

Consultation on the Review of the Bioresources Market

This response is provided on behalf of Severn Trent Water

Summary Response

We welcome this opportunity to comment on Ofwat's proposed approach to opening up the Bioresources market. We are supportive of the development of an effective market for bioresources. We consider that a market is developing at a pace that reflects the lags in investment decisions. For example, the bioresources assets that are being commissioned now reflect investment decisions taken before the development of the bioresources market.

We welcome Ofwat's attention in this area, in particular in engaging with Jacobs to review the market. We note that in their findings Jacobs identified the key constraints to market activity were environmental regulations, in particular the future of biosolids being spread to land and the implementation of IED. We appreciate that these are outside of OFWATs remit and are therefore not covered as part of this consultation, but we remain concerned that until these are addressed other measures such as those proposed in this consultation will have limited impact in helping the Bioresources market reach its potential.

Consultation Questions

Q1. Do you agree with, or have any comments regarding Jacob's bioresources market review report?

The Jacobs report has a reasonable and well-argued set of conclusions and recommendations. Some comments are set out below.

Constraints on competition

It needs to be recognised that the scope for competition is limited in the short to medium term. This is due to much of the potential competition relating to capacity growth, which is limited, and co-digestion, which requires regulatory change. These constraints are recognised in the main text but the conclusions and recommendations refer to large untapped potential which will unfold over the next two AMP cycles – this may be overstating the case.

The document refers to the opportunity to take advantage of AMP7 sludge production growth. However, it may be too late to make changes to the approach to competition for some of this growth, as some capacity schemes will already be under way.

Pricing at incremental cost

The report states that pricing at incremental cost for headroom trades, covering fixed costs from existing sludge business, would encourage competition between incumbents and efficiently use available capacity. However, it could discourage entry as new entrants would need to cover their fixed costs in order to be able to enter, so could not compete. Therefore there need to be clear guidelines on what can be treated as a headroom trade – there may be borderline cases where some additional investment is needed to provide the capacity.

The report considers differences in approaches to cost allocation. There also needs to be work on ensuring that calculation of incremental costs is done on a consistent basis. The report suggests current cost allocation for overheads and shared assets makes it difficult to for headroom traders to assess whether they are competitive, but these allocations are unlikely to be relevant for headroom trades – there needs to be a separate set of guidelines for incremental costs.

Risk and return

The report suggests that there should be an alignment of revenue risk between in-house and external capacity. The recommendation is to guarantee revenues for the duration of third-party contracts which can be demonstrated as efficient. This would go beyond aligning risk, as in-house bioresources services are uncertain in terms of future cost efficiency targets and cost of capital. There could be scope for contract variation for future cost of capital and efficiency targets, in order to align with the price-setting process for incumbents.

Major changes in market operation

The report raises the possibility of major restructuring, although it does not advocate this at this stage. In a future market, Network+ could be a customer, procuring sludge treatment services. Bioresources would be a supplier (but not necessarily the only supplier). The report refers to the risk of stranded incumbent assets, which is not an issue in relation to new capacity investment as the post-2020 RCV is not protected. However, if there was a restructuring of this type, opening the whole bioresources activity to competition, then it would become an issue. It is not clear how protected assets will be distinguished, given that the RCV is not attributable to specific assets. If Network+ buys services at lowest cost, this could leave protected assets stranded.

Q2. Do you agree with, or have any comments regarding, the proposals and views we set out in this document?

As set out in the Jacobs report, the main opportunities for market development are:

- Provision of additional capacity, through collaboration or a bidding approach – this is dependent on when and where additional capacity is required.
- Co-digestion, which requires regulatory change.
- Headroom trades at incremental cost – this may require additional guidance on when incremental pricing is appropriate, but is limited by available capacity and transport distances.

We support the development of the framework to promote these opportunities. However, they are limited by the need for additional capacity and the timing of regulatory change on co-digestion.

Specific Proposals;

1. Market Models – Establish bidding market arrangements

We can see benefits from establishing bidding market arrangements. This standard transparent approach would allow OFWAT to assess whether bids are prepared in a fair way with no bias over own assets. We believe for it to work, the bid tenders would need to be on longer term contracts and with the right framework in place we can help the market by looking at mid term tenders in our South region.

