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# Trading water rights – a consultation document



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The Environment Agency is the leading public body protecting and improving the environment in England and Wales.

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Our work includes tackling flooding and pollution incidents, reducing industry's impacts on the environment, cleaning up rivers, coastal waters and contaminated land, and improving wildlife habitats.

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# Foreword

The availability of water is fundamental to many human activities, particularly agriculture, and also underpins the Government's efforts to introduce greater competition into the water supply industry.

These activities may be restricted by the fact that in some areas it is no longer possible for us to grant abstraction licences, as water rights have already been allocated up to and, in some cases beyond, the limits that the environment can support.

The appropriate allocation of natural resources is a key element of sustainable development. If society is to meet its current and future needs without causing environmental harm, we must make the best use of natural resources within environmental constraints.

In *Tuning Water Taking*, the Government set out its proposals for encouraging the facilitation of water rights trading and proposed how the Agency should implement these proposals. We welcome this initiative and this consultation seeks the views of stakeholders on our suggested approach to water rights trading in England and Wales.

Water rights trading can reallocate water rights from licence holders who place a relatively low value on access to water to those for whom water is more valuable. Trading also gives licence holders greater

flexibility in managing their operations; water rights held to address particular circumstances, for instance prolonged dry weather, can be made available to others when they are not required by the licence holder. To achieve these benefits, water rights trading will need to operate within the context of the revised abstraction licensing system proposed in the Water Bill. The objective of the proposals in this consultation is to develop effective water rights trading arrangements whilst protecting the aquatic environment, other abstractors and third party interests.

This document sets out our proposals, which are intended to strike a balance between flexibility and scrutiny. Trading is an entirely voluntary activity and its success will depend on involving licence holders and others with an interest in water resources and the environment. The responses of consultees to this document will play a key role in how we manage water rights trading and I hope very much that you will be able to respond with your ideas and views on how water rights trading may be successfully implemented.



Sir John Harman, Chairman

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# Introduction

## 1.1 Background

Water rights trading is the transfer of licensable water rights from one party to another, for benefit.

The current stage of the development of water rights trading began with *The Review of the Water Abstraction Licensing System in England and Wales*<sup>1</sup>, published in June 1998. The results of this consultation were then published in *Taking Water Responsibly*<sup>2</sup>, and the proposals in that document have formed the basis for much of the content of the Water Bill. *Taking Water Responsibly* concluded that further research was needed into the design of economic instruments relating to abstraction licensing.

The results of this research<sup>3</sup> provided a fuller understanding of what is involved in introducing water rights trading to the abstraction licensing process, and compared the likely impacts of different types of trading scheme operating within catchments. The conclusion was that a trading process should be adopted based on existing rights. It was also suggested that this could be followed by the auctioning of rights that became available in the future. The research also highlighted the high degree of uncertainty amongst stakeholders relating to how water rights trading would work in practice. Following this research, the Government prepared a further consultation paper specifically on the use of economic instruments<sup>4</sup>, which signalled its support for trading but also raised questions on the means by which water rights trading should be implemented and managed. *Tuning Water*

*Taking*<sup>5</sup> confirmed the Government's intention to facilitate water rights trading and set out a proposed table of actions through which the Environment Agency would facilitate trading. The conclusions of *Tuning Water Taking* form the basis for much of this consultation document.

One of the first actions for the Agency was to provide information to abstractors and Agency staff on the scope for water rights trading within current legislation. A leaflet on water rights trading was published in December 2002 and distributed to licence holders. Following this consultation exercise, we will develop final guidance on how water rights trading will work under the expected new legislation. Responses to this consultation document will inform this future guidance. We also held a stakeholder workshop in October 2002 to enable interested parties to contribute to the development of this consultation document.

## 1.2 Aims of water rights trading and of this consultation

Our aims in encouraging water rights trading are to:

- encourage more efficient allocation of water rights in England and Wales
- protect the environment

<sup>1</sup> *The Review of the Water Abstraction Licensing System in England and Wales*, DETR/Welsh Office, June 1998.

<sup>2</sup> *Taking Water Responsibly: Government decisions following consultation on changes to the water abstraction licensing system in England Wales*, DETR/Welsh Office, March 1999.

<sup>3</sup> *Economic Instruments in Relation to Water Abstraction*, Risk & Policy Analysts Ltd, December 1999.

<sup>4</sup> *Economic Instruments in Relation to Water Abstraction: A Consultation Paper*, DETR, April 2000.

<sup>5</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001.

- meet the expectations expressed by Government in *Tuning Water Taking*.

This consultation document discusses what we consider to be the key issues in achieving these aims. The document sets out these key issues, our preferred approach to how we should tackle them and our reasoning. We hope you, the consultees, will give us feedback on whether we have identified the correct issues, whether there are alternative ways of resolving them and whether you agree with our preliminary views on how to resolve particular concerns.

### 1.3 Structure of the document

*Tuning Water Taking* asked the Agency to consult in relation to water rights trading on ‘its approach to the assessment of reasonable need’ and ‘its draft code of conduct when participating in [water rights] trading’<sup>6</sup>. In addition to this, there are other areas relevant to water rights trading on which we would welcome your comments and these are included in this document. *Tuning Water Taking* was the result of consultation and research on the possible use of water rights trading within the abstraction licensing system, but also considered other aspects of how water rights trading might operate and be managed. We have sought to build on the proposals contained in *Tuning Water Taking* and to present possible approaches to the range of issues relating to water rights trading, as well as to consult on our suggestions for which options should be pursued.

The document is divided into four sections:

- Section 1 explains the background to water rights trading and provides the context for this consultation.
- Section 2 provides a more detailed introduction to water rights trading in terms of its main objectives, the extent to which trading occurs under the current legislation and the reasons why there is scope for a market in water rights trading to develop. This section is for information purposes only and does not include specific questions for consultation.
- The main points for consultation are raised in Sections 3 and 4. As outlined above, one of the key requirements was for the Agency to consult on its proposed approach to the assessment of reasonable need. This discussion is included in Section 3, along with the linked subject of consideration of purpose. Other factors that

are relevant for the Agency to consider in its assessment of water rights trading applications are also discussed in Section 3. These are divided into discussions on:

- what it will be possible to trade
- trading and the application process
- facilitation and regulation of the market.

We have structured this section of the consultation to reflect the case-by-case approach that is suggested as appropriate for water rights trading and to address what we expect to be important to potential buyers and sellers.

- Section 4 considers in more detail those areas where the Agency could consider taking a more active role as a participant in trading. These include:
  - consideration of our role as a broker
  - the potential for us to participate in trading to resolve problems of over-abstraction
  - how we can make information available to facilitate trading.

In these sections, each question is prefixed with an individual number. When commenting on the consultation, please refer to the relevant question numbers.

### 1.4 How to respond

Your response should be sent, in writing, to:

Gwyn Williams  
Abstraction Licensing Review Programme Manager  
Environment Agency  
Wrens Court  
15-17 Lower Queen Street  
Sutton Coldfield  
West Midlands  
B72 1RT

Or by email to:  
[alr@environment-agency.gov.uk](mailto:alr@environment-agency.gov.uk)

This consultation document is also available on the Agency’s website:  
[www.environment-agency.gov.uk](http://www.environment-agency.gov.uk)

The closing date for responses is 24 October 2003. Please ensure that you include the reference to the point or question you are addressing.

<sup>6</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.7.7.

The UK Government has issued a Code of Practice on written consultation and this consultation paper is consistent with the consultation criteria contained in the Code. The criteria are reproduced in Appendix 1.

### **1.5 What happens next?**

Following this consultation, a consultation response document will be produced in early 2004, summarising the range of views that we receive. Extracts from individual responses may be included in the document, but anonymity will be respected where requested. Copies of the consultation response document will be made available on the Agency's website and sent to respondents on request. We will consider in detail the comments and views expressed by consultees in response to this consultation and these will assist us in producing final guidance on water rights trading in 2004. The Agency will also be publishing a consultation document on options for the abstraction charges scheme in autumn 2003.

# Background to water rights trading

## 2.1 The benefits of water rights trading

The Environment Agency is encouraging water rights trading to help secure the proper use of water resources in England and Wales and to contribute towards sustainable development.

We consider that a more efficient allocation of water rights and a greater awareness of the value of water amongst abstractors have a vital role to play; placing a tradable value on water resources will encourage water rights to move to the person who places the highest value on them and will promote economic efficiency.

Water rights trading is expected to:

- provide an incentive for abstractors to invest in water efficiency measures to make surplus water available to trade;
- allow potential abstractors in areas where water would not otherwise be available due to environmental objectives to access water resources currently licensed to other abstractors;
- enable licence holders to manage their water needs more flexibly in response to temporary changes, for example in relation to irrigation needs for different crops;
- allow licence holders to adjust the level of water rights they hold in response to any change in the reliability of their abstraction;
- enable licence holders seeking to retire, restructure or diversify to realise the value of their water rights whilst retaining their land or selling it separately.

The practical benefits that trading may bring include:

- Providing the opportunity for those wishing to compete with existing water suppliers to acquire potential sources of water.
- Enabling the allocation of water rights to be adapted to land use patterns and farming methods within an area. More flexible allocation should increase agricultural profitability where this depends on the availability of water; losses from crops should be reduced and trading will create the scope for farmers to switch crops where water availability or reliability was previously a constraint.
- A relatively regular potential supply of water rights for sale may develop in areas where changes to the economic characteristics of an area are taking place, for example where industrial activities that need large volumes of water for cooling are declining. The opportunity to trade will provide greater incentives for rights to be made available rather than remaining allocated to land that is now used for a different purpose. This may accelerate the rate of change in the economic characteristics and structures of these areas and provide an incentive for particular users or industries to develop locally.

- Giving clear signals indicating the value of water through trading should encourage abstractors to improve levels of water efficiency. It may be possible to reduce the need for water efficiency conditions to be included in abstraction licences if trading assists the Agency in achieving more efficient use of water resources. However, this will require the trading market to give strong, clear signals on water efficiency; whether this can be achieved in practice is considered further in section 3.1.3.

## 2.2 Background information

There are currently around 46,000 abstraction licences in England and Wales, which authorise the abstraction of over 35 million megalitres<sup>7</sup> of water each year. Historically, there has been little incentive for these rights to be allocated to users who place the highest economic or social value on them. On average, more than half of this volume of water remains unabstracted. There is likely to be scope within the licensing system for water rights trading to enable buyers to take advantage of the potential opportunities these circumstances create. A particular example of a potential water rights trading market relates to spray irrigation. This demonstrates that, in some years, there will be significant volumes of unabstracted water held by these licences and that the market is characterised by a relatively large number of individual licences that authorise the abstraction of relatively small volumes. This, together with the concentration of spray irrigation in particular geographical areas, means that there is the potential for an active and flexible market to develop. Figures 1–3 provide information that may indicate some of the likely characteristics of trading markets. They give details of the allocation and uptake of water abstraction rights in England and Wales from non-tidal water during the calendar year 2000.

<sup>7</sup> 35 x 10<sup>12</sup> litres.

Figure 1 | Breakdown of licensed volume, by sector

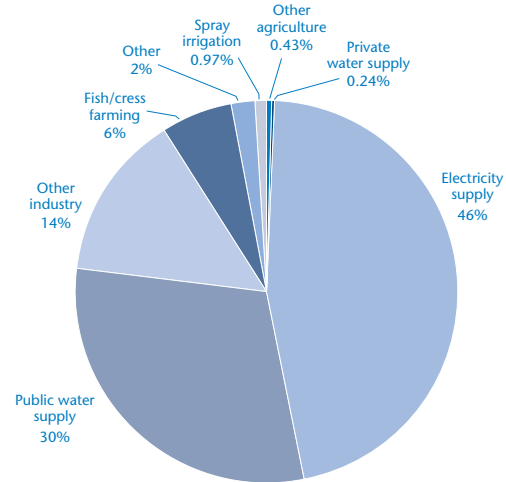


Figure 2 | Number of licences held, by sector

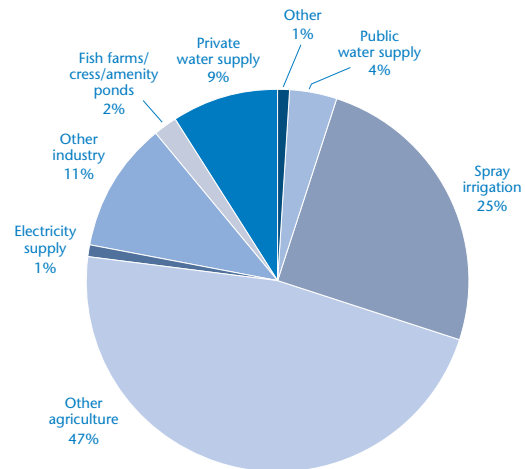
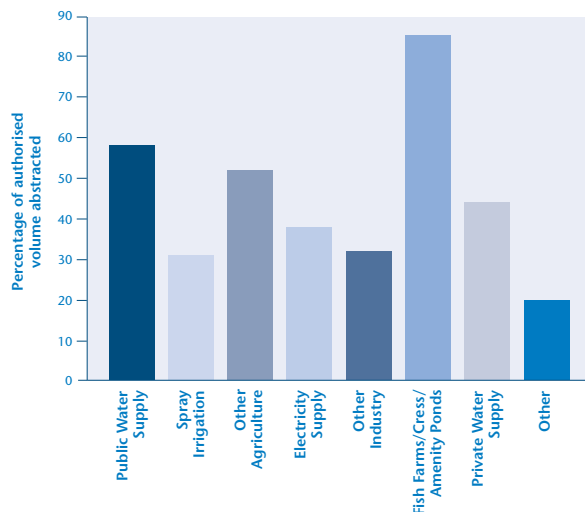


Figure 3 | Percentage of authorised volume actually abstracted, by sector



## 2.3 The abstraction licensing process

### *Introduction*

The Government has made it clear that any water rights trading system should be based on the provisions of the abstraction licensing system. This system is based on assessing individual applications; trading proposals will be treated in the same way, although we have looked at ways in which we can streamline the application process to encourage trading. We have indicated our expectations for particular types of trading application within this system and sought to simplify and speed up the process for trades where possible. However, we do not intend to set trading proposals outside the normal application process for abstraction licensing. This will inevitably mean that many trades will require an application to change the conditions contained on an existing abstraction licence. Where an application for a new or varied licence is needed to complete a trade, we have considered how to minimise these transaction costs<sup>8</sup> whilst continuing to protect the environment.

### *Our general duties*

Under the Environment Act 1995, our principal duty is to contribute towards the achievement of sustainable development, but we must also have regard to specific aspects of this concept, including 'the effect which the proposals would have on the economic and social well-being of local communities in rural areas'<sup>9</sup> and the duties of water undertakers<sup>10</sup>. We are also under a duty to take into account the likely costs and benefits of how we use our powers<sup>11</sup>. In relation to water resources, we have a duty to secure the proper use of water resources, which we do largely through the abstraction licensing system. We also have particular duties to promote the conservation of natural beauty and flora and fauna, as well as to promote amenity and recreational uses of water resources.

### *Water resources regulation*

An abstraction licence is required to abstract water from a source of supply in England and Wales, subject to certain specific exemptions. An abstraction licence

gives the holder the right to abstract water within the terms of the licence and gives the licence holder protection from derogation by any licence issued subsequently<sup>12</sup>. Abstraction licences are determined following an application and consultation process established by legislation that also sets out the statutory conditions that must be specified in an abstraction licence. In determining an abstraction licence application, we must have regard to the reasonable needs of the applicant and consider both the environmental impacts of the proposal and the impacts on existing abstractors and water users.

The Water Resources Act 1991, which sets out the regulatory framework for abstraction licensing in England and Wales, is expected to be amended soon by the Water Bill. While this will not change the fundamental principles and process of abstraction licensing, it is expected to change aspects of the application process and the required content of licences, which could facilitate trading as outlined below.

### *Pre-application discussion*

To optimise the opportunity for a successful trade, we encourage applicants to discuss proposals with us before submitting a formal application. Once these pre-application discussions have been completed and an outline proposal is agreed, the applicant will submit an application along with any necessary supporting information. Pre-application discussion is a key element in ensuring that a trade is successful and that any concerns are identified and dealt with at the earliest possible stage.

### *Right to apply*

The Water Bill is expected to simplify the minimum rights that an applicant must have before they can apply for an abstraction licence. A right of access to the point of abstraction will be sufficient to apply for a licence to abstract from either groundwater or surface water. This will make the application process for trades involving groundwater abstraction significantly easier as the new licence holder will no longer need to occupy the land at the point of abstraction.

<sup>8</sup> For example in relation to advertising requirements (section 3.8) or the extent of necessary supporting information (section 3.7).

<sup>9</sup> Environment Act 1995, s7(1)(c)(iii).

<sup>10</sup> Water Resource Act 1991, s15(1).

<sup>11</sup> Environment Act 1995, s39(1).

<sup>12</sup> With the exception of transfer and temporary licences granted following the expected introduction of these types of licence by the Water Bill.

