



Exploring views on the potential for more active water rights trading

Report

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Executive Summary

Introduction

The transfer of rights of water between licence holders has been possible for some time. In certain areas of the UK, water is licensed, but not all of the available water is used by the licence holder. Water rights trading enables these (or those not utilising it efficiently) to transfer the rights to their unwanted water to another party.

However, despite having been feasible for a number of years, only a small number of trades have taken place and further research was required to explore the barriers to water rights trading. We have adopted an iterative approach to this project, with an initial scoping stage to explore the issues and help formulate a sample profile, followed by a main stage of qualitative depth interviews to gain a broader understanding of the issues at hand.

A total of 46 executive depth interviews and 28 semi-structured depth interviews have been conducted amongst actual and potential participants in water rights trading. This report details the findings of the research.

Key Findings

What do people think of water rights trading?

At a conceptual level, most of the people we spoke to feel that more active water rights trading has the potential to deliver some overall benefits to the UK water industry, consumers and the environment. It might do this in a number of ways. It might help the environment and the economy through making more efficient and appropriate use of resources; it will provide greater access to water to raw water for those who need it; help to open up the water industry to greater competition by facilitating the entry of new suppliers; and thus benefit consumers through providing more choice and potentially cheaper bills.

Many people feel that now is a good time to review the possibilities of water rights trading. The market has obviously not taken off, but with the growing awareness of climate change, the increasing cost of raw water, together with the greater need for water demand management and the current economic climate, it is ever more important for organisations to revisit their business models and find alternative ways to operate and save/make money. People therefore generally welcome further efforts to develop trading.

What do people know about water rights trading?

Understanding across our sample varied, although those who were most aware (typically consultants, brokers and a few others who were more directly involved with water), were more aware of it on a conceptual level rather than having a detailed knowledge of the actual processes involved. Most would welcome the opportunity for the market to be given due support and investigation.

What experiences have people had of water rights trading?

The current trades that have taken place have tended to involve relatively small scale trading of surplus water. Most trades have been instigated by the purchaser, with sellers taking a passive role in the trades. The only exception to this has been when, through various circumstances, the seller has needed to realise the capital value of their water rights, for example, through the water no longer being of an appropriate quality, or because they were going out of business. Very few people have been involved in more than one trade, and it is interesting to note that a number of brokers have been endeavouring to generate business, but with only very limited success.

The actual process of making a trade is generally considered to be quite lengthy, taking 6-18 months in total. However, there is a recognition that it is likely to be a time-consuming process due to the complexity of the issues involved, not least the need to assess the potential impact on the environment of making the trade, and the

timescales given obviously also includes time spent in negotiations between the two parties involved in the trade.

What are the current barriers to water rights trading?

The current barriers to water rights trading can be divided into active and passive barriers.

Passive barriers are where for example, something is missing (e.g. understanding, awareness etc) which prevents serious or detailed consideration of trading, and results in a lack of *desire* to do so. The main passive barriers are:

The lack of a visible market – many people feel that water rights trading market has not actually started properly yet, and so have not seriously considered getting involved.

Inability to see the value in trading – people are unable to estimate the potential value in becoming involved in water rights trading, and therefore are unwilling to commit much time and resource to investigating it further. There are also some concerns as to whether a water rights trading market is feasible.

Lack of understanding of the water rights trading process – most respondents had little understanding of how to make a trade, and given the stagnant nature of the market, little incentive to find out more.

Hoarding and future uncertainty – water is a vital commodity, fundamental to businesses. Having it provides options and opportunities; selling it reduces these. The current focus on global warming also serves to increase uncertainty around this issue and encourage a more conservative approach to using resources.

Alternatives to trading – people also have other means of addressing the need for more water, instead of using water rights trading. For example, farmers rent or swap land; and businesses increase water efficiency.

Active barriers are real or perceived factors which make trading difficult or impossible for those who have a desire to do so. The main active barriers are:

The feasibility of making suitable trades – the restriction of trading licences within the same catchment area; the limitations on moving abstraction points; and the comparatively high cost of transporting water means that some people feel that there will be insufficient opportunities for trades to take place. This is further exacerbated by a perceived lack of information which might help minimise these issues.

Restrictions on trading and the reduction of rights at the point of trade – a key barrier to trading is the perception that the Environment Agency is using the trading process as a means of reducing or restricting the licence at the point of trade. This appears to be ‘received wisdom’ within the water industry and a number of respondents felt they had first-hand experience of this.

Difficulties with the trading process – the process of making a trade can be quite lengthy, especially if there are any significant amendments to the licences. Whilst people are relatively understanding about this – monitoring the potential impact on the environment is not a straightforward thing to do – there was some feeling that the requirements could sometimes be relaxed a little to help ease the process.

Broader barriers which may prevent the market from developing – the water rights trading market is of course, just one part of the efforts to open up the water industry to competition, and cannot be viewed entirely in isolation. For example, a key factor

impacting on water rights trading is the high cost of gaining access to water companies' distribution networks.

Conclusions

How can these barriers be overcome?

Possible actions suggested by participants, that would help to overcome these barriers would be as follows:

- **Removing any barriers to the establishment of a central market-place for trading water rights.** This would maximise the chances of putting potential buyers and sellers together.
- **Providing easier access to better information about licences.** This would help facilitate trades by removing an important obstacle to trading.
- **Establishing an independent body to facilitate the trading process.** Removing the current concern that the Environment Agency will 'penalise' people at the point of trade by reducing abstraction volumes or increasing restrictions. This should be done in conjunction with clarifying the roles of the Environment Agency and Ofwat.
- **Establishing a value for water rights and increase the cost of holding a licence.** This would encourage more people to consider trading their water rights and provide a financial reason for doing so.
- **Standardising the trading process** wherever possible to make it quicker and more accessible, but retaining sufficient flexibility to meet the needs of each set of trading partners.

1. Background

The transfer of rights of water between different licence holders has been possible for some time. In certain areas of the UK, water is licensed, but not all of the available water is used by the licence holder. Water rights trading enables these (or those not utilising it efficiently) to transfer the rights to their unwanted water to another party.

The merits of water rights trading have been debated in the last few years, and both Ofwat and the Environment Agency (EA) have consulted on the issue. The most recent consultation published by Ofwat (*“Review of competition in the water and sewerage industries: Part II”* (May 2008)) suggested that water rights trading could play an important role in helping the EA manage water resources, and supports Ofwat’s duty to protect the interests of consumers by promoting competition when and where possible.

It is believed that this form of trading has the potential to unravel the economic value of raw water and allow it to be efficiently allocated. However, a number of potential barriers towards water rights trading were identified in the above publication.

Synovate was commissioned to conduct research to explore in detail the potential barriers to participation in water rights trading. We have adopted an iterative approach to this project, with an initial scoping stage to explore the issues and help formulate a sample profile, followed by a main stage of qualitative depth interviews to gain a broader understanding of the issues at hand.

This document details the key findings from this research.

2. Objectives

2.1 Business Objectives

The key business objectives of the research were to:

- Provide findings which will contribute towards Ofwat's review of competition.
- Support the Environment Agency's duty to manage water resources.
- Explore potential participants' perceptions and expectations around water rights trading, including expectations around competition in the industry.
- To identify and explore potential barriers which are preventing participation in water rights trading.
- To suggest how these barriers could potentially be overcome.

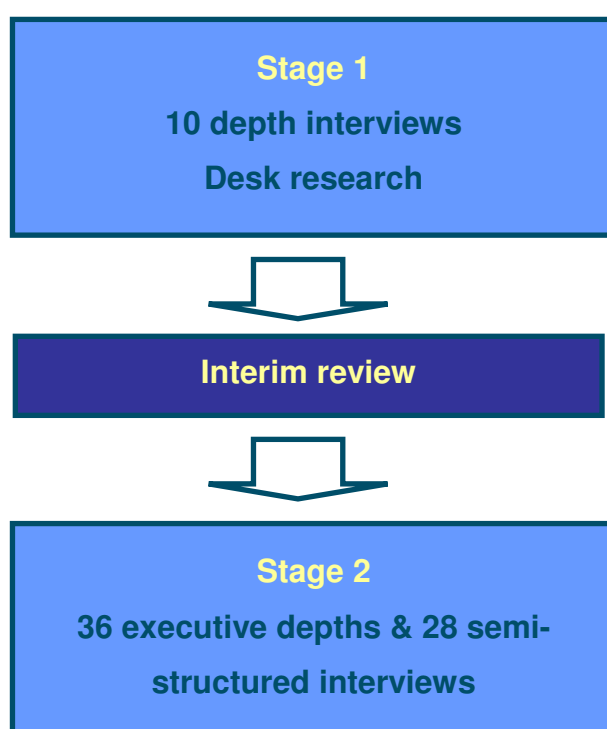
2.2 Research Objectives

The specific research objectives were to:

- Understand potential barriers to trading.
- Explore perceptions of the current water rights trading market, amongst both current and potential market participants.
- Explore how the current process could be improved to facilitate further trading.
- Explore why participants have decided to trade and understand reasons why potential participants have not considered trading as an option.
- Explore willingness to take part in a water rights trading market, including price incentives (which may make the market more or less attractive).
- Finally, to assess the likelihood of future trades.

3. How we conducted the research

The research was conducted in three stages, as can be seen in the diagram below.



Stage 1 was exploratory, combining desk research with depth interviews amongst a range of 'industry experts', academics and individuals with a broad understanding or experience of water abstraction and licence trading. The aim of this stage was to identify the key issues and scope out the second stage of the research.

These findings were thus fed into the interim review and were used to develop the sample profile and discussion guides for the second, more comprehensive stage of research.

Stage 2 of the research consisted of executive depth interviews and semi-structured interviews amongst a range of people with either a current or potential interest in water rights trading. This included brokers/ potential brokers; industry bodies/ organisations that either have or could potentially, take part in water rights trading; and organisations that could potentially be new entrants to the water supply sector (although with regard to this latter group, we found few people who – at this stage – would consider themselves as *serious* ‘potential new entrants’ into the water supply market, given the perceived difficulties of operating viably as such).

Executive depth interviews were conducted either face-to-face or by telephone, by specialist qualitative executives. This form of interviewing was mainly used for what were anticipated to be more complex interviews, typically organisations providing an overview of an industry sector, or those organisations most closely involved in the water industry.

Semi-structured depth interviews were used to supplement these interviews and as a more cost-effective technique, were used to gain a greater breadth of response, especially from organisations with a potential interest in water rights trading.

Executive depth interviews lasted up to an hour and were free-flowing discussions based around a discussion guide. Semi-structured interviews were slightly shorter interviews, using a more structured set of questions.

A more detailed description of the sample profile, together with the discussion guides and stimulus material used, can be found in the appendix.

Introduction to the findings

The commonsense cautions and limits of qualitative research apply to the following findings. The findings should be regarded as being indicative and should not be viewed as being statistically valid.

4. Research findings

4.1 Awareness and understanding of water rights trading

To what extent are different sections of the potential market aware of water rights trading?

Awareness of water rights trading is highest amongst consultants, brokers, potential new entrants and others directly involved in the water industry. Many of these respondents had been aware of the concept for some time, and some had taken part in consultations regarding the issue in the past (e.g. *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction, Defra, June 2001, the Environment Agency consultation in 2003*). Others in the water industry, in related sectors and the legal profession such as power generation, remembered hearing about the concept from peers, contacts within Ofwat or the Environment Agency or in the trade press.

Water companies, consultants and brokers are divided in their views on the degree to which trading has been considered and supported by Ofwat or the EA. Some consultants said that the issue has been investigated fully on more than one occasion, and suspected that the current consultation on the issue will yield similar findings and recommendations. Others think that the issue has yet to be 'seriously' investigated in a comprehensive manner, and welcome a move towards doing so now. However, all agree that the water rights market has yet to be given the regulatory support or publicity that it requires to become active.

"I suspect people aren't aware that they can trade. I personally haven't heard of any trades that have taken place". [Trade association]

Organisations that might be interested in trading existing licences, such as farmers and industry are generally more likely to be aware of the concept of

water rights trading, and the majority of our sample had heard of the concept. Those within these sectors who were aware, were often in roles which specifically dealt with water or environmental issues at a broader level. Within industry, the person with responsibility for water often has this as only one part of their remit, and it often seems to be a relatively minor part of their role. The reason for this is that water supply – whilst a vital part of their business – is a relatively low cost compared with the more high profile (and expensive) issue of gas and electricity supply.

To what extent is the concept of water rights trading understood?

Among those who are aware of water rights trading, understanding of the concept varies. Water companies, brokers, potential new entrants, consultants and trade associations are more likely to have a detailed understanding at a conceptual level, and to be confident of this. Those who have become more actively involved with the system – through investigating it as a possibility – also understand the *principles* of water rights trading. However, few respondents had a detailed understanding of the actual *process* that has to be gone through to make a trade.

“I’ve heard of the concept but I’m not quite sure about how it would work or what the model would be”. [Potential participant, Water Company]

Those previously unaware of water rights trading were sent a brief description of the principles and practices involved, as well as some case study examples of trades¹. Generally respondents were able to understand the concept of trading from this information relatively easily, but again, were not always confident of the practical details.

¹ These were taken from the Environment Agency website – please see the appendix.

Some consultants and water companies feel that they know as much as there is to know about the water rights market as it exists now. They assume that the market has yet to be ‘launched’ or encouraged, and that there is therefore little more to investigate or understand.

We discuss awareness and understanding further when outlining the barriers to trading in section 4.4.2.

4.2 Perception of the concept of water rights trading

4.2.1 Overview

At a conceptual level, most people we spoke to felt that more active water rights trading has the potential to deliver some overall benefits to the UK, and they generally welcome further efforts to develop trading.

Some consultants, potential new entrants and trade associations feel that the time is currently right for further review and consideration of the water rights trading issue, not least because of the ‘problems’ associated with the current trading system (see barriers in section 4.4) and the fact that the market is currently stagnant. They also cite the following factors which suggest potential for a developed market:

- Trading has been successfully implemented in other countries (e.g. Australia and Spain).
- Raw water costs are thought to be rising constantly (as are costs of other raw commodities).
- People are increasingly aware of climate change and its potential effect on the environment and future behaviour.
- Businesses are generally struggling economically at present and are therefore likely to look for alternative means of operating.

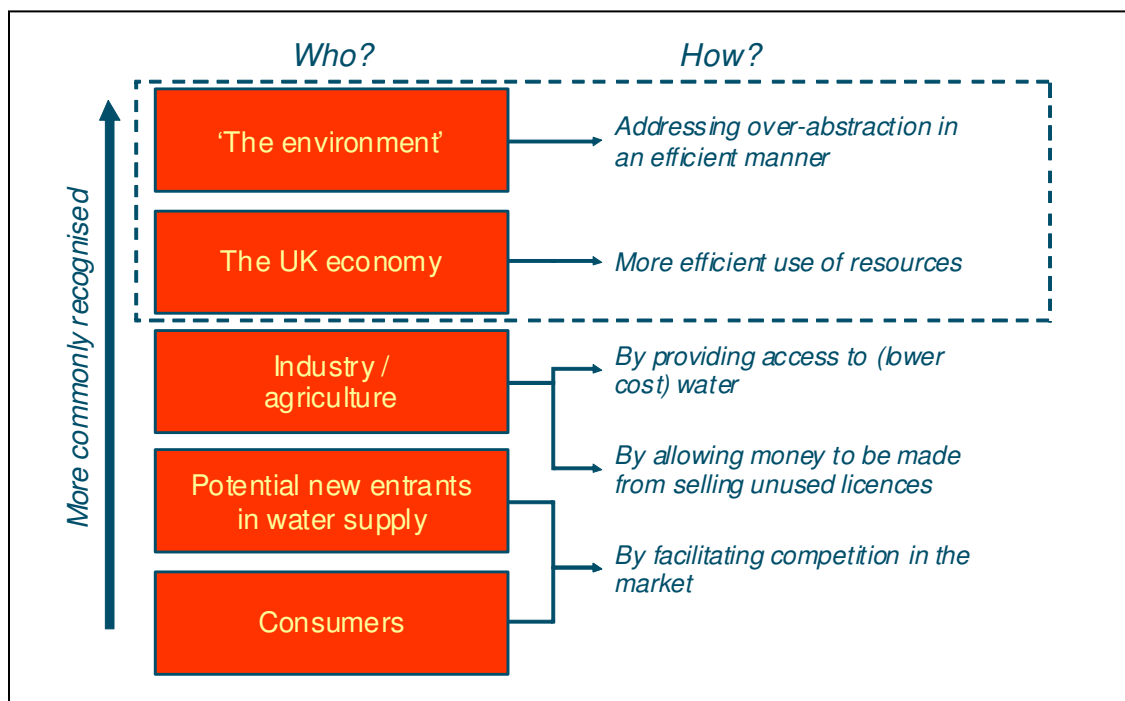
- There appears to be a growing awareness of carbon trading; and the belief that elements of this model might potentially be replicated with water. (However, it is worth noting that some consultants and economists argue that drawing comparisons between water rights trading and carbon trading is unhelpful and confusing, particularly as its effects have yet to be fully assessed).
- There appears to be a trend towards specialisation within some industrial and agricultural sectors, resulting in changes to water demand (volume and flow).

4.2.2 Potential benefits of an active water rights market

It is broadly recognised that developing a more active market in water rights has the potential to deliver benefits to:

- the UK economy as a whole
- the UK environment as a whole
- some specific types of organisation or businesses
- consumers of water

This is summarised in the chart overleaf.



At a general level, respondents agree that attaching a true value to water should drive more efficient usage. In particular, water companies, potential new entrants, consultants, public bodies and trade associations, appreciated that if the cost of accessing raw water was more reflective of its scarcity in particular areas, its usage could change to reflect this. Some said that as water begins to be used more efficiently, fairer prices for the **consumer** could result.

“The benefits are that the economy becomes more efficient. Basically, people pay the price that they need to allow them to run their businesses, and generally in terms of economic theory, the things work through. What is happening at the present time is that the majority of licences are held by water companies. They are not using a high proportion of these licences or they use them intermittently, to the extent

that the EA can't get them back off them. So basically they're sitting on water rights for the present time.” [Public body]

“It's hard to tell whether customers would face higher or lower bills. If water companies could sell their water rights on and make a profit, would they pass this on to the customer? Or they might focus on options which don't involve water which cost a bit more. They're both rational and irrational reactions to this uncertainty.” [Consultant]

A move towards more efficient use of water has the potential to deliver benefits for the **environment**. In general, respondents suggest that market forces have the potential to naturally curb over-abstraction and subsequent habitat damage. However, there is some recognition that whilst this is likely to be the long-term outcome, the danger is that in the short-term there could be some imbalances that would need to be managed to avoid harming the environment.

As well as the potential benefits to the UK economy and environment described above, other more specific benefits are apparent. For example, the trading of licences is thought by some water companies (including water supply licensees and inset appointees), some businesses and consultants to have the potential to open up the UK **water market** to greater levels of competition overall. Some potential new entrants into the water supply market said that this could in turn provide an opportunity for organisations like their's to grow and operate in areas where previously they might not have been able to. However, they also say that this would be dependent on other barriers to competition being removed. We discuss this issue in more detail in section 4.4.

“The regulators have now recognised that the water industry isn't sustainable any more.” [Inset Appointee]

“I guess (a group who would benefit would be) potential new entrant companies who would like to set up in a particular region and who require water for their processes but are unable to do that because the area is either over licensed or over abstracted.” [Potential participant, Manufacturing]

Some incumbent **water companies** predict specific benefits to themselves of a more active water rights market. Where they feel it would be beneficial, companies would welcome the opportunity to buy rights to more licences in their area, and beyond. This would allow them to have greater control over the water resources in a certain area, and therefore enable them to manage those resources more effectively and efficiently, through more integrated planning. This will lead, they say, to benefits for them, their customers and the environment.

