



Water Services Regulation Authority (Ofwat)

Modification of conditions of appointment (licences) for 16 appointed companies to require them to provide funding for Open Water

Background

On 14 May 2014, the [Water Act 2014](#) received Royal Assent. The Act seeks to introduce choice for all non-household customers of companies operating wholly or mainly in England (from April 2017) over their retail supplier of water and wastewater services, replacing the current monopoly provision with a competitive market.

The new legislation builds on the previous reviews of the levels of competition in the water sector undertaken first by [Ofwat](#) and subsequently by [Professor Martin Cave](#). It also follows the opening of a similar competitive market in Scotland in 2008. The UK Government has set an ambition of opening a single market covering England as well as Scotland by 1 April 2017. The existing water supply licence (WSL) arrangements will continue in Wales, allowing larger customers that use more than 50 million litres (megalitres – MI) of water a year to switch.

There have been a number of independent studies quantifying the potential costs and benefits of this package of changes, and these studies suggest net benefits of between £190 million and £2.5 billion (net present value – NPV – over 30 years) from the package of changes compared with the status quo.

One of the lessons from other utilities where choice and competition have been introduced is that in order for a market to work effectively some 'market architecture' needs to be in place beyond changes to the legislation. To deliver the UK Government's ambitions, it is essential that similar market architecture is introduced for the water sector. The Open Water programme was established in summer 2013 to help implement the new market and establish the necessary market architecture. The [programme is overseen by the High Level Group \(HLG\)](#).

On 14 July 2014, we issued a [notice under section 13 of the Water Industry Act 1991 \(WIA91\)](#) on our proposals to modify the conditions of appointment for 16 appointed companies operating wholly or mainly in England, to require them to provide funding for the Open Water programme.

The water and sewerage companies affected are:

- Anglian Water Services Limited;
- Northumbrian Water Limited;
- Severn Trent Water Limited;
- South West Water Limited;
- Southern Water Services Limited;
- Thames Water Utilities Limited;
- United Utilities Water plc;
- Wessex Water Services Limited; and
- Yorkshire Water Services Limited.

The water only companies affected are:

- Affinity Water Limited;
- Bristol Water plc;
- Portsmouth Water Limited;
- Sembcorp Bournemouth Water Limited;
- South East Water Limited;
- South Staffordshire Water plc; and
- Sutton and East Surrey Water plc.

Why is the licence change necessary?

Following the Royal Assent of the new legislation in May, it was always envisaged that the funding for the Open Water programme would move from the current voluntary arrangement to one where it would receive funding through a licence requirement.

A formal licence condition was considered appropriate to ensure that:

- the funding for this important work is on a stable footing, avoiding a potential problem under the existing voluntary arrangement where some companies may choose not to provide funding; and
- funding for the programme is fair and proportionately spread across the companies that will eventually participate in the market.

Under public expenditure rules, it was not possible to put such a licence condition in place until the legislation received Royal Assent.

The current plan for this programme of work, as highlighted in the licence consultation, is for the programme to be taken forward by Open Water Market Limited (OWML)¹ until January 2015, at which point the programme will formally move over to Ofwat. So the new licence condition will allow funding to be provided to either OWML or Ofwat, as directed by us.

The new licence condition will be temporary as funding will not be required on the same basis beyond the opening of the market.

Key aspects of the new condition

- The 16 larger appointees operating wholly or mainly in England are required to provide funding in proportion to their estimated market share of non-household customers.
- We have not required smaller appointees (new appointees and Cholderton & District Water), or appointees wholly or mainly based in Wales (Dee Valley Water and Dŵr Cymru), to provide funding as their share of eligible non-household customers is very small and so their contribution would be negligible.
- The total annual funding is capped at £10.5 million.
- The licence condition is flexible so that funding can be provided to OWML and/or Ofwat, as directed by us.
- The condition is temporary in nature because these market preparation activities are only required for a relatively short period between approximately August 2014 and the opening of the market in 2017. After that, the enduring market operator is anticipated to be in place. So the condition will end by April 2018.

¹ Open Water Market Limited (OWML) is the name of a company limited by guarantee that was established in December 2013 to progress the work of the Open Water programme.

Responses to the consultation

We consulted companies and other key stakeholders ahead of the statutory consultation under section 13 of the WIA91. Our proposals evolved during that period, partly in response to companies' concerns, and partly because of the recent decision to take this work forward as a ring-fenced programme within Ofwat from the beginning of 2015. We obtained agreement in principle from all relevant appointed companies before beginning the 28-day statutory consultation.

The consultation period closed on 13 August 2014, and we received [19 responses](#). The Welsh Government supported our proposals to not require appointees wholly or mainly based in Wales to provide funding. The Consumer Council for Water (CCWater) supported our proposals relating to the funding contributions. Both CCWater and Business Stream raised some issues about governance, which we propose to consider and address through our separate consultation on market governance. All 16 appointed companies confirmed that they accepted the proposed modification as drafted.

