Northumbrian Water response to: Review of the Bioresources Market – consultation July 2021

Overview of our response

In the consultation, Ofwat set out 7 main issues, with options and preferences.

We have structured our response in the same format, with our comments and reasoning on the options we prefer. In all cases, we broadly support the Ofwat preferred options, although we have made some caveats on how they might be implemented. There are several options we have agreed as worthy of investigation but might not be possible, as we recognise the difficulties associated with implementing them. It will be important not to be dogmatic about a proposed approach if it does not support a market or creates additional costs.

We note that the main PR24 consultation: *PR24 and Beyond: Creating tomorrow, together* summarises these options, so in our response to that consultation, we refer to this response for our more detailed comments on bioresources.

Finally, whilst Ofwat have published the Anglian bioresources submission letter that sets out the large range of very significant environmental regulation uncertainties, the consultation makes no mention of how these will be addressed. Whilst the Environmental Regulations uncertainties and barriers that they set out are significant, Ofwat makes no mention of how it plans to address them. We appreciate that this will require discussions with the EA and Government, but they cannot simply be ignored as 'too difficult'. Markets requiring significant upfront investment cannot develop efficiently if the future regulation of the core product is uncertain.

Issue 1: Market Models: NES response

We support the preferred option 2, the bidding market. It recognises that the most promising form of market competition will be for the provision of additional capacity for bioresources demand increases.

Competition for existing bioresources demand is limited as Wascs have already built and integrated bioresources assets for the current levels of demand. These asset costs are sunk and using them therefore will be more attractive to an incumbent than using a third party assets where the asset costs are included in the gate price.

The bioresources market is one that, if it is to grow, will do so incrementally over time. Bioresources provision typically requires upfront capital investment that is then recovered over a long period of time. Such investment is unlikely to be provided speculatively, it is more likely require the assurance of revenue from long term contracts from wastewater companies. These requirements are most closely aligned to the bidding market model.

Options 3 to 5 would clearly increase the regulatory and market risk of the bioresources service. This movement from monopoly provision to market competition would be accompanied by an increase in the cost of capital, as noted by Jacobs (Jacobs report page 11 suggests it could double).

There would also be a risk of loss of economies of scope – in our experience, our same-site integration of treatment and bioresources assets has enabled our bioresources service provision to be recognised as the most efficient in the industry. (PR19 Cost Assessment BR model WWW2).

Finally, any parallels with the creation of the separate non household retail market should be treated with caution. The separation of non household retail was aided by a series of factors that do not apply for bioresources:

- There was no RCV allocation to non household retail, making separation low risk for investors.
- The non household retail market is not asset intensive and has relatively low barriers to entry.
- There was a clear pathway to full deregulation for the service.
- Non household retail does not have any locational economies – it does not require integration or costly transportation of the product between services.
- The non household retail market is not bounded by environmental regulation

All these issues would have to be overcome to allow the creation of a fully deregulated and separated bioresource service.

Issue 2: Improving cost allocation between controls

We support any clarifications of cost allocation that Ofwat identifies as necessary, although they must apply from the end of the period as the PR19 cost adjustment models require actual and allowed costs to be calculated on the same basis.

Issue 3: Approach to assessing costs: NES response:

With some caveats, we believe that Option 2, (*inclusion of all company costs when benchmarking is more closely aligned to a market approach)* is worth considering, although we agree with Ofwat that, if issues cannot be resolved, a reversion to the Option 1 building blocks would be preferable.

We are wary about any attempt to benchmark bioresources gate prices with the wider waste sector. The Jacobs report (page 19) sets out a series of physical and regulatory differences between bioresources and the other organic waste market that can all affect the cost and gate fees of the services, making comparisons unreliable.

When setting the gate fee, Ofwat should bear in mind that setting it too low will preclude third party market entry. The move to a market based, unregulated service must be accompanied by market based levels of returns that recognises the increased risk of non recovery of investment. Not to do so would exclude third parties without the benefit of RCV based financing from competing.

We are not convinced that Ofwat could completely ignore enhancement costs in their assessment of a regulated gate fee. (Ofwat: *Introduce comparative competition on a wider set of costs, such as enhancement costs, and so reduce the need to set these directly ourselves)*. A fixed regulated gate fee would not allow companies to charge more should general industry costs rise due to legislation (e.g. the Industrial Emissions Directive or other changes in the EA Sludge strategy regulations). These external 'cost shocks' would raise prices in a competitive market, so should be allowed for in any regulated gate fee.

On depreciation, when setting an efficient gate fee, Ofwat will need to assume a single standard run off rate for bioresources for all companies. The run-off allowance for pre 2020 RCV should be npv neutral for companies, so standardisation should not be a material issue. It may be that Ofwat wish to set a relatively high run-off rate for pre 2020 RCV, with the aim of reducing the impact of this regulated component on the total gate fee over time.

The move to a gate fee approach would increase the risk of asset stranding and put the post 2020 bioresources RCV at risk of non-recovery. It is right that Ofwat recognise this increase in risk as a necessary consequence of moving to a competitive market. The most appropriate response would be to increase the cost of capital to the level on a competitive market (Jacobs p11).

The alternatives Ofwat sets out are more complex and subjective. A move from Upper Quartile to Average would reduce the risk of totex overspending, but more analysis would be required to calibrate this against the increased risk of non-recovery.

The regulatory protection intervention where companies have *demonstrated appropriately innovative, pro-market plans/activities and/or comply with our proposed bidding market arrangements* is very subjective. It is not how a market would work and, as Ofwat note would require lengthy submissions, assurance and regulatory challenge, with the outcome only being decided after the investment has been put at risk. We do not believe this would lower the perceived risk of non-recovery of totex investment. We also do not see why customers should pay for this relative level of inefficiency just because a company had plans to do better in future.