“We could make more efficient use of the regional resources. As a water company, we're responsible for supplying water in an area. We have access to certain resources of the area, but we don't have access to others. So I suppose that having access to all of it you can then make use of the water resources in the most efficient way.” [Potential participant, Water Company]

Purchasing more licences can deliver other benefits to water companies, such as providing an alternative solution to water demand issues or allowing them to sell off unprofitable sources. Demand management is a major priority for water companies, and some suggest that purchasing licences could be a more cost-effective approach to this issue than other measures such as leakage control and investing in new infrastructure.

Were a fully traded market in rights to develop, some **businesses** with licences that they are not fully using, can see the potential commercial benefit of selling all or part of them. Most are more likely to be thinking of temporary trades rather than selling the rights permanently, as this approach avoids the risk of reducing the options available to the business in an uncertain business environment.

However, realising this benefit depends on certain criteria being met (e.g. time limits on the trade and guaranteed return of all rights afterwards) and relies upon certain barriers being removed (see section 4.4). As such, most businesses in the sample were only able to discuss these benefits in general or hypothetical terms. While some inset appointees and consultants felt that trading water rights has the potential to be a significant generator of revenue, most assumed that any additional revenue generated from such activity would only be a very marginal part of their overall business operation.

“We could potentially capitalise on an existing asset if you consider abstraction licences as an asset, which we currently don't do.” [Potential participants, Industry]

“The cost for supplying the business with water is only about 1% of the company turnover, so although it's really important, it's actually quite a low priority”. [Potential participant, Industry]

For businesses needing water, for example to facilitate expansion plans or new commercial ventures, buying rights would meet a specific need and therefore deliver tangible and immediate benefits. Some businesses and potential brokers said that they (or their clients) were currently unable to fulfil their expansion plans due to the high cost of acquiring suitable water through other means (e.g. from a water company). Businesses and potential brokers note that for companies operating in areas of water scarcity, trading represented a

potential method of accessing additional water, should it be required. Indeed, any company that uses significant amounts of water would potentially have an interest in buying water rights, as it opens up further business opportunities.

“I suppose in an area that is over abstracted, where one of my factories is, if we needed more capacity, then it would be useful to be able to (trade). We know that in an over abstracted area there is no chance of additional volume (in any other way).” [Potential participant, Industry]

Benefits were also noted for farmers and the rural economy. Relatively small trades between farmers or farmers and other parties, have already been undertaken, and those who have participated generally feel that there has been a mutual benefit to all parties involved. Farmers who have not traded themselves, but who could potentially do so, would welcome the ability to diversify into different types of agriculture which may require more water. They can also see a benefit to the local economy in terms of generating commerce between neighbouring farmers and local industry.

As with other groups, having access to (additional) water opens up new opportunities, for example in a farming context, diversifying into new crops, investing in new infrastructure (hot-houses etc) or being able to enter into longer term contracts with suppliers. Some farmers said that they specifically failed to win certain major contracts because they were unable to access sufficient water supply to guarantee the quality and volumes of produce required.

4.2.3 Potential drawbacks of an active water rights market

Relatively few drawbacks to the principle of trading rights were mentioned. However, some businesses, consultants and public bodies are concerned that an open market in water rights would result in a consolidation of the incumbent water companies' positions in local areas, and thus a reduction in competition. They tend to view water companies as having the greatest buying power, particularly compared with potential new entrants or smaller businesses. They also suspect that water companies would be more willing than others to pay a high cost to protect their position in the water supply market. However, some of the water companies felt that there would actually be relatively few sources of water that would be of sufficient scale to be of practical use to them.

“The drawbacks of water rights trading are ultimately the rise in the price of the rights. It may price certain companies (e.g. farmers) out of the market but we'll have to see.” [Public body]

“In theory it sounds good, people will buy them. But I suspect anything that comes onto the market, the water companies will have it.” [Potential participant, Industry]

Under the existing system, the EA is seen to keep relatively tight control over the allocation of licences. Some assume that this extends to ensuring that water companies, or any other large organisation is not granted access to all licences in a particular area. They say that a fully active water rights market would be likely to result in a reduction in the agency's influence, and would like reassurance as to how the market would be regulated.

“The EA at the moment issue the licence and they monitor the licence quite closely. I was just wondering how that would work, and would there be a case where there would be one big company coming in, and

snapping up all the available abstractions in the area? What controls would there be?" [Potential participant, Industry]

Not all respondents agree that the consumer will necessarily benefit from trading through lower prices at the point of delivery. Some consultants and water companies argue that the increased costs of abstraction may have to be passed on to consumers, at least in the short term. They say that this situation is not inevitable, but the regulatory approach adopted will have an impact on whether it occurs.

"It might result in higher costs. It might result in wasteful use of resources that affect the environment. It could result in higher water bills because of that. It could result in theory, in more regulation being required so higher costs, but equally you could argue all of those could be less or more depending on how the regime was set up." [Water Company]

Some water companies see the drive towards competition in the water supply market – of which water rights trading is a part - as potentially detrimental to the water industry, depending on how this is handled. One respondent felt that there are dangers involved in introducing more competition into the industry, making it adopt a more short-term, financial focus and diminishing the long-term approach to planning taken by water companies and leading to an inability to properly address issues beyond the sale of water, such as environmental concerns.

"My fear is that it puts a lot of risk into the industry, there are literally hundreds of reasons why I don't like it. The industry is a long term industry and you have to plan 25 or 30 years ahead to build new

reservoirs, and the uncertainty that competition adds may prevent that long term view." [Potential participant, Water Company]

One respondent from a water company also felt that creating a situation where there would be a number of organisations in an area with different pockets of water supplies might have the effect of reducing the security of supply and introducing inefficiencies into the system.

4.3 Perception of the water rights trading process

Why have organisations traded?

Specific reasons for trading vary according to individual circumstances. However, trading activity to date seems to be restricted to the buying and selling of *surplus* water. None of the participants interviewed had factored the trading of rights into a broader decision to change their business model or land use. Rather, they had traded rights as a consequence of changes made for other reasons.

Most trades appear to be instigated by the purchaser. In some instances, organisations said that acquiring more water was essential for them to continue with certain business activities. They therefore approached the EA in the first instance to apply for new licences, and the EA suggested trading as an alternative, in some cases providing details of a potential trading partner.

Generally sellers are currently taking a passive role in trades. We only encountered two examples of trade that were instigated by sellers. In both cases it was imperative to the business that they sold their licences, either because the water acquired through them was no longer of acceptable quality for their needs and they needed to minimise the losses associated with this

situation, or because they were going out of business and were looking to sell all associated assets.

There is currently no evidence of licence-holders taking an entrepreneurial approach to the selling of licences (i.e. considering it as a potential tool to grow or diversify their business). In some cases, sellers said that the commercial benefit of trading was not the primary reason for participating. Rather, they felt that they 'might as well make some money' from an asset that they were not using, while maintaining positive relationships with other members of the local community. The only exceptions to this were the brokers that we spoke to who had all tried to generate some business through trading water rights, but in many cases had been unable to do so.

How have participants approached the trading process?

Those who have traded have approached the process in a variety of ways, suggesting that there is not a single accepted method of trading that is understood by all. The main differences in approach are that some start by approaching potential trading partners, others start with the EA, and a minority speak to land agents or brokers. There is no evidence that one approach results in a more efficient or fast trade than any other. Indeed, overall impressions of the trading process vary, with a range of contributory factors involved.

What is the role of brokers and consultants?

Our research has indicated that consultants can have a powerful influence in determining whether or not a trade is instigated. Some brokers admitted that they had warned their clients off trading because of the anticipated cost (time and money) that would be required of them. Most consultants believed that they were in a strong position to advise on this area, given their relatively broad perspective on their clients' overall objectives.

Dealing with the Environment Agency

The majority of those who have traded experienced few major problems in their dealings with the EA. Whilst the process is quite time consuming, there is a recognition that there are procedures that need to be followed and evaluating the potential impact on the environment does take time. Some said that EA was helpful and attempted to make the process run as smoothly as possible.

“My neighbour spoke to the EA to see if it was a legit trade then we got the paper-work together. The process was fine, the EA were very helpful”.

[Participant, agriculture]

However, there was some feeling that there could be scope for a more relaxed interpretation of the rules. One consultant, with experience of dealing with a number of EA offices, feels that the way in which water rights trading is handled is not always consistent. They also explain that there can often be a difference in interpretation of the law between consultants and the EA, and that some EA offices interpret the law differently to others.

“The EA is over-stuffed with staff, tripping over themselves. You have to consult so many sections, they become bogged down with the issues rather than having one person with overall responsibility.” [Consultant]

Finally, some of the forms that the EA send are thought to be quite vague, with people wondering why they are being asked for the information. Forms would benefit from being made more specific and having a more explicit rationale for the questions asked.

4.4 Barriers to more active water rights trading

4.4.1 Overview of barriers

The barriers to more active water rights trading are multi-faceted. They can be broad issues facing the potential market as a whole, or specific concerns of individuals, businesses or other interested parties, e.g. trade organisations or public bodies. Barriers to trading are often interrelated, and people generally cite a range of barriers as reasons for not trading.

We have set out the barriers described by respondents in the following section, outlining the rationale for, and importance of each. We have also described where differences in the importance or impact of barriers exist between different types of organisations.

The barriers to trading can be considered in two broad groups:

- **Passive barriers:** where for example, something is missing (e.g. understanding, awareness etc.) which prevents serious or detailed consideration of trading, and results in a lack of *desire* to do so.
- **Active barriers:** real or perceived factors which make trading difficult or impossible for those who have a desire to do so.

Within our sample, passive barriers were more commonly mentioned. Some respondents were not aware of active barriers as described above as they had simply not considered or investigated the issue in sufficient detail.

4.4.2 Passive barriers

The lack of a visible market

In general, potential participants feel that the market for trading licences simply does not exist in a true sense at the current time. Most water companies, consultants involved in the water industry and trade associations representing companies closely involved with the water industry, agree that while technically possible, the trading of rights has not yet been fully enabled or promoted. Businesses with water rights are often even less aware of the potential to trade, and assume that the concept is one which is yet to be developed and launched.

“I thought it was something that was still some way off. We're not aware of anyone locally or in business locally that needs water and can't get it. I assume you have to trade on the same stretch of water, but I don't know if that's true or not.” [Potential participant, Industry]

“There is a need to get information about which licences are being used and which aren't. This information came to me recently through a broker, but it would be useful if the EA played a role in distributing this information as well”. [Potential participant, Industry]

Without a strong sense that the market in licences exists and is operating effectively, many people simply have not considered the potential for getting involved with trading.

When discussing the potential for their own involvement in trading, businesses generally focused on whether they currently needed water or had surplus water that they might consider trading. They tended not to think seriously about the potential to change their business model, e.g. selling licences that they were currently using to a buyer who might value the rights to water more highly.

Some water companies, consultants and industrial businesses did talk in a general sense about this as a possibility within a fully operational market place, but could not see themselves trading in such circumstances. They could however, foresee that it might make it more likely that they would adopt more water efficient methods, thus potentially creating surplus water.

Water companies, trade organisations, some large industrial players and consultants generally agree that someone or something needs to kick start the market in some way, both in terms of stimulating trading through economic intervention and through better communication about trading at all levels.

“The EA could help develop a trading platform. It might just be a web page to say that licence AB123 is available for trade, if you’re interested contact John Smith... I think there are meetings that are held from time to time where this could be discussed... water events, water environment events...trading could be covered in seminars.” [Trade association]

Some water companies expressed doubts about whether Ofwat or the EA had a clear idea as to how water rights trading market might work in the future. Therefore, although they could see some potential benefits in a developed market, they were not confident that it would develop in the foreseeable future.

Inability to see the value in trading

Potential participants are generally unable to appreciate or estimate the value of becoming involved with trading. The very fact that they are not aware of an active market can suggest that the potential to benefit in a substantial way financially from trading is currently limited. This perception appears to drive further apathy in many, and some respondents explained that they were waiting to see how the market might develop before considering trading more seriously.

Some brokers, consultants and water companies were aware of some trades that have taken place to date. Trades were perceived to be of relatively low value and therefore not seen as an incentive for people to consider trading themselves.

“If it’s going to cost a client thousands of pounds of a broker’s time to trade the rights of an extraction when the rights themselves are only going to be sold or rented for £500, then trading can be hard to justify”. [Consultant]

The inability of potential participants to see and appreciate the potential value of trading leads to other barriers. When considering the potential value of trades, the most common reference point is the current cost of abstraction. However, water companies, consultants and some large businesses describe the abstraction component of operations as a relatively small proportion of costs. They therefore assume that the market would be somewhat marginal compared with other business activities.

The potential size of the market was also mentioned as a barrier to involvement. Again, when the value of participation is not understood, potential participants assume that other parties will also not be likely to participate. Some respondents suggested that water companies would be unlikely to trade licences when the returns on doing so were difficult to predict and the value of retaining capacity so potentially high. Some consultants and potential new entrants feel that water companies have little incentive to sell unused licences when they can instead sell water at a greater profit to whoever may need it; either industry, agriculture or new water supply licensees.

Some potential participants feel that while trading of licences is limited to the same catchment area, the laws of supply and demand will not result in trading activity. Put simply, they feel that in areas where water is in plentiful supply there is no potential market to sell to, and where water is more scarce there is not a potential market to buy from (businesses will not be willing to sell).

“There was no demand – no one’s asking us for the water”.

[Potential participant, Water Company]

Finally, some brokers and potential brokers suspect that some licences yield less water in reality than is stipulated in their terms. This suspicion can lead to concerns that potential trades would fail, as the buyer would not receive the value they expected.

Lack of awareness and understanding of the water rights trading process

The perception that a fully operational market does not yet exist, and doubts over when it might exist mean that the issue of water rights trading is often not an issue that is given detailed attention among potential participants.

This lack of engagement with the issue appears to result in a lack of understanding of the water rights trading process. Most respondents had little detailed understanding of how the process works, particularly those without an existing interest in the topic or strong links with Ofwat and/or the EA.

“Well, I don’t know, if it means I get lower water bills, fine, I don’t really know. If I have an asset here and I don’t know how to trade it, I don’t know what the benefits are.” [Potential participant, industry]

In some instances (often potential participants from industry and agriculture) respondents had no knowledge of how the process would work; who would

broker the trade, what involvement (if any) government agencies would have or what the administrative cost of trading would be.

“It needs to be made clear how the system can work and there needs to be clear accessible information so that people can understand easily how it's done.” [Industry – potential participant]

In addition, they (and others including some water companies, consultants and trade associations) were unsure of what the ‘rules’ of trading are, or might be in the future. Specifically, uncertainty exists about:

- **The nature of trades:** respondents were generally unsure whether limits were currently imposed on the length of a trade or whether trading parts of licences was permitted.
- **The rules relating to the physical abstraction activity:** some businesses with a borehole were unsure whether those to whom they sold their abstraction licence would be required to abstract from that source also. If they assumed that this was the case, they felt that this presented a considerable logistical barrier to trading. However, the lack of certainty itself can also prevent further action being taken in relation to trading.
- **The law relating to who is permitted to trade:** some potential participants and brokers are unsure about the regulations relating to the right to trade. Water abstraction licences have often traditionally been linked to land ownership. Some questioned whether the linkage between the two would have an impact on the potential to trade licences.

Hoarding and future uncertainty

Water is viewed as a vital commodity which is relatively unpredictable in terms of availability over time, and becoming more so. This means that many people in possession of rights to abstract are naturally inclined to hold on to them. Both industry experts and organisations who had licences, agreed that the lack of a visible market and the relatively low cost of keeping licences only served to reinforce this tendency to hoard. Indeed, some felt that the incentives required to overcome the psychological predisposition to hold on to water would need to be very compelling, and doubted that any market would deliver them.

Businesses for which water is at the core of their commercial activity (water companies and some industries with high water-usage) often regard protecting this resource as a key priority for the future. It represents the 'lifeblood' of their operations, and it is therefore seen as simple good business to keep hold of licences. These businesses are also aware that their requirements for water may change in the future; in some cases due to long term expansion plans, and in others based on an understanding that the business landscape is likely to change, and they may need to change their model to fit this.

"I was always told, 'We don't sell licenses.'" [Trader, Industry]

"I have the impression that utilities companies often hoard the abstraction licences that they have." [Water Supply Licensee]

Non-commercial factors can also lead to uncertainty about the future, and a tendency to hold on to licences that are not being used. Respondents were generally aware of the potential for climate change to impact on rainfall and the availability of water in the future. Often, respondents were unsure of specifically how this might affect their businesses. The lack of certainty around the issue encourages caution in relation to selling rights. Some consultants and

respondents working within the water industry felt that uncertainty around the ongoing development of the EU Water Framework and Habitats Directives, and how the EA will respond to these in terms of the development of the next stage of Catchment Area Management Schemes (CAMS) also prompts caution around selling licences. They felt that these directives were still in a state of flux, and as a result abstraction licences were at considerable risk of being revoked or reduced in the future.

Expected changes in the water abstraction licensing regulations may also add to a general sense of uncertainty and caution in the market. Water companies, consultants, brokers and industry representatives noted that all future licences will be time-limited, as opposed to in perpetuity. Some felt that this situation would discourage the selling of existing permanent licences (as it will not be possible to replace these in the future) and possibly make purchasing of licences unattractive as business planning and securing funding on the basis of having a ready water supply would be more problematic if only short-term licences were available.

“We are expecting to have time limited licences imposed upon us I believe in the not too distant future, and it's not exactly clear to me how that works with water rights trading.” [Potential participant, industry]

Incumbent water companies stressed the importance of maintaining sufficient headroom on their licences to cope with drought situations or fluctuations in demand. They take their statutory obligation to maintain public water supply seriously, and therefore are often not inclined to consider relinquishing rights; and certainly not on a long term basis.

The question of selling rights to new entrants to the water supply market was addressed by some water companies. While the overall concept of competition

in water supply is understood and the drive to deliver it accepted, some raised questions about the ability of water rights trading to facilitate entry into the market. They explained that were they to sell abstraction rights to new entrants, as the incumbent supplier, the legal duty to guarantee potable water supply to the public would still be theirs. They felt that this detail would need to be addressed in the regulations relating to trade, either through exemption, financial compensation or the terms and conditions relating to the trade.

Some brokers and land agents explained that some licence holders simply would not consider trading their licences because they consider them as integral to the value of their land; or have high (and sometimes unrealistic) expectations about the value of their licences (particularly those with high value land). This view is thought to be particularly prevalent amongst farmers.

While most potential participants feel that the market in water rights has not yet been established, many assume that it may do in the future. Most are unable to attach a measurable timeline to this assumption, but it does impact on propensity to consider trading at this point in time. Many assume that as water generally becomes scarcer, its potential value will increase. Therefore, it makes commercial sense to wait until the market is developed and the value increases.

Some businesses and farmers with licences which they are not using, and which only cost a marginal amount to maintain, said that they *might as well hang on to the licence* as an investment for the future. Clearly this has the potential to encourage stagnation, as nobody wants to be the first to enter a market which they consider is only likely to rise.

Alternatives to trading

The need to participate in formal trading of water rights can be avoided through other activity. Some licence holders in different commercial environments have

developed ways of sharing water with one another, or reducing their need for water, thus removing the need to buy licences. Given the potential difficulties with trading licences (described in more detail below), some organisations see these alternatives as a preferable solution. Examples of alternatives are:

Agriculture:

- Farmers rent land (complete with water rights) to one another, rather than entering into trades.
- They develop winter storage reservoirs to deal with seasonal fluctuations, meaning that trading is not necessary (although a large investment).