## **Advertising**

The Water Resources Act 1991 provides for very restricted discretion as to when we can waive the need for an applicant to advertise an abstraction licence application. Therefore, it has often not been possible to determine an application quickly even if there were no environmental considerations. The Water Bill contains measures that will extend this discretion significantly so that trades may be processed more quickly and at less expense where there are no impacts on the environment or the rights of third parties. The Bill also transfers responsibility for undertaking the advertising process from the applicant to the Agency when advertising is required. This will remove the danger that previously existed where some applications were flawed due to technical errors in the advertising process and had to be re-advertised. The importance of the advertising process is discussed in section 3.8.

## **The determination process and licence conditions**

An abstraction licence application is generally granted or refused within three months of the date of application, although this period can be shorter or may be extended by agreement for more complex applications. If the application is granted it will include conditions that protect the environment, protect the rights of other water users and ensure the proper management of water resources. Almost all licences must currently specify the land on which water may be used, but the Water Bill is expected to remove this requirement. The removal of this link to specific land will increase the scope for trading without requiring an application to the Agency for a change to the relevant licence. This change to the legislation is expected to be particularly useful for farmers wanting to trade with neighbouring landowners.

## **Registers and other information**

When an application is made, this is added to the public register of abstraction licences held at local Agency offices. Details of the determination of the application, the terms of the licence and any subsequent changes to the licence, including the name of the licence holder, are also held on this register. The public register is an important source of information for potential buyers and sellers. The Agency may also require any person who abstracts water to provide information on the abstraction and, for most significant abstractions,

licence holders are required to submit returns to us that document the amount of water abstracted. The availability of information will be key to ensuring that trading is successful and we discuss how we will make information more easily available to potential buyers and sellers in section 3.11.

## **Licence transfers**

These are currently termed successions; they transfer the rights contained in an abstraction licence from one party to another when there is a change in occupation of all or part of the land to which the licence refers. The Water Bill is expected to replace the succession process with a licence transfer process and it is expected that licence transfers will be completed by the parties involved simply notifying the Agency. This will remove the need for a change in occupation of land for a licence to change hands on the same terms and conditions. Licence transfers will also remove the complexity previously associated with parts of the land referred to on a licence being sold to more than one buyer. This is likely to be particularly useful for transferring public water supply licences as these do not generally make any reference to authorised land and cannot be transferred under existing legislation to another party other than through a scheme of delegation under the Water Industry Act 1991<sup>13</sup>.

## **Separation of land and water rights**

Taken together, the changes to the right to apply for an abstraction licence and the removal of the requirement to specify the land on which water may be used on a licence will remove the legal constraints that formerly tied water rights to particular parcels of land. This may increase the potential for water rights trading if a greater number of licences do not specify authorised land.

The removal of regulatory requirements linking land and abstraction licences will also open up other opportunities for abstraction licence holders that may affect trading. Water rights may be sold separately to land and it may even become possible to borrow against the predicted trading value of water rights. However, the likely unpredictability of being able to realise the value of water rights may restrict their appeal as security for lenders. By separating water rights from land rights, the value of the seller's land may decrease. However, we do not expect this to have wider economic impacts as, for reasons

<sup>13</sup> Due to an existing exemption from the requirement to specify authorised land contained in s46(4) of the Water Resources Act 1991.

explained in section 2.5, we expect trading to be within quite small geographical areas. We do not believe that there will be any detrimental effects as a result of enabling water rights to be transferred separately from land rights within the context of the abstraction licensing system.

## 2.4 Types of water rights trade

There are a number of ways in which a water rights trade may be undertaken and the regulatory process for the trade will depend upon the type of trade. In deciding on a definition for water rights trading and the scope of this consultation, we have decided to distinguish between water rights trading and what we see as water trading. A 'water rights trade' is the transfer of licensable water rights from one party to another, for benefit. This requires that, as part of the trade, the right to abstract water is moved voluntarily from one party to the other through the abstraction licensing process. A 'water trade' refers to a situation where a licence holder trades in water that they have already abstracted. In this consultation, we have focused our attention on water rights trades. The types of trade described below provide examples of this distinction and explain the different ways that we have approached different types of trade.

### *Relocation trades*

This type of trade involves a licence that authorises abstraction at location A being traded to enable a new or increased abstraction to be authorised at location B. These trades are likely to be the most complex to determine, although certain types of application such as downstream trades may be easier to complete, depending on the environmental characteristics and needs of particular catchments. Trades that can demonstrate environmental benefits should be the easiest of these to complete.

Example: Abstractor A at location A agrees to revoke his/her abstraction licence in return for a payment from Abstractor B. Abstractor B correspondingly applies to increase the quantity authorised for abstraction under his/her existing licence at location B.

### *Licence transfers*

The licence transfer process is an important tool for achieving the objectives of water rights trading. We have sought to highlight in this consultation that the Water Bill, when enacted, will create flexibility and make it much easier to change the name of the

licence holder. Licence transfers will also be important for those wanting to act as water suppliers either through acquiring a licence from an existing supplier or acquiring a licence from another abstractor and then applying for a variation. This consultation does not discuss what provisions should be contained in the Water Bill for the administration of licence transfers, but recognises their potential contribution to water rights trading. It is important to note that a licence transfer will only transfer a licence in its current form and location. Any changes to the terms of the licence, for example the point of abstraction or the purpose for which water is abstracted, will require an application to the Agency to vary the conditions of the licence.

Example: Abstraction licence holder C holds a licence to abstract water for spray irrigation on an area of land specified on his/her abstraction licence. C then leases this land to D to grow crops requiring irrigation. C and D jointly notify the Agency that they wish to transfer the abstraction licence from C to D. At the end of the lease, C and D notify the Agency that they wish the licence to be transferred back from D to C.

### *Variations*

Variations involve an application to the Agency to change the conditions contained in an existing abstraction licence. A variation may be used to change the purpose of the abstraction, for example to enable the licence holder to supply water to others. We have borne in mind the potential for these trades when preparing this consultation and will aim to facilitate such changes where possible. However, they fall outside the definition of water rights trading as they are changes to an existing licence and do not involve the transfer of water rights between two parties. Variations to abstraction licences will often be needed following a transfer of water rights, for example to enable the buyer to use water for his/her intended purpose or to remove a reference to land contained in the seller's licence. However, the principle that an environmentally beneficial trade will be easier to facilitate will still apply. The scope for facilitating applications relating purely, for example, to a change of purpose has not been considered in this consultation.

Example: Company E holds a licence to abstract water for industrial cooling but decides to relocate its factory. E agrees to transfer the licence to F. F then

applies for a variation to change the purpose of the licence from industrial cooling to enable him/her to supply others. The first stage of this process is the trade; the second is the variation of the acquired right.

## 2.5 Predicted characteristics of trading markets

By predicting the characteristics we expect to see in a future trading market, we can assess the likely nature and extent of markets. This helps when considering what we will need to address and how we might do so. The five main characteristics of water rights trading markets are likely to be:

- **Spatial:** where can I trade to? – the geographical area within which relocation trades are possible.
- **Sectoral:** who can I trade with? – whether there are any restrictions, either regulatory or practical, on trading between or within sectors.
- **Temporal:** how long will trades be for? – whether water rights can be traded for both the short and long term.
- **Types of water rights:** what will be traded? – whether there are likely to be any characteristics of water rights made available for trading.
- **Administration:** how will the trading process work? – how will the Agency administer trading applications.

### *Spatial*

Trading is likely to be concentrated in areas where water resources would otherwise be unavailable due to environmental or resource constraints. There is also likely to be demand in other areas for specific reliable sources of water, water rights for particular purposes or water rights linked to particular locations if these would otherwise be unavailable or expensive to develop. All trades that we approve should be consistent with our environmental and water resources management objectives and this will determine, for example, the geographical boundaries within which particular water rights may be traded. Where a trade is proposed that would change the point at which water is abstracted, the proposed change to a licence by the seller at one location must result in more water being available for abstraction at the location where the buyer proposes to abstract. A hydrological link must therefore exist between the two points of abstraction. This means that the majority of trades are expected to take place within

catchments or groundwater management units, although trading may also be possible where a hydrological relationship overlaps two or more catchments or units.

Characteristics of water resources in England and Wales will result in trading units that are much smaller than in other countries such as Australia or the USA due to the relatively small size of our catchments and groundwater management units. This will result in relatively small numbers of potential buyers and sellers able to trade with each other. Information must be available to encourage full participation and administrative barriers to trading must be kept to a minimum to ensure the success of trading markets<sup>14</sup>.

### *Sectoral*

We expect trading between sectors to be limited; most trades are likely to take place within sectors. The two expected to have an interest in trading are agriculture and water supply and the majority of both potential buyers and sellers are expected to come from these sectors. Quantities sought by water suppliers are likely to be such that most agricultural licences would hold little appeal, while few agricultural abstractors would have the ability to use the quantities authorised for abstraction by public water suppliers. There is likely to be some scope for agricultural and other abstractors to trade with water companies to acquire water rights to abstract small proportions of water companies' abstractions that may have been held for contingency reasons or to accommodate peak demands. We do not expect much competition for resources between these two sectors, as discussed in section 3.3. However, there is no reason in principle that trades between sectors could not develop if market conditions are favourable.

### *Temporal*

Many trades, particularly within the agricultural sector, are expected to be short term (that is, for less than a year), in response to short-term demands for water. We have given particular consideration to how our approach will help and affect short-term trades.

### *Types of water rights traded*

When looking to buy water rights, buyers will tend to look for the cheapest water rights that fit with their objectives. In the first instance, these are likely to be those water rights that are not currently used.

<sup>14</sup> This is addressed in section 3.11 on access to information for potential buyers and sellers and section 3 part B on water rights trading and the application process.

Licences that are used for relatively low value uses may also be traded to higher value users, although these licences would probably be traded at slightly higher prices than unused abstractions.

### **Administration**

As water rights trading will be based on the abstraction licensing system, trading applications will be assessed case by case, except for transfers, which will simply require a notification. Where an assessment is required, its length and cost will vary between trades and will depend on the potential impact of a particular trading application on the environment and other water users. Trades that have a positive impact on the environment or other abstractors should generally be quicker and cost less than other trades. Our suggestions for how water rights trading may be facilitated and encouraged are discussed in section 3, part B of this consultation

## **2.6 The roles of the Agency and Ofwat**

### **Introduction**

In carrying out our role of managing water resources and regulating the abstraction licensing system we work with a large number of stakeholders. In relation to public water supply, we work closely with the Office of Water Services (Ofwat) and this relationship will be important in ensuring that trading contributes to the Government's objective of promoting competition amongst water suppliers.

### **The role of Ofwat**

Ofwat is the economic regulator of the water and sewerage industries in England and Wales. Ofwat's powers and duties include:

- enforcing the provisions of the Water Industry Act 1991, the Competition Act 1998, the Enterprise Act 2002 and parts of the Environment Act 1995 as they apply to water services;
- facilitating effective competition;
- promoting greater efficiency by water and sewerage undertakers;
- how much water and sewerage companies may charge their customers;
- standards of service.

To a greater or lesser degree, water rights trading potentially affects all these activities. Trading is a potentially useful tool in increasing levels of competition within the water supply industry, as has been recognised by the Government in *Tuning Water Taking*.<sup>15</sup> The scope for greater competition through trading may raise the standards of service and lower charges for customers but, by seeking to avoid resources being tied up unnecessarily, standards of service must not be compromised. Enforcement of the provisions of the Water Industry Act 1991 and the Competition Act 1998 are essential in ensuring that the trading market is not distorted by the abuse of any dominant position that might prevent competitors accessing water resources.

The licensing system interacts with aspects of Ofwat's remit. These include:

- The site-specific nature of the impacts of abstraction from, and the return of water to, the environment as well as the site-specific nature of abstraction licences themselves can limit the scope for transferring licences to potential competitors.
- Addressing the environmental impact of water abstractions could require undertakers to operate in a particular way or to change their pattern of abstraction and this may have implications for the costs borne by water customers.

Given these overlapping interests between the Agency's and Ofwat's regulatory roles, the Government has recommended<sup>16</sup> that a memorandum of understanding be prepared between the two organisations delineating their roles in trading and establishing ground rules for how they will work together. The Agency and Ofwat will ensure that these overlaps are considered when working relationships are established.

## **2.7 Environmental protection**

As referred to in section 1.2, the aim of water rights trading is to improve sustainability and make the best economic and social use of available resources without damaging the environment. To achieve this, water rights trading must operate within a legislative framework that ensures that environmental needs are considered whilst avoiding excessive bureaucracy that might discourage trading. We will seek to encourage trades in which social and economic

<sup>15</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, sections 3.1.13–3.1.18.

<sup>16</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 4.5.

benefits may be combined with environmental gains. We will not approve any trade that is likely to result in environmental damage to a particular protected site or sites.

Many respondents to the Government’s consultation on the use of economic instruments in water abstraction<sup>17</sup> discussed the risk of water rights trading causing currently unused abstractions to be reactivated. We agree that this is a potential risk and have noted that the majority of queries we have received, following the publication of interim information for abstractors, have come from licence holders who no longer use their licences to abstract. Unused abstractions may also be reactivated for a number of other reasons such as changing farming or industrial practices and climate change increasing water scarcity. We have considered the potential problems posed by the trading of unused water rights and suggest solutions that would enable these rights to be traded without causing environmental damage. These proposals are discussed in section 3.5.

## 2.8 CAMS and water rights trading

Catchment Abstraction Management Strategies (CAMS) establish, through set guidelines and consultation processes, the abstraction licensing strategies for achieving the sustainable management of water resources within catchments in England and Wales. Within each CAMS, a catchment is broken down typically into six to eight Water Resource Management Units of a maximum size of around 50km<sup>2</sup> and an average size of around 25km<sup>2</sup>. Water Resource Management Units are the smallest scale considered by CAMS, so there will be very few opportunities for CAMS to identify specific potential trades and CAMS will not be able to indicate detailed licence conditions for an application at a specific site.

Assessment of trades will continue to be case-specific, based on the information contained in individual applications. This approach need not be complex and, in this consultation, we have looked at how we can simplify the process, particularly in relation to advertising and the provision of supporting information for trading applications.

Water rights trading does not depend on the production of a CAMS for a particular catchment, but one of the objectives of the CAMS process is the facilitation of trading and CAMS will contain information that will be valuable to potential buyers

and sellers. CAMS categorise individual water resource management units within one of four categories as shown in Table 1.

**Table 1** | Resource availability status categories

Indicative resource availability status	Definition
Over-abstracted	Existing abstraction is causing unacceptable environmental impact at low flows. Water may still be available at high flows with appropriate restrictions.
Over-licensed	Current actual abstraction is resulting in no water available at low flows. If existing licences were used to their full allocation, they would have the potential to cause unacceptable environmental impact at low flows. Water may be available at high flows with appropriate restrictions.
No water available	No water available for further licensing at low flows, although water may be available at higher flows with appropriate restrictions.
Water available	Water likely to be available at all flows including low flows. Restrictions may apply.

Trading is expected to be concentrated in catchments where additional water resources would not otherwise be available. However, these catchments are likely to be the most environmentally vulnerable to any increase in actual abstraction. To address this, the licensing strategy within CAMS will contain general principles for the determination of trades in each catchment that will aim to ensure that potential trades are consistent with the water resource management objectives for that catchment. Our proposals for how these principles should be established are discussed in section 3.5. The other potential key role of CAMS is to provide information to trading parties; our proposals for how CAMS could contribute to this are discussed in section 3.11.2.

A CAMS is a process with long-term objectives for a catchment. The CAMS process has started but, in some catchments, the first CAMS will not be completed until 2008 and it will be some time into the future before the objectives of CAMS are achieved.

<sup>17</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.4.

# Administration of trading by the Agency

## A. What will it be possible to trade?

### 3.1 Reasonable need

The Agency is required by the Water Resources Act 1991 to consider the reasonableness of an applicant's requirements when determining an application for a new or varied abstraction licence<sup>18</sup>. In practice we have used the term 'reasonable need' to refer to the assessment of whether an applicant for an abstraction licence can demonstrate that the volume of water applied for matches the volume that could reasonably be required for the proposed use. The term 'reasonable need' reflects the fact that our assessment considers whether an applicant needs the quantity of water applied for to achieve the purpose for which water is abstracted.

We do not consider whether the applicant is being reasonable in requiring water, for example because an applicant for a spray irrigation licence could grow other crops that would not require abstraction for irrigation. It has been suggested, however, that in addition to looking at the volume of water applied for, we should also consider whether the purpose for which the water will be used is reasonable when compared with other options for applicants or the value of water to other potential future users. This possibility is discussed in section 3.1.2.

While we are under a statutory requirement to assess whether an applicant's requirements are reasonable, many historic licences were not assessed on this basis. For 'licences of right'<sup>19</sup> and 'licences of entitlement'<sup>20</sup>, authorised quantities were based on evidence of historic use submitted to the Agency by applicants.

These licences were not subject to a test of reasonable need or other criteria against which licence applications submitted today would be assessed. Trading provides an opportunity to allocate rights that may not have been assessed for reasonableness of need more effectively.

