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Creating tomorrow, together:
consulting on our methodology for PR24

Appendix 2 – Water trading incentive

Ofwat

About this document

This appendix sets out two high-level options that we briefly set out in Chapter 3 of our consultation document. We intend to retain the current water trading incentive for PR24, but we consider that it will need replacing in future and in this appendix we set out some thinking on what the incentive could look like at PR29.

1. Introduction

This appendix sets out two high-level options that we are considering to replace the current water trading incentive at PR29. **We intend to retain the current water trading incentive for PR24**, but we consider that it will need replacing in future. In doing this, our aim is to provide a greater degree of certainty for investments which may be made in the coming years,

We provide an incentive for companies to trade water as it may offer an efficient way to contribute to their provision of adequate water resources to meet the needs of their customers. Without an incentive, selling companies would make no gains from water trades[1] and would therefore have little motivation to trade.

The strategic water resource solutions within the RAPID programme or others identified through the water resource management plans (WRMP)[2] /regional planning process may introduce much greater scope for large-scale inter-company water trading, and significantly increase the volumes of water traded. We will need to either adapt the current incentive so that it can apply these new types of trade, or replace it with a new incentive if that is a better solution.

1.1 The current trading incentive

The current water trading incentive was introduced in PR14 and carried over into PR19. It allows both exporters and importers to financially benefit from trading surplus water. It comprises of an export incentive and an import incentive.

- Exporters may retain 50% of lifetime economic profits.
- Importers may retain 5% of the costs of water imported, with a cap of 0.1% of the importer's water resources revenue allowance in each year of the control period.

To be eligible for the incentive, trades must be new and comply with each company's approved trading and procurement code. This ensures that the trades are non-discriminatory and economically and environmentally rational. Companies may seek approval from us to earn the incentive once the trade is operational. The amount is set on the basis of an ex-ante

[1] This is because we set companies revenue controls on a 'single till' basis. This involves setting a revenue allowance under which companies recover their costs for the services they provide to customers from charges to end customers and charges for services provided to other companies, such as the provision of bulk supplies of water.
[2] Each company is required to establish and maintain its WRMP, which is subject to guidance from the UK government and the Welsh Government, as applicable.

statement of traded volume and economic profit and may be claimed once the trade is approved, (subject to a cap set at 100% of expected profits in any price control period).[3]

1.2 The rationale for change

We have a water trading incentive to encourage the efficient trading of water resources between companies, where this is economically and environmentally rational. Some future trades, such as those that might arise from the development of strategic water resource solutions, may take a very different form from the types of trades that could be supported by the current incentive.[4] Such trades may underpin (in whole or part) the investment case for major capital expenditure, supported by long-term contracts that may cover several decades.

While the investment in supporting infrastructure is separately incentivised (either through delivery by direct procurement for customers (DPC), for separable infrastructure, or from returns on RCV), the nature of the trade itself is likely to have different features. There could be only limited confidence in ex-ante forecasts of traded volumes and profits for these contracts. Should an exporter retain its share of profits in the first half of the contract life it would create an issue of inter-generational equity for its customers, who might not see any benefits for many decades.

The trade (and the trading environment) may also evolve over its lifetime. For example, as more transfer options become available to companies, there may be more dynamism in operational decisions and a greater role for coordination in operations across companies.

For these reasons, we do not consider that the current trading incentive is well suited in its present form for these types of trades.

Rather than introduce an additional incentive mechanism to support long-term trades, we intend to operate a single incentive applicable to all inter-company trades. We propose to either adapt the current incentive or to introduce a new incentive.

Projects that commence construction during the 2025-30 period will benefit from greater certainty about the form of trading incentive that will be in place as part of their investment case.[5] We do not expect any strategic water resource solutions to commence trading in the 2025-2030 period. We therefore intend to retain the current incentive mechanism for PR24, and introduce a replacement mechanism at PR29. This will provide certainty for any trades currently under development in anticipation of claiming the current trading incentive in the

[3] In practice this means the company will retain the profits in the first half of the lifetime of the trade.
[4] We note, for example, that the incentive has already needed some significant adaptations in order to be applied to the trade between Portsmouth Water and Southern Water for Havant Thicket.
[5] Companies may also need to submit trading and procurement codes for approval during the PR24 period ahead of the new incentive coming into effect.

2020-2030 period, as well as for projects under development that expect to commence trading later.

The policy of a water trading incentive interacts strongly with our policy on bulk supply charges, and in particular whether we set bulk supply charging rules. RAPID's December 2021 consultation[6] set out options for charging rules, including principles-based rules, a wholesale-minus approach, and charging analogous to that for DPC.