No material concerns were raised to the proposed licence amendment in the responses, but there were a small number of suggested amendments to the condition and other points that respondents highlighted. These are set out in the table below.

Table 1 Proposed amendments to the licence condition from companies and our responses

Suggested amendments to the licence condition	Our response
<p>‘Lowest’ to ‘lower’. One company suggested that we should amend ‘lowest’ to ‘lower’ in 2(b) and 2(c) of the condition to improve the clarity of the text.</p>	<p>As this is a minor drafting change, we do not consider that it alters the effect of the condition, so no further consultation would be required. We have made this change.</p>
<p>An amendment to further clarify the purpose of the funds. One company suggested that the licence condition could be amended to restrict funds raised under this condition to be applied only for the purpose as set out in the condition by adding: “Funds raised under this condition shall not be applied for any purpose other than that set out in paragraph 1 of this condition”.</p>	<p>We see this change as simply strengthening of the scope of the licence condition as it is currently set out. Although the suggested change aligns with the spirit of the licence condition, we do not consider that it would be particularly effective to include such a restriction in it, which is only binding on companies, rather than Ofwat. We already committed to a robust ring-fence for this work and we are also mindful about making more significant changes to the condition which all companies have agreed in the consultation. So we have not made this change.</p>
<p>An amendment to ensure funding could only be requested once a year. One company requested that the licence condition be amended to permit Ofwat to request funding from companies only once each year. It was concerned that without this the incentives for robust budget management would be weaker.</p>	<p>The additional flexibility in the licence condition is drawn from the licence change introduced for the similarly ring-fenced Thames Tideway programme. We consider that it would be unhelpful to remove the additional flexibility for Ofwat, which has been included to enable us to provide better budget management. All our spend has to be agreed with HM Treasury in advance, through the parliamentary Estimate process, and we will need to produce robust budget forecasts ahead of each financial year, as part of that process. Although we may decide to simply invoice for all of it at the beginning of the year, and use credit notes to offset against the following year’s fee in the event of an underspend, we wanted to make the licence condition reasonably flexible on this point, to avoid any risk of needing a further licence modification at a later date. So we have not made this change.</p>

Suggested amendments to the licence condition	Our response
<p>Adding an overall cap, potentially at £27 million. One company confirmed its acceptance of the condition but would prefer if the condition included an additional, global cap on the overall cost for the programme, which it suggested could be set at £27 million.</p>	<p>We do not consider that a further change to the licence condition is required, as it already includes an annual cap of £10.5 million. A change to the proposed cap, or the introduction of a further cap, is likely to be considered a change to the ‘effect’ of the condition, and so could require a further section 13 consultation which would further delay this work. We have already confirmed that we expect the funding requirements under the condition to be lower than the annual cap, which has been included to provide precisely this form of assurance to companies. We remain committed to transparent and rigorous programme planning and budget management for this work beyond the licence condition in any event. So, we have not made this change.</p>

Beyond these specific amendments, stakeholders raised some other concerns in their responses which related in general to how we would ensure robust financial controls around the programme, including that:

- there should be a commitment to a ring-fenced programme within Ofwat;
- the procurement of external support and advice for the programme should follow good practice and ensure value for money;
- there should be clear and transparent reporting of costs and budgets each year;
- this reporting should clearly separate Ofwat's broader work from the work of Open Water from January next year; and
- the budget for the next financial year should be provided to companies by 31 January in the previous financial year to enable them to plan appropriately.

We are not proposing to amend the existing licence condition to address these points. We consider that these concerns can be addressed outside of the formal licence condition text through appropriate controls and processes. We are also concerned that these changes could be considered to change the 'effect' of the licence condition and require a further section 13 consultation resulting in unnecessary delays to the programme. Indeed, some of the respondents also recognised this point.

Even so, we think that the responses to our consultation raised very reasonable and valid points about the need for transparent and robust financial planning and controls. We have already committed publicly that the Open Water activity will be ring-fenced within Ofwat. We can also confirm that services will be procured by Ofwat under the same financial and governance frameworks, policies and controls that apply to all public bodies, and that although OWML has been granted an exemption from some of these controls we similarly expect it to also follow good practice in this area. We will also take the following additional steps to address companies' concerns.

1. **We will provide a high degree of transparency by sharing a detailed programme plan and forecast budget with companies in January ahead of each new financial year**, to input into their own planning processes. We will also provide a minimum of twice-yearly reports with a clear commentary about the budget and programme position against the programme plan and forecast budget, with a clear explanation for any material changes.

2. **We will provide assurance that we will not use the funding provided under this condition to cross-subsidise other Ofwat activity that has already been funded under the general licence fee.** To provide this assurance, we will explain clearly what activity is funded under this licence condition, and the boundary between this activity and other core activity funded under the general licence fee in our reported budgets and costs.

Next steps

We have now written to companies with the new licence condition to implement this change. We expect that Open Water will be writing to companies separately for funding requests in relation to the remainder of the 2014-15 financial year in early September.