The opportunity to trade should also, in theory, discourage licence holders from retaining water rights that they do not need by providing a financial incentive to sell. The Competition Act 1998 provides for significant financial penalties if companies are found to be abusing a dominant market position and this should discourage such practices within water rights trading markets. If our objectives for trading are to be achieved, the economic signals from the market and from the enforcement of competition legislation must be sufficiently strong and clear to discourage abstractors from holding more water rights than they can use or require. If this is not the case or there are uncertainties as to the strength or clarity of such economic signals we would suggest that the reasonable need of applicants should be assessed when trades take place. Without either appropriate economic signals or a test of reasonable need in place, buyers may use trading to acquire resources that they do not intend to, or cannot, use and the hoped for efficiencies sought through trading could be compromised.

The majority of responses received to *Tuning Water Taking* supported the use of a test of reasonable need when determining trading applications and this corresponds to existing practice for all other licence applications. Through the use of economic

<sup>18</sup> Water Resources Act 1991, s38(3)(b) states that 'the Agency shall have regard to... the requirements of the applicant, in so far as they appear to the Agency to be reasonable requirements'.

<sup>19</sup> Issued to authorise existing activities following the introduction of the water abstraction licensing system by the Water Resources Act 1963.

<sup>20</sup> Issued to authorise existing activities when further types of abstraction were brought into regulation by the Water Resources Act 1989.

instruments it may be possible for tests of reasonable need to be relaxed or even dispensed with for trading applications, on the basis that buyers would not buy water they did not need. There may consequently be an opportunity to reduce the bureaucratic burden for trading parties without compromising the management of water resources.

### 3.1.1 Existing assessments of reasonable need

To assess whether an applicant has a reasonable need for water, the Agency has adopted a number of processes that consider what quantities of water are reasonable for a range of uses across a number of purposes. We also work closely with water companies and Ofwat to ensure that quantities applied for by water undertakers are reasonable and are supported in the companies' water resources plans.

The Agency has produced guidance in recent years on how we will assess whether an applicant's need is reasonable. This takes the form of sector-specific guidance for particular industrial and agricultural purposes<sup>21</sup>. The guidance is based on the level of water use that would be required by a reasonably efficient process operating in that sector and the measures that would contribute towards achieving this. This is supported by other permitting systems such as IPPC<sup>22</sup>, and Government initiatives such as Envirowise that provide additional help and advice on these and other subjects.

Water resources plans show how water companies intend to maintain a balance between water supply and demand for the next 25 years. The measures identified in the plans take into account social, economic and environmental factors. The plans are scrutinised by Ofwat and the Environment Agency. We assess whether an applicant's need for water is reasonable by referring to the supply and demand estimates contained in their water resources plans.

By providing economic signals that should discourage buyers from seeking to buy water rights that they cannot make use of, water rights trading provides a possible opportunity to waive the tests of reasonable need that are used for other applications. However trading should not encourage water to be used inefficiently amongst abstractors and trading systems

should not encourage the abuse of a dominant position to prevent competitors acquiring water resources<sup>23</sup>. If the assessment of reasonable need is replaced by reliance on economic signals to abstractors, then achieving these objectives relies on the price of water rights. Water rights prices would need to be sufficiently high to make it more expensive for an abstractor to buy water rights than to improve water efficiency. Similarly, the value of water rights would need to be high enough to make selling water rights more attractive to existing licence holders than retaining them to deprive other potential abstractors. We do not expect prices to be high enough in the immediate future for this to happen and suggest that we need to retain the assessment of reasonable need to achieve the objectives of water rights trading.

### *New entrants into water supply markets*

Where a new entrant to the water supply market wishes to supply water, trading may offer potential opportunities to acquire a source with a proven yield or to acquire a resource in an area where they would not otherwise be able to acquire a licence. When assessing an application for a new licence or a variation to an existing licence made by a new entrant to the market, we are aware that applicants may not have an Ofwat inset appointment or agreements with end customers when making an application. It may be difficult to obtain these, however, before a suitable source of supply has been secured. It is suggested that we should not generally consider whether new entrants to the market have end customers or have a firm business plan based on a known end market.

While we suggest that reasonable need should be assessed on a basis that reflects the uncertainties for new entrants to the market, we should also seek to ensure that resources are not tied up unnecessarily. One possibility would be to do this by using 'self-destruct clauses'; if projected demand does not translate into actual customers, the related abstraction licence expires or the authorised abstraction is reduced proportionately<sup>24</sup>. These licences will also be time-limited, following our established policy on issuing any new or varied abstraction licence.

<sup>21</sup> *Optimum Water Use in Industry and Agriculture – Phase 3*, Technical Report W6-056, Environment Agency, 2003.

<sup>22</sup> Where the activity for which water is proposed to be abstracted is regulated under the IPPC system.

<sup>23</sup> Although we are not intending to suggest that the Agency should take on any function of regulating competition, we do think that the assessment of reasonable need indirectly provides a potential barrier to an abstractor seeking to abuse a dominant market position.

<sup>24</sup> An example of a simple self-destruct condition might be worded: 'Although the licence may otherwise remain in force until (*date specified on front of licence*), this licence shall cease to be of any effect if the abstraction it authorises has not commenced within (*e.g. 2 years*) of the date of issue of this licence.'

## Applications by brokers<sup>25</sup>

The ability to transfer a licence through notification without any transfer of land will enable anyone who wants to acquire a licence to do so, regardless of whether they have an end use for that water. Through trading, this may present brokers with the opportunity to acquire water rights through the licence transfer process so as to resell these rights. Brokers may also wish to hold water rights to resell to particular types of abstractors in the future without abstracting in the meantime. The prospect of speculation in water rights was almost universally opposed at the stakeholder workshop in October 2002. We do not have any power to refuse an application to transfer a licence so if someone wanted to buy water rights to resell them in the same form, this would not be something the Agency could get involved in other than to administer the licence transfer.

Changing the terms of a licence, for example changing the purpose of abstraction or removing a link to land, could increase the value of particular water rights. If a broker wishes to apply to change the terms of the licence following a licence transfer, this might not be considered to constitute a reasonable need for the water rights contained in the licence. However, this role may be seen as important in ensuring that markets are flexible enough to cater for peaks and troughs in supply and demand. An alternative to rejecting such applications would be to allow brokers to acquire rights and apply to change conditions on licences subject to including a condition on the licence that it will expire within a set period if the rights are not traded on or used.

WRT1	Would adopting existing tests for assessing reasonable need be appropriate for water rights trading or would it give rise to any particular problems? If you consider that existing tests would cause problems for trading, how should reasonable need be assessed for trading applications or particular types of trading application?
WRT2	Do you consider that we need to assess reasonable need when determining trading applications or should we presume that a need is reasonable if someone is prepared to pay for water rights?
WRT3	Should brokers be able to apply to change the conditions of an abstraction licence to sell water rights on and, if so, should any particular constraints be placed on such licences?

## 3.1.2 Reasonable purpose

In theory, the Agency may consider whether an applicant for an abstraction licence has a reasonable purpose for abstracting water as part of its duty to secure 'proper use of water resources'<sup>26</sup>. We have not, historically, done this as the question of what constitutes a proper use of water has been considered a matter of social policy with repercussions that go beyond the remit of the Agency. The principle of 'first come, first served' underpins the abstraction licensing system and we give precedence to the first application we receive over any future application.

By encouraging water rights trading, the economically efficient allocation of water rights will acquire a prominence that it has not previously had. Economic signals to abstractors through water rights trading markets should cause water to be diverted from low value to high value users. This will not take account of other factors such as the social impact of a change of purpose, for example where a buyer's purpose will employ fewer people than the seller's purpose does. To consider these impacts, and other impacts that cannot be expressed through willingness to pay, we could adopt a test of reasonable purpose.

In applying such a test, we would consider the perceived social, economic and environmental value of a particular use and decide whether that use was reasonable when balanced against other competing uses. If the use was of low economic, social or environmental value, we might refuse the application so that a higher value user can obtain the water rights in the future. For water rights trading, this test might ring-fence water rights in sectors or groups of sectors where they had a particular social or environmental value that was not expressed in the value buyers were able to pay.

Consideration of reasonableness of purpose would require us to establish a hierarchy of uses within a catchment and, possibly, even across catchment boundaries if a proposal would transfer water out of the catchment where it is abstracted. This would potentially bring the Agency's policies into conflict with other statutory processes such as Local Plans prepared by Local Planning Authorities. Considering reasonableness of purpose would also require us to consider aspects of social policy which lie outside our roles and responsibilities.

<sup>25</sup> See section 3.12 for a fuller discussion of the role of brokers in the water rights trading market.

<sup>26</sup> Environment Act 1995, s6(2)(a).

Given such pitfalls, it is suggested that the benefits of applying a test of reasonable purpose, in addition to existing tests of reasonable need, would be outweighed by the difficulties in applying it. Consideration of reasonable purpose may be influenced more by processes such as town and country planning and political decisions based on the social and economic views of local and national politicians.

**WRT4** Should we adopt a test of reasonableness of purpose when assessing applications for abstraction licences resulting from water rights trades? If a test of reasonable purpose is adopted, how should we establish a hierarchy of purposes against which reasonableness should be assessed?

### 3.1.3 Water efficiency

In theory, water rights trading should encourage licence holders to minimise the waste of water and reduce consumption. This provides them with the opportunity to trade in the released water rights and generate extra income. If the price for water rights increases, the incentive for licence holders to minimise waste and reduce consumption also increases.

For some time, along with other organisations, we have promoted measures that licence holders can take to increase levels of water efficiency, particularly for agricultural, industrial and water supply purposes. Levels of water efficiency have improved but substantial scope for water efficiency improvements remains for some licence holders. Through attaching a potential value to the water rights in abstraction licences, we hope licence holders will reconsider the scope for efficiency savings, for example through water audits and waste minimisation programmes. We also expect that those buying water rights will seek to make their process as efficient as possible to reduce the cost of acquiring water through the trading process. Trading highlights the financial incentives for efficient use amongst both buyers and sellers of water rights.

As discussed in section 3.1.1, economic signals are not yet sufficiently clear to prevent water rights trading being used to acquire water rights for abstractions that are not consistent with our guidance on water efficiency. We suggest that it remains necessary to include an assessment of water efficiency when determining trading applications to fit with our aims of improving levels of efficiency amongst abstractors.

<sup>27</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.7.6.

As discussed, we already have processes for assessing the reasonable need of applicants as part of the determination of an abstraction licence application. The Agency will also consider whether water is being used efficiently when deciding if a time-limited abstraction licence should be renewed; renewal of a licence on the same terms and conditions will depend partly on the level of efficiency achieved by the licence holder.

**WRT5** Should we assess water efficiency when determining a trading application or should the level of efficiency achieved be left to the market to determine? If we should assess water efficiency, are existing water efficiency tests suitable for trading applications or would you suggest an alternative approach?

### 3.1.4 Environmental purposes

Some environmental groups commented, in response to the Government's consultation on the use of economic instruments in water abstraction, that it should be possible to hold licences that reserved water within a source of supply (either through non-use or nominal abstraction) for environmental benefit. It was also suggested that abstraction for environmental purposes should always be considered a reasonable need<sup>27</sup>.

Trading highlights two particular questions for applications for environmental purposes:

- Is it possible to grant a licence for 'non-use', whereby no abstraction takes place but a licence is held to prevent abstraction by another party and so maintain or increase river flows for the benefit of fisheries or environmental features? If so, should we grant such licences or refuse applications on the grounds that applicants in these circumstances do not have a reasonable need for the water?
- What tests should be applied to assess whether requirements for site-specific environmental purposes are reasonable?

#### 'In situ' uses

'In situ' uses are activities that retain water within a source of supply rather than abstracting water from that source of supply. This would generally benefit particular environmental features or fisheries, but could also be used by existing licence holders; they could buy up water rights to enhance the reliability of their abstraction by ensuring that a hands-off flow

specified on their licence was reached less frequently. Where we are seeking to recover water resources, it would be possible for parties other than the Agency to pay abstractors to relinquish their licences to increase the proportion of water remaining in the environment. This would not be effective if we considered that resources were available, as we could reallocate any water rights revoked to a future licence application.

Where water is not temporarily or permanently removed from a source of supply, the applicant does not have to hold a licence<sup>28</sup>. We consider that neither the Water Resources Act nor the Water Bill enable us to issue a licence unless that licence is for an abstraction<sup>29</sup>. Also, a licence of this sort would not provide any useful protection to the holder as the protected rights they would acquire, and which we would take into account when determining future licence applications, would only protect their right to *abstract* to the extent authorised under their licence<sup>30</sup>. A licence of this sort would not, therefore, protect water in the environment as this water would remain available to future applicants.

Some environmental groups suggested that they might be prepared to make a nominal abstraction by abstracting and immediately returning water without any intervening use in order to acquire water rights that could be used to keep water in the environment. We suggest that such an abstraction does not constitute a reasonable need because the reasonable need for a catchment's environmental interests will have already been consulted upon and allocated through the CAMS process and these resources will not be licensed. If anyone disagrees with the environmental allocation set by a CAMS, this should be addressed through the consultation process. Where an environmental need is for a seasonal or periodic requirement at a site, this is something that would be included in the licensing strategy for that catchment and considered as part of the licence determination process. The option would remain open for organisations to pay abstractors not to abstract at certain times to protect or enhance environmental features or fisheries

WRT6

Do you agree with our view that an abstraction licence cannot be granted for in situ use and do you have any comments on the reasoning behind that proposal?

### *Site-specific abstractions*

Applications for environmental purposes relating to the abstraction of water to provide a supply to a specific site, such as the creation of an area of wetland habitat, are subject to tests of reasonable need and water efficiency. A number of these licences have already been issued to different licence holders. For site-specific applications there may be a reasonable need to abstract the volume applied for, as periodic site-specific issues are not incorporated within the CAMS process of establishing the environmental allocation for a catchment. The approach to licence determination established in the licensing strategy for a catchment may not be a suitable mechanism for ensuring that such sites receive a supply of water if abstraction is required to provide that supply.

As with any application, a proposal to abstract for site-specific environmental reasons would be determined within the guidelines contained in the relevant catchment's licensing strategy. The points considered might include the length of any deprived reach that the proposal would create and the extent of any overall losses from the source of supply resulting from the abstraction. The assessment of the application would continue to be site-specific, depending on the details of the proposal and consideration of existing protected rights and the broader environment.

We propose that applications to acquire water for specific environmental sites through water rights trading should be considered within existing processes for licence determination but that such proposals are acceptable in principle.

WRT7

Do you have any comments on the possible approaches to site-specific environmental proposals arising through trades?

<sup>28</sup> As their actions (or lack of action) would not constitute an offence under the provisions of s24(1) of the Water Resources Act 1991.

<sup>29</sup> Although the Act does not specifically limit the nature of the Agency's powers to grant an abstraction licence beyond the provisions of s38(2) of the Water Resources Act 1991, the form and content of abstraction licences prescribed by s46 of the Water Resources Act 1991 clearly does not contemplate the issue of abstraction licences for any reason other than to authorise abstraction.

<sup>30</sup> Water Resources Act 1991, s39.

### 3.2 Sale of headroom

Many abstractors, such as water companies or spray irrigators, place a high value on the availability of water but have uncertain demands and will have headroom quantities that they hold to address contingencies or potential future demands. They might require headroom volumes either to protect themselves from unacceptable risks, such as being unable to supply water to the public at times of peak demand, or to accommodate future increases in demand. These quantities of water may be suitable for trading before predicted increases in demand or at times when peak demands are unlikely to occur.

There are two different types of headroom: available headroom and target headroom. Available headroom is 'the difference (in Ml/d or percentage) between water available for use... and demand at any given point in time'<sup>31</sup>, while target headroom is defined, for water companies, as 'the threshold of minimum acceptable headroom, which would trigger the need for total water management options to increase water available for use or decrease demand'<sup>32</sup>.

Given the importance of headroom provision, particularly in public water supply, one option would be to prevent trades in headroom taking place to ensure security of supply was not threatened. However, the possibility of trading in headroom is potentially critical to enabling the water rights trading market to be flexible enough to accommodate short-term changes in demand amongst buyers and sellers. It would, properly utilised, enable those with unpredictable requirements for water to adjust the level of water rights held in the short term. In selling headroom, one of the most important questions for all buyers and sellers will be which party has the benefit of the water rights at times of concurrent demand. In deciding whether to sell headroom, abstractors will have to consider how they will balance the value of the water to them at times of peak demand against the potential value of those water rights to other abstractors.

We feel that preventing any trade in headroom would be disproportionate, but that it may be appropriate to limit the type of headroom that water companies can trade. Trading in headroom held to accommodate future, as yet unrealised, demands would be acceptable but trading in headroom held to ensure

that water is available during dry periods is often unlikely to be acceptable. Trading in quantities of water intended for these dry periods is likely to carry the risk that water would not then be available when it was needed for public water supply. In determining any application, it is suggested we should include an assessment as part of the application process that ensured security of supply was not compromised by a particular trading proposal. Water companies that propose to sell headroom should be able to show that their position following the sale would be consistent with their water resources and drought plans.

For other abstractors, it is not likely that Agency scrutiny is required to assess how water rights will be allocated at times of concurrent demand between the buyer and seller. Some sellers may choose to realise a greater proportion of the value of their water rights through a trade, by giving the buyer precedence over water rights in these circumstances, rather than providing for water rights to revert to the seller. We recognise that our proposals for different arrangements for the sale of headroom by different sectors will place greater constraints on water undertakers that propose to trade compared with traders from other sectors. This may well be necessary though, to fulfil both our responsibilities and those of water undertakers.