Trades between Wales and England may be subject to distinct arrangements, for example separate charging rules. Any new trades between Wales and England are subject to certain additional guiding principles, for example that the relevant company or companies must provide detailed analysis and explanation of the economic, environmental and multi benefits for Welsh citizens.[7]

[6] RAPID, 'The regulatory and commercial framework for strategic water resource solutions', December 2021.
[7] Welsh Government, 'The Welsh Government Guiding Principles for Developing Water Resources Management Plans', 2022

2. Options considered

We set out two options for consideration: an adaptation of the current incentive (option 1 below); and a new incentive, adapted from an approach proposed by NERA in a consultancy report for RAPID.[8]

2.1 Option 1 – adapting the current incentive

Our proposal for option 1 is to modify the current incentive in three ways.

The first modification would be to **change the point of approval of a trade as a qualifying trade**. This would move to the point at which we approve any capital expenditure that supports the trade. Currently, approval is given at the subsequent price review following the commencement of a trade. Approval would remain subject to the trade meeting the terms of the company's trading and procurement code. This adaptation would remove a large degree of potential revenue uncertainty in the business case related to any capital assets. The level of additional risk for customers is relatively small where the case for construction has been successfully made.

The second modification would be for **incentive payments to be calculated and claimed annually, based on actual traded volumes**. This would require companies to report revenues, detailed costs, and volumes traded, on an annual basis.[9] The annual payment of the incentive based on actual volumes and revenues would better protect customers and maintain the incentive for the life of the contract. The current incentive relies on forecasts of bulk supply costs and revenues (with no ex-post reconciliation) and capping the export incentive at 100% of the economic profit for the years the export operates in the current control period.

The third modification would be to **raise the cap on the import incentive** to sharpen the incentive to import water where it is economically efficient to do so. The current cap on importer benefits from trades is 0.1% of the water resources revenue allowance in each year of the control.[10] To sharpen the incentive we could raise the cap to a higher level. Alternatively, we could remove the cap altogether and allow companies to manage the risk of incentive revenues being disallowed and returned to customers at future price reviews if we consider that the level of water imported is not economically efficient.

[8] NERA, 'Review of Bulk Supply Contracts and Pricing in the English & Welsh Water Sector', 16 December 2020.
[9] Revenues would be net of fixed charges and costs would be net of construction costs.
[10] This would theoretically equate to £5.3m each year of the current control period were all companies to reach the cap, with a resulting impact on bills of c£0.20. In practice the actual current annual figure is negligible owing to the very low volumes of new trade.

One feature of the current incentive that we do not propose to change under this option is **the ability of a company to simultaneously benefit from both import and export incentives**. This could currently apply in circumstances where a company has a water resource zone in deficit in one area of its network and a water resource zone with surplus in another area. It might have no means of interconnection between its affected areas but have neighbours with which it could efficiently trade.

2.2 Option 2 – a new form of trading incentive

The basis of the new form of trading incentive is an approach proposed by NERA in 2020.[11] NERA recommended that we should allow a mark-up on the charges in bulk supply agreements above the cost of supply, rather than through a separate water trading incentive. It proposed basing the charge on long-run average incremental cost (LRAIC) plus a mark-up that is a proportion of the economic rent[12] associated with the trade. It argued that this approach would provide incentives to trade for both buyer and seller and would incentivise the buyer to minimise costs. NERA did not propose how this approach should be implemented.[13]

2.2.1 Issues with the original proposal

Our concern with the NERA proposal is that it might provide incentives to inflate the outside cost reported by the buyer of its next best option. This would have the effect of increasing the profits from the trade.[14] As such, the seller would also benefit and it would have no incentive to challenge the suggested cost of the next best option. Both buyer and seller would gain as there is more economic rent to share between them.[15]

There is a further risk that the buyer could strategically use this evidence to try to strengthen cost claims submissions in the future and increase its allowed totex, softening our cost challenge. Setting the buyer's share at a level that better aligns its incentives to reduce costs

[11] NERA, 'Review of Bulk Supply Contracts and Pricing in the English & Welsh Water Sector', 16 December 2020
[12] The economic rent in this instance is the difference between the cost of the option offered by the seller and the next best option available to the buyer that it would otherwise use. The proposal is that this difference is shared between the seller and its customers (who share the profits from the price mark-up) and the buyer and its customers (as the buyer resells the water to its customers at a higher price than it pays the seller, but a lower price than the customers would have paid for the next best option).
[13] In principle, the proportion of the economic rent that the seller gets from each trade could be the same across trades. This would lead to a different level of mark-up across trades since the value of both seller's and buyer's LRAICs varies across trades.
[14] Since the amount of economic rent would increase with a higher LRAIC of serving the additional demand by the buyer.
[15] The buyer's gain from the share of economic rent would be off-set to an extent by earning less from its totex performance through being less efficient in its procurement of water resources.

could improve the the original proposal. However, setting these rates seems challenging and may not be feasible.