Industry:

- Businesses implement measures to deliver greater water efficiency. These include water recycling and reclamation, leakage control and demand management.
- Others simply structure their business activity according to the water available to them at the current time.
- Some enter into informal agreements with neighbouring enterprises: e.g. a factory allowing a neighbouring farmer to use its borehole in exchange for coverage of the abstraction fee.

Water companies:

- Some water companies had looked at the option of leasing access to water on a short-term basis neighbouring land-owners, businesses or farmers.
- Others simply transfer water to one another when one has surplus and another has a need. They explained that this practice is encouraged by the regulator.

4.4.3 Active barriers

There also appear to be a number of tangible barriers which make trading difficult or impossible, even for those who would like to. While some of the barriers outlined below had been experienced first-hand by those who had traded or attempted to trade, they were also mentioned by people who had not actively investigated making a trade, but were aware of the issues anecdotally.

Feasibility of making suitable trades

The trading of rights is currently limited to systems which are hydraulically linked. Licences are classified by CAMS as well as management units within CAMS, and trading is only permitted within the same catchment area (or sub-catchment area). Some potential participants and consultants regard this physical restriction as key a barrier to trading. They say that the result of this regulation is that the potential pool of licences which can be traded is small from the outset, reducing the likelihood that a mutually beneficial trading situation might occur.

The potential for trading is reduced further by other specific restrictions described by respondents across the sample:

- **Limits on the potential abstraction points:** The fact that rights can only be traded for abstraction downstream of the original point was described as a very tangible barrier which is difficult to overcome. Some potential new entrants and consultants advising industry said that this issue adds to the complexity of planning for a new enterprise which may rely on the traded water rights.
- **How the water will be used:** The fact that the trade needs to take into account the consumptiveness of the water (determined by what it's going to be used for), might also restrict the potential number of trades. For example, water for spray irrigation is likely to use more water and

take more water out of the environment than water to be used on fish farms or for power generation.

- **The cost of transporting water:** If abstraction is only permitted in limited geographical areas, the issue of transporting water becomes important. Some organisations which may potentially be interested in becoming water supply licensees, along with businesses which might consider selling licences, said that the cost of the infrastructure required for transporting water in volume was simply too great to warrant serious consideration.
- **Concerns about the quality of water:** Businesses relying on a particular quality of water for manufacturing or other commercial processes said that they would be concerned that any new water acquired through trading might not meet the required standards.

The physical barriers to trading are often said to be exacerbated by a lack of information. Organisations who have investigated trading, or consultants with knowledge of trading pointed out that information around the whole issue of water rights trading is very difficult to find, and is not always useful. They say that information about the geographic location of available water / unused licences and about the licence holders themselves is not easy to find. Interested parties are required to ask the EA for this information themselves, rather than it being readily available to those who need it and the information is not always complete. Furthermore, respondents pointed out that there is no immediately obvious place for licence holders to advertise licences that are available for trade.

Restrictions on trading and the reduction of rights

A key barrier to trading is the perception (or experience) of the EA either refusing to allow a trade or restricting the terms of the licence at the point of trade. Those who had traded had experienced this, and some explained that it

has made them less likely to trade in the future. Several respondents are aware that EA have been known to reduce/alter licence terms at the point of trade, not least through placing a time limit on the licence. Only a minority of potential participants and brokers had direct experience of being turned down for trades, but others felt that this would be quite likely given the current policies of the EA.

"The EA tend to claw back licences. If someone's trading a licence and it is 10 mega litres a day then it may well be that they get 8 as a net licence after the trade." [Potential participant, Water Company]

Some consultants and water companies are under the impression that the EA is using the trading of rights primarily as a means to reduce or manage abstraction levels rather than working for the benefit of the licensees/ potential licensees. There is a perception among some that the agency adopts an overly cautious approach to its decisions around abstraction, rejecting proposals when the evidence base is not considered clear-cut by all.

Concerns about the reduction in rights at the point of a trade lead to a reluctance among many with spare water to even investigate the possibility of trading. Some water companies and businesses said that were they to approach the EA and declare that they might have water to spare; the licence in question would be reduced, restricted or revoked.

"I just phoned them [Environment Agency] up and said we want to trade this, and is it something we can do? They said no, under the circumstances, we can't allow you to trade this licence... I remember the catchment in question was quite stressed and there was quite a shortage of water in it." [Potential participant, Industry]

One water company spoke of how in the past, when they have mentioned that they were thinking of reviewing their use of a particular source of water, it has been taken as confirmation that they no longer have need of it and the licence will be revoked/ surrendered. It was also not lost on people that all the examples given on the EA website explaining the water rights trading process, involve a reduction in abstraction.

There is also the issue that once a licence is traded, it becomes time-limited, whereas people prefer to have licences that are in perpetuity, especially as renewal of the licence – whilst there is a presumption that it will be renewed – cannot be guaranteed.

Difficulties with the trading process

Perceptions of the trading process are discussed in section 4.3 of this report. Below, we summarise issues around the process (or perceptions of it) which could constitute barriers to trading:

- **Lack of available or accurate information:** A few respondents noted that the quality of information available about trading could be improved. For example, one broker was given inconsistent information by the EA about the transferability of licences (they were told that sleeper licences were still transferable, but subsequently found this not to be the case).
- **The length of the process:** Brokers, potential brokers and organisations who have participated in trades generally feel that the process of trading is quite long. They quoted timeframes ranging from 6 to 18 months from deciding to trade to completion (including the time taken to advertise the trade), depending on the level of complexity. This amount of time can be considered too long if temporary trading is to be considered. Some who had not experienced trading first-hand suspect that the process will be long and involved, and assume that they would need to spend time monitoring the impact on water supplies, exploring the environmental

impacts and negotiating with the other party in the trade about the logistics and price. While the length of the process was often described as not ideal, most feel that it is necessary for a trade to be successful, and some of it is determined by statutory requirements.

- **The costs of the process:** Potential participants suspect that the cost of trading will be high. They assume that they would need to pay for internal resource to investigate the viability of the trade and deal with the administration, as well as fees for professionals (e.g. lawyers, brokers or environmental specialists) to assist with the trading process and/or an environmental impact assessment. Some participants who had experienced trading first hand said that the cost of advertising trades was particularly high. When the potential value of trading is not fully appreciated, the costs of the trading process become relatively more important in the decision-making process around whether to pursue a trading opportunity.
- **The complexity of issues and the level of expertise required:** Some water companies and consultants suggest that a considerable level of knowledge is required to make a trade work and not everyone has access to this expertise. A few potential participants in industry were concerned that the process would be complex and difficult to deal with, based on their experiences with carbon trading. This negative experience was enough to put serious doubt in the mind of one respondent about considering trading water rights.

Problems with the trading process are likely to limit willingness to participate (again) in trading to some extent. For example, some brokers and potential brokers said that they advise clients against trading unless they are certain it will be successful as the time and costs involved are too great. However, concerns around the process were less evident among water companies or potential brokers, with experience of dealing with the EA. They said that were

they to participate in trading, process issues would be dealt with using their existing knowledge and systems.

Broader barriers which may prevent the market from developing

The trading of water rights does not occur in isolation. Rather, it takes place against the backdrop of a wider regulatory framework and the commercial environment, both of which can have an impact on the potential for the market to develop.

One of the potential benefits of trading rights is to encourage new entrants into the water supply market, stimulating competition and fairer prices for consumers. While this principle is often understood and accepted by those with an interest in entering the supply market, or those with a broader understanding of the issues (e.g. consultants and industry bodies), doubts exist about the delivery of this in the current regulatory climate. Some in the industry feel that the margins achievable for new entrants are too small to encourage true competition in the water market at a broad level. The reason most commonly mentioned for this is the high cost of gaining access to distribution networks. Water companies and consultants said that the question of accessing water through the trading of rights was redundant if the economic argument for supplying water cannot be made.

Other complications and difficulties around the implementation of a successful trade were noted. One respondent gave the example of a new entrant moving in to supply water to a new development or commercial activity in an area. As well as trading the licence itself, a great many other commercial deals would need to be struck around storage and delivery / movement of the water, maintenance etc. This example illustrates that not all barriers to trading are explicitly related to the trading process itself, but are linked to a wide range of other factors, not all of which are under the control of Ofwat or the EA.

4.5 Likelihood to Trade

4.5.1 How likely do people think they are to trade?

The majority of potential participants said that they would not discount the possibility of trading water rights, once the main barriers had been overcome. However, around a half of these were not sure how likely they would be, as they did not feel confident predicting what the market would look like in the future. Obviously, the key requirement for whether they would actually make a trade would be determined by a variety of different factors inputting into a cost / benefit analysis, resulting in such a trade being in their interest.

So for example, the higher the potential value of the water rights, the more likely it is that people will consider selling, as this would help to overcome any concerns they may have and make the investment in time and energy expended in making the trade worthwhile. Should the potential value be lower, then of course making a trade becomes less attractive, and the more likely it is that the time and money spent in making a trade will be considered prohibitive. Such a scenario might then make it more likely that trades would be generated by brokers, who could build up expertise in managing the process cost-effectively, and thus be able to make trades viable.

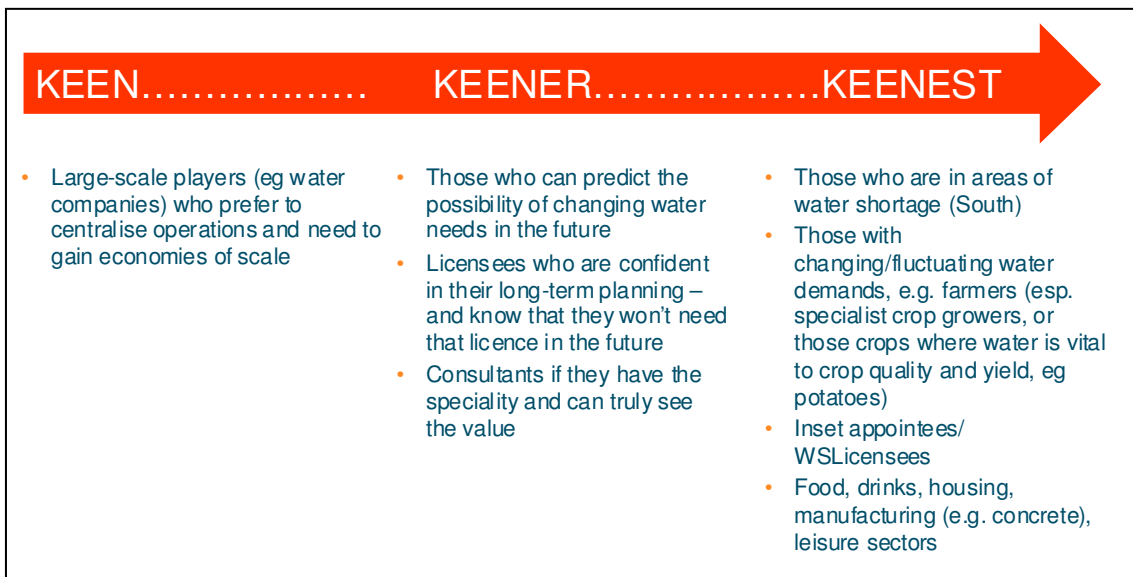
Around a third of potential participants said that they would be unlikely or very unlikely to trade. Generally they could not see any need to buy or sell, and assumed that there were no potential trading partners within the relevant catchment area(s).

Within our sample:

- Approximately a third said that they were likely to consider buying water rights in the future
- Approximately a third said that they were likely to consider selling water rights in the future

4.5.2 Which groups are most likely to trade?

The chart below shows which groups tend to be most likely to want to take part in water rights trading:



4.5.3 What would encourage people to take part in trading?

There are a number of ways in which respondents could be encouraged to trade, although overcoming the barriers in previous sections will of course play a key role in this.

Financially, respondents would either need an incentive to sell in the sense of a good price for the water rights, or a reason not to keep the licences, through making it more costly to actually renew them. Certainly at present, the cost of ownership of licences did not tend to encourage people to want to get rid of them.

However, as discussed previously, the value of the water rights is only one input into the cost / benefit equation. The potential profit on making a trade

would need to be sufficient to cover their costs incurred and be sufficiently large to make the effort worthwhile. They also suffered from not having any current point of reference: they do not know what water rights are likely to trade at. Respondents were thus not able to define an exact figure as to at what point they would be interested in selling their water rights. It would be very much dependent on the circumstances of the individual trade and the parties involved.

4.6 The value of water

One of the key perceived benefits of establishing a water rights trading market is that it will reveal the true value of water. This is also a key piece of information that people would like to know before getting involved in trades, and indeed, is a barrier for people entering the market.

Given the early stages of development of the market, it is not possible to currently identify what that value might be, however, we do have some feedback on what people have been paying for water rights, and how they reached these figures.

In the absence of any pricing information, the value of each trade is negotiated according to individual circumstances. The calculation appears to be:

- From the seller's perspective – what would the buyer have to pay to obtain the water from another source? Usually looking at the cost of mains water as the benchmark.
- From the buyer's perspective – what is the cost of the licence as it currently stands i.e. the renewal charge levied by the Environment Agency?

Other potential sources of information regarding the value of water can come from various sources. In the farming world, there are some other comparative measures:

- Rental values of land – with and without water
- The price of water (as opposed to the rights for water)

According to one land agent who had acted as a broker:

- When renting farming land, the approximate charge for supplying and applying water to the crop would be £30-£35 per acre inch, which works out at approximately 35p per cubic metre of water. 15-25p of this would be for the actual application, leaving approximately 10p per cubic metre to cover the value of the water/ the cost of the licence and the infrastructure being used.
- When renting farm land for a particular crop for one season, the approximate rental values are currently reported to be:
 - o £150-£200 per acre without water
 - o £225- £300+ per acre with water, possibly with an additional charge for administering the water

The land agent had estimated that in theory, the value of water rights should be approximately 10x the value of the water, estimating that in theory, the value of water rights should be up to approximately £2.50-£5 per cubic metre, although this will of course vary according to location, quality, volume etc. However, it does not seem to have reached these levels, only going as far as 50p - £1.50 per cubic metre

This estimate has been backed up by values from other trades, which have varied between approx 60p-£1 per cubic metre.


4.7 Overcoming the barriers

As we have seen, people are generally in favour of the principle of water rights trading. They would be interested in finding out more about it and in seeing how it works 'when it gets up and running'.

However, at this stage it is an unknown quantity: no-one knows what might happen. It therefore seems sensible to ensure that progress is carefully monitored in terms of impact on participants and consumers.

A key issue facing Ofwat and the EA will be balancing the need to 'step back' and let the market run its course, yet retaining sufficient control and powers of intervention, to avoid any potentially negative impacts as the system develops. Close monitoring of the development of trading will provide an opportunity to anticipate possible impacts of each.

The key potential steps suggested by respondents are summarised below.



Action	Aim
<ul style="list-style-type: none"> Remove barriers to development of a central 'market-place', with definitive licensing information 	<ul style="list-style-type: none"> Maximise the chance of people finding a trading partner
<ul style="list-style-type: none"> Create and communicate value in trading – increase cost of licences; promote the advantages of trading 	<ul style="list-style-type: none"> Encourages trading and gives a clearer indication of value of water
<ul style="list-style-type: none"> Remove 'penalties' for trading 	<ul style="list-style-type: none"> Reduce the 'fear' of trading and help overcome hoarding behaviour
<ul style="list-style-type: none"> Standardise the trading process to make it quicker and more accessible 	<ul style="list-style-type: none"> Remove possible 'stumbling blocks' to those with an interest in trading
<ul style="list-style-type: none"> Offer flexibility in trading – around length of tenure/ proportion of rights traded 	<ul style="list-style-type: none"> To allow potential participants to find a solution that 'fits' their needs
<ul style="list-style-type: none"> EA/ Ofwat to take a leading role – provide clarity, transparency and consistency 	<ul style="list-style-type: none"> Reduce uncertainty and stimulate interest in trading

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We will now explore these topics in more detail.

4.7.1 Awareness and Availability: Allowing a central market place for water rights trading to develop

One of the key barriers to water rights trading seems to be the difficulty in actually matching potential buyers and sellers. As earlier sections have shown, there are a number of issues which impact upon the ability to do this, both **physical** – for example, being restricted as to the degree that the point of abstraction can be moved; and **procedural** – gaining access to information regarding what licences are in existence in an area.

For water rights trading to be a success, it is important to remove as many potential barriers to a trade as possible.

A starting point in helping to overcome these issues, would be the development a central 'market-place' where everybody knows they can go to buy and sell licences. This would help people to access the system and highlight the fact that trading is an option.

It could be argued that Ofwat or EA are well placed to set up and administer such a market-place. However, as described above, there is a need for the regulator to 'step back' from the process of trading in order to allow the market to develop and actual values to emerge. Therefore, there is a counter argument which suggests that were any concrete actions taken to proactively create a market place, this should be carried out by a body independent of Ofwat / EA. However, were the development of a market place to be left up to the private sector, it is important that Ofwat / the Environment Agency ensure that as few barriers exist to the development of such a market place as possible.

The development of a market place should be linked to, and supported by the availability of a comprehensive set of licensing information, by (sub) catchment area, to help people to identify potential participants. This information should be as comprehensive as possible, providing contact details as well as information regarding the actual licence. While information regarding the abstraction situation within the catchment area (i.e. is it currently over-licensed/ abstracted etc) is available via CAMS documentation, people are often not aware of it. Raising awareness of the existence of this information, and therefore encouraging access to it would help people to gauge the likely demand for abstraction rights.

Finally, participants would also like to see, where possible, a relaxation of the rules around the moving of the point of abstraction. Doing this would increase the number of potential trading partners and thus the potential for trading, and make the licence more useful.

These actions would mean that if someone wants to trade, they can easily find out who the most likely potential trading partners might be. The creation of a market place would help generate interest in water rights trading; maximise the number of trades that could take place, and in doing so, also help to drive out the potential trades and indeed, whether there is a market for water rights trading. Whilst most people are in favour of the principle of water rights trading, no-one knows whether this appetite for trading is sufficient to overcome the practical barriers involved. The appeal is with the principle, but it is important to remember that the trading generally takes place at a local, restricted level, and is therefore usually dependent on a large number of geographical and environmental factors being in favour of a trade. This market place would help to demonstrate what level of interest there is in water rights trading.

“An improved directory of licences with contacts would be useful...just knowing that there are willing people out there.”
[Potential participant, industry]

4.7.2 Create and communicate the value of water licences

One of the aims of promoting water rights trading is to help establish a value for water. However, it seems that many people are waiting to gauge a value before committing themselves. We therefore suggest that Ofwat/ EA need to consider regulatory intervention to set the cost of licences according to the availability of water. This would at least make the cost of water more reflective of its true value and hopefully help to ‘start the ball rolling’.

A more appropriately structured charging system might also encourage people to trade licences as in some cases the cost of keeping hold of them is likely to become more significant. At present, the cost of renewing licences is generally felt to be relatively small, meaning there is no business imperative to sell them. This reinforces people’s hoarding behaviour.

Allied to this, there is also a role to be played in communicating the likely value of licences, whether through providing a framework to allow people to estimate the value of their licence, or for example, through publishing details of how much licences had been traded for². Simply promoting the possibility of trading more aggressively, when combined with the other measures, will also help to bring the issue to the front of people's minds and become something that is nearer the top of their agenda. Trade Associations in relevant industries could be a useful ally in this. They are looking to find ways to help their members, and once established, promoting and assisting with water rights trading is likely to be a possible service that will provide their members with a benefit.

4.7.3 Remove the 'penalties' of trading

The role of the EA in the trading process – whether actual or perceived – is currently a barrier to trading. Ofwat / EA could help to overcome this barrier by considering ways of reassuring potential licensees that they will not automatically have their licences reduced or restricted at the point of trade (and in the future).