Issue 4: Planning & collaboration: NES response:

We support the preferred Option 1 – encourage greater sector collaboration. We agree that the other proposals in the document, in particular the 'bidding in' proposals will encourage this.

Ofwat should be aware that we do have regular discussions with other WaSCs about bioresources service provision, but, as these are commercially confidential, they are not in the public domain.

The market information tables do serve the same purpose as would a more complex bioresources management plan – they signal projections of supply and demand and the requirements for increased capacity.

Issue 5: Information remedies: NES response

We support the use of market information to signal tradeable capacity and desired future capacity. These should form the basis of the bidding in market, sending important signals over availability for import and opportunities for export respectively.

We do not believe that headroom or total capacity have any relevance for market information. They are not useful information for import or export and are simply a component in the calculation of tradeable capacity and desired capacity, which are separately shown.

There is a risk of information overload if too much data is shown, so the exclusion of these Sections would help the user focus on the ones that are particularly relevant.

Issue 6: Outcomes: NES response

We agree that Option 3 is worthy of investigation. It has been difficult for companies to derive customer facing outcomes relating to bioresources. Typically, the service level requirements are set by Government and the EA in terms of safe treatment and disposal and are related to compliance rather than performance.

The benefits of renewable energy from bioresources are also covered by a combination of treating renewable income as negative opex and by the greenhouse gas ODI.

We agree that this area is worth a fresh look to consider whether any of the current bespoke pcs work well and would suit converting into common pcs.

Issue 7: Trading Incentives: NES response

We support Option 1. The enabling of a bioresources market is an appropriate regulatory intervention, and the proposals in the document are designed to remove barriers and allow a market to develop.

For Option 2, the use of a relatively small trading incentive may be worth considering giving an additional incentive to companies to commit the time and resources to investigate and agree such trades. In such a situation, there will be just as much preparatory investigation by the importer as the exporter, so we do not see why the importer should not have a small incentive as well as the exporter. Importing bioresources is a voluntary activity, so needs to be incentivised to happen.

We do not support Option 3 for the reasons Ofwat sets out. It would require a great deal of analysis and regulatory intrusion into company decision making. It is very unlikely that Ofwat could be certain that their trading assumption was optimal. The current incentive to minimise costs, along with the bidding in proposals should be sufficient to incentivise companies to trade where appropriate.

To require customers to subsidise what could be sub-optimal trades in order to achieve a target level of market activity would not be in customers interests, but would instead reflect an imposition of regulatory priorities on customers. We thus do not support Option 3.

8 Other issues

8.1 Cost of Capital

We consider that OOW companies' cost of capital could be lower than the amount shown by Jacobs if they had a long-term contract to underpin the investment. In any case, we consider that increasing sewerage companies' allowed revenues by using an unduly high allowed return on capital would not be in customers' interests.
Therefore, we do not intend to promote competition in this way by raising companies' returns.

NES response: We have noted earlier that, if Ofwat set a gate price with a cost of capital lower than the level of market risk, this will preclude third party operators from entering. There is a trade off between lower risk regulation and higher risk competitive markets that Ofwat needs to consider before moving to competitive markets.

In the same way as Ofwat created a retail margin to allow the non household market to develop, an increase in the cost of capital will be necessary if market risk is introduced.

8.2 'Double funding'

The CMA, in assessing an enhancement scheme from Anglian Water, considered that there was potentially a wider issue of 'double funding'. The CMA was concerned that companies could participate in the market by using assets funded by customers and recommended we consider the treatment of RCV as part of opening up the bioresources market.
We agree that where excess capacity is funded through the price control then this will give companies the opportunity to use this capacity in the bioresources market.
We consider that this is not a significant problem in the short-term, because:
a. the amount of excess capacity in the bioresources market is currently limited;
b. transfer pricing rules requires an appropriate amount of revenue to be passed back to the appointed company; and
c. the way we set companies' price controls ensures an appropriate share of the profit from trading is passed back to customers and this share should reflect the investment risks taken by both parties in order to provide the service, with a greater relative risk meriting a greater share of the reward.

NES response: We agree with all the points Ofwat makes. The transfer pricing and profit sharing mechanisms are sufficient to ensure that existing customers receive a share of the gains from trading using existing assets.

8.3 Pricing of trades:

Some companies raised concerns about how to price trades, in particular longer-term trades, and suggested that further guidance would be helpful. However, we note that:
i. companies' raised similar concerns about the transfer pricing rules at the time to the Office of Fair Trading in 2011. Although the OfT found issues with our previous transfer pricing approach, the OfT considered that the perception that transfer pricing rules were complicated and uncertain indicated the existence of a sectoral culture that focused on the core (regulated) business to the potential determinant of consideration of market incentives;
ii. we also heard that guidance on pricing needs to be stable in order for confident in setting fate fees;
iii. Jacobs' report found that that overcharging gate fees could suppress market activity and recommends charging only the incremental cost in accordance existing guidance (RAG 5.0760);

NES Response

Our interpretation of the current RAG5 guidance on the recovery of incremental costs by the regulated business sets the starting minimum gate fee that the non appointed business will charge. The non appointed business will need to recover its own costs and charge a margin, some of which will be shared with the appointed business.

It would be helpful if this could be illustrated by Ofwat as part of the bioresources guidance to ensure all parties are aware of the process.

Northumbrian Water
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