The Government in *Tuning Water Taking* proposed what it termed 'acquisition curtailment conditions' for short-term water rights trades<sup>33</sup>. This system is already operated by the Agency to transfer rights or replace sources within an operating system, but has been termed a linked licence condition. The use of linked licence conditions is likely to be particularly important for this sort of trade to create the necessary flexibility in the use of the relevant water rights.

The concept of a linked licence condition is that it creates a relationship between two or more licences, usually to prevent concurrent abstraction or to set an aggregate limit across two or more licences that is less than the maximum authorised quantity on each licence. Links between licences can be set to continue for any period up to the duration of the abstraction licences involved in the trade and may apply across two or more licences. We agree that linked licence conditions provide a useful way of achieving greater flexibility in the allocation of water rights between

<sup>31</sup> *Water Resources Planning Guideline*, Environment Agency, February 2003.

<sup>32</sup> *Water Resources Planning Guideline*, Environment Agency, February 2003.

<sup>33</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.2.7.

different users without compromising levels of environmental protection. While this would create greater flexibility in the use of water rights in both the short and the long term, priority between abstractors would remain a matter for the parties to agree contractually rather than being something incorporated into any abstraction licence. The Agency would also need to be assured that the parties had satisfactory arrangements to ensure licence conditions were complied with.

#### WRT8

Do you consider that consistency with water resources and drought plans provides an appropriate framework to consider proposals from water companies that wish to trade in headroom or should there be more or fewer constraints upon such trades?

### 3.3 Ring-fencing

One potential impact of water rights trading that organisations representing farmers expressed concern about was that it might result in water rights being transferred out of agriculture and into sectors with greater purchasing power, particularly public water supply<sup>34</sup>. This trend has been noted in New South Wales, Australia, where water companies have bought up rights to give greater security of supply to customers in urban areas. The impact of water rights being traded out of the agricultural sector on a significant scale is that farmers may be unable to achieve the standards and characteristics demanded by supermarkets and other buyers. This would affect the agricultural economy and have knock-on impacts for other rural businesses. However, as the Government concluded in *Tuning Water Taking*<sup>35</sup>, it remains open to sellers to trade only within a particular sector and they are under no obligation to sell simply for the highest price or at all.

We agree with the Government that it is unlikely that trading water rights will result in large volumes of water being transferred out of the agricultural sector in England and Wales. Agricultural abstraction licences tend to be for relatively small volumes that would be of little value to most other buyers. Although water rights trading can take place

under current legislation, we are not aware of any incidences of water companies, which are often in a dominant position in a catchment, seeking to purchase agricultural licences. There may be some instances where other sectors would be interested in acquiring agricultural licences, but these instances are likely to be localised and dependent on it being possible to relocate the licence easily or get water cheaply and easily from the point of abstraction to the point where it is to be used.

We do not propose that water rights trading should be restricted between sectors, although in transferring water between sectors, any applicant would need to show they had a reasonable need to abstract and use the water rights applied for. Our view reflects the Government's conclusion in *Tuning Water Taking* that sectoral restrictions should not be imposed on trades in England and Wales<sup>36</sup>.

### 3.4 Abuse of dominant position in trading markets

A number of consultees responding to the Government's consultation papers on the use of economic instruments in water abstraction<sup>37</sup> expressed concern that the abuse of dominant positions amongst licence holders intending to prevent competitors entering the market would distort water rights trading activity. A particular concern was that licence holders, particularly water companies, which are in a dominant position in a catchment, may be either unwilling to make water rights available for trade or seek to buy up all water rights that become available in an area. This would amount to an abuse of such a dominant position if such action was intended to prevent competitors acquiring water rights. Simply buying or retaining water rights because an abstractor believes they may require them in the future would not constitute an abuse of a dominant market position.

We could address the potential for abuse of a dominant position amongst buyers or sellers by:

- assessing all trading applications for consistency with competition principles;

<sup>34</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.8.3.

<sup>35</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.8.5.

<sup>36</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.8.5.

<sup>37</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.5.

- relying on the suggested assessment of reasonable need and water efficiency to discourage abstractors from abusing any dominant position they may hold;
- relying on signals from the market and competition legislation to discourage such abuse and for such activity to be dealt with by Ofwat and the Office of Fair Trading (OFT).

We suggest that retaining the assessment of reasonable need for trading applications may discourage applicants from seeking to acquire water rights in order to prevent potential competitors accessing water resources. Where concern remains that a particular water rights trade constitutes an abuse of a dominant market position, it is expected that Ofwat should deal with the matter as part of its statutory role. A memorandum of understanding between the Agency and Ofwat is being prepared and this will provide a framework for communication and the exchange of views between the two organisations<sup>38</sup>.

**WRT9** To what extent will the Agency's proposals to apply existing tests of reasonable need, as discussed in section 3.1.1, discourage the abuse of dominant market position in a catchment?

### 3.5 Trading in over-abstracted and over-licensed catchments

#### *Issues for trading*

As discussed in section 2.8, water may not be available due to catchments being considered 'over-abstracted' or 'over-licensed' when assessed through the CAMS process. A catchment which is over-licensed will generally not be suffering environmental damage as a result of existing abstractions, but levels of abstraction would be unsustainable if all abstractors took the full volume of water they are authorised to take.

Three main environmental problems could make a proposed trade unsustainable:

- local impacts of an abstraction, for example an abstraction within or near a wetland site of special scientific interest (SSSI);
- using existing water rights to their full extent so that a catchment previously categorised as over-licensed becomes over-abstracted and damages the environment;
- making the environmental situation in over-abstracted catchments worse by trading water rights.

<sup>38</sup> See section 2.6.

The fact that catchments are over-abstracted or over-licensed, including the potential for trading to reactivate licences that are partly or wholly unused, reflects historical problems with the abstraction licensing system and is not a result of trading. The view was expressed at the stakeholders' workshop that these problems should be solved through the processes of revocation and non-renewal offered by the abstraction licensing system rather than through trading. The Agency already has measures in place, for example the Restoring Sustainable Abstraction (RSA) Programme, to address these problems although this will take time. We accept that trading should not set out to solve these problems, but we do feel there is an argument that trading should provide some environmental benefits that will contribute towards the objectives of activities like the RSA Programme.

The majority of problems in over-abstracted catchments or water resource management units are site-specific and trading within this approach may offer opportunities to move abstraction away from these sites through a relocation trade. This may be the case with certain downstream trades; for example, a trade of this type could involve moving a currently used abstraction to prevent damage or moving a sleeper licence (see below) to remove the risk that reactivating that licence might result in environmental damage. We are particularly keen to encourage these sorts of trades. This approach would have the added benefit of recovering water from those who place the lowest value on its use, as buyers will aim to buy water rights at the lowest possible price.

#### *'Sleeper' and 'part-utilised' licences*

These are licences where all ('sleeper') or part ('part-utilised') of the volume authorised for abstraction is not abstracted from year to year. In practice, almost all licences where abstraction takes place will be part-utilised, as it is unusual for an abstractor to abstract exactly the full quantity authorised by an abstraction licence. On average, less than 50 per cent of the overall volume of water authorised for abstraction will be abstracted each year. The reasons will be specific to each licence:

- The licence may be required to cope with future demands for water.
- The licence may be required to deal with contingent demands, particularly prolonged periods of dry weather.

- The licence was granted for historical quantities that are now greater than the licence holder requires because of changes in practice or the licence holder undertaking water efficiency measures.
- The licence holder, due to a change in circumstances, no longer requires the water authorised for abstraction.

Many sleeper licences are also intended to address circumstances that arise when water resources are at their most stressed. It is not correct that sleeper licences represent an additional 'environmental allocation' of water, as they will tend to be used at times when the environment is most vulnerable. If trading were to reactivate sleeper licences within a catchment, there is a risk that trading could cause environmental damage by encouraging the abstraction of water that is allocated but remains unabstracted.

### ***Tuning Water Taking***

In *Tuning Water Taking*, the Government made clear its view that trading should be possible in all catchments, subject to the need to protect the environment<sup>39</sup>, and we agree with this. As already indicated, we expect the greatest interest in trading to be in areas where water resources would not otherwise be available. Trading in these catchments will require a clear approach to be set for how trades will be managed, as will trading in catchments where resources are believed to be stressed but a CAMS has not yet been completed. We believe that the approach we propose should enable trading to take place while protecting the environment and ensuring that trading contributes towards the recovery of water resources in that catchment. To be successful in both giving certainty to abstractors and protecting the environment, our proposed approach is likely to need to apply to any trade within these catchments, ranging from trades of volumes that are fully utilised to the trading of sleeper licences.

### ***Trading and resource recovery strategies***

We have considered the potential for water rights trading to be used as a possible resource recovery option within CAMS, but consider that this is limited by the unpredictability of trading activity. The extent of the resource recovery potential of trading in a particular catchment will depend on how active

trading parties are and the extent of the opportunities we have to recover resources. The degree to which we would wish to recover resources will also narrow as resources are recovered through trading and other processes, so that a set figure in a CAMS is highly unlikely to provide useful guidance to traders as the situation will always be changing. We suggest that the principle of seeking to contribute towards resource recovery through trades should be included in the licensing strategy for over-abstracted catchments, subject to the local environmental impacts of a trade, rather than being seen as an option for resource recovery across a whole catchment or management unit.

### ***Options***

We have considered a number of ways in which licensing strategies could encourage water rights trading to take place without causing environmental damage:

1. We could prevent sleeper or part-utilised licences being traded in over-licensed and over-abstracted catchments until sustainable levels of abstraction have been achieved. This approach would delay water rights trading and would not achieve either the environmental or economic benefits we are seeking to achieve through the trading process. Attendees at the stakeholder workshop in October 2002 considered this approach to be unnecessarily rigid and the Government has also stated its aim that water rights trading should be possible in any catchment<sup>40</sup>.
2. Trading could be restricted to the volumes that have been abstracted in the past. This would restrict trading activity to abstraction licences that have been used and for which the existing licence holder will have an existing use. This would ensure that trading did not directly increase abstraction and could be combined with the recovery of a proportion of such trades to reduce the level of over-licensing within a catchment. The risk with this approach is that it may encourage abstractors to abstract unnecessarily to increase the quantity of water rights available to them for trading purposes. This approach may well also have the effect of discouraging trading. It could restrict the water rights available to potential buyers and increase the price of water

<sup>39</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.1.11.

<sup>40</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.1.11.

rights, as those used by the potential seller would be expected to be more expensive than unused volumes.

3. We could recover a set proportion through any proposed trade within the catchment (for example, 20 per cent of the seller's licensed volume). This would ensure that all trades resulted in a proportion of the water traded being returned to the environment. It would also provide certainty to potential abstractors within a catchment that they would be able to trade a specified volume of water and is likely to encourage trading. This approach would not, on its own, overcome the environmental risk posed by sleeper licences and could result in an increase in abstraction within a catchment that is over-abstracted or could cause an over-licensed catchment to become over-abstracted. This approach would also prevent us from fine-tuning our approach to the environmental impacts specific to a particular proposal.
4. We could establish the principle that trades should not cause damage to specific sites and should demonstrate a long-term overall environmental benefit. This principle would be particularly important for trading in over-licensed and over-abstracted catchments. It would not provide a mechanism by which buyers or sellers could judge exactly how much water they would be able to trade, or on what terms, but would indicate the general approach we would take to any trading proposals in over-abstracted or over-licensed catchments.

The principle we suggest is that any environmental detriment, for example an increase in actual abstraction resulting from the trading of a sleeper licence, should be short-term and balanced over the longer term by an environmental benefit such as a reduction in overall authorised abstraction within a catchment. Since we propose to time limit licences granted as a result of a trade, usually for a maximum of 12 years, as for any other licence, the overall environmental benefit should be achieved within this time period. What will be possible within this approach will depend upon balancing the beneficial and detrimental impacts of a specific proposal.

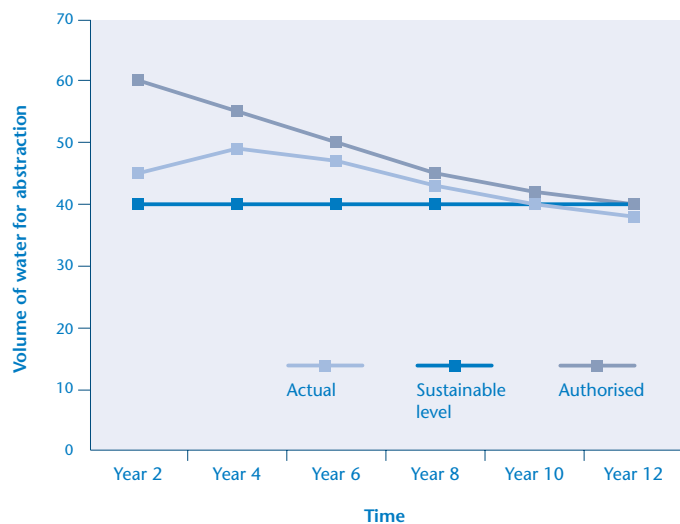
### Preferred option

Our preferred option is 4. This option provides sufficient flexibility for trading to take place in a manner that can be adapted to the needs of the water environment in a particular catchment because:

- trading would be permitted in over-abstracted and over-licensed catchments where the long-term environmental benefits of a trade outweigh any short-term environmental detriment;
- we would aim to achieve a long-term reduction in authorised abstraction where necessary;
- trades would not be permitted that would cause environmental damage to particular sites or adversely affect other licence holders and any trade that reactivates a sleeper licence must show that any short-term environmental detriment is balanced by a long-term environmental benefit<sup>41</sup>.

The expected impact on licensed and actual abstraction is shown in Figure 4.

Figure 4 | Illustration of the predicted impact of trading in over-abstracted catchments



To secure these long-term environmental benefits, we are willing to accept that actual abstraction within a catchment is likely to increase in the short-term as a result of trading. The acceptability of such trades would depend on the balance struck between the short-term detriment and the long-term benefit. This balance would be assessed against the extent to which abstraction would be expected to increase and

<sup>41</sup> See also section 3.7 on the provision of supporting information for applications.

the extent to which changes to the seller's licence would contribute towards the environmental objectives for the catchment. When considering the long-term benefits of a trade, we would take account of any change to the consumptiveness of abstraction between the buyer and the seller. A reduction in consumptiveness would normally indicate that a greater proportion of rights could be transferred, while an increase would indicate the opposite. Any short-term environmental detriment would be minimised through licence conditions and long-term concerns would be addressed through the renewal process for time-limited licences.

In catchments where a CAMS has not been completed, trades and resource recovery should be within the licensing policy set for that particular catchment. It is not considered necessary to set these policies in writing before completion of CAMS, as these policies are generally well understood by operational staff and the preparation of a written policy would risk pre-empting CAMS.

This approach would apply to sleeper, part-utilised and fully utilised licences. The extent of resource recovery for all three types of licence is likely to differ, however, as the impact on actual abstraction will depend on the proportion of the licensed volume abstracted before the trade. Since this approach depends on the characteristics of the trading proposal and the seller's licence, the extent of the seller's water rights that may be traded to the buyer would vary from trade to trade. This approach could be used in both over-abstracted and over-licensed catchments.

**WRT10** What are your views on the options for trading in over-abstracted and over-licensed catchments that we have considered and on our preferred option for such trades? Are there any options you feel we should consider further or dismiss entirely, or any other options you believe we should consider?

## B. Trading and the application process

### 3.6 Pre-approval of trades

#### *Background*

Pre-approval refers to the approval of a trading proposal by the Agency before an applicant submits a formal application. Responses to *Tuning Water Taking* were mixed on the question of whether the Agency should pre-approve trades and the Government concluded that it did not intend to ask the Agency to establish a system of pre-approval for trading applications<sup>42</sup>.

#### *The nature of pre-approval could range from:*

- full pre-approval for particular types of trade or in particular areas;
- partial pre-approval subject to the determination of an application for particular types of trade or in particular areas;
- pre-application discussion of what sort of trades we would be likely to be able to approve subject to the details of an application;
- no pre-approval or pre-application guidance.

We do not operate a system of pre-approval for abstraction licence applications. Instead we rely on potential applicants discussing their proposals with us at an early stage in the process to assess whether proposals are feasible. This discussion is not a formalised process but is well established and generally understood amongst abstractors. Trades that can be completed through a licence transfer without any other changes to the licence(s) involved are, effectively, pre-approved as they are simply entered on the public register of abstraction licences by the Agency rather than determined as applications.

#### *Opportunities*

In theory, CAMS provide an opportunity for pre-approval to be given to particular types of trades or trades within specific catchments or water management units. We have previously exercised our powers and duties relating to the determination of abstraction licence applications on the details of each particular application. It is possible that some of these powers and duties could theoretically be exercised within the framework of CAMS or a similar process, supported by the extended discretion on advertising and

streamlining of the application process provided by the Water Bill. As already discussed, however, CAMS only look at water resources down to the water resource management unit level and do not assess all potential impacts of abstraction on the environment or other abstractors. Given that the impacts of a particular abstraction may depend to a large degree on factors such as the exact location of abstraction and the use to which water is put, we believe that CAMS could not replace the licence determination process. It would probably not be possible to use CAMS or develop the CAMS process to predict many of the possible trading opportunities within a catchment so it would pose a significant environmental risk to use CAMS to pre-approve trades. While CAMS will be a useful tool in gathering information on what sorts of trades may be possible within a catchment, our view is that it could not replace the abstraction licensing system for trading.