A number of respondents felt that when establishing a market-place for water rights trading, there should be an **impartial, independent facilitator** for the trades. This would help ease concerns, encouraging organisations to explore the commercial viability of trading without fear of demonstrating to the agency that they did not need a licence (and therefore risk losing it). Some suggested that the EA could actually become an active participant in the trading process, thus helping to stimulate the market.

² Given that some people might view this information as being commercially sensitive, it may be that this would need to be anonymised in some cases.

Where any reductions or restrictions need to be made, respondents felt it would help if the EA could communicate a more transparent 'position' on this in terms of the criteria used to make such decisions.

"If the agency could give reassurances to the producers that they wouldn't do it (reduce rights) unless there were impacts on a nearby protected site or habitat, I think that might ease concerns, not in all cases, but it might do for some people." [Consultant]

4.7.4 Making the trading process easier

There are currently generally low levels of knowledge regarding how to actually make a trade, with most people who have thought about it assuming that it would involve the two parties working out an agreement from scratch, and also having to get involved in various evaluations of the impact of any variations to the licence – environmental impacts etc.

Improvements to this would be to:

- Ensure that everyone has access to information about the 'mechanics' of the market. If they can understand what the process will be and easily evaluate the time, effort and expense required to make a trade, they will then be able to make a judgement as to whether it is worth proceeding. Currently, many do not get this far or make assumptions that are unlikely to be accurate.
- Identify ways in which the process could be speeded up. Trades can take up to 18 months in total to complete, with the general assumption that it would take approximately 6 months. Whilst some of this time is obviously dependent on the negotiations between the two parties, any way of speeding up the assessment of the trade application would be helpful.

- An important factor in achieving this would be to introduce more **standardisation**, in terms of the products and the legal processes. The main distinction would be between the permanent and temporary trade of rights for a set period of time. Given people's attitudes towards abstraction licences, it would seem likely that sellers would find most appeal in making temporary trades.
- Given the complexity and individual nature of each licence, it is likely that there is only so much standardisation that can take place with regard to the product, but a standard set of terms and conditions would at least prove a useful starting point and could be amended where necessary. A key point of principle mentioned by a number of respondents was that when trading temporarily, responsibility for the abstraction and any consequences, should rest with the abstractor rather than the original licence holder (otherwise they will be liable for the behaviour of people over which they have no control). This is a point for clarification with prospective traders, as this does actually happen already: responsibility transfers to the buyer through the new or varied licence.
- Standard terms and conditions should help to provide clarity and certainty around the process at the end of the trading period.
- It also needs to be clear that licence holders are allowed to sell part of the licence as well the licence in its entirety.
- The difficulty will be in balancing the needs of the buyers and sellers. Both of course, want the best terms available, but the seller is often likely to want the opportunity to revoke the deal if necessary (especially water companies, who might like reassurance that they can claw back water sources in times of scarcity); whilst the buyer will often want as much certainty/ guarantee of supply to enable them to make future plans. It will need to be made clear that this is something that the two parties will need to negotiate between themselves.

There is therefore a balance to be made between standardising the process to make it as easy as possible to trade, whilst allowing sufficient flexibility to allow potential participants to find a solution that ‘fits’ their needs, as well as reliability and reassurance that they will not be ‘trapped’.

4.7.5 Greater ‘leadership’ from the EA/ Ofwat

As described above, there is a degree of uncertainty about the role and motivations of Ofwat and in particular the EA. Many feel that the regulator and EA will need to ‘make water rights trading happen’:

“They’ve both very heavily into regulation, so I don’t know why they think we’re just going to get on with it.” [Consultant]

As we have seen, there is widespread uncertainty regarding the role of the EA, with the perception that the organisation will get involved at the point of trades and reduce the volumes being sold and/ or impose tighter restrictions. Greater transparency would help to minimise scepticism, encourage take-up and stimulate the market.

“I’d like to see the opening up of the facts, getting over the secretive nature of their plans.” [Inset Appointee]

Most respondents accept the need for an over-arching regulator in the water rights trading market (indeed many feel it should be a leading role in terms of stimulating and driving the market forward), and most believe that Ofwat and the EA have key parts to play:

- Ofwat: providing financial and economic acumen. Many see a key role for Ofwat in putting in place the right regulatory framework to encourage competition in the water supply market at a general level

- Environment Agency: environmental considerations are imperative in the success of water rights trading. Most say that the EA has a role to play as an educator and information provider (e.g. providing easy and accessible lists of licensees, areas where water is available etc)

Many feel that a central organisation must exist to 'manage' trades, provide information etc, but there is also a general desire to see an end to degree of control currently imposed by EA. This facilitator should therefore be independent of the EA/ Ofwat.

It will also be important to clarify the role and motivations of the regulators to try to dispel some of the confusion and misperceptions that currently exist.

Appendix

- A. Detailed Methodology
- B. Discussion Guides
- C. Stimulus Material

A. Sample Profile

Stage one

A total of **10 executive depth interviews** were conducted amongst a range of industry 'experts' and individuals with a broad understanding of water abstraction and licence trading.

The sample profile was as follows:

Type	No. of depths
Trade associations / industry bodies	5
Academics / economists	3
Brokers	2
Total	10

The details of the interviews are as follows:

- 5 conducted by telephone; 5 conducted in person
- Interviews lasted between 40 mins and 1 hour
- Respondents were recruited by telephone, using a short screening questionnaire from sample provided by Ofwat / EA
- All interviews were audio recorded and the recordings analysed

Stage two

A total of **36 executive depth interviews** and **29 semi-structured interviews** were conducted amongst a range of industry 'experts' and individuals with a broad understanding of water abstraction and licence trading.

The sample profile was as follows:

- 2 x current brokers
- 4 x potential brokers (land agents and consultants)
- 6 x organisations representing companies which may wish to trade existing licences
- 2 x organisations representing companies which may wish to enter the water supply market
- 9 x organisations who have participated in trades
- 11 x water companies
- 3 x inset appointees
- 5 x water supply licensees
- 20 x companies which may wish to trade existing licences
- 3 x companies which may wish to enter the water supply market

B. Discussion Guides

Stage one

Ofwat/ EA Water Rights Trading Research – Stage 1 Depths

Discussion Guide

Introduction

Interviewer/ Synovate introduction

Nature/ purpose of the research inc Ofwat/ EA sponsorship

MRS Code of Conduct / confidentiality

Recording

Duration – Up to 1 hour (times to be adjusted according to respondent availability)

Background

Respondent introduction

- job title
- job role
- where/ how fits within organisation

Organisation

- purpose
- description of activities

Where / how does water abstraction fit

- interest in the issue of abstraction and rationale
- role played in water abstraction
- relationship with the water industry
- interest in the industry

Overview of water abstraction

Relationship between different organisations with an interest (esp Ofwat and EA)

- description
- positive / negative

Key trends in the water abstraction, and the industry

- recent past/ current/ future
- importance

Key issues facing the water abstraction, and the industry

- recent past/ current/ future
- importance

Water Rights Trading

Awareness of water rights trading

- level of understanding
- description

Overall perceptions of water rights trading

- good thing/ bad thing
- rationale

Benefits of water rights trading

- currently being realised
- potential in the future
 - o Benefits of attributing market values to licences?

Who will benefit?

- how will they benefit?
- how much will they benefit?

What are the implications of having water rights trading?

- significance?

Drawbacks of water rights trading – whether real or potential

- currently being realised
- potential in the future
 - o Drawbacks of attributing market values to licences?

Who is being / will be affected?

- how significant are the drawbacks?

What are the implications?

- significance?

Expectations of a fully traded water rights market

- what would be the main affects of a fully traded market?
- who would be most likely to benefit / lose out?
- how would the market vary geographically?

Who should/ could water rights trading be of **most** interest to?

- description/ definition
- why would it be of interest to them?
 - o positive / negative
- how important/ useful / interesting would it be to them?
- number of people/ organisations affected
- who would be responsible for this within the organisation?

Who should/ could water rights trading be of **some** interest to?

- description
- rationale
- number of people/ organisations affected
- who would be responsible for this within the organisation?

Is there anyone who you think water rights trading will **not** appeal to?

- description
- rationale
- number of people/ organisations affected
- who would be responsible for this within the organisation?

Triggers and barriers to water rights trading

Who is currently involved in water rights trading?

- awareness
- description

Why do you think they are involved? What are the benefits to them/ the triggers to get involved?

- description
- relative importance

Who is **not** currently involved in water rights trading?

- awareness
- description

Why do you think they are **not** getting involved?

- description
- rationale

What are the **barriers** to involvement?

- description
- who do they impact on?
- relative severity/ importance

How can people/ organisations be encouraged to take part in water rights trading?

- description
- rationale

What price incentives would be needed to encourage people to take part?

- price level vs likely impact on future trades
- what is the optimum level?

How can the barriers to water rights trading be overcome?

- description
- rationale

Could the processes be improved at all?

- how?
- potential impact of this?

The Future of Water Rights Trading

What should Ofwat / Environment Agency be aiming at?

- What will success look like?
- What should be avoided? Situations/ occurrences
 - o description
 - o rationale

What steps need to be taken to create liquidity in abstraction rights?

- How would this vary by licences...
 - o Held and used by existing parties?
 - o Held but unused?
 - o Newly created?

What types of rights trading are likely to be of most value / be most relevant to potential participants in the market?

- Probe on long term Vs short term allocation rights
- Probe on bilateral agreements (with specific terms and conditions) Vs standardised products (traded electronically)
- Explore pros and cons of the above and rationale

What needs to be done to develop the water rights trading market? Who by?

- description
- rationale
- responsibility

What should Ofwat / Environment Agency do to help develop the water rights trading market?

- description
- rationale
- relative importance

Could the processes be improved at all?

- how?
- potential impact of this?

Are there any other external factors that might influence the outcome?

- description
- rationale

How might they be controlled? What could be done to affect them?

- description
- rationale

Are there any lessons that can be learnt from elsewhere in the world/ other types of trading markets, for example emissions trading?

- description
- rationale

Round up

Review of key themes

How do you think water rights trading will develop in the next few years?

What are the key opportunities that need to be capitalised upon?

What are the key issues/ drawbacks that need to be addressed?

Key message to take back to Ofwat/ EA

- what are the top 3 priorities for them to do?

If necessary, explain next steps of the project:

- further desk research to scope out the potential market for water rights trading
- a broader stage of qualitative research to explore levels of interest in water rights trading and identify barriers to doing so

Thank & close

Stage two

Ofwat/ EA Water Rights Trading Research – Stage 2 (Overview Organisations)

Discussion Guide

Introduction

Interviewer/ Synovate introduction

Nature/ purpose of the research inc Ofwat/ EA sponsorship

MRS Code of Conduct / confidentiality

Recording

Duration – 1 hour (face-to-face); 40 mins (telephone)

Background

Respondent introduction

- Job title
- Job role
- Where/ how fits within organisation

Organisation

- Purpose
- Description of activities

Where / how does water abstraction fit

- Interest in the issue of abstraction and rationale
- Role played in water abstraction
- Relationship with the water industry
- Interest in the industry

For trade & industry bodies / environmental bodies...

- Explore their role within the industry
- Explore how their members use / abstract water
- Do they tend to hold abstraction licences?
- Are full entitlements typically used? Examples?
- Any trends in abstraction which may release water on a temporary basis for trading?

Overview of water abstraction

Relationship between different organisations with an interest (esp Ofwat and EA)

- Description
- Positive / negative

Key trends in the water abstraction, and the industry

- Recent past/ current/ future
- Importance

Key issues facing the water abstraction, and the industry

- Recent past/ current/ future
- Importance

Water Rights Trading – awareness and understanding

Awareness of water rights trading

- Level of understanding
- Description

Refer respondent to description of water rights trading and example(s) – these will be sent to respondents in advance of the interview)

Check comprehension and levels of understanding after looking at the examples

Water Rights Trading – experiences (where relevant)

ASK BROKERS ABOUT TRADES THEY HAVE BROKERED AND TRADE BODIES ABOUT TRADES THAT THEIR MEMBERS HAVE MADE THAT THEY ARE AWARE OF

How many times have you / organisations you represent traded water rights?

Who did you / they trade with?

What were the circumstances that led you / they to trade water rights?

- Were you / they the donor or the recipient?

What was the nature of the trade(s)? Explore...

- Length of trade
- Whether full or partial quantity traded
- Over what geographical area the trade took place
- The price paid (if willing)

What would the parties involved have done had they not been able to trade water rights?

How easy was it to make the trade?

Have you / organisations you represent ever tried to trade but been unsuccessful?
Why?

Can you suggest any improvements to the administrative process that would have improved the trading experience?

How have the organisations you represent / acted as a broker for benefited from water rights trading?

ASK TRADE BODIES: Who would organisations you represent be likely to consider entering a trade with?

- Explore likelihood to trade outside of own sector, and rationale for this

ASK BROKERS: How have you gone about promoting your services as a broker?

- How easy have you found it obtaining information to undertake your brokering service?
- What would make brokering easier?

Water Rights Trading – Impressions

Overall perceptions of water rights trading

- Good thing/ bad thing
- Rationale

What do you think are the **benefits** of water rights trading?

Who will benefit from it? Do you think you could benefit from water rights trading? If so, how?

What, if any **drawbacks** are there to water rights trading?

Who, if anyone, might lose out as a result of water rights trading? Why?

What sort of organisations do you think are currently involved in water rights trading?
(IF APPROPRIATE PROBE FOR SPECIFIC EXAMPLES AND REFERRALS)

Why do you think they have got involved? What are the benefits to them/ the triggers to get involved?

Who should/ could water rights trading be of **most** interest to?

- Description/ definition
- Why would it be of interest to them?
 - o Positive / negative
- How important/ useful / interesting would it be to them?
- Number of people/ organisations affected
- Who would be responsible for this within the organisation?

Are there any types of organisations that would **not** want to get involved in water rights trading?

Why do you say that?

What are the **barriers** to people getting involved in water rights trading?

Probe – any others? List all

Which are the biggest barriers?

How could these barriers be overcome/ removed?

How can people/ organisations be encouraged to take part in water rights trading?

- Description / rationale

Could the processes be improved at all?

- How?
- Potential impact of this?

The Future of Water Rights Trading

Expectations of a fully traded water rights market

- What would be the main affects of a fully traded market?
- Who would be most likely to benefit / lose out?
- How would the market vary geographically?

What could be done to help encourage water rights trading?

How could you as an umbrella organisation work to promote water rights trading within your sector better?

- Why do you say that?
- Relative importance of actions
- Who should be responsible for that?

Probe for how this varies by:

- Licences that are held and being used
- Licences that are held but currently not being used/ fully used
- Newly created licences
- Conditions on the licences (e.g. clear set of rules about how a licence could be traded in certain scenarios)

What could be done to provide interested parties with information about a future trading 'market'?

What types of trades are likely to be of most interest to potential participants in the market?

- Why do you say that?
- Advantages and disadvantages of each
- Relative appeal of each

Probe for:

- Permanent Vs temporary trades
- Long term Vs short term allocation rights (e.g. whether the option to trade for a fixed period – 3 months – is of interest)

- Bilateral agreements (with specific terms and conditions) Vs standardised products (traded electronically)
 - o Probe on the ideal scenario in terms of the degree of specificity required. Would a system with any 'automation' be appropriate? (e.g. U.S. 'Water Banks' system)

What **price incentives** would be needed to encourage you or others to take part in water rights trading?

- Description
- What is the optimum level? (where's the right balance between make it worthwhile for people to sell their licences, but not being prohibitively costly for people to buy?)

What could **Ofwat** do to help encourage water rights trading?

- Why do you say that?

What could the **Environment Agency** do to help encourage water rights trading?

- Why do you say that?

Are there any other external factors that might influence the outcome?

- Description
- Rationale

How might they be controlled? What could be done to affect them?

- Description
- Rationale

Are there any lessons that can be learnt from other trading markets, which would help develop water rights trading?

- Description
- Rationale

Round up

Review of key themes

How do you think water rights trading will develop in the next few years?

What are the key opportunities that need to be capitalised upon?

What are the key issues/ drawbacks that need to be addressed?

Key message to take back to Ofwat/ EA

- What are the top 3 priorities for them to do?

If necessary, explain next steps of the project:

- pulling together a report
- can send a summary to them once it is published, most likely early in the new year

Thank & close

Ofwat/ EA Water Rights Trading Research – Overview Organisations

Discussion Guide

Introduction

Interviewer/ Synovate introduction

Nature/ purpose of the research inc Ofwat/ EA sponsorship

MRS Code of Conduct / confidentiality

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Key trends in the water abstraction, and the industry

- Recent past/ current/ future
- Importance

Key issues facing the water abstraction, and the industry

- Recent past/ current/ future
- Importance

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What was the nature of the trade(s)? Explore...

- Length of trade
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- Over what geographical area the trade took place
- The price paid (if willing)

What would the parties involved have done had they not been able to trade water rights?

How easy was it to make the trade?

Have you / organisations you represent ever tried to trade but been unsuccessful? Why?

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- Good thing/ bad thing
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 - o Positive / negative
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- Number of people/ organisations affected
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Are there any types of organisations that would **not** want to get involved in water rights trading?

Why do you say that?

What are the **barriers** to people getting involved in water rights trading?

Probe – any others? List all

Which are the biggest barriers?

How could these barriers be overcome/ removed?

How can people/ organisations be encouraged to take part in water rights trading?

- Description / rationale

Could the processes be improved at all?

- How?
- Potential impact of this?

The Future of Water Rights Trading

Expectations of a fully traded water rights market

- What would be the main affects of a fully traded market?
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- What is the optimum level? (where's the right balance between make it worthwhile for people to sell their licences, but not being prohibitively costly for people to buy?)

What could **Ofwat** do to help encourage water rights trading?

- Why do you say that?

What could the **Environment Agency** do to help encourage water rights trading?

- Why do you say that?

Are there any other external factors that might influence the outcome?

- Description
- Rationale

How might they be controlled? What could be done to affect them?

- Description
- Rationale

Are there any lessons that can be learnt from other trading markets, which would help develop water rights trading?

- Description
- Rationale

Round up

Review of key themes

How do you think water rights trading will develop in the next few years?

What are the key opportunities that need to be capitalised upon?

What are the key issues/ drawbacks that need to be addressed?

Key message to take back to Ofwat/ EA

- What are the top 3 priorities for them to do?

Thank & close

C. Stimulus Material

Where respondents were unfamiliar with water rights trading, they were directed to the relevant pages within the Environment Agency website:

<http://www.environment-agency.gov.uk/subjects/waterres/564321/1874219/>

The main page of the website is reproduced below.

water rights trading

What is water rights trading?

Water rights trading is the transfer of rights to abstract water from one person to another. It involves the trading of rights only, not the trading of actual water. The transferred rights are set out in a new abstraction licence.

Why trade water rights?

If you already have an abstraction licence, you can sell the rights to some, or all of that water. If you need a licence to abstract water, but no new licences are available in your area, you can buy the rights to abstract water currently held under someone else's licence.

Why the Environment Agency is encouraging water rights trading

We must allocate our water resources carefully to meet demand and maintain the environment, i.e. it is better to use water that is already licensed, rather than abstract more water. Trading can also be valuable if abstractions are transferred to locations where more water is available.

Where are the main opportunities for trading?

The main opportunities are where water is scarce. The best areas are where catchments are termed 'no water is available', or 'over licensed'. Follow the link on the left to our CAMS pages, to look at the situation in your area.

How to trade a licence

Step 1: Read the leaflet “Accessing Water Resources: A guide to water rights trading” and other information here, to gain a basic understanding of trading and how to find more.

Step 2: Contact us on 08708 506 506 to find out whether a trade is possible, and to avoid unexpected costs, or delays in getting our approval.

