



Review of the Bioresources market



Consultation response

Q1: Do you agree with, or have any comments regarding, Jacobs' bioresources market review report?

Jacobs appear to have identified all of the key issues and barriers in developing the bioresources market. Overall we agree with their analysis, but we would note the following comments:

- In terms of the biosolids-to-land market constraint, Jacobs have recognised the issues very well. However they have not fully acknowledged the efforts water companies have undertaken to seek to get the Environment Agency to relax their stance on their interpretation of the farming rules for water; it is not clear from the report the plan for resolving this issue.
- Jacobs rightly explain the high potential for co-treatment in the market, the constraints involved in this and the fact that even when we get the Environment Agency's sludge strategy delivered there will be technical issues over large scale co-treatment, given the very different nature of waste streams between water companies and other sectors.
- On developing joint capacity, we think this opportunity is limited by existing asset lifecycles and the synchronisation of their replacement. Co-location is a good idea in principle, although the set-up costs of this arrangement would be high and understanding and agreeing the equitable transfer price would be challenging. For example, to share a CHP engine you would need to understand the outputs and how they are impacted by each of the companies' inputs
- Jacobs highlight some of the key bioresources market risks and uncertainties very well. However, in terms of IED requirements, the timescale for delivering compliance means there is likely to be a significant funding gap as we were not funded for IED compliance at PR19. It is also not clear whether Jacobs recognise the full extent of the risk of supplier failure. If a supplier of services fails to meet its obligations and doesn't dispose of sludge safely then the incumbent company is at fault. Further consideration needs to be given to whether this risk can be re-allocated, or this will remain a significant barrier to further market development.

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

We set out below our comments on each of the seven issues highlighted in the consultation.

Issue 1: Market Models

We are open to developing a bid assessment framework and believe standardisation of this process would remove potential market frictions, but we are keen to understand what it will be applied to. We would suggest that the framework is restricted to new treatment capacity only.

A significant amount of transport and disposal is already subject to market competition through outsourcing and competitive tendering, so introducing new regulatory rules is likely to inhibit rather than stimulate competition in this area.

Any bid assessment framework will need to recognise that there are risks involved in an incumbent using a third party to treat and dispose of sludge, where the incumbent may still be liable but lose control of this activity. The allocation of this compliance risk will be an important consideration for any assessment framework.

Issue 2: Improving cost allocation between controls

We agree that the introduction of a separate price control for bioresources means there is a risk that the allocation of costs could be distorted by the differences in cost sharing rates. We therefore support further standardisation of cost allocation assumptions, and would welcome further guidance in this area. Agreeing on the most appropriate assumptions that take account of all companies' particular circumstances will however be challenging and the requirements could become onerous. (See our response to the energy cost allocation consultation for further details.)

We note that in Jacobs earlier report titled 'Setting a standardised methodology for quantifying the cost of sludge liquor treatment in the water industry' that the use of MEAV continues to be recommended as an allocation methodology. As the requirement to maintain a full current cost accounting system and report current cost financial information was removed during AMP6, we believe all GMEAV related allocations should be replaced in the regulatory accounting framework. The use of MEAV as suggested would require a full valuation exercise to be undertaken along with subsequent future maintenance of the valuation both adding unnecessary costs and regulatory burden to the production of information.

Issue 3: Approach to assessing costs

Any evolution of the bioresources price control will need to meet two essential conditions in our view. These are:

- The pre-2020 RCV is fully protected and companies are able to earn a reasonable return on their pre-2020 investment in the RCV.
- Any approach to revenue controls needs to take into consideration individual companies' infrastructure and asset base (a good example of this is the impact of IED compliance will impact some companies more than others as a result of their asset inheritance).

In addition, minimising the risk of asset stranding must be a key objective.

In terms of the two proposed approaches to cost assessment, in principle they should produce broadly the same answer. We would therefore suggest that the most appropriate approach may be to assess the revenue requirement using Option 2, but with a cross-check against Option 1 (the building block approach).

For PR24 the approach to cost assessment will need to take particular account of the current legislative risks that will impact costs in the future and cannot be based simply on historic costs. We are currently in discussions with the Environment Agency regarding bringing 16 of our sludge treatment centres up to fully compliant IED standards. Depending on the date we have to bring our assets up to the IED standard, there is potential for a large cost gap in the current AMP and the future investment requirements may be very different between companies.

A change in legislation such as farming rules for water (e.g. the Environment Agency's interpretation of Rule 1, preventing the majority of biosolids spreading in autumn) could severely impact biosolids recycling to farm land. This would have a significant cost impact for the industry as a whole and it needs to be considered how this would be funded under a revenue control if this were to occur.

Securing the necessary investment to meet these new standards may be very challenging in the absence of RCV protection (or equivalent) for investors. Without such regulatory protection the costs of financing this investment are likely to be materially higher than under a regulated RCV model. These additional costs need to be assessed against the benefits from opening the market to greater competition.

Issue 4: Planning and Collaboration

We agree with the option to encourage collaboration in the sector and believe that where new capacity is required there should be an obligation on companies to consider regional collaboration. We do not believe



that the opportunities that exist for joint solutions are likely to be extensive enough to warrant more onerous requirements, where the costs are likely to significantly outweigh any available benefits.

With respect to existing capacity, while we think it is reasonable for companies to explore opportunities to reduce costs through collaboration with neighbouring companies - and there are existing incentives for them to do so - this assessment would need to have regard to the significant economic costs of asset stranding.

We agree that doing research at a sectoral level would be best for the industry and we agree with the development of sector-level measures for sludge quality, although depending on the level of standard required on the quality of sludge there be a large cost involved in measurement apparatus to be able to understand sludge quality at every tradeable output.

Issue 5: Information remedies

We are happy to support increased market information with regards to bioresources, but the data collected needs to be proportional and targeted at what will actually help stimulate the market. Rather than simply producing ever-more information, it should be considered carefully exactly what information potential market participants would require – and in addition, what current information is not adding value and can be removed. The focus should be on the ‘right’ information not necessarily just more. By way of an example, providing further details of small works is highly unlikely to drive more market engagement and we believe therefore that a materiality threshold on these works should be considered.

The degree of accuracy required is also an important consideration. At times the required level of accuracy seems excessive for the need. For example, the requirement to report the % of dry solids to 2 decimal places is well beyond the level of measurement accuracy.

Issue 6: Outcomes

We strongly support the PR24 proposal for reducing the number of performance commitments overall. In that context it is not obvious that there is a need for specific performance commitments in relation to bioresources, and indeed they may not be compatible with seeking to move to a competitive market.

To the extent that there are any specific bioresources performance commitments we agree that these should be common to ensure a level playing field between companies.

It is also important to ensure that the existence of performance commitments don't have the unintended consequence of inhibiting market activity. As an example, if we are sending sludge to a third party for treatment, this would reduce our ability to meet a performance commitment on renewable generation, as less biosolids are available to generate energy

Issue 7: Trading incentives

Given the fundamental physical characteristics of sludge – being heavy and expensive to transport – we believe there are limited, localised opportunities for trading currently. Most trades that do happen currently are short term ‘mutual aid’ trades.

As well as the physical constraints on moving sludge around, the absolute obligation on ensuring one's own sludge is disposed of safely can act to inhibit market activity. In the event of capacity constraints at the importing sludge treatment centre the incumbent company will necessarily prioritise treatment of their own sludge ahead of imported sludge. Trading incentives may have a role to play in overcoming these barriers, but we think further consideration of how to overcome this fundamental market barrier is required.