There may be scope for encouraging potential applicants who are interested in the possibility of selling water rights in the future to discuss this with the Agency on a general basis. This would help them to identify potential buyers and may indicate some of the likely conditions that would be placed on a buyer's licence. This approach would bring greater certainty to the trading process when water was required and should also spread our workload and speed up the determination process for any future application.

#### *Proposals*

We propose that the Agency should continue with pre-application discussion for water rights trades. We do not think it would be practical to replace the determination process with generic pre-approval for trades of particular types or in particular areas.

If buyers and sellers are to rely on pre-application discussion, they will need accurate information to enable them to assess the potential for using trading to achieve their objectives. This will need to be easily available if it is to compensate for the fact that we cannot give definitive answers on whether a trade will be possible before a specific application has been submitted<sup>43</sup>.

#### *Future possibilities*

Our proposals reflect the fact that many catchments are abstracted or licensed beyond sustainable limits and that these catchments are where we expect

<sup>42</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.9.11.

<sup>43</sup> See section 3.11 on access to information.

interest in trading to be concentrated. Before we have reached sustainable levels of licensing in these catchments, it will remain important to assess trading applications individually to consider their impacts and how they may contribute towards management objectives for that catchment or water resource management unit. Under our preferred proposal in section 3.5, the acceptability and detailed conditions of these trades will depend on balancing environmental benefit and short-term detriment. As more catchments reach sustainable levels of abstraction, it may be possible to develop methods to indicate that we consider certain types of trade generally acceptable subject to remaining within the limits established for abstraction in that catchment or unit. This would depend on the development and progress of the CAMS process and would only be possible a long way into the future.

**WRT11** Is the existing pre-application consultation process, together with greater availability and accessibility of information, sufficient to support the trading process without a pre-approval system and, if not, what else is required?

### 3.7 Supporting information

When determining an application for a new abstraction licence or an application to vary an existing licence, we may require supporting information to assess the impact of the proposal on the environment and existing protected rights. We recognise that we should only require such information as is necessary to determine the application made. The extent of supporting information required for an application is likely to be particularly important for proposed trades, as it will affect them in terms of time and cost.

Stakeholders at the October workshop raised the possibility of CAMS describing the supporting information that would be required for a trade and indicated this would be useful in deciding whether they would be interested in buying or selling particular water rights. While we recognise the potential benefits of being able to prescribe supporting information in this way it is likely that, as with the potential for CAMS to act as a pre-approval mechanism, it would not be practical. Information contained in CAMS technical documents should indicate where particular environmental features or designations are located. These might lead to a requirement for additional supporting information

such as an environmental assessment. This information will be at a catchment level and thus may not identify every environmental feature within a catchment. We are not, therefore, suggesting that CAMS can offer a definitive answer as to whether such assessments are required or what they should contain.

It is likely that we should continue to consider, case by case, what supporting information is required for a particular application and aim to inform the applicant of this at the earliest possible stage in the pre-application process. The extent of the supporting information we require will depend on the level of environmental risk related to a particular trade; less supporting information will generally be needed for environmentally beneficial trades and short-term trades. Environmental considerations will remain paramount when determining trading applications and a precautionary approach is suggested when requesting information if a proposal has a potential environmental impact. This approach would include ensuring that applications do not have localised impacts, even if they are environmentally beneficial at a catchment level, for example a trade to a point downstream of the original abstraction point.

**WRT12** Is a case-by-case approach, with indications of likely requirements for particular types of trades, an appropriate way to specify supporting information for a trade or should more clearly defined approaches be sought for particular types of trade? To what extent will better availability of information help potential buyers and sellers to assess what supporting information will be necessary? If we were to indicate the likely supporting information for particular types of trade, how certain would applicants need to be that this would be the information needed to support their particular application?

### 3.8 Advertising

The Water Bill is expected to provide for Regulations to give the Agency greater discretion when deciding if an abstraction licence application needs to be advertised. The presumption that advertising is required will continue but we are likely to have greater scope for exempting specific applications, or types of application, from advertising requirements. In using this discretion, we might adopt a test of 'no appreciable effect' on the environment or third parties which is likely to encompass many trading applications, particularly those that are environmentally beneficial. This could ease the burden on those undertaking

trades<sup>44</sup> and, where these are environmentally beneficial, enable those benefits to be realised as soon as is feasible. The normal licence application determination process and consideration of representations relating to any application, whether formally advertised or not, will remain.

We have considered whether it may be possible to exempt certain trades from the need for advertising. However, due to the site-specific nature of abstraction we do not consider that this is possible. While we expect that many trades will not need to be advertised, we propose to exercise our discretion on advertising on a case-by-case basis.

### 3.9 Licence administration

#### 3.9.1 Environmentally beneficial trades

As discussed in section 3.7, we propose that applications for environmentally beneficial trades would be subject to less stringent information requirements and will not need to be advertised. This should save time and money. We will need to be confident that an application for a particular trade is environmentally beneficial before we can specify what supporting information is required or exempt an application from advertising.

In over-abstracted and over-licensed catchments, a trade would only be granted if it contributes towards the objectives for the management of that catchment or water resources management unit. The greater the contribution an application makes towards those objectives, proportionate to any short-term increase in actual abstraction, the quicker the relevant application may be determined for the following two reasons:

- A clear environmental benefit would make it unlikely that an application will need to be advertised and will reduce the amount of supporting information required to support such an application.
- The transaction costs for a particular trade should be reduced if a clear environmental benefit can be shown to result from the proposed trade.

#### 3.9.2 Short-term trades

We propose that short-term trades should be defined as trades of less than a year. This period has been chosen to reflect the fact that these trades are likely to be undertaken with the aim of gaining seasonal

access to water resources for agricultural purposes and will often depend on weather and crop patterns in a particular year. Trades of a year or less will also normally have a smaller environmental impact than longer term trades and should often be possible with less detailed supporting information. This would mean that longer agricultural leases to grow particular crops with specific water requirements would fall outside the definition of a short-term trade.

The use of linked licence conditions is likely to be particularly important for short-term trades. Links between licences may be established either for a short period to reflect a particular need, or for a longer period to create a 'pool' of water rights from which a number of abstractors may draw. By linking two or more licences on a long-term basis, users of water rights may gain greater flexibility in how they use water and may also be able to tailor the availability of water to their individual requirements, subject to agreement on the terms of the trade. By applying to vary existing licences to link licences like this, it could be possible for water rights to be transferred within an overall 'pooled' licence without the need for any further variation. This would enable water rights to be transferred quickly and without administrative burden where the need arose and this may prove particularly useful for agricultural abstractors.

We expect that advertising may often be waived for short-term trades and consider it unlikely that detailed environmental reports or test pumping data will be required to support these applications. Where a proposed trade has a potential impact on a candidate Special Area of Conservation (cSAC) or SSSI, statutory processes apply that provide English Nature and the Countryside Council for Wales with an opportunity to consider the potential impacts of an application and these processes may take up to three months. We are looking into ways that trades may be approved more quickly, whilst ensuring that any potential impact on a protected site is fully considered. Under our proposals, early pre-application discussion would help identify proposals that could potentially affect a protected site and ensure that any subsequent application is determined as quickly as possible.

Short-term trades may constitute the majority of water rights trading activity, particularly in the agricultural sector. These trades are also the most sensitive to regulatory burdens that may hinder or prevent sustainable trades taking place.

<sup>44</sup> Exemption from advertising will save applicants between £300 and £1000 for an abstraction licence application.

WRT13	Do you agree with the proposed definition of a short-term trade? If not how would you change the definition?
WRT14	How could environmentally beneficial and short-term trades be further facilitated within the structures provided by the Water Bill?

WRT15	If generic rules cannot be established for trades between surface water and groundwater, do you feel that this is likely to significantly discourage such trades?
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### 3.9.3 Groundwater/surface water trading

The report on water rights trading by Risk & Policy Analysts Ltd.<sup>45</sup> identified the importance of the management of trading between groundwater and surface water in establishing an effective system of water rights trading. These trades may involve, for example, the seller revoking or reducing the quantity on a licence for abstraction from a river so that the buyer can apply for a licence to abstract from an adjacent groundwater source. It may be possible to set principles to enable trades between hydrologically linked abstractions to take place within environmental constraints, but the details of each trade will still be site-specific.

While almost all groundwater and surface water abstraction are ultimately linked, this link is usually over a long period and often subject to uncertainty. Occasionally it may be possible to establish a hydrological link but it would be necessary, as part of the trade, to show a hydrological link between the groundwater and surface water concerned and the nature and extent of that link. Because these trades are likely to be rare, we have not suggested that we should establish more detailed generic rules for how we would determine these applications. Whilst this may discourage these trades to some extent, due to the time an application is likely to take and the transaction costs involved, we think this is necessary to protect the environment. In a trade between surface water and groundwater, we expect that the environmental impact will generally be the overriding factor. A trade that moves a summer surface water abstraction to a groundwater source some distance away may often be beneficial, but the opposite may be unacceptable. Similarly, a trade from a groundwater abstraction to winter abstraction from surface water for a storage reservoir is often likely to give an environmental benefit while the reverse will often have an unacceptable environmental impact. Trades between surface water and groundwater may therefore be possible but they would be determined case-by-case subject to the Agency's statutory duties and responsibilities.

<sup>45</sup> *Economic Instruments in Relation to Water Abstraction*, Risk & Policy Analysts Ltd, December 1999.

## C. Facilitation and regulation of the market

### 3.10 Enforcement

Linked licence conditions require enforcement, particularly to prevent concurrent abstraction<sup>46</sup>. We currently draft linked licence conditions in such a way that a breach may be enforced against one or all of the holders of the linked licences. For trading, we would continue this parallel enforcement or enforce such conditions only against either the buyer or the seller. Restricting enforcement to only one of the parties in a trade would probably not provide a significant encouragement to trade, but it could make it more difficult for the Agency to ensure that linked licence conditions were observed. If the buyer and seller wanted to protect themselves from the possibility of enforcement action, this could be achieved through provisions in the contract agreeing the trade.

We would suggest that linked licence conditions should be enforceable against all the holders of linked licences. It would then be open to the buyer and seller to agree any indemnity through the contract for the trade.

**WRT16** Do you support the enforceability of licence conditions against both the buyer and the seller in a trade or would trading be further encouraged if only the buyer or the seller was to be liable for enforcement purposes?

### 3.11 Access to information

#### 3.11.1 General information on abstractions

The availability of information is crucial in enabling traders to take part in trading, so its provision is key. Under our proposals, it is expected that information will be provided partly by brokers operating in the private sector (see section 3.12) and partly by the Agency, but that most information will be derived from Agency sources.

We already hold information that could be of use to those interested in trading on public registers of abstraction licences and in the form of information provided by abstractors on the actual volumes of water abstracted each year. Information held on the registers will be supplied by the Agency on request<sup>47</sup> or can be viewed by the public at our local offices.

The public registers include the terms of every licence issued by the Agency and its predecessors, including the location of the abstraction, the quantity authorised for abstraction and the name of the licence holder. These registers are held at our area and regional offices and are updated manually whenever any change is made to an existing licence, an application for a licence is received or an application for a licence is determined. In the future we intend these registers to be available electronically on our website, but this process will not be completed for some time.

We already provide information on the quantities abstracted under specific licences but this is subject to legal constraints relating to commercially confidential information<sup>48</sup> and information that would enable the identification of a particular individual<sup>49</sup>. We propose to take steps that would improve the consistency and speed with which we can provide information on actual abstraction while ensuring that we comply with statutory requirements.

While the information we hold may be valuable, it may not be in a form that is co-ordinated and easily accessible for potential buyers and sellers. The potential for CAMS to play a co-ordinating role for this information is discussed in section 3.11.2. The future development of an electronic public register is likely to make this information more available and more adaptable.

Information on the price being paid for water rights is also potentially valuable to potential buyers and sellers. By obtaining this information from trading parties and making it publicly available, buyers and sellers will, in theory, have greater confidence in entering into trades and this confidence should increase trading activity. Price availability should also enable trading prices to be set at a price that reflects the true value of water resources, rather than allowing rights to be bought and sold for significantly more or less than their true value.

In practice, stakeholders at the October workshop showed little enthusiasm for making use of price information and many resented the idea of making information from a private transaction publicly available. The price of water rights is also likely to be extremely variable depending on location, so comparison between trades is likely to be difficult without extensive information on other trades and

<sup>46</sup> See sections 3.2 and 3.9.2 for more information on linked licence conditions.

<sup>47</sup> Subject to the Agency's policy on charging for information for large or complex queries.

<sup>48</sup> Environmental Information Regulations 1992.

<sup>49</sup> Data Protection Act 1998.

the capacity to analyse this information. It is not suggested that we should make information on prices publicly available in a form that would enable third parties to identify the parties involved in a particular trade. We suggest that the Agency should monitor prices and provide information on general trends that would illustrate the extent and development of the market and the principal factors influencing prices.

WRT17	Do you agree with our proposals on price information or would you prefer to have access to information on the prices paid as part of specific trades?
WRT18	What is the minimum information that potential buyers and sellers would require to take part in trading and would changes to the form in which we hold this information encourage you to trade?

### 3.11.2 Information provided by CAMS

The role of CAMS in water rights trading was one of the main areas of discussion at the stakeholders' workshop in October 2002 and has been discussed at various stages in this consultation:

- Section 2.8 gives the background to CAMS and explains that, while CAMS will be valuable to potential buyers and sellers, trading does not depend on the completion of CAMS.
- Section 3.1.4 discusses the role of CAMS in setting environmental allocations for catchments and water resource management units in the context of applications for licences for environmental purposes.
- Section 3.5 sets out the options for how the licensing strategies contained in CAMS could approach trading within over-abstracted and over-licensed catchments and the approach that has been suggested. This section also explains that this approach will be suitable in catchments where CAMS have not yet been completed.
- Sections 3.6 and 3.7 discuss the possible use of CAMS for pre-approval of trades and specifying supporting information for trades.

We expect that the CAMS<sup>50</sup> process and associated documents will also play a key role in providing information to potential buyers and sellers. We propose that CAMS documents should provide high-level catchment information that will enable

potential traders to identify potential trading areas and the points that may need to be addressed in any application. CAMS could possibly do this by providing:

- a characterisation of water management units showing where designated environmental interests are water-level dependent and where there are protected sites that rely on water availability;
- information on the characteristics of major groundwater and surface water units and the main related issues associated with abstraction;
- a map of existing licences within each water management unit or catchment showing the locations of licensed abstractions. This will indicate the location and size of existing licences, the licence number and whether the licence authorises abstraction from groundwater or surface water. This information is already available, along with details of the conditions contained in specific licences, from the public register of abstraction licences, but its inclusion in CAMS documents would be useful to potential buyers and sellers of water rights. It is not suggested that we should include the names and addresses of licence holders as these change regularly and would quickly become out of date in CAMS technical documents. This information could be obtained either through the public register or on request from the Agency<sup>51</sup>.

All this information is contained within CAMS technical documents in CD-ROM format and these are available on request. CAMS technical documents are a summary of these and other aspects of a catchment at a particular point in time and we do not currently plan to update these outside the six-yearly CAMS cycle. We suggest that, by providing links for those interested in trading to take them directly to this information in CAMS technical documents, much of the information relevant to potential buyers and sellers can be made available.

This information would help prospective buyers and sellers identify the likely geographical scale of particular trading markets and the extent of possible trading opportunities in an area. This was one of the key requirements for information provision identified by attendees at the October stakeholder workshop. There will be limited opportunities for CAMS to identify specific trading opportunities, however, because CAMS set policies across catchments as a whole.

<sup>50</sup> See section 2.8.

<sup>51</sup> Requests for large volumes of such information may be subject to a charge under the Agency's policy on charging for information.

In the absence of a CAMS, some of this information is already available through the public register and the remainder may be acquired through pre-application discussion with the Agency. All potential buyers and sellers should have this information available through CAMS by 2008, when CAMS are expected to be in place in all catchments.

One possibility is that we should target the provision of information on possibilities for trading rather than the likely application process. The information contained in CAMS would enable parties to get an idea of what they are likely to need to do to complete a particular trade. This may provide potential buyers and sellers with an opportunity to provisionally estimate:

- the possible extent of supporting information that may be needed to support an application to trade<sup>52</sup>;
- whether advertising is likely to be necessary<sup>53</sup>;
- what a trade would need to include to show consistency with the management objectives for a CAMS or a water resources management unit<sup>54</sup>.

**WRT19** Will the information suggested for CAMS provide the information that buyers and sellers would find useful in these documents, or would you suggest any changes to the information or format suggested?

### 3.11.3 Website

In *Tuning Water Taking*, the Government proposed that the Agency develop a website providing information on completed water rights trades and details of water rights that are for sale or sought<sup>55</sup>. This website would be for information only and brokering would be undertaken by third parties on the basis of information contained on this site.