Step 3: Find a trading partner and agree what water rights you want to trade. If you need a broker, you may be able to find one on the Internet, or through your trade association. We are not able to act as a broker, or to provide a list of brokers.

Step 4: Submit an application. If you are the current licence holder, you will need to make an application to vary your licence using forms WR173 and WR174, or revoke it using WR4. To obtain water rights you need to make an application for a new licence using WR173 and WR174. We will determine the application within three months (four months if advertising is needed).



Exploring views on the potential for more active water rights trading

Report

Prepared for: Ofwat / Environment Agency
Prepared by: Synovate UK
Date: 5th December 2008
Version: D2.0



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Appendix

- A. Detailed Methodology
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Executive Summary

Introduction

The transfer of rights of water between licence holders has been possible for some time. In certain areas of the UK, water is licensed, but not all of the available water is used by the licence holder. Water rights trading enables these (or those not utilising it efficiently) to transfer the rights to their unwanted water to another party.

However, despite having been feasible for a number of years, only a small number of trades have taken place and further research was required to explore the barriers to water rights trading. We have adopted an iterative approach to this project, with an initial scoping stage to explore the issues and help formulate a sample profile, followed by a main stage of qualitative depth interviews to gain a broader understanding of the issues at hand.

A total of 46 executive depth interviews and 28 semi-structured depth interviews have been conducted amongst actual and potential participants in water rights trading. This report details the findings of the research.

Key Findings

What do people think of water rights trading?

At a conceptual level, most of the people we spoke to feel that more active water rights trading has the potential to deliver some overall benefits to the UK water industry, consumers and the environment. It might do this in a number of ways. It might help the environment and the economy through making more efficient and appropriate use of resources; it will provide greater access to water to raw water for those who need it; help to open up the water industry to greater competition by facilitating the entry of new suppliers; and thus benefit consumers through providing more choice and potentially cheaper bills.

Many people feel that now is a good time to review the possibilities of water rights trading. The market has obviously not taken off, but with the growing awareness of climate change, the increasing cost of raw water, together with the greater need for water demand management and the current economic climate, it is ever more important for organisations to revisit their business models and find alternative ways to operate and save/make money. People therefore generally welcome further efforts to develop trading.

What do people know about water rights trading?

Understanding across our sample varied, although those who were most aware (typically consultants, brokers and a few others who were more directly involved with water), were more aware of it on a conceptual level rather than having a detailed knowledge of the actual processes involved. Most would welcome the opportunity for the market to be given due support and investigation.

What experiences have people had of water rights trading?

The current trades that have taken place have tended to involve relatively small scale trading of surplus water. Most trades have been instigated by the purchaser, with sellers taking a passive role in the trades. The only exception to this has been when, through various circumstances, the seller has needed to realise the capital value of their water rights, for example, through the water no longer being of an appropriate quality, or because they were going out of business. Very few people have been involved in more than one trade, and it is interesting to note that a number of brokers have been endeavouring to generate business, but with only very limited success.

The actual process of making a trade is generally considered to be quite lengthy, taking 6-18 months in total. However, there is a recognition that it is likely to be a time-consuming process due to the complexity of the issues involved, not least the need to assess the potential impact on the environment of making the trade, and the

timescales given obviously also includes time spent in negotiations between the two parties involved in the trade.

What are the current barriers to water rights trading?

The current barriers to water rights trading can be divided into active and passive barriers.

Passive barriers are where for example, something is missing (e.g. understanding, awareness etc) which prevents serious or detailed consideration of trading, and results in a lack of *desire* to do so. The main passive barriers are:

The lack of a visible market – many people feel that water rights trading market has not actually started properly yet, and so have not seriously considered getting involved.

Inability to see the value in trading – people are unable to estimate the potential value in becoming involved in water rights trading, and therefore are unwilling to commit much time and resource to investigating it further. There are also some concerns as to whether a water rights trading market is feasible.

Lack of understanding of the water rights trading process – most respondents had little understanding of how to make a trade, and given the stagnant nature of the market, little incentive to find out more.

Hoarding and future uncertainty – water is a vital commodity, fundamental to businesses. Having it provides options and opportunities; selling it reduces these. The current focus on global warming also serves to increase uncertainty around this issue and encourage a more conservative approach to using resources.

Alternatives to trading – people also have other means of addressing the need for more water, instead of using water rights trading. For example, farmers rent or swap land; and businesses increase water efficiency.

Active barriers are real or perceived factors which make trading difficult or impossible for those who have a desire to do so. The main active barriers are:

The feasibility of making suitable trades – the restriction of trading licences within the same catchment area; the limitations on moving abstraction points; and the comparatively high cost of transporting water means that some people feel that there will be insufficient opportunities for trades to take place. This is further exacerbated by a perceived lack of information which might help minimise these issues.

Restrictions on trading and the reduction of rights at the point of trade – a key barrier to trading is the perception that the Environment Agency is using the trading process as a means of reducing or restricting the licence at the point of trade. This appears to be ‘received wisdom’ within the water industry and a number of respondents felt they had first-hand experience of this.

Difficulties with the trading process – the process of making a trade can be quite lengthy, especially if there are any significant amendments to the licences. Whilst people are relatively understanding about this – monitoring the potential impact on the environment is not a straightforward thing to do – there was some feeling that the requirements could sometimes be relaxed a little to help ease the process.

Broader barriers which may prevent the market from developing – the water rights trading market is of course, just one part of the efforts to open up the water industry to competition, and cannot be viewed entirely in isolation. For example, a key factor

impacting on water rights trading is the high cost of gaining access to water companies' distribution networks.

Conclusions

How can these barriers be overcome?

Possible actions suggested by participants, that would help to overcome these barriers would be as follows:

- **Removing any barriers to the establishment of a central market-place for trading water rights.** This would maximise the chances of putting potential buyers and sellers together.
- **Providing easier access to better information about licences.** This would help facilitate trades by removing an important obstacle to trading.
- **Establishing an independent body to facilitate the trading process.** Removing the current concern that the Environment Agency will 'penalise' people at the point of trade by reducing abstraction volumes or increasing restrictions. This should be done in conjunction with clarifying the roles of the Environment Agency and Ofwat.
- **Establishing a value for water rights and increase the cost of holding a licence.** This would encourage more people to consider trading their water rights and provide a financial reason for doing so.
- **Standardising the trading process** wherever possible to make it quicker and more accessible, but retaining sufficient flexibility to meet the needs of each set of trading partners.

1. Background

The transfer of rights of water between different licence holders has been possible for some time. In certain areas of the UK, water is licensed, but not all of the available water is used by the licence holder. Water rights trading enables these (or those not utilising it efficiently) to transfer the rights to their unwanted water to another party.

The merits of water rights trading have been debated in the last few years, and both Ofwat and the Environment Agency (EA) have consulted on the issue. The most recent consultation published by Ofwat (*“Review of competition in the water and sewerage industries: Part II”* (May 2008)) suggested that water rights trading could play an important role in helping the EA manage water resources, and supports Ofwat’s duty to protect the interests of consumers by promoting competition when and where possible.

It is believed that this form of trading has the potential to unravel the economic value of raw water and allow it to be efficiently allocated. However, a number of potential barriers towards water rights trading were identified in the above publication.

Synovate was commissioned to conduct research to explore in detail the potential barriers to participation in water rights trading. We have adopted an iterative approach to this project, with an initial scoping stage to explore the issues and help formulate a sample profile, followed by a main stage of qualitative depth interviews to gain a broader understanding of the issues at hand.

This document details the key findings from this research.

2. Objectives

2.1 Business Objectives

The key business objectives of the research were to:

- Provide findings which will contribute towards Ofwat's review of competition.
- Support the Environment Agency's duty to manage water resources.
- Explore potential participants' perceptions and expectations around water rights trading, including expectations around competition in the industry.
- To identify and explore potential barriers which are preventing participation in water rights trading.
- To suggest how these barriers could potentially be overcome.

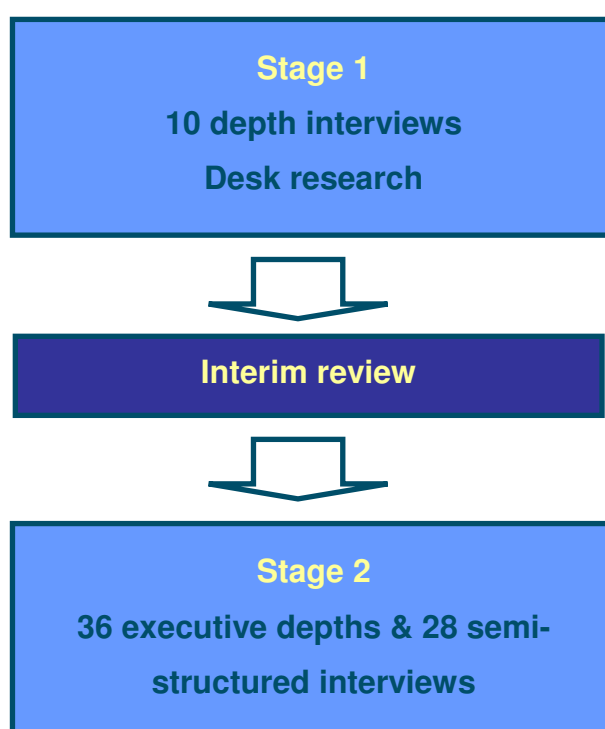
2.2 Research Objectives

The specific research objectives were to:

- Understand potential barriers to trading.
- Explore perceptions of the current water rights trading market, amongst both current and potential market participants.
- Explore how the current process could be improved to facilitate further trading.
- Explore why participants have decided to trade and understand reasons why potential participants have not considered trading as an option.
- Explore willingness to take part in a water rights trading market, including price incentives (which may make the market more or less attractive).
- Finally, to assess the likelihood of future trades.

3. How we conducted the research

The research was conducted in three stages, as can be seen in the diagram below.



Stage 1 was exploratory, combining desk research with depth interviews amongst a range of 'industry experts', academics and individuals with a broad understanding or experience of water abstraction and licence trading. The aim of this stage was to identify the key issues and scope out the second stage of the research.

These findings were thus fed into the interim review and were used to develop the sample profile and discussion guides for the second, more comprehensive stage of research.

Stage 2 of the research consisted of executive depth interviews and semi-structured interviews amongst a range of people with either a current or potential interest in water rights trading. This included brokers/ potential brokers; industry bodies/ organisations that either have or could potentially, take part in water rights trading; and organisations that could potentially be new entrants to the water supply sector (although with regard to this latter group, we found few people who – at this stage – would consider themselves as *serious* ‘potential new entrants’ into the water supply market, given the perceived difficulties of operating viably as such).

Executive depth interviews were conducted either face-to-face or by telephone, by specialist qualitative executives. This form of interviewing was mainly used for what were anticipated to be more complex interviews, typically organisations providing an overview of an industry sector, or those organisations most closely involved in the water industry.

Semi-structured depth interviews were used to supplement these interviews and as a more cost-effective technique, were used to gain a greater breadth of response, especially from organisations with a potential interest in water rights trading.

Executive depth interviews lasted up to an hour and were free-flowing discussions based around a discussion guide. Semi-structured interviews were slightly shorter interviews, using a more structured set of questions.

A more detailed description of the sample profile, together with the discussion guides and stimulus material used, can be found in the appendix.

Introduction to the findings

The commonsense cautions and limits of qualitative research apply to the following findings. The findings should be regarded as being indicative and should not be viewed as being statistically valid.

4. Research findings

4.1 Awareness and understanding of water rights trading

To what extent are different sections of the potential market aware of water rights trading?

Awareness of water rights trading is highest amongst consultants, brokers, potential new entrants and others directly involved in the water industry. Many of these respondents had been aware of the concept for some time, and some had taken part in consultations regarding the issue in the past (e.g. *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction, Defra, June 2001, the Environment Agency consultation in 2003*). Others in the water industry, in related sectors and the legal profession such as power generation, remembered hearing about the concept from peers, contacts within Ofwat or the Environment Agency or in the trade press.

Water companies, consultants and brokers are divided in their views on the degree to which trading has been considered and supported by Ofwat or the EA. Some consultants said that the issue has been investigated fully on more than one occasion, and suspected that the current consultation on the issue will yield similar findings and recommendations. Others think that the issue has yet to be 'seriously' investigated in a comprehensive manner, and welcome a move towards doing so now. However, all agree that the water rights market has yet to be given the regulatory support or publicity that it requires to become active.

"I suspect people aren't aware that they can trade. I personally haven't heard of any trades that have taken place". [Trade association]

Organisations that might be interested in trading existing licences, such as farmers and industry are generally more likely to be aware of the concept of

water rights trading, and the majority of our sample had heard of the concept. Those within these sectors who were aware, were often in roles which specifically dealt with water or environmental issues at a broader level. Within industry, the person with responsibility for water often has this as only one part of their remit, and it often seems to be a relatively minor part of their role. The reason for this is that water supply – whilst a vital part of their business – is a relatively low cost compared with the more high profile (and expensive) issue of gas and electricity supply.

To what extent is the concept of water rights trading understood?

Among those who are aware of water rights trading, understanding of the concept varies. Water companies, brokers, potential new entrants, consultants and trade associations are more likely to have a detailed understanding at a conceptual level, and to be confident of this. Those who have become more actively involved with the system – through investigating it as a possibility – also understand the *principles* of water rights trading. However, few respondents had a detailed understanding of the actual *process* that has to be gone through to make a trade.

“I’ve heard of the concept but I’m not quite sure about how it would work or what the model would be”. [Potential participant, Water Company]

Those previously unaware of water rights trading were sent a brief description of the principles and practices involved, as well as some case study examples of trades¹. Generally respondents were able to understand the concept of trading from this information relatively easily, but again, were not always confident of the practical details.

¹ These were taken from the Environment Agency website – please see the appendix.

Some consultants and water companies feel that they know as much as there is to know about the water rights market as it exists now. They assume that the market has yet to be ‘launched’ or encouraged, and that there is therefore little more to investigate or understand.

We discuss awareness and understanding further when outlining the barriers to trading in section 4.4.2.

4.2 Perception of the concept of water rights trading

4.2.1 Overview

At a conceptual level, most people we spoke to felt that more active water rights trading has the potential to deliver some overall benefits to the UK, and they generally welcome further efforts to develop trading.

Some consultants, potential new entrants and trade associations feel that the time is currently right for further review and consideration of the water rights trading issue, not least because of the ‘problems’ associated with the current trading system (see barriers in section 4.4) and the fact that the market is currently stagnant. They also cite the following factors which suggest potential for a developed market:

- Trading has been successfully implemented in other countries (e.g. Australia and Spain).
- Raw water costs are thought to be rising constantly (as are costs of other raw commodities).
- People are increasingly aware of climate change and its potential effect on the environment and future behaviour.
- Businesses are generally struggling economically at present and are therefore likely to look for alternative means of operating.

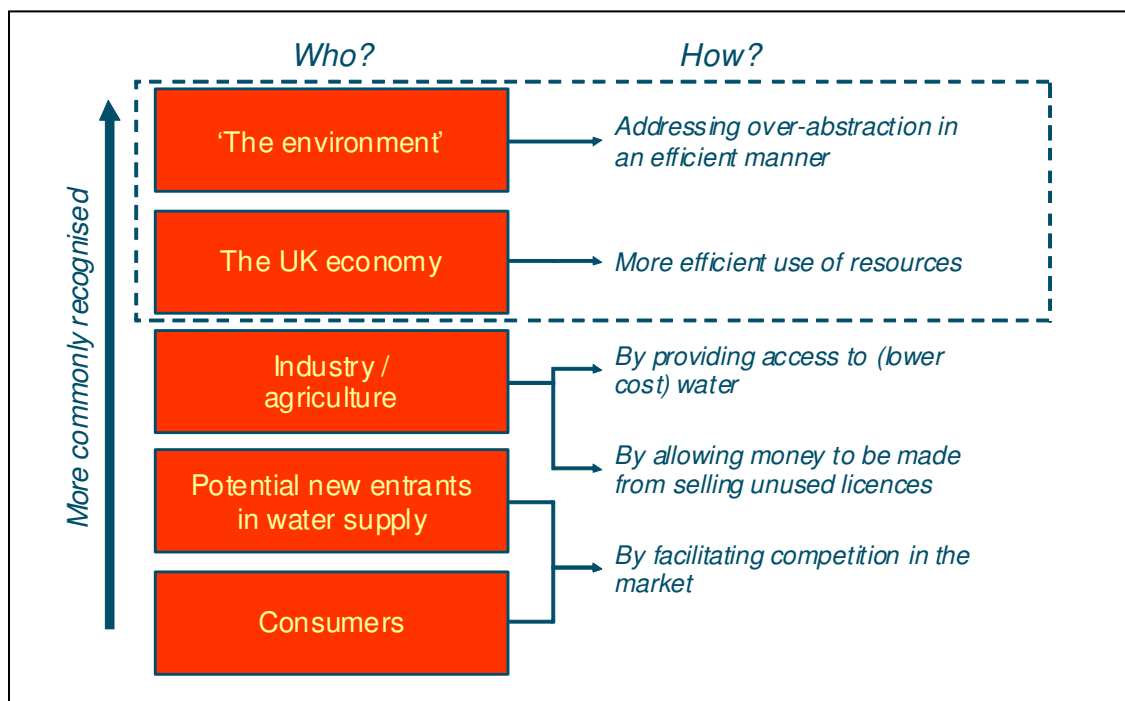
- There appears to be a growing awareness of carbon trading; and the belief that elements of this model might potentially be replicated with water. (However, it is worth noting that some consultants and economists argue that drawing comparisons between water rights trading and carbon trading is unhelpful and confusing, particularly as its effects have yet to be fully assessed).
- There appears to be a trend towards specialisation within some industrial and agricultural sectors, resulting in changes to water demand (volume and flow).

4.2.2 Potential benefits of an active water rights market

It is broadly recognised that developing a more active market in water rights has the potential to deliver benefits to:

- the UK economy as a whole
- the UK environment as a whole
- some specific types of organisation or businesses
- consumers of water

This is summarised in the chart overleaf.



At a general level, respondents agree that attaching a true value to water should drive more efficient usage. In particular, water companies, potential new entrants, consultants, public bodies and trade associations, appreciated that if the cost of accessing raw water was more reflective of its scarcity in particular areas, its usage could change to reflect this. Some said that as water begins to be used more efficiently, fairer prices for the **consumer** could result.

“The benefits are that the economy becomes more efficient. Basically, people pay the price that they need to allow them to run their businesses, and generally in terms of economic theory, the things work through. What is happening at the present time is that the majority of licences are held by water companies. They are not using a high proportion of these licences or they use them intermittently, to the extent

that the EA can't get them back off them. So basically they're sitting on water rights for the present time.” [Public body]

“It's hard to tell whether customers would face higher or lower bills. If water companies could sell their water rights on and make a profit, would they pass this on to the customer? Or they might focus on options which don't involve water which cost a bit more. They're both rational and irrational reactions to this uncertainty.” [Consultant]

A move towards more efficient use of water has the potential to deliver benefits for the **environment**. In general, respondents suggest that market forces have the potential to naturally curb over-abstraction and subsequent habitat damage. However, there is some recognition that whilst this is likely to be the long-term outcome, the danger is that in the short-term there could be some imbalances that would need to be managed to avoid harming the environment.

As well as the potential benefits to the UK economy and environment described above, other more specific benefits are apparent. For example, the trading of licences is thought by some water companies (including water supply licensees and inset appointees), some businesses and consultants to have the potential to open up the UK **water market** to greater levels of competition overall. Some potential new entrants into the water supply market said that this could in turn provide an opportunity for organisations like their's to grow and operate in areas where previously they might not have been able to. However, they also say that this would be dependent on other barriers to competition being removed. We discuss this issue in more detail in section 4.4.