Whilst we appreciate option 3: mandatory further separation will require legislative change, it is worth noting that Bioresources is already functionally separated within Severn Trent. This allows the Bioresources business to have separate decision makers and to be more prescriptive on what sludge we will accept.

A potential blocker may be on how risks are shared in the bidding price process.

2: Improving cost allocation between controls - Undertake better targeted cost assessment

We agree with the need to ensure costs are allocated on a consistent basis across all companies before applying any specific efficiency challenges to Bioresources. Careful consideration will be needed as this runs the risk of impacting the customers bills negatively.

We will respond in detail to the two separate consultations on energy generation and odour control & overhead cost reporting.

3: Approach to assessing costs - Changing the basis of cost challenge so it is based on average revenue requirement rather than expenditure

We have concerns over your proposal to move towards benchmarking of average revenue (Option 2):

Our first concern is that because enhancement costs are lumpy and vary between companies it will be difficult to draw meaningful comparisons between them without considering enhancement expenditure separately, so Option 2 does not really offer an advantage over Option 1 in this respect.

Secondly, you acknowledge that although Option 2 would move the sector closer to a “gate fee” approach used in the wider waste sector it is still fundamentally different because it would be based on dry tonnes rather than wet tonnes.

Thirdly, costs, and therefore average revenue, differ between regions depending on a number of factors such as population density and availability of agricultural land. These factors would need to be taken into account in benchmarking.

Fourthly, you acknowledge the proposed approach could introduce an excessive risk of asset stranding (page 20 of [Review of the Bioresources Market – consultation](#)). This could undermine investment incentives for companies and discourage innovative approaches. If you do pursue option 2 we will want to engage with you on the options for reducing the risk of stranding.

It is not clear how moving to benchmarking of average revenue would lead to asset stranding. On its own, this would be unlikely to create asset stranding, as it would require substantial changes in sludge volumes for this to happen. We consider there are three potential forms of stranding:

1. If what is envisaged is Network+ being a customer, procuring sludge treatment services based on prices set at lowest average cost, then this could lead to asset stranding. This option is not advocated in the Jacobs report. It creates difficulties in determining whether the commitment to protect pre-2020 RCV is delivered, because assets are not specifically identified as being pre or post 2020. Glidepaths for average revenue would not deliver on the commitment to protect pre-2020 RCV because if volume reduces due to competition then the overall return on pre-2020 RCV would not be achieved.
2. If what is meant is not that actual assets are stranded but that the average revenue assessment is insufficient to cover pre-2020 RCV run-off and return, then we agree that this would be a risk. A floor or glidepath on average revenue would not in itself remove this issue. There would need to be some apportionment of the average revenue to pre-2020 RCV return and run-off, to assess whether it is fully covered. This would be a complex and contentious process.
3. If what is meant is that for any investment there would be a risk that return and depreciation would not be covered in future, then we also agree that this could be a risk. The Jacobs report and Ofwat's consultation refer to the possibility of long-term contracts, which would address this risk and encourage investment and competitive entry. The proposed approach would conflict with these objectives, by putting future returns at excessive risk.

4: Planning and collaboration - Encourage greater sector collaboration

We can see benefits for encouraging greater collaboration between companies especially on common issues such as the implementation of IED and undertaking research and are supportive of your preferred approach over the other more prescriptive options. It has been encouraging to see the number of joint bids submitted to the OFWAT Innovation Fund which will benefit the Bioresources market and we see further opportunity to build on this especially in finding innovative solutions to deliver our carbon net zero commitment.

It will be critical to ensure collaboration does not contravene Competition Law and is carried out in a transparent and proactive way. We believe there could be a role Water UK could play in helping with this collaboration.

5: Information remedies - Improve Information remedies

We are supportive of the need to standardise and expand the market monitoring information provided by companies as an enabler to encourage new entrants into the market.

We also agree that individual companies should consider what information they can produce which supports the market. Severn Trent already publishes its sludge trading capacity at key sites over the coming 7 days on its website. This information is updated daily and has had received great feedback from the market.

6: Outcomes - Ensure more joined-up, pro-market outcomes

We can see benefits for ensuring more joined-up pro-market outcomes and support your recommendation to ensure definitions for any bespoke bioresources PCs are appropriate and explore potential for common bioresources PCs.

Having a common bioresources PC in PR24 around satisfactory sludge disposal would assist with levelling out the playing field amongst companies.