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Thursday 22 July 2021

Dear Ofwat

### **Review of the bioresources market - consultation**

We are pleased to offer our comments on the proposals set out in this consultation.

Our approach has always been to welcome the development of markets where they offer benefits to customers, and this applies to bioresources as much as any other area of the value chain. We were the first company to publish its bioresources market information tables, before they were a regulatory requirement, in 2017. We led the development of the bioresources assurance scheme (BAS), which is designed to raise the standard of bioresources management and the quality of biosolids, and were the first company to achieve BAS certification. We have undertaken small scale sludge trades with our neighbouring companies and remain in discussion with them and others about future opportunities.

We make full use of the market for biosolids disposal and, to a degree, for sludge transport but we recognise the conclusion of Ofwat's bioresources market report that the level of competition in sludge treatment remains very low. In principle, we support the removal of barriers to market development which arise from the way in which bioresources is regulated. However, it is clear to us that there are more significant barriers that need to be removed before the sludge market achieves its potential. We set these out in both my letter of 15 December 2020, which was published on Ofwat's website, and our response to the market monitoring survey. They are covered fully in the Jacobs report and do not need to be rehearsed again.

The non-regulatory barriers are also acknowledged, briefly, in the bioresources market consultation. In *PR24 and beyond: creating tomorrow, together*, Ofwat commits to work with environmental regulators and other stakeholders to ensure environmental regulation and other barriers are addressed as appropriate. We encourage Ofwat to do so and to support the effort companies are currently making to prevent the raising of those barriers.

Here are our comments on each of the proposals in the consultation:

#### **Market model**

We support preferred option 2: require companies to produce a bid assessment



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framework and demonstrate they had adhered to this. We generally concur with the reasons for rejecting the other options considered.

In terms of implementation, our preference would be for each company to develop its own framework, as happens in water resources. By working individually, companies should be able to develop their frameworks more speedily, accelerating the delivery of the resulting benefits. This approach will also allow companies' frameworks to align with any of their other relevant inter-dependent strategies. We suggest the bidder framework – or, possibly, separate frameworks - should encompass transport and recycling as well as treatment.

#### **Undertake better targeted cost assessment**

We agree that we must achieve consistent approaches on all cost allocation to ensure we have a level playing field for PR24. We will respond in August to the separate consultations on energy accounting and the allocation of overheads.

#### **Approach to assessing costs**

Of all the proposals in Ofwat's consultation, this is the one which we have found most difficult to assess. We are not confident that we have fully understood the details of Ofwat's proposed option nor identified all of the potential implications so are unable to give it our support at this stage. Given the potential consequences of changing the basis of determining the allowed revenue and the number of design and implementation issues which the consultation identifies, we suggest there should be opportunity to have greater discussion with companies before a decision on this proposal is made.

One concern we have focussed on in our consideration of the proposal is the risk of asset stranding. Historically investors in the industry have recognised the risks that accompany a price review about the revenue they will be allowed to maintain and operate the assets they have funded. However, they have been reassured that they will continue to earn a return on their investment, albeit without knowing the precise rate of return which will be determined. The confidence that comes from the RCV model has encouraged the high levels of investment we have seen in the industry over the last thirty years.

A consequence of the proposal to change the basis of setting the revenue allowance is that investors will no longer have the confidence that came with the RCV model. Our concern is that this will have the opposite effect from the one Ofwat intends. Instead of encouraging market development, the risk that comes from the proposed new basis of revenue setting could act as a deadweight on the development of the market and discourage new investment. The consultation document discusses options for how to reduce this risk to investors but unless these are sufficiently strong and trusted the change could act against Ofwat's strategic intention.

The consultation document rightly highlights that in competitive markets companies' investments are generally exposed to risk. However, in competitive markets companies also generally have the choice about whether to enter the market or not. In contrast, water companies have a statutory duty to deal effectively with the contents of their sewers. Refusing to enter the market is not an option for a water company faced with the daily challenge of

dealing with its sludge production. This point is sometimes lost in discussions about putting water companies on a level playing field with other potential market participants.

#### **Encourage greater sector collaboration**

We support Ofwat's proposal here and consider that the other, more interventionist options would be disproportionate while the non-regulatory barriers referred to in my introduction remain.

We expect to continue the collaboration which already exists between the companies and other market participants through forums such as the WaterUK bioresources network and UKWIR. The Innovation for Water Competition (IWC) proposal, which we led and for which we partnered with Thames Water, Yorkshire Water and Northumbrian Water, illustrated the scope for greater joint working. We will explore the options for delivering the IWC project by other means.

We agree that collaboration should extend to encompass environmental regulators and government departments such as BEIS. Bioresources markets and technology have a significant role to play in the achievement of national goals for net zero. This is a rapidly changing regulatory environment with new and changing incentives and evolving technology pathways. We recognise the need to work with government departments to ensure that the opportunities from these new technologies are exploited fully.

#### **Improve information remedies**

We will report this month in line with the revised information direction. As we said in our response to the consultation on revised information requirements, we regard the requirement to publish the market activity tables annually as disproportionate given that the small changes from one year to the next are unlikely to have any material bearing on whether a would-be participant in the market would approach us.

#### **Ensure more joined-up, pro-market outcomes.**

We are willing to explore with others the development of a common bioresources performance commitment but consider that if it is to be included in the AMP8 suite it must be well aligned with the objectives of rational market development and not create incentives for uneconomic behaviour.

#### **Trading incentives**

We agree that the existing incentives on companies to trade sludge are sufficiently strong without the need for additional trading incentives.

Yours sincerely,



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**Director of Strategy and Regulation**