“The regulators have now recognised that the water industry isn't sustainable any more.” [Inset Appointee]

“I guess (a group who would benefit would be) potential new entrant companies who would like to set up in a particular region and who require water for their processes but are unable to do that because the area is either over licensed or over abstracted.” [Potential participant, Manufacturing]

Some incumbent **water companies** predict specific benefits to themselves of a more active water rights market. Where they feel it would be beneficial, companies would welcome the opportunity to buy rights to more licences in their area, and beyond. This would allow them to have greater control over the water resources in a certain area, and therefore enable them to manage those resources more effectively and efficiently, through more integrated planning. This will lead, they say, to benefits for them, their customers and the environment.

“We could make more efficient use of the regional resources. As a water company, we're responsible for supplying water in an area. We have access to certain resources of the area, but we don't have access to others. So I suppose that having access to all of it you can then make use of the water resources in the most efficient way.” [Potential participant, Water Company]

Purchasing more licences can deliver other benefits to water companies, such as providing an alternative solution to water demand issues or allowing them to sell off unprofitable sources. Demand management is a major priority for water companies, and some suggest that purchasing licences could be a more cost-effective approach to this issue than other measures such as leakage control and investing in new infrastructure.

Were a fully traded market in rights to develop, some **businesses** with licences that they are not fully using, can see the potential commercial benefit of selling all or part of them. Most are more likely to be thinking of temporary trades rather than selling the rights permanently, as this approach avoids the risk of reducing the options available to the business in an uncertain business environment.

However, realising this benefit depends on certain criteria being met (e.g. time limits on the trade and guaranteed return of all rights afterwards) and relies upon certain barriers being removed (see section 4.4). As such, most businesses in the sample were only able to discuss these benefits in general or hypothetical terms. While some inset appointees and consultants felt that trading water rights has the potential to be a significant generator of revenue, most assumed that any additional revenue generated from such activity would only be a very marginal part of their overall business operation.

“We could potentially capitalise on an existing asset if you consider abstraction licences as an asset, which we currently don't do.” [Potential participants, Industry]

“The cost for supplying the business with water is only about 1% of the company turnover, so although it's really important, it's actually quite a low priority”. [Potential participant, Industry]

For businesses needing water, for example to facilitate expansion plans or new commercial ventures, buying rights would meet a specific need and therefore deliver tangible and immediate benefits. Some businesses and potential brokers said that they (or their clients) were currently unable to fulfil their expansion plans due to the high cost of acquiring suitable water through other means (e.g. from a water company). Businesses and potential brokers note that for companies operating in areas of water scarcity, trading represented a

potential method of accessing additional water, should it be required. Indeed, any company that uses significant amounts of water would potentially have an interest in buying water rights, as it opens up further business opportunities.

“I suppose in an area that is over abstracted, where one of my factories is, if we needed more capacity, then it would be useful to be able to (trade). We know that in an over abstracted area there is no chance of additional volume (in any other way).” [Potential participant, Industry]

Benefits were also noted for farmers and the rural economy. Relatively small trades between farmers or farmers and other parties, have already been undertaken, and those who have participated generally feel that there has been a mutual benefit to all parties involved. Farmers who have not traded themselves, but who could potentially do so, would welcome the ability to diversify into different types of agriculture which may require more water. They can also see a benefit to the local economy in terms of generating commerce between neighbouring farmers and local industry.

As with other groups, having access to (additional) water opens up new opportunities, for example in a farming context, diversifying into new crops, investing in new infrastructure (hot-houses etc) or being able to enter into longer term contracts with suppliers. Some farmers said that they specifically failed to win certain major contracts because they were unable to access sufficient water supply to guarantee the quality and volumes of produce required.

4.2.3 Potential drawbacks of an active water rights market

Relatively few drawbacks to the principle of trading rights were mentioned. However, some businesses, consultants and public bodies are concerned that an open market in water rights would result in a consolidation of the incumbent water companies' positions in local areas, and thus a reduction in competition. They tend to view water companies as having the greatest buying power, particularly compared with potential new entrants or smaller businesses. They also suspect that water companies would be more willing than others to pay a high cost to protect their position in the water supply market. However, some of the water companies felt that there would actually be relatively few sources of water that would be of sufficient scale to be of practical use to them.

“The drawbacks of water rights trading are ultimately the rise in the price of the rights. It may price certain companies (e.g. farmers) out of the market but we'll have to see.” [Public body]

“In theory it sounds good, people will buy them. But I suspect anything that comes onto the market, the water companies will have it.” [Potential participant, Industry]

Under the existing system, the EA is seen to keep relatively tight control over the allocation of licences. Some assume that this extends to ensuring that water companies, or any other large organisation is not granted access to all licences in a particular area. They say that a fully active water rights market would be likely to result in a reduction in the agency's influence, and would like reassurance as to how the market would be regulated.

“The EA at the moment issue the licence and they monitor the licence quite closely. I was just wondering how that would work, and would there be a case where there would be one big company coming in, and

snapping up all the available abstractions in the area? What controls would there be?" [Potential participant, Industry]

Not all respondents agree that the consumer will necessarily benefit from trading through lower prices at the point of delivery. Some consultants and water companies argue that the increased costs of abstraction may have to be passed on to consumers, at least in the short term. They say that this situation is not inevitable, but the regulatory approach adopted will have an impact on whether it occurs.

"It might result in higher costs. It might result in wasteful use of resources that affect the environment. It could result in higher water bills because of that. It could result in theory, in more regulation being required so higher costs, but equally you could argue all of those could be less or more depending on how the regime was set up." [Water Company]

Some water companies see the drive towards competition in the water supply market – of which water rights trading is a part - as potentially detrimental to the water industry, depending on how this is handled. One respondent felt that there are dangers involved in introducing more competition into the industry, making it adopt a more short-term, financial focus and diminishing the long-term approach to planning taken by water companies and leading to an inability to properly address issues beyond the sale of water, such as environmental concerns.

"My fear is that it puts a lot of risk into the industry, there are literally hundreds of reasons why I don't like it. The industry is a long term industry and you have to plan 25 or 30 years ahead to build new

reservoirs, and the uncertainty that competition adds may prevent that long term view." [Potential participant, Water Company]

One respondent from a water company also felt that creating a situation where there would be a number of organisations in an area with different pockets of water supplies might have the effect of reducing the security of supply and introducing inefficiencies into the system.

4.3 Perception of the water rights trading process

Why have organisations traded?

Specific reasons for trading vary according to individual circumstances. However, trading activity to date seems to be restricted to the buying and selling of *surplus* water. None of the participants interviewed had factored the trading of rights into a broader decision to change their business model or land use. Rather, they had traded rights as a consequence of changes made for other reasons.

Most trades appear to be instigated by the purchaser. In some instances, organisations said that acquiring more water was essential for them to continue with certain business activities. They therefore approached the EA in the first instance to apply for new licences, and the EA suggested trading as an alternative, in some cases providing details of a potential trading partner.

Generally sellers are currently taking a passive role in trades. We only encountered two examples of trade that were instigated by sellers. In both cases it was imperative to the business that they sold their licences, either because the water acquired through them was no longer of acceptable quality for their needs and they needed to minimise the losses associated with this

situation, or because they were going out of business and were looking to sell all associated assets.

There is currently no evidence of licence-holders taking an entrepreneurial approach to the selling of licences (i.e. considering it as a potential tool to grow or diversify their business). In some cases, sellers said that the commercial benefit of trading was not the primary reason for participating. Rather, they felt that they 'might as well make some money' from an asset that they were not using, while maintaining positive relationships with other members of the local community. The only exceptions to this were the brokers that we spoke to who had all tried to generate some business through trading water rights, but in many cases had been unable to do so.

How have participants approached the trading process?

Those who have traded have approached the process in a variety of ways, suggesting that there is not a single accepted method of trading that is understood by all. The main differences in approach are that some start by approaching potential trading partners, others start with the EA, and a minority speak to land agents or brokers. There is no evidence that one approach results in a more efficient or fast trade than any other. Indeed, overall impressions of the trading process vary, with a range of contributory factors involved.

What is the role of brokers and consultants?

Our research has indicated that consultants can have a powerful influence in determining whether or not a trade is instigated. Some brokers admitted that they had warned their clients off trading because of the anticipated cost (time and money) that would be required of them. Most consultants believed that they were in a strong position to advise on this area, given their relatively broad perspective on their clients' overall objectives.

Dealing with the Environment Agency

The majority of those who have traded experienced few major problems in their dealings with the EA. Whilst the process is quite time consuming, there is a recognition that there are procedures that need to be followed and evaluating the potential impact on the environment does take time. Some said that EA was helpful and attempted to make the process run as smoothly as possible.

“My neighbour spoke to the EA to see if it was a legit trade then we got the paper-work together. The process was fine, the EA were very helpful”.

[Participant, agriculture]

However, there was some feeling that there could be scope for a more relaxed interpretation of the rules. One consultant, with experience of dealing with a number of EA offices, feels that the way in which water rights trading is handled is not always consistent. They also explain that there can often be a difference in interpretation of the law between consultants and the EA, and that some EA offices interpret the law differently to others.

“The EA is over-stuffed with staff, tripping over themselves. You have to consult so many sections, they become bogged down with the issues rather than having one person with overall responsibility.” [Consultant]

Finally, some of the forms that the EA send are thought to be quite vague, with people wondering why they are being asked for the information. Forms would benefit from being made more specific and having a more explicit rationale for the questions asked.

4.4 Barriers to more active water rights trading

4.4.1 Overview of barriers

The barriers to more active water rights trading are multi-faceted. They can be broad issues facing the potential market as a whole, or specific concerns of individuals, businesses or other interested parties, e.g. trade organisations or public bodies. Barriers to trading are often interrelated, and people generally cite a range of barriers as reasons for not trading.

We have set out the barriers described by respondents in the following section, outlining the rationale for, and importance of each. We have also described where differences in the importance or impact of barriers exist between different types of organisations.

The barriers to trading can be considered in two broad groups:

- **Passive barriers:** where for example, something is missing (e.g. understanding, awareness etc.) which prevents serious or detailed consideration of trading, and results in a lack of *desire* to do so.
- **Active barriers:** real or perceived factors which make trading difficult or impossible for those who have a desire to do so.

Within our sample, passive barriers were more commonly mentioned. Some respondents were not aware of active barriers as described above as they had simply not considered or investigated the issue in sufficient detail.

4.4.2 Passive barriers

The lack of a visible market

In general, potential participants feel that the market for trading licences simply does not exist in a true sense at the current time. Most water companies, consultants involved in the water industry and trade associations representing companies closely involved with the water industry, agree that while technically possible, the trading of rights has not yet been fully enabled or promoted. Businesses with water rights are often even less aware of the potential to trade, and assume that the concept is one which is yet to be developed and launched.

“I thought it was something that was still some way off. We're not aware of anyone locally or in business locally that needs water and can't get it. I assume you have to trade on the same stretch of water, but I don't know if that's true or not.” [Potential participant, Industry]

“There is a need to get information about which licences are being used and which aren't. This information came to me recently through a broker, but it would be useful if the EA played a role in distributing this information as well”. [Potential participant, Industry]

Without a strong sense that the market in licences exists and is operating effectively, many people simply have not considered the potential for getting involved with trading.

When discussing the potential for their own involvement in trading, businesses generally focused on whether they currently needed water or had surplus water that they might consider trading. They tended not to think seriously about the potential to change their business model, e.g. selling licences that they were currently using to a buyer who might value the rights to water more highly.

Some water companies, consultants and industrial businesses did talk in a general sense about this as a possibility within a fully operational market place, but could not see themselves trading in such circumstances. They could however, foresee that it might make it more likely that they would adopt more water efficient methods, thus potentially creating surplus water.

Water companies, trade organisations, some large industrial players and consultants generally agree that someone or something needs to kick start the market in some way, both in terms of stimulating trading through economic intervention and through better communication about trading at all levels.

“The EA could help develop a trading platform. It might just be a web page to say that licence AB123 is available for trade, if you’re interested contact John Smith... I think there are meetings that are held from time to time where this could be discussed... water events, water environment events...trading could be covered in seminars.” [Trade association]

Some water companies expressed doubts about whether Ofwat or the EA had a clear idea as to how water rights trading market might work in the future. Therefore, although they could see some potential benefits in a developed market, they were not confident that it would develop in the foreseeable future.

Inability to see the value in trading

Potential participants are generally unable to appreciate or estimate the value of becoming involved with trading. The very fact that they are not aware of an active market can suggest that the potential to benefit in a substantial way financially from trading is currently limited. This perception appears to drive further apathy in many, and some respondents explained that they were waiting to see how the market might develop before considering trading more seriously.

Some brokers, consultants and water companies were aware of some trades that have taken place to date. Trades were perceived to be of relatively low value and therefore not seen as an incentive for people to consider trading themselves.

“If it’s going to cost a client thousands of pounds of a broker’s time to trade the rights of an extraction when the rights themselves are only going to be sold or rented for £500, then trading can be hard to justify”. [Consultant]

The inability of potential participants to see and appreciate the potential value of trading leads to other barriers. When considering the potential value of trades, the most common reference point is the current cost of abstraction. However, water companies, consultants and some large businesses describe the abstraction component of operations as a relatively small proportion of costs. They therefore assume that the market would be somewhat marginal compared with other business activities.

The potential size of the market was also mentioned as a barrier to involvement. Again, when the value of participation is not understood, potential participants assume that other parties will also not be likely to participate. Some respondents suggested that water companies would be unlikely to trade licences when the returns on doing so were difficult to predict and the value of retaining capacity so potentially high. Some consultants and potential new entrants feel that water companies have little incentive to sell unused licences when they can instead sell water at a greater profit to whoever may need it; either industry, agriculture or new water supply licensees.

Some potential participants feel that while trading of licences is limited to the same catchment area, the laws of supply and demand will not result in trading activity. Put simply, they feel that in areas where water is in plentiful supply there is no potential market to sell to, and where water is more scarce there is not a potential market to buy from (businesses will not be willing to sell).

“There was no demand – no one’s asking us for the water”.

[Potential participant, Water Company]

Finally, some brokers and potential brokers suspect that some licences yield less water in reality than is stipulated in their terms. This suspicion can lead to concerns that potential trades would fail, as the buyer would not receive the value they expected.

Lack of awareness and understanding of the water rights trading process

The perception that a fully operational market does not yet exist, and doubts over when it might exist mean that the issue of water rights trading is often not an issue that is given detailed attention among potential participants.

This lack of engagement with the issue appears to result in a lack of understanding of the water rights trading process. Most respondents had little detailed understanding of how the process works, particularly those without an existing interest in the topic or strong links with Ofwat and/or the EA.

“Well, I don’t know, if it means I get lower water bills, fine, I don’t really know. If I have an asset here and I don’t know how to trade it, I don’t know what the benefits are.” [Potential participant, industry]

In some instances (often potential participants from industry and agriculture) respondents had no knowledge of how the process would work; who would

broker the trade, what involvement (if any) government agencies would have or what the administrative cost of trading would be.

“It needs to be made clear how the system can work and there needs to be clear accessible information so that people can understand easily how it's done.” [Industry – potential participant]

In addition, they (and others including some water companies, consultants and trade associations) were unsure of what the ‘rules’ of trading are, or might be in the future. Specifically, uncertainty exists about:

- **The nature of trades:** respondents were generally unsure whether limits were currently imposed on the length of a trade or whether trading parts of licences was permitted.
- **The rules relating to the physical abstraction activity:** some businesses with a borehole were unsure whether those to whom they sold their abstraction licence would be required to abstract from that source also. If they assumed that this was the case, they felt that this presented a considerable logistical barrier to trading. However, the lack of certainty itself can also prevent further action being taken in relation to trading.
- **The law relating to who is permitted to trade:** some potential participants and brokers are unsure about the regulations relating to the right to trade. Water abstraction licences have often traditionally been linked to land ownership. Some questioned whether the linkage between the two would have an impact on the potential to trade licences.

Hoarding and future uncertainty

Water is viewed as a vital commodity which is relatively unpredictable in terms of availability over time, and becoming more so. This means that many people in possession of rights to abstract are naturally inclined to hold on to them. Both industry experts and organisations who had licences, agreed that the lack of a visible market and the relatively low cost of keeping licences only served to reinforce this tendency to hoard. Indeed, some felt that the incentives required to overcome the psychological predisposition to hold on to water would need to be very compelling, and doubted that any market would deliver them.

Businesses for which water is at the core of their commercial activity (water companies and some industries with high water-usage) often regard protecting this resource as a key priority for the future. It represents the 'lifeblood' of their operations, and it is therefore seen as simple good business to keep hold of licences. These businesses are also aware that their requirements for water may change in the future; in some cases due to long term expansion plans, and in others based on an understanding that the business landscape is likely to change, and they may need to change their model to fit this.

"I was always told, 'We don't sell licenses.'" [Trader, Industry]

"I have the impression that utilities companies often hoard the abstraction licences that they have." [Water Supply Licensee]

Non-commercial factors can also lead to uncertainty about the future, and a tendency to hold on to licences that are not being used. Respondents were generally aware of the potential for climate change to impact on rainfall and the availability of water in the future. Often, respondents were unsure of specifically how this might affect their businesses. The lack of certainty around the issue encourages caution in relation to selling rights. Some consultants and

respondents working within the water industry felt that uncertainty around the ongoing development of the EU Water Framework and Habitats Directives, and how the EA will respond to these in terms of the development of the next stage of Catchment Area Management Schemes (CAMS) also prompts caution around selling licences. They felt that these directives were still in a state of flux, and as a result abstraction licences were at considerable risk of being revoked or reduced in the future.

Expected changes in the water abstraction licensing regulations may also add to a general sense of uncertainty and caution in the market. Water companies, consultants, brokers and industry representatives noted that all future licences will be time-limited, as opposed to in perpetuity. Some felt that this situation would discourage the selling of existing permanent licences (as it will not be possible to replace these in the future) and possibly make purchasing of licences unattractive as business planning and securing funding on the basis of having a ready water supply would be more problematic if only short-term licences were available.

“We are expecting to have time limited licences imposed upon us I believe in the not too distant future, and it's not exactly clear to me how that works with water rights trading.” [Potential participant, industry]

Incumbent water companies stressed the importance of maintaining sufficient headroom on their licences to cope with drought situations or fluctuations in demand. They take their statutory obligation to maintain public water supply seriously, and therefore are often not inclined to consider relinquishing rights; and certainly not on a long term basis.

The question of selling rights to new entrants to the water supply market was addressed by some water companies. While the overall concept of competition

in water supply is understood and the drive to deliver it accepted, some raised questions about the ability of water rights trading to facilitate entry into the market. They explained that were they to sell abstraction rights to new entrants, as the incumbent supplier, the legal duty to guarantee potable water supply to the public would still be theirs. They felt that this detail would need to be addressed in the regulations relating to trade, either through exemption, financial compensation or the terms and conditions relating to the trade.

Some brokers and land agents explained that some licence holders simply would not consider trading their licences because they consider them as integral to the value of their land; or have high (and sometimes unrealistic) expectations about the value of their licences (particularly those with high value land). This view is thought to be particularly prevalent amongst farmers.

While most potential participants feel that the market in water rights has not yet been established, many assume that it may do in the future. Most are unable to attach a measurable timeline to this assumption, but it does impact on propensity to consider trading at this point in time. Many assume that as water generally becomes scarcer, its potential value will increase. Therefore, it makes commercial sense to wait until the market is developed and the value increases.

Some businesses and farmers with licences which they are not using, and which only cost a marginal amount to maintain, said that they *might as well hang on to the licence* as an investment for the future. Clearly this has the potential to encourage stagnation, as nobody wants to be the first to enter a market which they consider is only likely to rise.