We have begun work on this and the website could be ready in 2004. However, feedback from the October workshop suggests that support for this website is limited. Stakeholders suggested brokers in the private sector were best placed to make information available on the Internet by providing publicly available information acquired from the Agency and obtaining information directly from potential buyers and sellers. Stakeholders at the workshop were concerned that, in providing a

website of this sort, we risked confusing our regulatory role with the role of brokers involved directly in the trading market.

Information contained on a water rights trading website operated by the Agency may increase levels of confidence in the quality of information available to buyers and sellers and encourage trading to take place. This would be balanced by the fact that we would not guarantee the accuracy of this information.

**WRT20** Do you believe that the development of a trading website by the Agency would be of value or is this something that should be developed by the private sector?

**WRT20** Would the provision of a website by the Agency confuse its role with the role of brokers?

### 3.12 Brokering

The report prepared for the Government by Risk & Policy Analysts Ltd identified the availability of brokers as one of the main factors that would encourage parties to trade water rights. Brokers are considered an integral part of the water rights trading system and are expected to play an important role in trading by:

- developing the market for water rights
- identifying potential traders
- bringing together potential buyers and sellers of water rights
- taking applications through the pre-application and application processes with the Agency on behalf of the parties.

There could be advantages if the Agency were to act as a broker of water rights trades. These include:

- an overseeing role to ensure that water rights trading markets are not manipulated;
- the opportunity to ensure that buyers and sellers receive a high quality of information when deciding whether to trade;
- being a single contact that should speed up the process of taking a trade from conception to determination;
- increased confidence in the impartiality and reliability of brokering;

<sup>52</sup> See section 3.7.

<sup>53</sup> See section 3.8.

<sup>54</sup> See section 3.6.

<sup>55</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, sections 3.10.5–3.10.9.

- minimal transaction costs, as the Agency would be constrained to recovering its costs for undertaking a brokering role.

While these benefits may encourage parties to trade, there are some very significant risks to the Agency acting as a broker. These include:

- putting us in a position of both receiving payment for promoting a trade and carrying out our statutory role of assessing the application for that trade;
- the lack of any clear statutory remit to undertake a brokering role in trading;
- the potential to hinder other brokers entering the market.

The consensus amongst those responding to *Tuning Water Taking* was that we should not take on this role<sup>56</sup> and that we should restrict ourselves to providing information. Delegates at the October workshop reinforced this view.

A number of participants are likely to wish to become involved in brokering water rights trades including land agents, irrigation consultants, farmers' co-operatives and international organisations set up to trade environmental authorisations. The involvement of these parties would depend on the nature of the market that develops in water rights, but interest has already been expressed in undertaking this role. We expect the private sector will provide a suitable brokering resource to support water rights trading. Brokers would gather information mainly from the Agency, but information would also come from those interested in buying or selling water rights.

As well as acting as a facilitator to bring together buyers and sellers of water rights, brokers may wish to take a more active role in the trading market by buying and selling water rights themselves in the hope that the rights acquired will increase in value. Brokers would be able to both buy and sell water rights through the licence transfer process by simply notifying the Agency of any change of holder. It has been suggested that any trading carried out by brokers on their own behalf would only be possible within the terms of an existing abstraction licence. Alternatively, water rights acquired by brokers could be subject to a self-destruct clause as has been proposed for water rights acquired for potential water supply purposes<sup>57</sup>.

We have also considered whether we should establish a scheme to regulate brokers involved in water rights trading or set up an accreditation scheme. This would have the effect of stimulating the trading market by increasing levels of confidence amongst traders. It would also help prevent the problems experienced with market manipulation in some of the Australian states' water rights trading schemes. However, we do not consider that we are equipped to run a scheme for regulating or accrediting brokers and would be unwilling to take on the potential liabilities that this might attract. Brokers for other activities are generally self-regulated on the basis of the industry or activity for which they provide services.

We do not propose that the Agency should act as a broker in the water rights trading market due to the potential conflicts of interest that this might cause and the belief that this role can be filled adequately by the private sector. Nor do we suggest that we should regulate or accredit brokers as this is not a role or responsibility of the Agency and self-regulation is used successfully for brokers in other fields.

WRT22	Do you agree that the Agency should not act as a broker of water rights nor establish any specific system of accreditation or regulation? If you believe that the Agency should carry out one of these roles, please explain why.
WRT23	Do you consider that the lack of any specific scheme for regulating or accrediting brokers would significantly impair the development of the water rights trading market and, if so, in what way?

### 3.13 Monitoring the effects of trading and levels of trading activity

Trading water rights is a relatively new process, particularly with the expected introduction of new legislation containing amended regulatory mechanisms in the Water Bill. Monitoring is essential to assess how the water rights trading market is developing and the impact it is having on the management and use of water resources.

Monitoring and reporting could be carried out by collecting information on trades which have taken place and reporting on the form of trades. This information could also be used to discuss how we might encourage both these trades and any other trades where we believe opportunities exist that are

<sup>56</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.10.11.

<sup>57</sup> See section 3.1.1.

not yet being exploited. We could also undertake an economic analysis of trading markets by gathering information on how easy it is to get access to water rights trading markets, the extent to which the market is affected by the availability of information, and the total financial cost and benefit of trades for buyers and sellers.

Monitoring and reporting could include information on:

- the sectors involved
- the volumes involved
- the duration for which water rights are traded
- price.

This may well provide a clearer picture of which water rights are being traded, in what form, and by whom. We would then be able to see whether our predictions for water rights trading markets have become reality. Monitoring and reporting processes should show whether water rights trading opportunities are being taken up and help us improve the process in a way that contributes towards our stated objectives for trading.

Information could also be gathered on the price at which water rights trades take place, although we recognise that trades will not necessarily be based on a monetary transaction, to gain a better understanding of their value. This would enable us to provide information on trends in the price of water rights and the main aspects that determine prices. Monitoring this information is likely to contribute towards the development of future economic instruments in other areas by both the Agency and Government<sup>58</sup>.

It has not been suggested that licence transfers or changes of purpose should be monitored specifically in the context of water rights trading. Licence transfers would be reported on by the Agency, but the reasons for these transfers will vary and the transfer of water rights may often be incidental to other aspects of land transactions. It is likely that data on licence transfers would require a significant degree of processing to be useful to potential buyers and sellers. Changes of purpose will be important for those intending to supply water to others where trades involve sellers from other sectors, although a change in the purpose referred to in an abstraction licence may not be necessary where water will be supplied for a specific purpose only. Such a change would not fall within the proposed definition of a

water rights trade, as it would not transfer licensable water rights between different parties. It is not therefore suggested that, as part of water rights trading, we should monitor applications to change the purposes referred to in an abstraction licence.

WRT24

Do you consider that any further monitoring of water rights trading is required and, if so, what should this involve?

<sup>58</sup> See also section 3.11.1 for further discussion of information on prices.

# The Agency as a party in water rights trading

## 4.1 Introduction

Water rights trading has the potential to involve the Agency as either a buyer or a seller of water rights. Purchases of water by the Agency would be made to improve the environment, for example agreeing to pay an abstractor to vary or revoke their licence to prevent environmental damage. The Restoring Sustainable Action programme is already identifying abstractions that are causing, or have the potential to cause, environmental damage and trading would be a means by which these problems can be resolved by agreement. We do not intend to compete with other potential buyers by purchasing water rights on the open market. Neither do we intend to purchase water to create a 'water bank' or for resale.

We could potentially be involved in selling rights that are either held by the Agency or are unallocated and both these possibilities are explored below. These possible roles were recognised by the Government in *Tuning Water Taking* and one of the tasks the Government set us in that document was to draft a code of conduct for the Agency's participation in trading<sup>59</sup>. Given the variety of roles and circumstances in which we could participate in trading, this consultation considers approaches to our involvement in trading rather than offering a formal code of conduct.

## 4.2 Auctions

Auctions may be used for water rights trading either as a mechanism for the initial allocation of water rights amongst abstractors, for transactions involving

existing licences or for the allocation of previously unallocated rights. The Government has stated<sup>60</sup> that the licensing system will remain the basis for abstraction licensing and rights will not, therefore, be reallocated through an auction before trading takes place. Competing interests for existing licences would be dealt with through direct trading arrangements, with no financial involvement by the Agency. We have only considered auctions for applications to acquire resources that have not previously been allocated through the licensing process. The mechanism through which existing licence holders trade existing water rights will be a matter for each individual seller.

*Tuning Water Taking* envisaged auctioning being used to allocate water resources in only very narrow circumstances. The Government concluded that it is prepared to consider an auction in circumstances where the following three criteria are satisfied:

1. A currently unallocated, sustainable abstraction is available without potentially impacting the environment or protected rights in that area.
2. Two or more parties with an ostensibly reasonable requirement for water, the ability to utilise that right and roughly equivalent environmental impacts must be in a position to acquire those water rights.
3. The Environment Agency must consider, for clearly stated reasons, that a 'first past the post' allocation would not be appropriate<sup>61</sup>.

<sup>59</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.5.15.

<sup>60</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.6.7.

<sup>61</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.6.8.

<sup>62</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001, section 3.6.9.

The Government added that:

‘Situations complying with these tests are likely to be exceptional. The Environment Agency will be expected to consult Ministers prior to conducting an auction. Proceeds would go to the Agency’s water resources management accounts. If it becomes apparent that this administrative process would need to be placed explicitly on a statutory footing, the necessary provisions could be added to the Water Bill on introduction to Parliament. The Government will keep the option of auctioning abstraction licences under review.’<sup>62</sup>.

We agree that this would provide a sound format upon which to base any auction of water rights, but consider that there are some legislative points that must also be taken into account before an auction of water rights could be conducted.

To manage an auction of the type envisaged in *Tuning Water Taking* would require specific statutory provisions. The ‘first come, first served’ principle would mean that the Agency could not reserve water rights that it intended to auction and we would have no power to refuse any application we received before the completion of an auction. Provision would therefore be required to ensure that the rights the Agency intended to auction could be reserved for auctioning and could not be acquired outside the auctioning process. These provisions would be required to ensure that resources that were allocated to be auctioned were protected both before and, for a reasonable period, after an auction had taken place. Without these legislative provisions we would be bound to determine any application we received through the normal application process, either before an auction had taken place or before the successful party at an auction had made an application. There would be little incentive to take part in an auction without the necessary legislative protection.

If future legislative changes provide a suitable framework, auctions could well have a valuable role to play within the criteria specified by Government. Auctioning in such circumstances would fit the broader aims of water rights trading, particularly by allocating previously unallocated rights more efficiently than the ‘first come, first served’ principle. If future legislative changes provide an appropriate framework to enable us to auction currently unallocated water rights, we will explore how an auction of water rights would work and how it should be managed.

Initial allocation of licences where unallocated water rights became available would remain through the ‘first come, first served’ principle. This means that the water rights will be acquired by the first applicant to submit an application to the Agency with any necessary supporting information consistent with the licensing strategy for the relevant catchment.

**WRT25** Do you have any comments on our intention not to auction water rights without additional statutory powers, but to explore options for auctioning water rights in the future?

### 4.3 Agency-held licences

The Agency holds a number of licences – generally groundwater licences to support rivers and streams during periods of low flows. An example of this type of group of licences is the Shropshire Groundwater Scheme, which supports flows in the River Severn for the benefit of the environment and abstractors during extended periods of low flows. By their nature, these licences are not used in many years and might be considered suitable for short-term trading if held by anyone other than the Agency. As with trades in headroom for other abstractors, we would need to be confident that, in selling such rights in the short term or subject to reversion, we would not prejudice our ability to operate the support scheme when it was needed.

We suggest that there are three options for how we should approach trades in water rights held by the Agency:

- Trading could be prevented either on the grounds that such licences are unsuitable for trading because of the risk that water might not be available for abstraction when needed or on the basis that such trades would create an unacceptable conflict of interests for the Agency.
- Trading could be permitted subject to additional constraints to ensure that water resources for abstraction are not depleted ahead of when they are required and additional safeguards to protect against conflicts of interest.
- Trading of licences held by the Agency could be on the same basis, and subject to the same tests, as other trading proposals.

In catchments where we hold a licence or licences but no further resources are available, it would appear to represent an efficient use of both water and the

Agency's resources to enter into short-term trades. This would improve the sustainability of the abstraction through more efficient use of available water resources without resultant environmental damage. We are aware, however, that there is also a potential conflict of interest in such trades. In granting any new licence or variation to enable the trade to take place, we would benefit financially from exercising our statutory role in the licence determination process. There is also a potential perceived conflict of interest if people think the Agency holds licences for which it no longer has a reasonable need because they provide us with income. It is arguable that such licences may be traded without compromising our ability to fulfil the water resources objectives of holding particular licences, but this is likely to require guidance on the terms on which these rights could be traded.

**WRT26** Is the potential conflict between the Agency acting as a regulator and a seller of water rights acceptable or should we refer applications in which we have an interest to the Secretary of State or the National Assembly for Wales, in the same way as other licence applications made by the Agency? Alternatively, are the conflicts inherent in the Agency trading licences such that licences held by the Agency should not be traded as a matter of principle?

# Summary of issues and proposals

This section summarises the issues and proposals contained in the consultation document. We hope you will respond. When you do, please ensure that you include the reference to the issue or question you are addressing and send your response, in writing, to:

Gwyn Williams  
Abstraction Licensing Review Programme Manager  
Environment Agency  
Wrens Court  
15-17 Lower Queen Street  
Sutton Coldfield  
West Midlands  
B72 1RT

or by email to:  
[alr@environment-agency.gov.uk](mailto:alr@environment-agency.gov.uk)

The closing date for responses is 24 October 2003.

## WRT1

Would adopting existing tests for assessing reasonable need be appropriate for water rights trading or would it give rise to any particular problems? If you consider that existing tests would cause problems for trading, how should reasonable need be assessed for trading applications or particular types of trading application?

## WRT2

Do you consider that we need to assess reasonable need when determining trading applications or should we presume that a need is reasonable if someone is prepared to pay for water rights?

## WRT3

Should brokers be able to apply to change the conditions of an abstraction licence to sell water rights on and, if so, should any particular constraints be placed on such licences?

## WRT4

Should we adopt a test of reasonableness of purpose when assessing applications for abstraction licences resulting from water rights trades? If a test of reasonable purpose is adopted, how should we establish a hierarchy of purposes against which reasonableness should be assessed?

## WRT5

Should we assess water efficiency when determining a trading application or should the level of efficiency achieved be left to the market to determine? If we should assess water efficiency are existing water efficiency tests suitable for trading applications or would you suggest an alternative approach?

## WRT6

Do you agree with our view that an abstraction licence can not be granted for in situ use and do you have any comments on the reasoning behind that proposal?

## WRT7

Do you have any comments on the possible approaches to site-specific environmental proposals arising through trades?

## WRT8

Do you consider that consistency with water resources and drought plans provides an appropriate framework to consider proposals from water companies that wish to trade in headroom or should there be more or fewer constraints on such trades?

## WRT9

To what extent will the Agency's proposals to apply existing tests of reasonable need, as discussed in section 3.1.1, discourage the abuse of a dominant market position in a catchment?

## WRT10

What are your views on the options for trading in over-abstracted and over-licensed catchments that

we have considered and on our preferred option for such trades? Are there any options you feel we should consider further or dismiss entirely, or any additional options you believe we should consider?

#### WRT11

Is the existing pre-application consultation process, together with greater availability and accessibility of information, sufficient to support the trading process without a pre-approval system and, if not, what else is required?

#### WRT12

Is a case-by-case approach, with indications of likely requirements for particular types of trades, an appropriate way to specify supporting information for a trade or should more clearly defined approaches be sought for particular types of trade? To what extent will better availability of information help potential buyers and sellers to assess what supporting information will be necessary? If we were to indicate the likely supporting information for particular types of trade, how certain would applicants need to be that this would be the information needed to support their particular application?

#### WRT13

Do you agree with the proposed definition of a short-term trade? If not how would you change the definition?

#### WRT14

How could environmentally beneficial and short-term trades be further facilitated within the structures provided by the Water Bill?

#### WRT15

If generic rules cannot be established for trades between surface water and groundwater, do you feel that this is likely to significantly discourage such trades?

#### WRT16

Do you support the enforceability of licence conditions against both the buyer and the seller in a trade or would trading be further encouraged if only the buyer or the seller were to be liable for enforcement purposes?

#### WRT17

Do you agree with our proposals on price information or would you prefer to have access to information on the prices paid as part of specific trades?

#### WRT18

What is the minimum information that potential buyers and sellers would require to take part in

trading and would changes to the form in which we hold this information encourage you to trade?

#### WRT19

Will the information suggested for CAMS provide the information that buyers and sellers would find useful in these documents, or would you suggest any changes to the information or format suggested?

#### WRT20

Do you believe that the development of a trading website by the Agency would be of value or is this something that should be developed by the private sector?

#### WRT21

Would the provisions of a website by the Agency confuse its role with the role of brokers?

#### WRT22

Do you agree that the Agency should not act as a broker of water rights nor establish any specific system of accreditation or regulation? If you believe that the Agency should carry out one of these roles, please explain why.

#### WRT23

Do you consider that the lack of any specific scheme for regulating or accrediting brokers would significantly impair the development of the water rights trading market and, if so, in what way?

