

**Consultation on Ofwat's section 13
proposal to modify company licences
– condition N**

About this document

This document invites comments on our proposal to modify condition N of the conditions of appointment (licences) of all appointed water and sewerage and water only companies in England and Wales. The proposed changes will allow us to increase the funding that we can recover from companies to carry out price reviews.

Under section 13 of the Water Industry Act 1991 (WIA91), we are able to modify the conditions of a company's licence if it agrees to the change we are proposing to make.

This document and the attached appendix is a Notice under section 13 of the WIA91.

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Responding to this consultation

We invite stakeholders to comment on our proposed modification by **29 November 2013**. Companies should also indicate their acceptance or otherwise of the proposed modification by this date. You can email your responses to ingrid.olsen@ofwat.gsi.gov.uk or post them to:

Finance and Networks Division
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Centre City Tower
7 Hill Street
Birmingham B5 4UA.

If you wish to discuss any aspect of this document, please direct your enquiry to Ingrid Olsen on 0121 644 7525 or by email to ingrid.olsen@ofwat.gsi.gov.uk.

We will publish responses to this document on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

1. Background

Ofwat is funded by fees charged to the regulated companies. Companies' licences place an upper limit on the fees which we can charge them. As well as being allowed to charge fees for our ongoing costs, we are also able to charge a fee for the extra costs of carrying out the five-yearly price review. We are currently engaged in delivering the 2014 price review, which will set the price and service package ('price controls') that all of the companies must deliver in each of the five years between 2015 and 2020.

The maximum amount of extra money that we can recover to fund the price review is covered by a specific cap in companies' licences. We are seeking to raise the cap to enable us to recover the increased costs of delivering the 2014 price review. This price review, while building on the stability and transparency of our previous approach, is significantly different to those we have carried out previously. In order to raise the cap, we need to make a modification to each company's licence.

Prior to the publication of this Notice, we have been in contact with individual companies to set out the reasons why we need to make this modification. We have welcomed the constructive approach that companies have taken in responding to our proposals. We have sought to understand any concerns that companies have with our proposals as well as to gain their indicative agreement to them.

We are now seeking companies' formal agreement to our proposed modifications.

2. What are the changes that we are proposing?

We are proposing to modify condition N of the licences of all appointed water and sewerage and water only companies in England and Wales, to change the constraints that exist on the fees we can charge to cover the costs of carrying out the price review. We are proposing to raise the cap on the recovery of price review costs by increasing the element linked to companies' turnover from 0.1% of each company's turnover to 0.3% of that turnover¹.

This modification will allow us to have a one-off licence fee increase in 2014-15 to meet the costs of the price review. We will reduce the fee for 2015-16, once the price review process is complete. The modification we are proposing will remain in place after 2014-15. This is to avoid another modification process, with the time and resource implications this has for us and the companies, should it be necessary to increase our fees, as we move towards the 2019 price review.

We always inform companies, before the start of any financial year, about the costs that we propose recovering from them. We will engage with companies should we need to make an uplift in our costs at a future price review.

We are also proposing to take this opportunity to update or delete any outdated provisions, terms and references in condition N, where necessary. These changes are set out in appendix 1.

¹ The turnover figure used is the mean annual regulated business turnover of each regulated company measured over the five years of the price review period immediately before the current one (for the 2014 price review this is the period 2005-10).

3. Why do we need to make the changes we are proposing?

We published our final methodology for the 2014 price review, '[Setting price controls for 2010-15 – final methodology and expectations for companies' business plans](#)', in July 2013 and this confirmed the significant changes to our approach to price setting compared with previous price reviews. This revised approach has been developed after more than two years of engagement with our key stakeholders, including:

- customers;
- companies;
- government;
- investors;
- regulators; and
- environmental groups.

The 2014 price review marks a significant shift in the way in which we regulate the water sector through the price setting process.

The changes which we are making to the way we regulate are securing a long-term cultural change in the sector. Companies are putting customers at the heart of their businesses, while delivering environmental benefits and securing significant ongoing infrastructure investment. Independent analysis shows that more than £2 billion in benefits may be achieved by setting separate retail controls and encouraging water trading².