Alternatives to trading

The need to participate in formal trading of water rights can be avoided through other activity. Some licence holders in different commercial environments have

developed ways of sharing water with one another, or reducing their need for water, thus removing the need to buy licences. Given the potential difficulties with trading licences (described in more detail below), some organisations see these alternatives as a preferable solution. Examples of alternatives are:

Agriculture:

- Farmers rent land (complete with water rights) to one another, rather than entering into trades.
- They develop winter storage reservoirs to deal with seasonal fluctuations, meaning that trading is not necessary (although a large investment).

Industry:

- Businesses implement measures to deliver greater water efficiency. These include water recycling and reclamation, leakage control and demand management.
- Others simply structure their business activity according to the water available to them at the current time.
- Some enter into informal agreements with neighbouring enterprises: e.g. a factory allowing a neighbouring farmer to use its borehole in exchange for coverage of the abstraction fee.

Water companies:

- Some water companies had looked at the option of leasing access to water on a short-term basis neighbouring land-owners, businesses or farmers.
- Others simply transfer water to one another when one has surplus and another has a need. They explained that this practice is encouraged by the regulator.

4.4.3 Active barriers

There also appear to be a number of tangible barriers which make trading difficult or impossible, even for those who would like to. While some of the barriers outlined below had been experienced first-hand by those who had traded or attempted to trade, they were also mentioned by people who had not actively investigated making a trade, but were aware of the issues anecdotally.

Feasibility of making suitable trades

The trading of rights is currently limited to systems which are hydraulically linked. Licences are classified by CAMS as well as management units within CAMS, and trading is only permitted within the same catchment area (or sub-catchment area). Some potential participants and consultants regard this physical restriction as key a barrier to trading. They say that the result of this regulation is that the potential pool of licences which can be traded is small from the outset, reducing the likelihood that a mutually beneficial trading situation might occur.

The potential for trading is reduced further by other specific restrictions described by respondents across the sample:

- **Limits on the potential abstraction points:** The fact that rights can only be traded for abstraction downstream of the original point was described as a very tangible barrier which is difficult to overcome. Some potential new entrants and consultants advising industry said that this issue adds to the complexity of planning for a new enterprise which may rely on the traded water rights.
- **How the water will be used:** The fact that the trade needs to take into account the consumptiveness of the water (determined by what it's going to be used for), might also restrict the potential number of trades. For example, water for spray irrigation is likely to use more water and

take more water out of the environment than water to be used on fish farms or for power generation.

- **The cost of transporting water:** If abstraction is only permitted in limited geographical areas, the issue of transporting water becomes important. Some organisations which may potentially be interested in becoming water supply licensees, along with businesses which might consider selling licences, said that the cost of the infrastructure required for transporting water in volume was simply too great to warrant serious consideration.
- **Concerns about the quality of water:** Businesses relying on a particular quality of water for manufacturing or other commercial processes said that they would be concerned that any new water acquired through trading might not meet the required standards.

The physical barriers to trading are often said to be exacerbated by a lack of information. Organisations who have investigated trading, or consultants with knowledge of trading pointed out that information around the whole issue of water rights trading is very difficult to find, and is not always useful. They say that information about the geographic location of available water / unused licences and about the licence holders themselves is not easy to find. Interested parties are required to ask the EA for this information themselves, rather than it being readily available to those who need it and the information is not always complete. Furthermore, respondents pointed out that there is no immediately obvious place for licence holders to advertise licences that are available for trade.

Restrictions on trading and the reduction of rights

A key barrier to trading is the perception (or experience) of the EA either refusing to allow a trade or restricting the terms of the licence at the point of trade. Those who had traded had experienced this, and some explained that it

has made them less likely to trade in the future. Several respondents are aware that EA have been known to reduce/alter licence terms at the point of trade, not least through placing a time limit on the licence. Only a minority of potential participants and brokers had direct experience of being turned down for trades, but others felt that this would be quite likely given the current policies of the EA.

"The EA tend to claw back licences. If someone's trading a licence and it is 10 mega litres a day then it may well be that they get 8 as a net licence after the trade." [Potential participant, Water Company]

Some consultants and water companies are under the impression that the EA is using the trading of rights primarily as a means to reduce or manage abstraction levels rather than working for the benefit of the licensees/ potential licensees. There is a perception among some that the agency adopts an overly cautious approach to its decisions around abstraction, rejecting proposals when the evidence base is not considered clear-cut by all.

Concerns about the reduction in rights at the point of a trade lead to a reluctance among many with spare water to even investigate the possibility of trading. Some water companies and businesses said that were they to approach the EA and declare that they might have water to spare; the licence in question would be reduced, restricted or revoked.

"I just phoned them [Environment Agency] up and said we want to trade this, and is it something we can do? They said no, under the circumstances, we can't allow you to trade this licence... I remember the catchment in question was quite stressed and there was quite a shortage of water in it." [Potential participant, Industry]

One water company spoke of how in the past, when they have mentioned that they were thinking of reviewing their use of a particular source of water, it has been taken as confirmation that they no longer have need of it and the licence will be revoked/ surrendered. It was also not lost on people that all the examples given on the EA website explaining the water rights trading process, involve a reduction in abstraction.

There is also the issue that once a licence is traded, it becomes time-limited, whereas people prefer to have licences that are in perpetuity, especially as renewal of the licence – whilst there is a presumption that it will be renewed – cannot be guaranteed.

Difficulties with the trading process

Perceptions of the trading process are discussed in section 4.3 of this report. Below, we summarise issues around the process (or perceptions of it) which could constitute barriers to trading:

- **Lack of available or accurate information:** A few respondents noted that the quality of information available about trading could be improved. For example, one broker was given inconsistent information by the EA about the transferability of licences (they were told that sleeper licences were still transferable, but subsequently found this not to be the case).
- **The length of the process:** Brokers, potential brokers and organisations who have participated in trades generally feel that the process of trading is quite long. They quoted timeframes ranging from 6 to 18 months from deciding to trade to completion (including the time taken to advertise the trade), depending on the level of complexity. This amount of time can be considered too long if temporary trading is to be considered. Some who had not experienced trading first-hand suspect that the process will be long and involved, and assume that they would need to spend time monitoring the impact on water supplies, exploring the environmental

impacts and negotiating with the other party in the trade about the logistics and price. While the length of the process was often described as not ideal, most feel that it is necessary for a trade to be successful, and some of it is determined by statutory requirements.

- **The costs of the process:** Potential participants suspect that the cost of trading will be high. They assume that they would need to pay for internal resource to investigate the viability of the trade and deal with the administration, as well as fees for professionals (e.g. lawyers, brokers or environmental specialists) to assist with the trading process and/or an environmental impact assessment. Some participants who had experienced trading first hand said that the cost of advertising trades was particularly high. When the potential value of trading is not fully appreciated, the costs of the trading process become relatively more important in the decision-making process around whether to pursue a trading opportunity.
- **The complexity of issues and the level of expertise required:** Some water companies and consultants suggest that a considerable level of knowledge is required to make a trade work and not everyone has access to this expertise. A few potential participants in industry were concerned that the process would be complex and difficult to deal with, based on their experiences with carbon trading. This negative experience was enough to put serious doubt in the mind of one respondent about considering trading water rights.

Problems with the trading process are likely to limit willingness to participate (again) in trading to some extent. For example, some brokers and potential brokers said that they advise clients against trading unless they are certain it will be successful as the time and costs involved are too great. However, concerns around the process were less evident among water companies or potential brokers, with experience of dealing with the EA. They said that were

they to participate in trading, process issues would be dealt with using their existing knowledge and systems.

Broader barriers which may prevent the market from developing

The trading of water rights does not occur in isolation. Rather, it takes place against the backdrop of a wider regulatory framework and the commercial environment, both of which can have an impact on the potential for the market to develop.

One of the potential benefits of trading rights is to encourage new entrants into the water supply market, stimulating competition and fairer prices for consumers. While this principle is often understood and accepted by those with an interest in entering the supply market, or those with a broader understanding of the issues (e.g. consultants and industry bodies), doubts exist about the delivery of this in the current regulatory climate. Some in the industry feel that the margins achievable for new entrants are too small to encourage true competition in the water market at a broad level. The reason most commonly mentioned for this is the high cost of gaining access to distribution networks. Water companies and consultants said that the question of accessing water through the trading of rights was redundant if the economic argument for supplying water cannot be made.

Other complications and difficulties around the implementation of a successful trade were noted. One respondent gave the example of a new entrant moving in to supply water to a new development or commercial activity in an area. As well as trading the licence itself, a great many other commercial deals would need to be struck around storage and delivery / movement of the water, maintenance etc. This example illustrates that not all barriers to trading are explicitly related to the trading process itself, but are linked to a wide range of other factors, not all of which are under the control of Ofwat or the EA.

4.5 Likelihood to Trade

4.5.1 How likely do people think they are to trade?

The majority of potential participants said that they would not discount the possibility of trading water rights, once the main barriers had been overcome. However, around a half of these were not sure how likely they would be, as they did not feel confident predicting what the market would look like in the future. Obviously, the key requirement for whether they would actually make a trade would be determined by a variety of different factors inputting into a cost / benefit analysis, resulting in such a trade being in their interest.

So for example, the higher the potential value of the water rights, the more likely it is that people will consider selling, as this would help to overcome any concerns they may have and make the investment in time and energy expended in making the trade worthwhile. Should the potential value be lower, then of course making a trade becomes less attractive, and the more likely it is that the time and money spent in making a trade will be considered prohibitive. Such a scenario might then make it more likely that trades would be generated by brokers, who could build up expertise in managing the process cost-effectively, and thus be able to make trades viable.

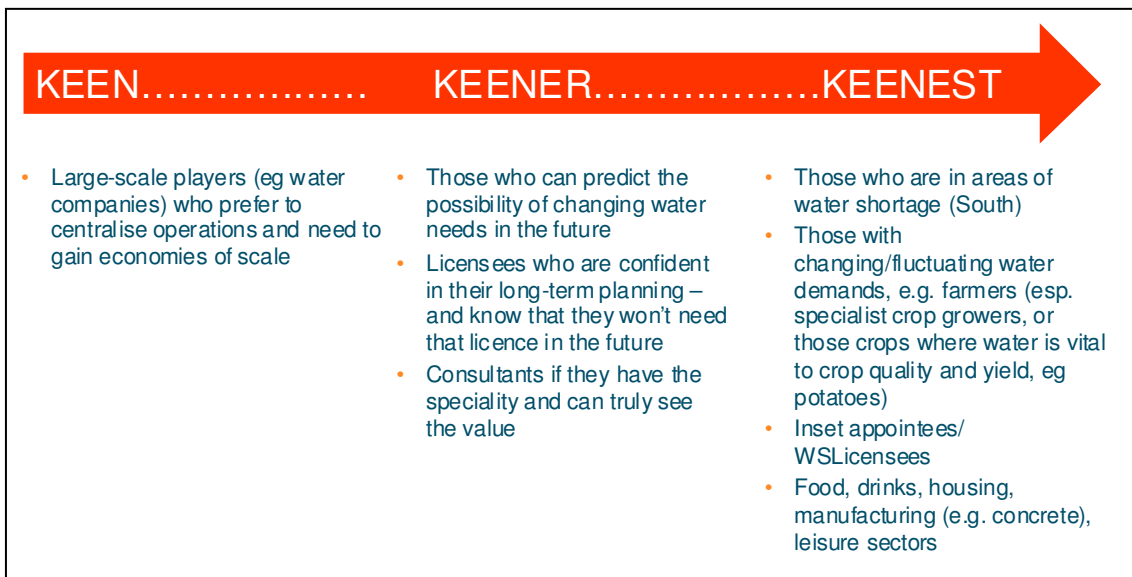
Around a third of potential participants said that they would be unlikely or very unlikely to trade. Generally they could not see any need to buy or sell, and assumed that there were no potential trading partners within the relevant catchment area(s).

Within our sample:

- Approximately a third said that they were likely to consider buying water rights in the future
- Approximately a third said that they were likely to consider selling water rights in the future

4.5.2 Which groups are most likely to trade?

The chart below shows which groups tend to be most likely to want to take part in water rights trading:



4.5.3 What would encourage people to take part in trading?

There are a number of ways in which respondents could be encouraged to trade, although overcoming the barriers in previous sections will of course play a key role in this.

Financially, respondents would either need an incentive to sell in the sense of a good price for the water rights, or a reason not to keep the licences, through making it more costly to actually renew them. Certainly at present, the cost of ownership of licences did not tend to encourage people to want to get rid of them.

However, as discussed previously, the value of the water rights is only one input into the cost / benefit equation. The potential profit on making a trade

would need to be sufficient to cover their costs incurred and be sufficiently large to make the effort worthwhile. They also suffered from not having any current point of reference: they do not know what water rights are likely to trade at. Respondents were thus not able to define an exact figure as to at what point they would be interested in selling their water rights. It would be very much dependent on the circumstances of the individual trade and the parties involved.

4.6 The value of water

One of the key perceived benefits of establishing a water rights trading market is that it will reveal the true value of water. This is also a key piece of information that people would like to know before getting involved in trades, and indeed, is a barrier for people entering the market.

Given the early stages of development of the market, it is not possible to currently identify what that value might be, however, we do have some feedback on what people have been paying for water rights, and how they reached these figures.

In the absence of any pricing information, the value of each trade is negotiated according to individual circumstances. The calculation appears to be:

- From the seller's perspective – what would the buyer have to pay to obtain the water from another source? Usually looking at the cost of mains water as the benchmark.
- From the buyer's perspective – what is the cost of the licence as it currently stands i.e. the renewal charge levied by the Environment Agency?

Other potential sources of information regarding the value of water can come from various sources. In the farming world, there are some other comparative measures:

- Rental values of land – with and without water
- The price of water (as opposed to the rights for water)

According to one land agent who had acted as a broker:

- When renting farming land, the approximate charge for supplying and applying water to the crop would be £30-£35 per acre inch, which works out at approximately 35p per cubic metre of water. 15-25p of this would be for the actual application, leaving approximately 10p per cubic metre to cover the value of the water/ the cost of the licence and the infrastructure being used.
- When renting farm land for a particular crop for one season, the approximate rental values are currently reported to be:
 - o £150-£200 per acre without water
 - o £225- £300+ per acre with water, possibly with an additional charge for administering the water

The land agent had estimated that in theory, the value of water rights should be approximately 10x the value of the water, estimating that in theory, the value of water rights should be up to approximately £2.50-£5 per cubic metre, although this will of course vary according to location, quality, volume etc. However, it does not seem to have reached these levels, only going as far as 50p - £1.50 per cubic metre

This estimate has been backed up by values from other trades, which have varied between approx 60p-£1 per cubic metre.


4.7 Overcoming the barriers

As we have seen, people are generally in favour of the principle of water rights trading. They would be interested in finding out more about it and in seeing how it works 'when it gets up and running'.

However, at this stage it is an unknown quantity: no-one knows what might happen. It therefore seems sensible to ensure that progress is carefully monitored in terms of impact on participants and consumers.

A key issue facing Ofwat and the EA will be balancing the need to 'step back' and let the market run its course, yet retaining sufficient control and powers of intervention, to avoid any potentially negative impacts as the system develops. Close monitoring of the development of trading will provide an opportunity to anticipate possible impacts of each.

The key potential steps suggested by respondents are summarised below.



Action	Aim
<ul style="list-style-type: none"> Remove barriers to development of a central 'market-place', with definitive licensing information 	<ul style="list-style-type: none"> Maximise the chance of people finding a trading partner
<ul style="list-style-type: none"> Create and communicate value in trading – increase cost of licences; promote the advantages of trading 	<ul style="list-style-type: none"> Encourages trading and gives a clearer indication of value of water
<ul style="list-style-type: none"> Remove 'penalties' for trading 	<ul style="list-style-type: none"> Reduce the 'fear' of trading and help overcome hoarding behaviour
<ul style="list-style-type: none"> Standardise the trading process to make it quicker and more accessible 	<ul style="list-style-type: none"> Remove possible 'stumbling blocks' to those with an interest in trading
<ul style="list-style-type: none"> Offer flexibility in trading – around length of tenure/ proportion of rights traded 	<ul style="list-style-type: none"> To allow potential participants to find a solution that 'fits' their needs
<ul style="list-style-type: none"> EA/ Ofwat to take a leading role – provide clarity, transparency and consistency 	<ul style="list-style-type: none"> Reduce uncertainty and stimulate interest in trading

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We will now explore these topics in more detail.

4.7.1 Awareness and Availability: Allowing a central market place for water rights trading to develop

One of the key barriers to water rights trading seems to be the difficulty in actually matching potential buyers and sellers. As earlier sections have shown, there are a number of issues which impact upon the ability to do this, both **physical** – for example, being restricted as to the degree that the point of abstraction can be moved; and **procedural** – gaining access to information regarding what licences are in existence in an area.

For water rights trading to be a success, it is important to remove as many potential barriers to a trade as possible.

A starting point in helping to overcome these issues, would be the development a central 'market-place' where everybody knows they can go to buy and sell licences. This would help people to access the system and highlight the fact that trading is an option.

It could be argued that Ofwat or EA are well placed to set up and administer such a market-place. However, as described above, there is a need for the regulator to 'step back' from the process of trading in order to allow the market to develop and actual values to emerge. Therefore, there is a counter argument which suggests that were any concrete actions taken to proactively create a market place, this should be carried out by a body independent of Ofwat / EA. However, were the development of a market place to be left up to the private sector, it is important that Ofwat / the Environment Agency ensure that as few barriers exist to the development of such a market place as possible.

The development of a market place should be linked to, and supported by the availability of a comprehensive set of licensing information, by (sub) catchment area, to help people to identify potential participants. This information should be as comprehensive as possible, providing contact details as well as information regarding the actual licence. While information regarding the abstraction situation within the catchment area (i.e. is it currently over-licensed/ abstracted etc) is available via CAMS documentation, people are often not aware of it. Raising awareness of the existence of this information, and therefore encouraging access to it would help people to gauge the likely demand for abstraction rights.

Finally, participants would also like to see, where possible, a relaxation of the rules around the moving of the point of abstraction. Doing this would increase the number of potential trading partners and thus the potential for trading, and make the licence more useful.

These actions would mean that if someone wants to trade, they can easily find out who the most likely potential trading partners might be. The creation of a market place would help generate interest in water rights trading; maximise the number of trades that could take place, and in doing so, also help to drive out the potential trades and indeed, whether there is a market for water rights trading. Whilst most people are in favour of the principle of water rights trading, no-one knows whether this appetite for trading is sufficient to overcome the practical barriers involved. The appeal is with the principle, but it is important to remember that the trading generally takes place at a local, restricted level, and is therefore usually dependent on a large number of geographical and environmental factors being in favour of a trade. This market place would help to demonstrate what level of interest there is in water rights trading.

“An improved directory of licences with contacts would be useful...just knowing that there are willing people out there.”
[Potential participant, industry]

4.7.2 Create and communicate the value of water licences

One of the aims of promoting water rights trading is to help establish a value for water. However, it seems that many people are waiting to gauge a value before committing themselves. We therefore suggest that Ofwat/ EA need to consider regulatory intervention to set the cost of licences according to the availability of water. This would at least make the cost of water more reflective of its true value and hopefully help to ‘start the ball rolling’.

A more appropriately structured charging system might also encourage people to trade licences as in some cases the cost of keeping hold of them is likely to become more significant. At present, the cost of renewing licences is generally felt to be relatively small, meaning there is no business imperative to sell them. This reinforces people’s hoarding behaviour.

Allied to this, there is also a role to be played in communicating the likely value of licences, whether through providing a framework to allow people to estimate the value of their licence, or for example, through publishing details of how much licences had been traded for². Simply promoting the possibility of trading more aggressively, when combined with the other measures, will also help to bring the issue to the front of people's minds and become something that is nearer the top of their agenda. Trade Associations in relevant industries could be a useful ally in this. They are looking to find ways to help their members, and once established, promoting and assisting with water rights trading is likely to be a possible service that will provide their members with a benefit.

