



waterwise



Protecting consumers, promoting
value and safeguarding the future

WWF, Waterwise and Ofwat joint response to the Cave Review

This note is submitted to the *Cave Review of Competition and Innovation in Water Markets* on the basis of a series of discussions held between WWF-UK, OFWAT and Waterwise concerning sustainability in the water sector. It covers some emerging points of consensus between the organisations about key issues.

In addition to this note, each of the organisations is submitting its own evidence to the Cave Review.

Overall comments

1. The water sector faces some particular emerging challenges in the next quarter of a century. We believe that these can be used to evaluate any proposed alterations to the regulatory regime:
 - Adapting to climate change
 - Ensuring sustainable abstractions
 - Increasing responsiveness to customer requirements
 - Affordability
 - Realising the potential for increased water efficiency and demand management
2. In seeking to secure these objectives, there is a need for better economic signals in the water sector than is currently the case.
3. Markets are in theory the first choice for providing signals – where those markets can be effective and complete. However, there are significant market failures in the water sector, and this means that more effective regulation is likely to continue to be important alongside any increase in market competition.
4. There are a number of potential benefits from competition:
 - Downward pressure on prices
 - Increase responsiveness to what consumers want
 - Delivering environmental benefits, in a correctly incentivised context.
 - Potential for better regulation and de-regulation where competition is effective.
5. Within the overall water supply sector there are a number of different markets with different characteristics. In seeking to meet the objectives of increased competition, it is likely to be important to recognise that different rules are likely to be required for different markets. It may be possible to move at different speeds in different markets.

6. A more effective regime to enable the trading of abstraction licences is an important part of beginning to generate economic signals upstream. This would generate knowledge about the willingness of licence-holders to trade. We can't know the potential for significant trading at this stage, so we should be cautious in assuming that abstraction trading alone will be capable of generating the necessary economic signals in a competitive market. However, even transparent trading at the margin could give new information about the economic values, and relative values, of water in different locations.
7. Competition in water downstream (retail) services – particularly a vertically-separated retail market - may have an important role to play in generating downstream economic incentives:
 - for supporting customers in taking water efficiency measures
 - for providing the services customer want, and
 - for bearing down on costs.

Retail markets

8. Competition between retailers ('water services' providers), separated from the upstream network business, could incentivise competing water services providers to better understand and respond to customers' needs and innovate to develop new services, where customer want these. Water services providers could make money by providing services around water, not water itself. They could therefore have incentives to help customers save water, by providing water efficiency analysis, advice and implementation, and sharing the financial benefits.
9. In order to meet objectives, including sustainability objectives, in any competitive retail market, there will remain a need to consider regulatory incentives, in particular incentivising and rewarding water efficiency (as OFWAT currently does).
10. Retail services competition may therefore have an important part to play in addressing demand-side issues, such as water efficiency, which are part of the solution to sustainable abstractions. In isolation however, retail services competition cannot address supply-side challenges, such as a water supply systems which are inefficient or damaging to certain environments.

Abstractions

11. Significant measures to remove key obstacles will be needed if there is to be a significant upstream market. Measures include developing an effective model for upstream water supply competition, including access pricing. This note concentrates on the issue of abstraction licensing.
12. There is a need to consider significant reform of the current regime of water licensing, pricing and trading arrangements in order to develop effective economic signals: both for the efficient development of the water supply system and for efficient achievement of sustainable levels of abstraction. These two outcomes are linked.

13. There are a number of possible parts to a reformed water licensing, pricing and trading system.
14. Measures will be needed which reduce barriers to secondary market trading, promote the migration of water away from lower value uses, enable water supply entrants to obtain water, and begin to reveal more information about the economic value of water in particular areas.
15. It is unclear how much trading would take place once barriers were reduced, but water rights trading is likely to be an important part of the solution.
16. Productive licence trading is more likely to occur with a transparent set of ex ante constraints and conditions on trades in place of non-transparent regulatory judgement. A number of enabling conditions would be necessary for this to be possible, in particular a more sophisticated water rights regime, for example one that required licences to incorporate any limits on time and location of abstraction, hands off flow conditions, and return flows.
17. Over-licensing and over-abstraction in some areas are key barriers to reform and liberalisation of the water license market. At the same time market mechanisms are likely to be part of the solution to addressing over-licensing in the most efficient way, and in the context of long-lived / perpetual property rights. Trading needs to be developed alongside a process for addressing the issues of over-licensing and over-abstraction.
18. A target maximum level of abstraction (or minimum level of flow) needs to be set for any given area, based on assessment of environmental and other amenity values. Achieving such sustainable licensing and abstraction targets is likely to require some time, and could be pursued through a number of options:
 - Regulatory cuts to abstraction are one option. There are issues of existing water rights in perpetuity, and perhaps a limit to how soon in reality regulatory action could remove or reduce these rights to target. There are also questions as to whether simple regulatory action would allocate reductions in a more costly and inefficient manner than other possibilities.
 - An alternative approach is to combine regulatory and market mechanisms. For example, reducing licenses through a reverse auction reduces cost to society, as those who least value licences sell-up. An effective secondary market would provide a context for ensuring a more efficient and predictable reverse auction. There remain issues of where funding for the auction comes from – licence charges are one option.
19. Licence charges could be recovered from licence holders informed by trading prices or calculated economic value/ environmental cost/ scarcity (which should all be equivalent). Such pricing would provide some additional economic signals for efficient and sustainable use of water.

20. Another possibility would be to link licence charges to environmental standards, so that the price paid by abstractors increased when river levels fell below a specified environmental standard. The practicalities of, and incentives from, such an approach would need to be considered.
21. An alternative to 'target and trade' would be to go further in the use of licence charging and attempt to move prices towards estimates of full economic values of water rights. However, such an approach could be difficult to implement, not least in assessing the true economic values of water in each location. It could also disrupt the trading market by appropriating economic values to a Govt agency, it could not guarantee particular priority environmental outcomes and there would be the question of what would happen to funds generated.
22. There might nevertheless be a role for a partial move in this direction, for example in combination with a target. Pricing could be used as a signal to provide incentives for companies and users to move to a more sustainable pathway.
23. Issues may need to be resolved to ensure that water companies have the right incentives to decide whether to hold or release rights. Regulation would need to take into account incentivising companies to hold efficient level of rights.
24. There is also the important question of the impact on customers of exposing water's economic value. We would need to put in place protections for customers to insulate them, through regulation, from any windfall increases in the value of water supply companies' existing water rights.

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