The significant changes in our approach and the scale of assurance required to guarantee successful delivery of the price review have led to an increase in our costs. This means that the cap, on the fees we can charge for the price review process, in companies' licences is insufficient to allow us to recover the costs of carrying out the 2014 price review.

² See '[Updated Price Limits Impact Assessment](#)'.

4. What is the impact of our proposals?

As explained above, we are seeking the changes we have set out to allow us to fund delivery of the 2014 price review. The current cap of 0.1% in companies' licences would allow us to recover around £9 million over five years to fund the 2014 price review.

The increase in the cap equates to an additional £18 million, although we are not proposing to recover the full amount of funding allowed by our proposed modification (0.3% of turnover). We consider it prudent to set the cap at 0.3% to allow some headroom. We consult on our forward programme each year, including the proposed licence fee for the coming year. This means that use of any additional fee within the cap will be clearly signalled to companies and subject to consultation.

5. Next steps

We would like responses to this document, including formal acceptances by companies to our proposals, by **29 November 2013**.

Subject to companies' agreement to our proposals, we will amend all companies' licences by the end of 2013. We will publish an indicative budget and calculate indicative licence fees for 2014-15 in December 2013, in line with our usual timetable, and confirm our final budget in February 2014.

But if we cannot secure agreement from companies, we can use our powers under section 14 of the WIA91 to refer the matter to the Competition Commission. The Competition Commission would then be free to decide whether the modification should be made and, if so, in what form.

Appendix 1: Proposed modifications to condition N

This draft sets out an illustrative example of what condition N may look like following our proposed modifications. The purpose of this example is to help to show the effect of the proposed modifications. It does not necessarily include the exact wording that will apply for each water company, because the conditions of each company's licence are individual and may vary.

The main change on which we are consulting is in paragraph 3.2, which is shown in bold. The changes we propose making to update or delete any outdated provisions, terms and references in condition N, where necessary, include:

- deleting sub-paragraph 2(8), which relates to the fee used to recover the costs of establishing the Consumer Council for Water because it is now redundant;
- replacing references to 'Director' with 'Water Services Regulation Authority';
- (for Welsh companies) references to the 'Secretary of State' will become references to the 'Welsh Ministers' where functions have been devolved;
- removing references to Schedule 4 to the Water Industry Act 1991, which was repealed in 2005 by the Water Act 2003 because it related to the customer service committees that have been replaced by the Consumer Council for Water; and
- simplifying the wording of the fee for the ongoing running costs of the Consumer Council for Water (sub-paragraph 2(9)) by including the actual figure (£5.7 million) the Secretary of State specified as the Base Amount for 2006-07. This will not change the amount any company has to pay towards the running costs of the Consumer Council for Water.

For ease of reference, the changes are shown as underlined and deletions are struck through.

Condition N: Fees

1 Interpretation and Construction

In this Condition a "**Periodic Review Year**" means the Charging Year starting on 1st April immediately preceding the start of a Review Charging Year.

2 Fees

The Appointee shall render the following payments to the Secretary of State at the times stated:

- (1) [Not used]

- (2) on 1st April 1990 and at the start of each subsequent Charging Year an amount equal to the costs estimated by the Water Services Regulation Authority (in consultation with the Competition Commission) as having been incurred in the preceding Charging Year by the Competition Commission following:
 - (a) references under section 14 of the Water Industry Act 1991 which mention the Appointments (or either of them) only; and
 - (b) references under Condition B or Condition C;
- (3) on 1st April 1990 and at the start of each subsequent Charging Year an amount, which shall represent a fair proportion, to be determined each year by the Water Services Regulation Authority according to a method which has been disclosed in writing to the Appointee, of the costs estimated by the Water Services Regulation Authority (in consultation with the Competition Commission) as having been incurred in the preceding Charging Year by the Competition Commission following any reference under section 14 of the Water Industry Act 1991 which mentions both the Appointments (or either of them) and also any other appointment held under Chapter I of Part II of the Water Industry Act 1991;
- (4) Within thirty days of the date on which the Water Services Regulation Authority notifies the Appointee of the amount payable under this sub-paragraph, an amount equal to the costs determined by the Water Services Regulation Authority as having been or likely to be incurred by it in respect of any reference by the Appointee under paragraph 13 of Condition B and any determination by the Water Services Regulation Authority under paragraph 14 of Condition B made in the Charging Year in which the Water Services Regulation Authority's notification for the purposes of this sub-paragraph is given;
- (5) on 1st April 1990 and at the start of each subsequent Charging Year a renewal fee, which shall represent a fair proportion, to be determined each year by the Water Services Regulation Authority according to a method which has been disclosed in writing to the Appointee, of the costs estimated by the Water Services Regulation Authority as being likely to be incurred in that Charging Year by it in the regulation and enforcement of appointments held under Chapter I of Part II of the Water Industry Act 1991 (including the Appointments) and in the carrying out of its other functions under the Water Industry Act 1991,