2.2.2 Our proposed modified approach

Our modified approach mitigates our concerns about the perverse incentives on inflated costs. Under this approach **we set the charge of each trade**. We would undertake a one-off assessment of the costs of the buyer's next best option and estimate the economic rent and set the proportions that should accrue to buyer and seller. This would make it more challenging for the buyer to game the costs (although it would not eliminate its incentive to do so). It would entail a higher regulatory burden and the challenge of information asymmetry on the costs of both the trade and the next best option would remain. We are also mindful that the assessment process could deter or delay trades as the buyer and seller would not know the value of the economic rent until we set the charges.

3. Assessment of options

A high-level assessment of the two options is provided in Table 3.1 below.

Table 3.1: assessment of options

Criteria	Option 1	Option 2
Provides incentives to trade	Yes. Suited to long-term trades. Not getting profits upfront may slightly reduce seller's incentive, but is better aligned with intergenerational equity principles.	Yes. Incentives for all parties.
Robust to market power	Limited (when this is a concern in water trading). Buyer protection from market power may be increased through charging rules.	Can be used to address market power (when this is a concern in water trading) as costs open to regulatory scrutiny.
Protects customers	Includes limits and caps to protect customers; better aligned with intergenerational equity. Raising the cap on import incentive may increase customer payments, but should reduce totex.	Price regulation would incorporate mechanisms to protect customers and market power could be mitigated – but 'heavy handed' approach may deter beneficial trades too.
Multi-party trades	Would allow point-to-point transportation by granting intermediate networks import and export incentives. This could face challenges and limits on incentives may reduce third parties' willingness to trade and/or undertake deep reinforcement required.	It is unclear how the economic rent for a reseller would be calculated. This would affect reseller incentives to engage in trade.
Information assymetry	Revenues, costs and volumes provided annually and profits would be calculated and taken on this basis. Information asymmetry could remain for complex schemes, and seller may be incentivised to misallocate costs	Costs are scrutinised and can be challenged by Ofwat for each trade. Information asymmetry could still be high, in particular for "next best option".
Practicality	Low regulatory burden. Keeps many of the features of current scheme. Information requirements would slightly increase with annual provision of costs, revenues and volumes.	High regulatory burden, potentially increased uncertainty around incentives - this could delay/deter trades.

3.1 Stakeholders views

RAPID consulted at a high-level on the issues around trading incentives for strategic water resource solutions in December 2021.[16] The consultation set out the challenges of incentivising trading for strategic water resource solutions and invited views as to whether an evolution of the current incentive would be needed. Stakeholders broadly agreed that incentives would be required and with the analysis of the challenges. A number of respondents discussed the distinction between the incentive to deliver infrastructure and the incentive to trade once the infrastructure is operational. The water trading incentive is

[16] RAPID, 'The regulatory and commercial framework for strategic water resource solutions', December 2021. Stakeholder responses are published alongside the consultation.

intended to encourage the efficient trading of water. The incentive does not cover the delivery of infrastructure, which is dealt with separately.

Having considered feedback from stakeholders in the RAPID consultation, we developed two alternative approaches for water trading which are the two options we are putting forward for consultation. On 29 March 2022 we held a stakeholder workshop that set out these options and explained that we intended to introduce a new incentive from PR29 (retaining the current incentive for PR24). We explained that to provide greater certainty for investors, we intended to confirm the policy outline of the new incentive to be introduced at PR29 in our PR24 Final Methodology. Stakeholders confirmed that they considered either option to be viable. We are therefore putting forward the option designs for more detailed feedback from stakeholders, including their reasoned preferences.

4. Proposal

We consider that both options we are putting forward for consultation are credible and we invite stakeholders views on them. **Our preferred approach is Option 1 (which is to adapt the current incentive)**. We consider that this provides greater certainty to trading parties and imposes a lower regulatory burden. We consider that Option 2 is attractive from the point of view of being conceptually simple, with the benefits of the trade being captured and shared amongst the trading parties and their customers. However, we consider that it would be challenging to implement in practice and it would come with a high regulatory burden.

In question Q3.1 in our consultation document, we ask whether stakeholders agree that in our final methodology we should commit to introducing either an adapted water trading incentive or a new water trading incentive at PR29. We ask that, if stakeholders have a preferred approach, to provide reasons, including any thoughts on how the options could be improved. When answering this question, it would be helpful if stakeholders could consider the points below.

In terms of Option 1:

- Any challenges that might arise from the reporting of costs, revenues and volumes to calculate the incentive payment and how these might be addressed; and
- Any views on whether the import incentive should remain capped, and if so, the level at which the cap should be set (by default, the cap would remain at the current level).

In terms of Option 2:

- How to address the challenges of informational asymmetry in terms of the LRAIC of the trade and the next best option in order to calculate the regulated price;
- How the option could be optimised to facilitate multi-party trades; and
- How the process of regulating the price of trades could be streamlined (to reduce the regulatory burden) while still ensuring that customers are protected.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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