</a>
<a href="#">Albion Water</a>	<a href="#">South West Water</a>
<a href="#">Anglian Water</a>	<a href="#">Thames Water</a>
<a href="#">Bristol Water</a>	<a href="#">Uniper</a>
<a href="#">Castle Water</a>	<a href="#">United Utilities</a>
<a href="#">Clear Business</a>	<a href="#">Water2Business</a>
<a href="#">Consumer Council for Water</a>	<a href="#">Water Plus</a>
<a href="#">Energy UK</a>	<a href="#">WaterScan</a>
<a href="#">Northumbrian Water</a>	<a href="#">Water UK</a>
<a href="#">River Chess Association</a>	<a href="#">Wave</a>
<a href="#">RWE</a>	<a href="#">Yorkshire Water</a>

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