~~including payments made by it under schedule 4 of the Water Industry Act 1991;~~

- (6) on 1st April of the first Charging Year after the announcement by the Water Services Regulation Authority of its intention to carry out a Periodic Review, and at the start of each Charging Year up to but not including the Periodic Review Year, an additional fee, which shall represent a fair proportion, to be determined each year by the Water Services Regulation Authority according to a method which has been disclosed in writing to the Appointee, of additional costs estimated by the Water Services Regulation Authority as being likely to be incurred in that Charging Year by it in the preparation for or the carrying out of a Periodic Review, over and above the costs estimated by the Water Services Regulation Authority as being likely to be incurred in that Charging Year under paragraph 2(5) above;
- (7) where the Water Services Regulation Authority so determines, on 1st January in any year, a special fee, which shall represent a fair proportion, to be determined each year by the Water Services Regulation Authority according to a method which has been disclosed in writing to the Appointee, of the amount, if any, by which the aggregate of the costs estimated by the Water Services Regulation Authority to have been already incurred in that Charging Year and to be incurred in the remainder of that Charging Year by the Water Services Regulation Authority in the regulation and enforcement of appointments held under Chapter I of Part II of the Water Industry Act 1991 (including the Appointments) and in the carrying out of its other functions under the Water Industry Act 1991, ~~including payments made by it under Schedule 4 of the Water Industry Act 1991,~~ exceeds the aggregate of:
- (a) all renewal and additional fees payable at the start of that Charging Year under the Appointments and all other appointments held under the said Chapter I; and
 - (b) all amounts (if any) payable in that Charging Year under subparagraph 2(4) and the equivalent provisions in other appointments held under the said Chapter I in respect of references and determinations of the kind described in subparagraph 2(4);

subject to its apportioning the special fee, according to the nature of the costs intended to be covered by it, between the renewal fee, the additional fee and the amounts referred to in paragraph (b);

- (8) ~~within 30 days of the date on which the Water Services Regulation Authority notifies the Appointee of the amount payable under this sub-paragraph, the amount derived from the following formula:~~

$$I = M \times \frac{t}{T}$$

~~Where~~

~~I is the amount payable under this sub-paragraph;~~

~~M is the expenses, attributed by the Water Services Regulation Authority to the Charging Year in which the notification is given, of the Water Services Regulation Authority, the Secretary of State and the National Assembly for Wales in relation to the establishment of the Consumer Council for Water;~~

~~t is equal to the turnover of the Appointed Business as shown in the accounting statements prepared by the Appointee under Paragraph 4 of Condition F for the financial year ending twelve months before the start of the Charging Year in which the payment under this sub-paragraph is payable;~~

~~T is equal to the aggregate of the turnover of the Appointed Business of all of the companies holding an Appointment under Chapter 1 of Part 2 of the Water Industry Act 1991, as shown in their accounting statements prepared under Paragraph 4 of Condition F for the financial year ending twelve months before the start of the Charging Year in which the payment under this paragraph is payable; and~~