4.7.3 Remove the 'penalties' of trading

The role of the EA in the trading process – whether actual or perceived – is currently a barrier to trading. Ofwat / EA could help to overcome this barrier by considering ways of reassuring potential licensees that they will not automatically have their licences reduced or restricted at the point of trade (and in the future).

A number of respondents felt that when establishing a market-place for water rights trading, there should be an **impartial, independent facilitator** for the trades. This would help ease concerns, encouraging organisations to explore the commercial viability of trading without fear of demonstrating to the agency that they did not need a licence (and therefore risk losing it). Some suggested that the EA could actually become an active participant in the trading process, thus helping to stimulate the market.

² Given that some people might view this information as being commercially sensitive, it may be that this would need to be anonymised in some cases.

Where any reductions or restrictions need to be made, respondents felt it would help if the EA could communicate a more transparent 'position' on this in terms of the criteria used to make such decisions.

"If the agency could give reassurances to the producers that they wouldn't do it (reduce rights) unless there were impacts on a nearby protected site or habitat, I think that might ease concerns, not in all cases, but it might do for some people." [Consultant]

4.7.4 Making the trading process easier

There are currently generally low levels of knowledge regarding how to actually make a trade, with most people who have thought about it assuming that it would involve the two parties working out an agreement from scratch, and also having to get involved in various evaluations of the impact of any variations to the licence – environmental impacts etc.

Improvements to this would be to:

- Ensure that everyone has access to information about the 'mechanics' of the market. If they can understand what the process will be and easily evaluate the time, effort and expense required to make a trade, they will then be able to make a judgement as to whether it is worth proceeding. Currently, many do not get this far or make assumptions that are unlikely to be accurate.
- Identify ways in which the process could be speeded up. Trades can take up to 18 months in total to complete, with the general assumption that it would take approximately 6 months. Whilst some of this time is obviously dependent on the negotiations between the two parties, any way of speeding up the assessment of the trade application would be helpful.

- An important factor in achieving this would be to introduce more **standardisation**, in terms of the products and the legal processes. The main distinction would be between the permanent and temporary trade of rights for a set period of time. Given people's attitudes towards abstraction licences, it would seem likely that sellers would find most appeal in making temporary trades.
- Given the complexity and individual nature of each licence, it is likely that there is only so much standardisation that can take place with regard to the product, but a standard set of terms and conditions would at least prove a useful starting point and could be amended where necessary. A key point of principle mentioned by a number of respondents was that when trading temporarily, responsibility for the abstraction and any consequences, should rest with the abstractor rather than the original licence holder (otherwise they will be liable for the behaviour of people over which they have no control). This is a point for clarification with prospective traders, as this does actually happen already: responsibility transfers to the buyer through the new or varied licence.
- Standard terms and conditions should help to provide clarity and certainty around the process at the end of the trading period.
- It also needs to be clear that licence holders are allowed to sell part of the licence as well the licence in its entirety.
- The difficulty will be in balancing the needs of the buyers and sellers. Both of course, want the best terms available, but the seller is often likely to want the opportunity to revoke the deal if necessary (especially water companies, who might like reassurance that they can claw back water sources in times of scarcity); whilst the buyer will often want as much certainty/ guarantee of supply to enable them to make future plans. It will need to be made clear that this is something that the two parties will need to negotiate between themselves.

There is therefore a balance to be made between standardising the process to make it as easy as possible to trade, whilst allowing sufficient flexibility to allow potential participants to find a solution that ‘fits’ their needs, as well as reliability and reassurance that they will not be ‘trapped’.

4.7.5 Greater ‘leadership’ from the EA/ Ofwat

As described above, there is a degree of uncertainty about the role and motivations of Ofwat and in particular the EA. Many feel that the regulator and EA will need to ‘make water rights trading happen’:

“They’ve both very heavily into regulation, so I don’t know why they think we’re just going to get on with it.” [Consultant]

As we have seen, there is widespread uncertainty regarding the role of the EA, with the perception that the organisation will get involved at the point of trades and reduce the volumes being sold and/ or impose tighter restrictions. Greater transparency would help to minimise scepticism, encourage take-up and stimulate the market.

“I’d like to see the opening up of the facts, getting over the secretive nature of their plans.” [Inset Appointee]

Most respondents accept the need for an over-arching regulator in the water rights trading market (indeed many feel it should be a leading role in terms of stimulating and driving the market forward), and most believe that Ofwat and the EA have key parts to play:

- Ofwat: providing financial and economic acumen. Many see a key role for Ofwat in putting in place the right regulatory framework to encourage competition in the water supply market at a general level

- Environment Agency: environmental considerations are imperative in the success of water rights trading. Most say that the EA has a role to play as an educator and information provider (e.g. providing easy and accessible lists of licensees, areas where water is available etc)

Many feel that a central organisation must exist to 'manage' trades, provide information etc, but there is also a general desire to see an end to degree of control currently imposed by EA. This facilitator should therefore be independent of the EA/ Ofwat.

It will also be important to clarify the role and motivations of the regulators to try to dispel some of the confusion and misperceptions that currently exist.

Appendix

- A. Detailed Methodology
- B. Discussion Guides
- C. Stimulus Material

A. Sample Profile

Stage one

A total of **10 executive depth interviews** were conducted amongst a range of industry 'experts' and individuals with a broad understanding of water abstraction and licence trading.

The sample profile was as follows:

Type	No. of depths
Trade associations / industry bodies	5
Academics / economists	3
Brokers	2
Total	10

The details of the interviews are as follows:

- 5 conducted by telephone; 5 conducted in person
- Interviews lasted between 40 mins and 1 hour
- Respondents were recruited by telephone, using a short screening questionnaire from sample provided by Ofwat / EA
- All interviews were audio recorded and the recordings analysed

Stage two

A total of **36 executive depth interviews** and **29 semi-structured interviews** were conducted amongst a range of industry 'experts' and individuals with a broad understanding of water abstraction and licence trading.

The sample profile was as follows:

- 2 x current brokers
- 4 x potential brokers (land agents and consultants)
- 6 x organisations representing companies which may wish to trade existing licences
- 2 x organisations representing companies which may wish to enter the water supply market
- 9 x organisations who have participated in trades
- 11 x water companies
- 3 x inset appointees
- 5 x water supply licensees
- 20 x companies which may wish to trade existing licences
- 3 x companies which may wish to enter the water supply market

B. Discussion Guides

Stage one

Ofwat/ EA Water Rights Trading Research – Stage 1 Depths

Discussion Guide

Introduction

Interviewer/ Synovate introduction

Nature/ purpose of the research inc Ofwat/ EA sponsorship

MRS Code of Conduct / confidentiality

Recording

Duration – Up to 1 hour (times to be adjusted according to respondent availability)

Background

Respondent introduction

- job title
- job role
- where/ how fits within organisation

Organisation

- purpose
- description of activities

Where / how does water abstraction fit

- interest in the issue of abstraction and rationale
- role played in water abstraction
- relationship with the water industry
- interest in the industry

Overview of water abstraction

Relationship between different organisations with an interest (esp Ofwat and EA)

- description
- positive / negative

Key trends in the water abstraction, and the industry

- recent past/ current/ future
- importance

Key issues facing the water abstraction, and the industry

- recent past/ current/ future
- importance

Water Rights Trading

Awareness of water rights trading

- level of understanding
- description

Overall perceptions of water rights trading

- good thing/ bad thing
- rationale

Benefits of water rights trading

- currently being realised
- potential in the future
 - o Benefits of attributing market values to licences?

Who will benefit?

- how will they benefit?
- how much will they benefit?

What are the implications of having water rights trading?

- significance?

Drawbacks of water rights trading – whether real or potential

- currently being realised
- potential in the future
 - o Drawbacks of attributing market values to licences?

Who is being / will be affected?

- how significant are the drawbacks?

What are the implications?

- significance?

Expectations of a fully traded water rights market

- what would be the main affects of a fully traded market?
- who would be most likely to benefit / lose out?
- how would the market vary geographically?

Who should/ could water rights trading be of **most** interest to?

- description/ definition
- why would it be of interest to them?
 - o positive / negative
- how important/ useful / interesting would it be to them?
- number of people/ organisations affected
- who would be responsible for this within the organisation?

Who should/ could water rights trading be of **some** interest to?

- description
- rationale
- number of people/ organisations affected
- who would be responsible for this within the organisation?

Is there anyone who you think water rights trading will **not** appeal to?

- description
- rationale
- number of people/ organisations affected
- who would be responsible for this within the organisation?

Triggers and barriers to water rights trading

Who is currently involved in water rights trading?

- awareness
- description

Why do you think they are involved? What are the benefits to them/ the triggers to get involved?

- description
- relative importance

Who is **not** currently involved in water rights trading?

- awareness
- description

Why do you think they are **not** getting involved?

- description
- rationale

What are the **barriers** to involvement?

- description
- who do they impact on?
- relative severity/ importance

How can people/ organisations be encouraged to take part in water rights trading?

- description
- rationale

What price incentives would be needed to encourage people to take part?

- price level vs likely impact on future trades
- what is the optimum level?

How can the barriers to water rights trading be overcome?

- description
- rationale

Could the processes be improved at all?

- how?
- potential impact of this?

The Future of Water Rights Trading

What should Ofwat / Environment Agency be aiming at?

- What will success look like?
- What should be avoided? Situations/ occurrences
 - o description
 - o rationale

What steps need to be taken to create liquidity in abstraction rights?

- How would this vary by licences...
 - o Held and used by existing parties?
 - o Held but unused?
 - o Newly created?

What types of rights trading are likely to be of most value / be most relevant to potential participants in the market?

- Probe on long term Vs short term allocation rights
- Probe on bilateral agreements (with specific terms and conditions) Vs standardised products (traded electronically)
- Explore pros and cons of the above and rationale

What needs to be done to develop the water rights trading market? Who by?

- description
- rationale
- responsibility

What should Ofwat / Environment Agency do to help develop the water rights trading market?

- description
- rationale
- relative importance

Could the processes be improved at all?

- how?
- potential impact of this?

Are there any other external factors that might influence the outcome?

- description
- rationale

How might they be controlled? What could be done to affect them?

- description
- rationale

Are there any lessons that can be learnt from elsewhere in the world/ other types of trading markets, for example emissions trading?

- description
- rationale

Round up

Review of key themes

How do you think water rights trading will develop in the next few years?

What are the key opportunities that need to be capitalised upon?

What are the key issues/ drawbacks that need to be addressed?

Key message to take back to Ofwat/ EA

- what are the top 3 priorities for them to do?

If necessary, explain next steps of the project:

- further desk research to scope out the potential market for water rights trading
- a broader stage of qualitative research to explore levels of interest in water rights trading and identify barriers to doing so

Thank & close

Stage two

Ofwat/ EA Water Rights Trading Research – Stage 2 (Overview Organisations)

Discussion Guide

Introduction

Interviewer/ Synovate introduction

Nature/ purpose of the research inc Ofwat/ EA sponsorship

MRS Code of Conduct / confidentiality

Recording

Duration – 1 hour (face-to-face); 40 mins (telephone)

Background

Respondent introduction

- Job title
- Job role
- Where/ how fits within organisation

Organisation

- Purpose
- Description of activities

Where / how does water abstraction fit

- Interest in the issue of abstraction and rationale
- Role played in water abstraction
- Relationship with the water industry
- Interest in the industry

For trade & industry bodies / environmental bodies...

- Explore their role within the industry
- Explore how their members use / abstract water
- Do they tend to hold abstraction licences?
- Are full entitlements typically used? Examples?
- Any trends in abstraction which may release water on a temporary basis for trading?

Overview of water abstraction

Relationship between different organisations with an interest (esp Ofwat and EA)

- Description
- Positive / negative

Key trends in the water abstraction, and the industry

- Recent past/ current/ future
- Importance

Key issues facing the water abstraction, and the industry

- Recent past/ current/ future
- Importance

Water Rights Trading – awareness and understanding

Awareness of water rights trading

- Level of understanding
- Description

Refer respondent to description of water rights trading and example(s) – these will be sent to respondents in advance of the interview)

Check comprehension and levels of understanding after looking at the examples

Water Rights Trading – experiences (where relevant)

ASK BROKERS ABOUT TRADES THEY HAVE BROKERED AND TRADE BODIES ABOUT TRADES THAT THEIR MEMBERS HAVE MADE THAT THEY ARE AWARE OF

How many times have you / organisations you represent traded water rights?

Who did you / they trade with?

What were the circumstances that led you / they to trade water rights?

- Were you / they the donor or the recipient?

What was the nature of the trade(s)? Explore...

- Length of trade
- Whether full or partial quantity traded
- Over what geographical area the trade took place
- The price paid (if willing)

What would the parties involved have done had they not been able to trade water rights?

How easy was it to make the trade?

Have you / organisations you represent ever tried to trade but been unsuccessful?
Why?

Can you suggest any improvements to the administrative process that would have improved the trading experience?

How have the organisations you represent / acted as a broker for benefited from water rights trading?

ASK TRADE BODIES: Who would organisations you represent be likely to consider entering a trade with?

- Explore likelihood to trade outside of own sector, and rationale for this

ASK BROKERS: How have you gone about promoting your services as a broker?

- How easy have you found it obtaining information to undertake your brokering service?
- What would make brokering easier?

Water Rights Trading – Impressions

Overall perceptions of water rights trading

- Good thing/ bad thing
- Rationale

What do you think are the **benefits** of water rights trading?

Who will benefit from it? Do you think you could benefit from water rights trading? If so, how?

What, if any **drawbacks** are there to water rights trading?

Who, if anyone, might lose out as a result of water rights trading? Why?

What sort of organisations do you think are currently involved in water rights trading?
(IF APPROPRIATE PROBE FOR SPECIFIC EXAMPLES AND REFERRALS)

Why do you think they have got involved? What are the benefits to them/ the triggers to get involved?

Who should/ could water rights trading be of **most** interest to?

- Description/ definition
- Why would it be of interest to them?
 - o Positive / negative
- How important/ useful / interesting would it be to them?
- Number of people/ organisations affected
- Who would be responsible for this within the organisation?

Are there any types of organisations that would **not** want to get involved in water rights trading?

Why do you say that?

What are the **barriers** to people getting involved in water rights trading?

Probe – any others? List all

Which are the biggest barriers?

How could these barriers be overcome/ removed?

How can people/ organisations be encouraged to take part in water rights trading?

- Description / rationale

Could the processes be improved at all?

- How?
- Potential impact of this?

The Future of Water Rights Trading

Expectations of a fully traded water rights market

- What would be the main affects of a fully traded market?
- Who would be most likely to benefit / lose out?
- How would the market vary geographically?

What could be done to help encourage water rights trading?

How could you as an umbrella organisation work to promote water rights trading within your sector better?

- Why do you say that?
- Relative importance of actions
- Who should be responsible for that?

Probe for how this varies by:

- Licences that are held and being used
- Licences that are held but currently not being used/ fully used
- Newly created licences
- Conditions on the licences (e.g. clear set of rules about how a licence could be traded in certain scenarios)

What could be done to provide interested parties with information about a future trading 'market'?

What types of trades are likely to be of most interest to potential participants in the market?

- Why do you say that?
- Advantages and disadvantages of each
- Relative appeal of each

Probe for:

- Permanent Vs temporary trades
- Long term Vs short term allocation rights (e.g. whether the option to trade for a fixed period – 3 months – is of interest)

- Bilateral agreements (with specific terms and conditions) Vs standardised products (traded electronically)
 - o Probe on the ideal scenario in terms of the degree of specificity required. Would a system with any 'automation' be appropriate? (e.g. U.S. 'Water Banks' system)

What **price incentives** would be needed to encourage you or others to take part in water rights trading?

- Description
- What is the optimum level? (where's the right balance between make it worthwhile for people to sell their licences, but not being prohibitively costly for people to buy?)

What could **Ofwat** do to help encourage water rights trading?

- Why do you say that?

What could the **Environment Agency** do to help encourage water rights trading?

- Why do you say that?

Are there any other external factors that might influence the outcome?

- Description
- Rationale

How might they be controlled? What could be done to affect them?

- Description
- Rationale

Are there any lessons that can be learnt from other trading markets, which would help develop water rights trading?

- Description
- Rationale

Round up

Review of key themes

How do you think water rights trading will develop in the next few years?

What are the key opportunities that need to be capitalised upon?

What are the key issues/ drawbacks that need to be addressed?

Key message to take back to Ofwat/ EA

- What are the top 3 priorities for them to do?

If necessary, explain next steps of the project:

- pulling together a report
- can send a summary to them once it is published, most likely early in the new year

Thank & close

Ofwat/ EA Water Rights Trading Research – Overview Organisations

Discussion Guide

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Nature/ purpose of the research inc Ofwat/ EA sponsorship

MRS Code of Conduct / confidentiality

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- Importance

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Probe – any others? List all

Which are the biggest barriers?

How could these barriers be overcome/ removed?

How can people/ organisations be encouraged to take part in water rights trading?

- Description / rationale

Could the processes be improved at all?

- How?
- Potential impact of this?

The Future of Water Rights Trading

Expectations of a fully traded water rights market

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What could **Ofwat** do to help encourage water rights trading?

- Why do you say that?

What could the **Environment Agency** do to help encourage water rights trading?

- Why do you say that?

Are there any other external factors that might influence the outcome?

- Description
- Rationale

How might they be controlled? What could be done to affect them?

- Description
- Rationale

Are there any lessons that can be learnt from other trading markets, which would help develop water rights trading?

- Description
- Rationale

Round up

Review of key themes

How do you think water rights trading will develop in the next few years?

What are the key opportunities that need to be capitalised upon?

What are the key issues/ drawbacks that need to be addressed?

Key message to take back to Ofwat/ EA

- What are the top 3 priorities for them to do?

Thank & close

C. Stimulus Material

Where respondents were unfamiliar with water rights trading, they were directed to the relevant pages within the Environment Agency website:

<http://www.environment-agency.gov.uk/subjects/waterres/564321/1874219/>

The main page of the website is reproduced below.

water rights trading

What is water rights trading?

Water rights trading is the transfer of rights to abstract water from one person to another. It involves the trading of rights only, not the trading of actual water. The transferred rights are set out in a new abstraction licence.

Why trade water rights?

If you already have an abstraction licence, you can sell the rights to some, or all of that water. If you need a licence to abstract water, but no new licences are available in your area, you can buy the rights to abstract water currently held under someone else's licence.

Why the Environment Agency is encouraging water rights trading

We must allocate our water resources carefully to meet demand and maintain the environment, i.e. it is better to use water that is already licensed, rather than abstract more water. Trading can also be valuable if abstractions are transferred to locations where more water is available.

Where are the main opportunities for trading?

The main opportunities are where water is scarce. The best areas are where catchments are termed 'no water is available', or 'over licensed'. Follow the link on the left to our CAMS pages, to look at the situation in your area.

How to trade a licence

Step 1: Read the leaflet “Accessing Water Resources: A guide to water rights trading” and other information here, to gain a basic understanding of trading and how to find more.

Step 2: Contact us on 08708 506 506 to find out whether a trade is possible, and to avoid unexpected costs, or delays in getting our approval.

Step 3: Find a trading partner and agree what water rights you want to trade. If you need a broker, you may be able to find one on the Internet, or through your trade association. We are not able to act as a broker, or to provide a list of brokers.

Step 4: Submit an application. If you are the current licence holder, you will need to make an application to vary your licence using forms WR173 and WR174, or revoke it using WR4. To obtain water rights you need to make an application for a new licence using WR173 and WR174. We will determine the application within three months (four months if advertising is needed).