

April 2021

## **Reporting of sludge liquor treatment costs – final decisions**

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# 1. Introduction

## Purpose of this document

- 1.1 In November 2020 we published proposals<sup>1</sup> concerning how companies account for sludge liquor treatment costs in their Annual Performance Reports (APRs). This followed on from work undertaken for us by Jacobs to establish a standard methodology for quantifying these costs<sup>2</sup>, also published in November 2020. This piece of work was commissioned in response to the significant variation in the current methodologies companies use to quantify liquor treatment costs, which in turn leads to wide variation in cost and a potential distortion of the bioresources market.
- 1.2 This document sets out our original proposals, the feedback we received from the industry on said proposals, our response to this feedback and our final decisions.

## Our strategic objectives

- 1.3 In our strategy, ‘Time to act, together’<sup>3</sup>, we set out our ambition for the sector, which includes providing the very best service for customers, improving the environment and improving life through water, both now and in the future – and the role we will play in achieving it. Our strategy sets out three strategic goals:
  - to transform water companies’ performance;
  - to drive water companies to meet long-term challenges through increased collaboration and partnership; and
  - for water companies to provide greater public value, delivering more for customers, society and the environment.
- 1.4 A well-functioning bioresources market can contribute to achieving these strategic objectives by delivering cost efficiencies and encouraging improved service levels, while also incentivising innovation.
- 1.5 In order to improve the functioning of the market, costs such as those for sludge liquor treatment must be allocated accurately to ensure that pricing for sludge trades is transparent and fair. This is key to enabling greater trade of sludge between both incumbent wastewater companies and incumbent wastewater companies and third

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<sup>1</sup> [Reporting-of-sludge-liquor-treatment-costs.pdf \(ofwat.gov.uk\)](#)

<sup>2</sup> [Setting-a-standardised-methodology-for-quantifying-the-cost-of-sludge-liquor-treatment-in-the-water-industry-1.pdf \(ofwat.gov.uk\)](#)

<sup>3</sup> <https://www.ofwat.gov.uk/wp-content/uploads/2019/10/Time-to-act-together-Ofwats-strategy-1.pdf>

parties, which should in turn deliver improved outcomes for customers and the environment.

## 2. Our proposals

2.1 In our November document, we outlined our proposals for the accounting of sludge liquor treatment costs. In summary we proposed that:

- The standard methodology developed by Jacobs will be implemented for the reporting year 2021-22. A full description of the standard methodology can be found in Jacobs' report<sup>4</sup>. Companies will shadow report the cost of internal recharges for liquor treatment based on this until the end of Asset Management Plan period (AMP) 7, in order to avoid material financial impact resulting from a mid-AMP change. The methodology will be fully implemented from AMP 8 onwards.
- Companies use the standard methodology when agreeing sludge trades from reporting year 2021-22 onwards. The difference between the standard methodology and current liquor treatment recharging practice could lead to excess revenues being generated by companies. We consider that this excess revenue should be passed in full to customers.
- For the purpose of 2020-21 reporting, we request that companies report an indicative shadow cost as far as they are able to, following the guidelines in RAG 2. At a minimum this should include estimated operating costs, capital costs and overheads.
- Companies continue using their current methodology for accounting for liquor treatment costs for the remainder of AMP 7. Companies must clearly state this methodology within the 2020-21 accounting methodology statement that is submitted to us and continue to use it, unchanged, for each remaining year of AMP 7. This is in addition to using the standard methodology to shadow report.

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<sup>4</sup> [Setting-a-standardised-methodology-for-quantifying-the-cost-of-sludge-liquor-treatment-in-the-water-industry-1.pdf](#) (ofwat.gov.uk)

## 3. Industry feedback and our response

### Industry feedback

- 3.1 We received one response from the incumbent wastewater companies.
- 3.2 The company was broadly supportive of our proposals, and noted the need to ensure that industry reporting of sludge liquor treatment costs using the standard methodology is consistent if this is to be used to set PR24 determinations. The company suggested undertaking a horizontal review of company reporting during AMP 7 to assess this.

### Our response

- 3.3 We welcome the support for our proposals. We also agree that there is a need to ensure the standard methodology is being implemented accurately and consistently, before its use to set PR24 revenue allowances. There is potential for significant variation in reported costs outside of companies' control initially, due to the length of time needed to generate a reliable estimate of some cost factors. However, by implementing full shadow reporting for reporting year 2021–22, companies should have enough time to generate reliable sample estimates to be used in the PR24 process. We will take steps to ensure this reporting is accurate and consistent as AMP7 progresses and may issue additional guidance as we deem appropriate.

## 4. Final decisions

4.1 We have decided to implement our proposals in full and in the same manner as they are set out in our November 2020 document.

4.2 Our November 2020 document contains full details of how companies should implement these decisions. In summary though, companies are required to:

- Implement the standard methodology developed by Jacobs for reporting year 2021-22. Companies should shadow report the cost of internal recharges for liquor treatment based on this until the end of Asset Management Plan period (AMP) 7, in order to avoid material financial impact resulting from a mid-AMP change. The methodology should be fully implemented from AMP 8 onwards.
- Use the standard methodology when agreeing sludge trades from reporting year 2021-22 onwards. The difference between the standard methodology and current liquor treatment recharging practice could lead to excess revenues being generated by companies. This excess revenue should be passed in full to customers.
- Continue using their current methodology for accounting for liquor treatment costs for the remainder of AMP 7. Companies must clearly state this methodology within the 2020-21 accounting methodology statement that is submitted to us and continue to use it, unchanged, for each remaining year of AMP 7. This is in addition to using the standard methodology to shadow report.
- Sample liquor returns 12 times over the year for 2021-22, as this is the minimum number of samples recommended by Jacobs to determine representative samples of biochemical oxygen demand and ammonia concentrations. These estimates should then be updated by quarterly samples in subsequent years and a rolling average should be used to calculate appropriate charges.

4.3 We also request that:

- For the purpose of 2020-21 reporting, companies report an indicative shadow cost as far as they are able to, following the guidelines in RAG 2. At a minimum this should include estimated operating costs, capital costs and overheads.

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