#### WRT24

Do you consider that any further monitoring of water rights trading is required and, if so, what should this involve?

#### WRT25

Do you have any comments on our intention not to auction water rights without additional statutory powers, but to explore options for auctioning water rights in the future?

#### WRT26

Is the potential conflict between the Agency acting as a regulator and a seller of water rights acceptable or should we refer applications in which we have an interest to the Secretary of State or the National Assembly for Wales, in the same way as other licence applications made by the Agency? Alternatively, are the conflicts inherent in the Agency trading licences such that licences held by the Agency should not be traded as a matter of principle?

## Appendix 1:

# Consultation criteria

This is a summary of the key principles in the Government's Code of Practice on Written Consultation published by the Cabinet Office in November 2000.

1. The timing of a consultation should be built into the planning process for a policy of service from the start.
2. It should be clear who is being consulted, about what questions, in what timescale and for what purpose.
3. A consultation document should be as simple and concise as possible. It should make it as easy as possible for readers to respond, make contact or complain.
4. Documents should be made widely available, with the fullest use of electronic means.
5. Sufficient time should be allowed for considered responses from all groups with an interest.
6. The results of a consultation should be made widely available, together with the reasons for decisions finally taken.
7. Departments should monitor and evaluate consultations.

## Appendix 2:

# Summary of relationships between this consultation and *Tuning Water Taking*

<i>Tuning Water Taking</i> reference	Defra recommendation	Consultation reference	Agency proposal
3.1.9	"...the Government wishes the Agency to ensure that its licensing staff are fully aware of the scope for trading in the current system, and should advise all abstractors accordingly by means of an information sheet..."	–	Interim guidance and information issued in November 2002.
3.1.11 – 3.1.12	"...trading should be possible in any catchment, limited only by the need to protect the environment through the consideration both of abstractions and also of the return of water to the environment."  "The Government believes that the Environment Agency already has sufficient powers to ensure that [water rights] trading does not harm the water environment."	3.5	Options are put forward for enabling trades in over-abstracted and over-licensed catchments that would also protect the environment and a preferred option is proposed.
3.1.18  3.3.9	"The Government wants the process for approving trades to be as efficient as possible."  "The Government expects the Environment Agency to ensure that administration of licence changes is as streamlined as possible..."	3.6, 3.9 and 3.11	Section 3.6 discusses the potential for pre-application discussion to streamline the administration of trades.  Section 3.9 presents proposals for how the Agency might administer particular types of trades, particularly short-term trades and trades that give an environmental benefit.  Section 3.11 sets out the role that information could play in making the trading approval process more efficient.

Tuning Water Taking reference	Defra recommendation	Consultation reference	Agency proposal
3.2.7	“The Government has asked the Environment Agency to draw attention to the concept of acquisition curtailment conditions in its general promotion of [water rights] trading, and to work imaginatively with abstractors who wish to apply that concept.”	3.2 and 3.10	The use of linked licence conditions has been suggested as a means of facilitating trading. Enforcement of such conditions is discussed in section 3.10. It would remain open to buyers and sellers to agree who will have first call on water rights at times of concurrent demand.
3.3.4	“The Government will expect the Environment Agency to place the minimum possible constraints on [water rights] trading but at the same time to prevent environmentally damaging trades.”	Section 3, part B	This section explains how we propose to reduce transaction costs for buyers and sellers by minimising bureaucracy. It also explains where we believe that regulatory mechanisms need to be retained to protect the environment.
3.3.4	“The CAMS process should better inform and assist those interested in trading, particularly in relation to environmental issues, but the Government does not believe that it is necessary to await publication of CAMS before further facilitating trading.”	3.11.2	This section suggests particular information that could be provided within CAMS.
3.4.10	“The Government would not want sleeper licences to become reactivated as the result of trading where this would be environmentally damaging. The licensing regime operated by the Environment Agency should be sufficiently robust to guard against this.”	3.5	This is addressed as part of our proposals for trading in over-abstracted and over-licensed catchments.
3.5.8 – 3.5.9	<p>“Licence hoarding may involve the acquisition of new or varied abstraction licences for speculative purposes – but here considerable safeguards against non-use or inappropriate use are provided by the Environment Agency’s need to determine the ‘reasonable needs’ of the applicant.”</p> <p>“Holders of existing licences whose actual abstractions are well below the licensed quantity could also be said to be hoarding licences. Here, the provisions of the Competition Act 1998 may be particularly relevant if it can be shown that retention of those licensed quantities amounts to the abuse of a dominant position.”</p>	3.4	This section discusses how the abuse of a dominant position with the intention of hindering the entry of competitors into the market could be addressed, primarily through Ofwat and the Competition Act 1998.

<i>Tuning Water Taking reference</i>	<i>Defra recommendation</i>	<i>Consultation reference</i>	<i>Agency proposal</i>
3.5.15 – 3.5.16	“[The Government has] asked the Agency to prepare and consult on a draft code of conduct when participating in trading...”	4.1	This section explains that the Agency proposes to purchase water rights for environmental reasons only and in accordance with our guidelines on compensation for voluntary changes to abstraction licences.
3.6.7 – 3.6.9	“...the Government remains of the view that new abstraction licences should not normally be auctioned.” “...the Government is prepared to consider an auction in [exceptional] circumstances...”	4.2	We propose to explore options for auctioning should future legislative change provide a suitable framework, but do not currently propose to auction water rights.
3.7.7	“The Government has asked the Environment Agency to draw up, for consultation, a guidance document on its approach to the assessment of ‘reasonable need’...”	3.1	This section explores the specific aspects of the assessment of reasonable need that relate to trading and makes proposals on these aspects. The proposals support retaining existing tests of reasonable need on the basis that these remain appropriate for trading.
3.7.8	“This guidance will need to cover assessment of whether a particular use is ‘reasonable’ in terms of the efficiency of the proposed use.”	3.1.2	This section considers whether we should introduce an assessment of reasonable purpose within the abstraction licensing process and suggests that this is not appropriate or necessary to support trading.
3.7.9	“The Government considers that, in some circumstances, a delay between grant of a licence and the commencement of abstraction would be unavoidable, whether as a result of a competitive venture or as a consequence of prudent forward planning. The Government considers that... licence conditions about commencement of abstraction, coupled with appropriate time limits could be applied in such a way as to reflect the ‘reasonableness’ of such ventures while ensuring that, if they do not succeed the grant of that licence does not unnecessarily obstruct access to the water resources by others.”	3.1.1	We have suggested that we could continue to use a combination of time limits and ‘self-destruct clauses’ to allow potential competitors to access water resources, but prevent access to resources being unnecessarily restricted for others.

Tuning Water Taking reference	Defra recommendation	Consultation reference	Agency proposal
3.8.5	“The Government notes the concerns of some respondents. But it does not consider that there is a need for sector restrictions to trading.”	3.3	It is suggested that trading should be possible between all sectors and that trading between different sectors will often be restricted by the characteristics of water rights held by different sectors.
3.9.11	“The Government does not intend to ask the Agency to provide licence-specific pre-approval.”	3.6	This section discusses the scope for pre-approval of trades and opportunities and obstacles for pre-approval.
3.9.16	“The Government agrees that the introduction of CAMS should not only bring environmental benefits but also greatly facilitate [water rights] trading.”	3.5, 3.6, 3.7 and 3.11.2	<p>Section 3.5 discusses the role of CAMS in setting approaches for trading in over-abstracted and over-licensed catchments and suggests an approach to be contained in licensing strategies.</p> <p>Sections 3.6 and 3.7 discuss the scope for CAMS to provide a pre-approval mechanism and to specify supporting information for trades but proposes that CAMS is better suited to providing information that would be useful to buyers and sellers.</p> <p>Section 3.11.2 suggests information that CAMS could provide and asks if potential buyers and sellers would find other information useful.</p>

Tuning Water Taking reference	Defra recommendation	Consultation reference	Agency proposal
3.10.5  3.10.8 – 3.10.9	<p>“The Government has asked the Environment Agency to begin development of an information website on which suitable details of all completed [water rights] trades will be posted.”</p> <p>“The Government also proposes that a part of the Environment Agency’s [water rights] trading website should be available for prospective traders to post details of [water rights] they have to sell or which they would like to buy.”</p> <p>“The website would be maintained by the Environment Agency simply as an information service. The Agency would accept no liability for the accuracy of the information posted upon it.”</p>	3.11.3	This section highlights that we have begun to develop a trading website, but following feedback received at the October stakeholder workshop, we have also asked potential buyers and sellers if they would find such a website useful.
3.10.6	“The Government’s initial view is that the substituted s201 of the Water Resources Act 1991... will provide the Environment Agency with sufficient powers to obtain the information required [to provide information on trading].”	3.11 and 3.13	<p>Section 3.11 discusses how the Agency could provide a range of information that could encourage trading and puts forward proposals for how this would be done.</p> <p>Section 3.13 discusses monitoring of trading by the Agency and reporting of this information and makes proposals for how this would be done so that such information is useful to trading parties.</p>
3.10.16	“The general view was that active brokering would emerge if it could provide a useful service, and that regulation of this activity should only be activated if it was required. There might not be any need for it as long as central information on trades was available.”	3.12	This section suggests that the Agency should not act as a broker in water rights trades and should not regulate or approve brokers who participate in the market. It is suggested that brokering will be important in the development of water rights trading.

## Appendix 3:

# Index of terms and acronyms

### ***Abstraction***

In relation to water contained in any source of supply, means the doing of anything whereby any of that water is removed from that source of supply, whether temporarily or permanently, including anything whereby the water is so removed for the purpose of being transferred to another source of supply; and 'abstract' shall be construed accordingly.

Section 221(1) Water Resources Act 1991.

### ***Abstraction charges***

The charges payable to the Environment Agency under the terms of an abstraction licence.

### ***Abstraction licence***

The authorisation granted by the Environment Agency to allow the removal of water from a source.

### ***Agriculture***

Includes horticulture, fruit growing, seed growing, dairy farming and livestock breeding and keeping, the use of land as grazing land, meadow land, osier land, market gardens and nursery grounds, and the use of land for woodlands where that use is ancillary to the farming of land for other agricultural purposes.

Section 109(3) Agriculture Act 1947.

### ***Available headroom***

The difference (in Ml/d or percentage) between water available for use... and demand at any given point in time.

### ***CAMS***

Catchment Abstraction Management Strategy or Strategies.

### ***Catchment***

The area from which precipitation and groundwater will collect and contribute to the flow of a specific river.

### ***Consumptive use***

Use of water where a significant proportion of the water is not returned either directly or indirectly to the source of supply after use.

### ***cSAC***

A candidate Special Area of Conservation is one proposed for classification under the EC Habitats Directive, subject to agreement with the EU, to contribute to biodiversity by maintaining and restoring habitats and species.

### ***Derogate***

In relation to a protected right, shall be construed in accordance with section 39(4) of the Water Resources Act 1991.

### ***Groundwater***

Refers to all subsurface water, as distinct from surface water. Generally, groundwater is considered to be that water which is below the zone of saturation and contained within porous soil or rock stratum (aquifer).

### ***Groundwater management unit***

Administrative sub-divisions of aquifers, defined on geological and hydrogeological criteria, which form the basis for groundwater resource management and licensing policy decisions.

### ***Hands-off flow***

The flow below which abstraction must cease or be reduced.

### **Headroom**

See Available headroom and Target headroom.

### **Hydrogeology**

The study of the quality, quantity, storage and movement of water in rock and the interaction of geology.

### **Hydrology**

The study of water on and below the earth's surface.

### **Inland waters**

Means the whole or any part of:

- (a) any river, stream or other watercourse (within the meaning of Chapter II of Part II of the Water Resources Act 1991), whether natural or artificial and whether tidal or not;
- (b) any lake or pond, whether natural or artificial, or any reservoir or dock, in so far as the lake, pond, reservoir or dock does not fall within paragraph (a) of this definition;
- (c) so much of any channel, creek, bay, estuary or arm of the sea as does not fall within paragraph (a) or (b) of this definition.

Section 221(1) Water Resources Act 1991.

### **Licence**

Means a licence to abstract or impound water in accordance with Part II of Chapter II of the Water Resources Act 1991.

### **Licence of Entitlement**

Abstraction licences issued to authorise existing activities when further types of abstraction were brought into regulation by the Water Resources Act 1989.

### **Licence of Right**

Abstraction licences issued to authorise existing activities following the introduction of the water abstraction licensing system by the Water Resources Act 1963.

### **Ofwat**

Office of Water Services.

### **Protected right**

Existing rights which must not be derogated by the granting of a new licence, except with the consent of the holder of these rights. They include all existing licensed abstractions and certain exempt abstractions for domestic and agricultural purposes (excluding spray irrigation) not exceeding 20m<sup>3</sup>d as defined within section 39(3) of the Water Resources Act 1991.

### **SAC**

A Special Area of Conservation is one classified under the EU Habitats Directive and agreed with the EU to contribute to biodiversity by maintaining and restoring habitats and species.

### **Source of supply**

Means:

- (a) any inland waters except, without prejudice to subsection 221(3) of the Water Resources Act 1991 in its application to paragraph (b) of this definition, any which are discrete waters; or
- (b) any underground strata in which water is or at any time may be contained;

Section 221(1) Water Resources Act 1991.

### **Spray irrigation**

The irrigation of land or plants (including seeds) by means of water or other liquid emerging (in whatever form) from apparatus designed or adapted to eject liquid into the air in the form of jets or spray.

Section 72(1) Water Resources Act 1991.

### **SSSI**

Site of Special Scientific Interest.

### **Surface water**

A general term used to describe all the water features such as rivers, streams, springs, ponds and lakes.

### **Surface water catchment**

The land that drains, whether naturally or artificially, to any point in a specified stream or river.

### **Sustainable development**

Development that meets the needs of the present without compromising the ability of future generations to meet their own needs.

### ***Target headroom***

The threshold of minimum acceptable headroom, which would trigger the need for total water management options to increase water available for use or decrease demand.

### ***Total water management***

All water management activities from source to end use (i.e. resource management, production management, distribution management and customer-side management).

### ***Watercourse***

Includes all rivers, streams ditches, drains, cuts, culverts, dykes, sluices, sewers, and passages through which water flows except mains and other pipes which belong to the Environment Agency or a water undertaker, or are used by a water undertaker or any other person for the purpose only of providing a supply of water to any premises.

Section 221(1) Water Resources Act 1991.

### ***Wetland***

An area of low lying land where the water table is at or near the surface for most of the time, leading to characteristic habitats.

### ***Winter storage reservoir***

Reservoirs to store water during winter months when it is plentiful for re-use during the summer.

### ***Yield***

The reliable rate at which water can be drawn from a water resource.

## Appendix 4:

# Regulatory impact assessment

### 1. Introduction

The report presents a regulatory impact assessment (RIA) of the application of our proposals for water rights trading within the abstraction licensing system, following the expected enactment of the Water Bill. It has been prepared in accordance with the guidance on RIA issued by the Cabinet Office's Better Regulation Unit and presents the estimated costs, benefits and risks of this mechanism for implementing water rights trading.

Our flexibility in terms of considering fundamentally different approaches to trading is constrained by the need to encourage water rights trading within the regulatory framework that applies to abstraction. However, within that framework there are inter-related issues that arise from trading. How each of these is tackled can influence the significance or otherwise of other issues. In the consultation document, we have considered alternative approaches to particular issues and suggested the option which is believed to provide the most favourable balance between benefits and costs. This appraisal concentrates on assessing the costs, benefits and risks of the Agency's overall approach to water rights trading.

### 2. Background and purpose

Water rights trading is the transfer of licensable water rights from one party to another, for benefit. This process is regulated through the Water Resources Act 1991, but this legislation is expected to be superseded by the expected enactment of the Water Bill. The development of water rights trading began

with *The Review of the Water Abstraction Licensing System in England and Wales*<sup>63</sup>, published in June 1998. The results of this consultation were then published in *Taking Water Responsibly*<sup>64</sup>, which has formed the basis for much of the content of the Water Bill. Further Government-funded research concluded that a trading process should be adopted based on existing rights and could be followed by auctioning rights that became available in the future. The research also highlighted the high degree of uncertainty about how water rights trading would work in practice. Following this research, the Government prepared a further consultation paper specifically on the use of economic instruments<sup>65</sup>, which signalled its support for trading but also raised a number of questions on how to implement and manage water rights trading. *Tuning Water Taking*<sup>66</sup> confirmed the Government's intention to introduce water rights trading and set out a proposed table of actions through which the Agency would facilitate trading. This appraisal therefore assesses the impacts of our proposals for how water rights trading should be implemented rather than seeking to assess the impacts of facilitating water rights trading in principle.

Aspects of the Water Bill are intended to facilitate water rights trading, particularly in relation to the right to apply for an abstraction licence, advertising requirements for applications and the means through which licences may be transferred. These changes will take place if the Water Bill is enacted in its current form, independently of the approach we suggest for trading in this consultation document. We welcome these proposed legislative changes, but trading does

<sup>63</sup> *The Review of the Water Abstraction Licensing System in England and Wales*, DETR/Welsh Office, June 1998.