- (9) within 30 days of the date on which the Water Services Regulation Authority notifies the Appointee of the amount payable under this sub-paragraph, as derived from the following formula:

$$J = G \times \frac{t}{T}$$

Where

J is the amount payable under this sub-paragraph

~~G is:~~

- ~~(a) for that part of the current Charging Year commencing on 1 October 2005, the sum of £2.9 million;~~
- ~~(b) for the following Charging Year, an amount to be specified by the Secretary of State for this purpose (the "Base Amount"); and~~
- ~~(c) for each Charging Year following that one, the Base Amount, increased by the percentage increase in the Retail Price Index between that published for November 2005 and that published for November in the Prior Year;~~

G is for each Charging Year, the sum of £5.7 million, increased by the percentage increase in the Retail Prices Index between that published for November 2005 and that published for November in the Prior Year;

t is equal to the turnover of the Appointed Business as shown in the accounting statements prepared by the Appointee under paragraph 4 of Condition F for the financial year ending 12 months before the start of the Charging Year in which the payment under this sub-paragraph is payable;

T is equal to the aggregate of the turnover of the Appointed Business of all of the companies holding an Appointment under Chapter I of Part II of the Water Industry Act 1991 as shown in their accounting statements prepared under paragraph 4 of Condition F for the financial year ending 12 months before the start of the Charging Year in which the payment under this sub-paragraph is payable

PROVIDED THAT if, in respect of any Charging Year to which sub-paragraph (c) above applies, the Secretary of State issues to the Water Services Regulation Authority any direction or directions under section 37(8) of the Water Act 2003, which requires or require it to recover under this Condition any amount or amounts greater than that produced by the calculation in sub-paragraph (c) above, the amount of that excess shall also be recoverable under this sub-paragraph (9).

3 Limits on renewal fee, special fee and additional fee applied to Ofwat

- 3.1 The aggregate of the renewal fee payable in respect of any Charging year starting on or after 1 April 2000 (other than a Periodic Review Year) and part

of any special fee apportioned to the renewal fee payable in the same Charging Year shall not exceed X, where X shall be calculated in any year by the equation:

$$X = S \times \frac{t}{T}$$

Where the figures in the equation are defined as follows:

"S" is equal to the figure £11.9 million, increased by the percentage increase in Retail Prices Index between that published for the month of November 1998 and that published for the month of November immediately preceding the start of the Charging Year in which that renewal fee and special fee are payable;

"t" is equal to the turnover of the Appointed Business as shown in the accounting statements prepared by the Appointee under paragraph 4 of Condition F for the financial year ending twelve months before the start of the Charging Year in which that renewal fee and special fee are payable;

"T" is equal to the aggregate of the turnover of the Appointed Business of all of the Appointees as shown in their accounting statements prepared under Paragraph 4 of Condition F for the financial year ending twelve months before that start of the Charging Year in which that renewal fee and special fee are payable.

3.2 The aggregate of the renewal fee and any special fee payable in any Periodic Review Year and of the additional fees payable under paragraph 2(6), in the years immediately preceding that Periodic Review Year, shall not exceed X derived from sub-paragraph 3.1 plus a figure of ~~0.4~~ 0.3, calculated as the sum of the percentages which each such fee represents of the turnover of the Appointed Business, as shown in the Accounting Statements prepared by the Appointee under paragraph 4 of Condition F, as an average over the five years concluding with the previous Periodic Review Year.

3.3 Where:

- (1) ~~a Review Notice has been given under paragraph 7 of Condition B;~~
- (2) a Periodic Review falls to be carried out under paragraph 8 of Condition B; or

(3) a Reference Notice has been given under paragraph 9 of Condition B

the Water Services Regulation Authority may, by notice to the Secretary of State, refer to the Secretary of State for determination by him not later than twelve months after the date which is the Review Notice Date for the purpose of the relevant Periodic Review, the question whether the limits on the fees specified in sub-paragraph 3.1 and 3.2 payable in respect of any Charging Year starting on or after 1st April 2000 should be changed (and if so what change should be made to that limit).

3.4 This Condition shall be modified by the change or changes (if any) to the said limits necessary to give effect to any determination made by the Secretary of State following a reference under sub-paragraph 3.3.



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