

15 September 2022

Attn: [REDACTED]
Water Services Regulation Authority
(via email)

Subject: Response to PR24 Bioresources Control Consultation

Dear [REDACTED]

Thank you for the opportunity to respond to your consultation on the proposed methodology for the Bioresources price control at PR24. We appreciate your openness to dialogue and your efforts to regulate this sector fairly for the benefit of customers. Our comments on the proposed methodology are as follows.

Separate efficiency challenge for Bioresources. The separate price control for Bioresources has revealed the operating costs for this part of the business more precisely than before. We understand why a separate efficiency challenge could be seen as the next logical step in driving efficiency.

However, we consider that companies themselves are best placed to decide how to efficiently allocate work, cost and benefit between wastewater treatment and sludge treatment because the two areas are so closely interrelated. For example, the use of chemically enhanced primary settlement within the wastewater treatment process will fundamentally change the nature, volume and value of the resulting sludge and impact sludge treatment efficiency, but the decision to implement such a practice for water quality drivers is outside of the Bioresources price control.

Under the proposed separate efficiency challenge, without formal and consistent service level and quality standards between the price control interfaces, it will be difficult if not impossible to assess efficiency consistently. Every organisation will choose to apply and control cost and efficiency levers that impact both sides of the price control interface differently.

To give an analogy from outside the water sector, if a householder wanted to work out the efficient cost to build an extension, they would not test each possible layout to separately work out the best cost per metre for the walls and the best cost per square metre for the roof. That way, they would end up with two competing layouts. The length and layout of the walls affects the cost of the roof, so a better measure is £/m² for the entire structure. Of course, they could do it the first way, but they would need to bring the measures together at some point to work out the overall best value, so they would probably end up creating some relationship between the two measures and ending up with the same result, but in a complex way.

Under the proposed separate efficiency challenge, companies will still decide how to allocate work, but it will be through service level agreements instead. This will add complexity and management time, but won't resolve the fundamental challenge of economic regulation, which is to ensure costs are efficient.

As an alternative, we consider that the best currently available approach to drive efficiency would be to reform how efficient costs are calculated by using more effective measures of service and dissociating spend from RCV growth (and thereby revealing efficient costs more effectively). At present, actual spend reflects the cost allowance, not the efficient cost. The efficiency challenge is intended to address this but may in some cases leave the allowance too high, leading to inefficient spend, or force it too low, leading to asset sweating and (usually with a significant lag) operational and safety issues, and ultimately service failings.

Econometrics for Bioresources. The three options for modelling Bioresources costs presented in the 2nd September 2022 document show extreme variance between companies, with some having reversals between high and low efficiency depending on the package of inputs selected. This could show that the old model had a great deal of unexplained variance, or that the new ones do, or that they all do. It is likely that the outturn costs input to the model are heavily influenced by the cost allowances which were in force at the time, so testing the models' explanatory power with reference to outturn costs is really testing their explanatory

power for the previous cost allowances. We consider the models used would need calibration against an independent known efficient company to be known to be reliable. There may also be more powerful cost driver variables, but without known high-quality efficient cost data it will be difficult to reliably test these using an econometrics approach.

Definition of Bioresources. A minor point. The definition of Bioresources in the consultation agrees to the definition of biosolids. We would suggest setting out a new definition for the term 'bioresources' to avoid confusion, such as 'the economics of sludge treatment' or something similar.

Annualised growth enhancement. This should simplify planning for inter-company trades for growth. It gives companies producing sludge the freedom to decide how they will spend, without being tied to a particular option. However, different service level expectations in future will affect growth costs, probably increasing them.

Annualised quality enhancement. This proposal would leave companies with the risk that the efficiency frontier could recede after quality expenditure has been committed, despite the commitment being made in good faith with the best information available at the time. We understand that under the current system there is a risk companies could make inefficient quality expenditure, but this is really driven at least in part by the desire to spend up to the cost allowance. The new proposal is likely to discourage long-term quality investment of any sort as this will be riskier, so it will tend to drive lower-risk opex-heavy solutions regardless of whole life cost, locking inefficient spend into the cost information for future price reviews. These solutions may also fail to consider the wider Net Zero goals and considerations that the sector is seeking to achieve.

Adaptive planning. Requirements for how sludge is treated and what can be done with it are set largely by Defra, the Environment Agency, and the agricultural and retail sectors. The expectations and requirements of these organisations and groups have very strong influence on the sector, to the extent that sludge treatment as an activity was brought into existence by regulation. Given that there are a number of well-known possible changes which may happen over the next several years, such as the change to environmental permitting for sludge to land and Defra's review of the Farming Rules for Water implementation, it is in customers' best interests for companies to make use of adaptive planning to prepare for these.

In a normal market, customers select products based on their own analysis of cost vs. quality. However, in sludge treatment, customers bear the cost but others choose the quality. Using adaptive planning will bring the potential costs of these measures to light, which can only be beneficial for customers by making the decision-making process more democratically transparent. Understanding the cost of future interventions to meet changing service requirements and their associated time to implement (information developed via adaptive planning) can be used to inform the Regulatory Impact Assessments of legislative changes, the phasing of their implementation and the timescales to comply.

Average revenue price control. Water companies bear the availability risk which comes with treating a waste stream which never stops coming. Moving to an average revenue price control will not change this, but it will create volume risk. We do not agree that this will lead to better efficiency. Accepting volume risk follows from an efficient market, but we do not see how it will help to create one. There is also the factor that companies have a limited ability to affect how much sludge is produced from wastewater treatment processes.

Performance commitments. We support your proposals around creating a common performance commitment for Bioresources. A more encompassing performance commitment could be on the fraction of biogas including estimated off-gas being put to beneficial use. This would drive efficiency and reduced emissions across the entire sludge treatment process.

This concludes our response. We would be pleased to discuss our comments with you.

Yours sincerely,

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