<sup>64</sup> *Taking Water Responsibly: Government decisions following consultation on changes to the water abstraction licensing system in England Wales*, DETR/Welsh Office, March 1999.

<sup>65</sup> *Economic Instruments in Relation to Water Abstraction: A Consultation Paper*, DETR, April 2000.

<sup>66</sup> *Tuning Water Taking: Government decisions following consultation on the use of economic instruments in relation to water abstraction*, Defra, June 2001.

present risks that need to be managed by the Agency and which our proposals seek to address.

The important aspects in facilitating water rights trading break down into two areas: how we will manage water rights trading and the Agency's participation as a trading party within any future trading system. The means by which we manage trading will, to a large degree, determine the success of trading in achieving its objectives. The Agency's participation in trading could potentially result in significant conflicts of interest for the Agency to the potential detriment of other participants in the trading market. The risks we have sought to address when drafting the consultation document include:

- Uncertainty as to the Agency's approach to trading proposals may increase transaction costs and limit the benefits that can be achieved through trading.
- Trading in sleeper or part-utilised licences, particularly in over-licensed or over-abstracted catchments, could lead to environmental damage. Abstractors in a dominant position within a trading market could abuse that dominant position to prevent competitors accessing water rights through trading.
- Trades could result in water being used in ways that are in conflict with the Agency's guidance on water efficiency.
- The potential for existing processes such as CAMS to contribute towards the objectives for water rights trading may be missed.
- Potential conflicts of interest relating to the Agency's involvement in water rights trades may remain unresolved.

Interim information on water rights trading before the expected enactment of the Water Bill was produced in November 2002 and the consultation document to which this assessment relates is aimed at developing final guidance on water rights trading after the Water Bill has been enacted. Responses to this consultation document will inform the results of this final report. We also held a stakeholder workshop in October 2002 to enable interested parties to provide input and ideas on the points covered in this consultation document. The views expressed at the workshop have been considered in developing the consultation document and in preparing this assessment.

### 3. Options

#### 3.1 Overview

Water rights trading is part of the process of introducing economic instruments into environmental regulation where such instruments are considered to be effective in achieving environmental and sustainability objectives. In facilitating water rights trading, we aim to increase the value to society of water authorised for abstraction, whilst protecting the environment. These proposals are intended to promote the allocation of water to the highest value users amongst abstractors, subject to the impact of such proposals on the environment and other water users. They are based on the principle that any trading mechanisms must operate within the constraints of the relevant legislation, the impacts of which have been considered in the context of those legislative proposals<sup>67</sup>.

#### 3.2 Alternative approaches

When it is enacted and implemented, the Water Bill will make water rights trading easier. *Tuning Water Taking* set out clearly the Government's support for the Agency encouraging water rights trading and indicated the areas it felt would need to be addressed to do this beyond the legislative changes proposed in the Bill.

Our options when considering the regulatory impact of water rights trading are limited to considering whether we should encourage trading to take place following the legislative changes proposed in the Water Bill. Trading will be possible whether or not the Agency encourages trading activity, both under current and proposed legislation. Encouraging trading will only influence the extent of such activity.

The benefits we believe will be brought about as a result of water rights trading are set out in section 4 of this appraisal. Encouraging water rights trading will increase the extent to which abstractors as a whole and the environment will feel these benefits. In providing information and guidance on water rights trading, we will also be able to achieve benefits in time and cost for the Agency by providing consistent guidance to staff on how to administer trading proposals and determine related applications. Taking action to encourage trading consistent with the proposals set out by Defra in *Tuning Water Taking* would also have the benefit of meeting Government's expectations.

<sup>67</sup> For general information on the regulatory impact of changes to legislation proposed by the Water Bill, see the regulatory impact assessment accompanying the Water Bill; *Water Bill – Regulatory Impact Assessment, Environmental and Equal Treatment Appraisals*, Defra, February 2003.

We do not believe there are any real benefits to pursuing a 'do nothing' option following the expected enactment of the Water Bill. We must have a consistent approach to trading proposals to support staff who determine applications in reaching their decisions and to reduce costs. Water rights trading, including environmentally or economically beneficial trades, would also be discouraged by higher transaction costs resulting from a less predictable administrative system.

The Agency could base water rights trading on the case-by-case approach to the determination of abstraction licence applications that it currently operates. This could be supported by particular approaches for trading on aspects of the licensing system such as advertising, the assessment of reasonable need and the determination of trading applications in over-abstracted and over-licensed catchments. Transaction costs could potentially be reduced through these trading-specific approaches as well as by ensuring that relevant information on the potential trading market in particular areas was readily available. Much of what has been suggested in the consultation document reflects this approach.

An extension of this approach would be to disapply certain parts of the licence determination process, for example the assessment of reasonable need or water efficiency. This would reduce transaction costs for buyers and sellers, but could result in trades that are inconsistent with the Agency's approach to the efficient use of abstracted water if inefficient use is not discouraged sufficiently by economic signals.

Alternatively, the Agency could seek to provide generic approvals for particular types of trades or trades within particular areas. This would encourage trading by reducing transaction costs for buyers and sellers and would contribute to achieving the benefits sought through water rights trading. There are, however, environmental risks associated with generic approvals, as these would restrict our ability to consider the local impacts of trading proposals, for example the impact of a change in the location of an abstraction on other licence holders. These environmental risks are particularly significant in catchments that are presently over-abstracted or over-licensed. It is probable that generic approvals for particular types of trades carry an environmental risk that outweighs the benefits that would be brought in reducing transaction costs. One suggestion that may limit the impact of this approach on transaction costs

is the provision of suitable information to potential buyers and sellers that will assist them in estimating how easy or complex the advertising or information requirements for a particular trade are likely to be.

## 4. Proposed water rights trading mechanisms

### 4.1 Overview

Current legislation regulating the abstraction of water did not foresee the trading of water rights and was not established with this in mind. Legislation has allocated water rights on the basis of historic use, with little consideration of economically efficient allocation amongst abstractors. As a consequence, abstractors may find they are unable to obtain a licence to abstract water due to water resources in a catchment being licensed up to or beyond their sustainable level, although only half of the water in that catchment may actually be abstracted in practice. Trading is intended to overcome this problem by creating a mechanism and incentives for parties to transfer water rights where this transfer benefits both parties. Trading mechanisms will need to ensure that the correct incentives and checks and balances are contained within the trading system to achieve these objectives.

### 4.2 Methodology

Trading is an entirely voluntary process; its success depends on encouraging parties to trade actively. The trading process will be available to all licence holders in all catchments subject to ensuring that hydrological links are present between current and proposed licences and that the environment is protected. Our proposals have a number of key features:

- Trading would be possible in all catchments. If a catchment is over-licensed or over-abstracted, we suggest that a trade will need to show it does not result in localised environmental damage and that it contributes towards achieving sustainable levels of abstraction within that catchment.
- We suggest that we should use existing processes to assess reasonable need and water efficiency. One consequence of this may be to discourage the abuse of dominant positions in the water rights trading market.
- Ways of easing regulatory burdens on trades that are for a short period of time and/or environmentally beneficial have been suggested, for example by exercising discretion on the need

for advertising, by minimising the supporting information required for such trades and by making use of linked licence conditions.

- We suggest that we could provide information useful to potential buyers and sellers within CAMS technical documents and discuss possible trading proposals at either a general or specific level, but that we would not act as a broker for water rights trades.
- We propose to continue to allocate previously unlicensed resources on a first come, first served basis in the absence of legislation to enable the auctioning of water rights.

## 5. Benefits

We believe that the appropriate use of economic instruments is a key part of modernising regulatory techniques. This assessment does not consider the appropriateness of introducing water rights trading, but of how water rights trading will be introduced. When formulating these proposals, we have sought to facilitate trading in a manner that realises its potential benefits to the greatest extent possible whilst minimising any associated risks. The expected benefits include:

- providing an incentive for abstractors to invest in water efficiency measures to make surplus water available to trade;
- allowing potential abstractors access to water resources in areas where environmental objectives would otherwise make this impossible;
- enabling licence holders to manage their water needs more flexibly in response to temporary changes, for example in relation to irrigation needs for different crops;
- allowing licence holders to adjust the level of water rights they hold in response to any change in the reliability of their abstraction;
- enabling licence holders seeking to retire, restructure or diversify to realise the value of their water rights whilst retaining their land or selling it separately.

We suggest that the proposals for water rights trading set out in the consultation document will have the following benefits compared with the alternative methods and mechanisms for the administration of water rights trading that have been explored:

- Trading would contribute towards the recovery of resources in over-licensed and over-abstracted

catchments through reductions in overall licensed volume secured through the determination of trading proposals.

- The interests of the environment and other abstractors would continue to be protected in accordance with our statutory duties and the Agency's broader organisational objectives.
- Existing processes that have a proven regulatory track record would be applied to trading, giving certainty to trading parties and consistent regulation.
- Environmentally beneficial and short-term trades would be made quicker and cheaper by not having to advertise.
- Our role as a regulator would be kept distinct from the market role of brokers.
- The abuse of dominant market positions would be discouraged through the assessment of reasonable need and water efficiency.
- Certainty would be enhanced within the application and pre-application process for trading parties, thus increasing levels of participation in trading and shortening the discussion periods between the Agency and applicants as proposals would be further refined by the time they reach this stage.
- Refusals of applications should be minimised through providing the maximum opportunities by which water resources may be accessed.
- Regulatory tools are reinforced by complementary economic signals which would contribute to environmental objectives.

Due to the uncertainty as to the likely scope and extent of trading, we have not been able to attach specific values to these benefits or to quantify the contribution that our proposals will have on securing them.

## 6. Costs and risks

We believe that all sectors that abstract water will be potentially affected by these proposals, but that trading will have particular importance to the agricultural sector and those supplying water to others. We do not believe that our proposals for water rights trading will create any burdens for particular sectors. Because water rights trading is a voluntary process, the scope for putting figures on the costs of particular measures is limited. Due to the nature of the abstraction licensing system and the nature of water resources,

these costs will vary widely between different potential traders. Water rights trading will not impose any additional costs on licence holders, as the costs associated with trading will be incurred through preparing and making an application for a new or varied licence. There will also be some costs incurred by the parties to a trade in gathering information, finding a trading partner and negotiating the details of a trade, but these costs will be voluntarily entered into on the basis that the benefits of trading will outweigh transaction costs. In the consultation document, we have suggested how we might minimise these transaction costs, for example by using our discretion to exempt a particular application from advertising requirements.

The costs and risks we perceive as arising from our proposals are:

#### *Agency, the environment and other users*

- By allowing trading to take place within over-licensed and over-abstracted catchments, trading may increase the extent to which some catchments are over-abstracted or cause some catchments to move from over-licensed to over-abstracted status. This should be limited by the prevention of localised environmental damage and the requirement that any trade with a short-term environmental cost should result in a greater long-term environmental gain.
- By proposing to apply existing tests of reasonable need and water efficiency, rather than a relatively loosely regulated trading system, we will incur administrative costs.
- The lack of specific mechanisms to regulate and prevent the abuse of dominant market positions in order to prevent competitors entering the market may risk such activities not being successfully discouraged or leave gaps that may be exploited.
- By proposing to incorporate water rights trading within existing regulatory processes and proposing to continue to assess applications for trading case-by-case, there may be an additional regulatory burden placed on the Agency in determining applications and advising applicants. We do not expect these costs to be significant in the context of our overall water resources management duties and responsibilities, but we will monitor carefully the demands placed upon our staff as a result of this initiative and others.

#### *Buyers*

- By proposing to apply existing tests of reasonable need and water efficiency, rather than a relatively loosely regulated trading system, we will prevent some applicants from obtaining the resources they want through the market.
- The Agency would not control the information supplied to trading parties, as much of this is expected to be provided by brokers in the private sector. There may be inconsistent or incorrect information provided by brokers and this might reduce confidence in the operation of the market and discourage trading.

#### *Sellers*

- Our proposals would provide potential trading parties with only a limited degree of certainty when considering whether a trading application will be granted. Again, this may prevent potential efficiencies being achieved, as traders may not be sufficiently encouraged.

### **7. Impacts on small businesses**

The proposals are expected to create benefits for small businesses as these businesses, particularly in agriculture, are likely to be in the best position to take advantage of the opportunities offered by water rights trading. This will enhance the opportunities for these businesses to hold water abstraction licences that reflect the demand they have for water from year to year. These proposals place no burdens on small businesses due to the voluntary nature of water rights trading.

*Tuning Water Taking* identified the concern of small businesses, particularly in the agricultural sector, that they would be at a disadvantage against larger competitors when seeking to trade water rights. We believe this may be true within sectors due to the greater resources and expertise available to larger companies, which will potentially reduce transaction costs. We have sought to address this by making information that we believe will reduce transaction costs publicly available to all potential buyers and sellers through the CAMS process. We believe that, due to the expected nature of trading markets, sectors characterised by large numbers of small businesses will not be at a significant disadvantage when seeking to acquire water rights as direct competition between these sectors is predicted to be limited.

## 8. Monitoring and evaluation

Trading water rights is a relatively new process, particularly with the expected introduction of new legislation contained in the Water Bill. Monitoring is essential to assess how the water rights trading market is developing and the impact that trading is having on the management and use of water resources. Monitoring and reporting could include information on the sectors involved, the volumes involved in such trades and the duration for which water rights are traded. This information may well provide a clearer picture of which water rights are being traded, in what form, and by whom.

Reporting on the impact of trading as a process on water resources and their use is also suggested. This reporting process would focus on transaction costs for trades, variability of prices and how open the market is as well as the economic, social and environmental impacts of trading. We would also consider the extent to which trading has contributed towards the objectives contained in CAMS and our national and regional water resources strategies.

It has also been suggested that we should gather information on the price at which water rights trading takes place (although trades will not necessarily be based on a monetary transaction) to gain a better understanding of the value of water rights. This information would be requested from abstractors at the time that any new or varied licence resulting from a trade is issued by the Agency<sup>68</sup>. We do not propose, however, to report this information in any form that would allow a particular price to be linked to a particular transaction. As well as enabling us to improve and develop the water rights trading system, the information reported will be particularly useful, in conjunction with CAMS, to those interested in trading their water rights or acting as a broker by helping them gain a better understanding of the trading market. Information will also contribute towards the development of future economic instruments in other areas by both the Agency and Government.

## 9. Competition assessment

Guidelines produced by the Office of Fair Trading and the Cabinet Office explain how to assess the impact of proposed policies and legislation on competition in the market place<sup>69</sup>. The guidelines set out a two-stage process for examining the

competition implications of proposals; the first stage is a filter which identifies policies where there is a risk of substantial detrimental effect on competition. If such a risk is detected, then a detailed assessment is required. We have considered the nine questions of the competition filter (the results are given in Annex A) and concluded that our proposals for water rights trading do not create a substantial detrimental effect on competition.

## 10. Consultation

This consultation document is intended to get the views of stakeholders on our proposals for water rights trading and to gain their views on whether previous concerns have been addressed as well as any additional suggestions they may have for developing the water rights trading process. Before this consultation, a number of activities have been undertaken to obtain stakeholders' views on changes to the abstraction licensing system, whether water rights trading should be encouraged and how water rights trading should be managed. These previous consultations are summarised in section 1.2 of this assessment.

## 11. Conclusion

We believe that our proposals represent an appropriate balance between ensuring that the environment is properly protected and providing the opportunity for water resources to be allocated more efficiently through the trading process. The proposals contained in the consultation document and considered in this appraisal are not expected to impose significant cost burdens on either businesses or the Agency and nor will they threaten the environment.

<sup>68</sup> This option will be available to the Agency using the proposed s47 of the Water Bill.

<sup>69</sup> *Guidelines for Competition Assessment*, Office of Fair Trading, February 2002.

**Annexe A:**  
**Competition assessment: competition filter**

The Office of Fair Trading’s *Guidelines for Competition Assessment*, published in February 2002 sets out a competition filter of nine questions, the answers to which determine the need to complete a competition assessment as part of an RIA.

The questions and the responses that are relevant to this RIA are:

No.	Question	Response
1.	In the market(s) affected by the new regulation, does any firm have more than 10 per cent market share?	Yes, in particular catchments or water resource management units.
2.	In the market(s) affected by the new regulation, does any firm have more than 20 per cent market share?	Yes, in particular catchments or water resource management units.
3.	In the market(s) affected by the new regulation, do the three largest firms together have at least 50 percent market share?	Yes, in particular catchments or water resource management units.
4.	Would the costs of the regulation affect some firms more than others?	No. There may be some substantially differences in firms’ costs when seeking to trade, but these are not considered likely to be significant and trading as a process will be equally available to all firms.
5.	Is the regulation likely to affect the market structure, changing the number or size of small firms?	No. Trading may reflect changes of this sort, but is considered highly unlikely to cause them directly.
6.	Would the regulation lead to higher set-up costs for new or potential firms compared with the costs for existing firms?	No. Trading should reduce such costs and make it easier to set up. The consultation sets out ways in which these benefits may be realised.

No.	Question	Response
7.	Would the regulation lead to higher ongoing costs for new or potential firms compared with the costs for existing firms?	No.
8.	Is the market characterised by rapid technological change?	No.
9.	Would the regulation restrict the ability of firms to choose the price, quality, range or location of their products?	No.



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