

March 2017

Trust in water

**Water Supply and Sewerage
Licensing Regime:
consultation on setting
licence fees – summary of
consultation responses and
conclusions on the general
principles to be applied
under Condition 9 of Part A
of WSSL standard licence
conditions**

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About this document

This document summarises the responses we received to our consultation '[Water Supply and Sewerage Licensing Regime: Consultation on setting licence fees](#)' which we published on 14 October 2016. It also sets out our consideration of those responses, our conclusions and our next steps.

Contents

1. Introduction and executive summary of conclusions	3
2. Summary of consultation responses	7
3. Other comments and issues	26
4. Next steps	33

1. Introduction and executive summary of conclusions

On 14 October 2016, we published our consultation - '[Water Supply and Sewerage Licensing Regime: consultation on setting licence fees](#)'.

From 1 April 2017 the retail market for business customers (the **business retail market**) will be open. New water supply licensees and sewerage licensees (collectively **WSSL licensees**) will then be obliged under condition 9 of Part A of the standard conditions of water supply and sewerage licences (**WSSL standard conditions**) to pay an annual licence fee for the 'regulatory cost for that year' of each Licence.

We are conscious that turnover is uncertain until the market opens and that cash flows may be uncertain for some time after that. We therefore need to set licence fees in a way that minimises uncertainty, encourages market entry and enables the Water Services Regulation Authority (**Ofwat**) to recover the costs it estimates to be associated with regulating WSSL licensees and the estimated costs of the Consumer Council for Water (**CCWater**) from handling complaints and enquiries from business customers and monitoring the retail market.

The purpose of our consultation was to set out our considerations and proposals for setting licence fees for the new WSSL licensees from April 2017. With respect to the element of the fees relating to the regulatory costs of Ofwat with respect to the water supply and sewerage licensing (**WSSL**) regime, we proposed that:

- the most appropriate basis of charging combines a flat fee per WSSL licensee with the bulk of Ofwat's costs allocated through a variable element based on market share;
- a fixed fee would enable us to recover costs from all WSSL licensees, including those with a very low or minimal customer base, but if set at a low level we could avoid the fee becoming a barrier to entry;
- 10% of Ofwat's budgeted costs for overseeing the WSSL regime should be allocated to the fixed fee element, divided equally between the WSSL licensees;
- the other 90% of the fee should be allocated to WSSL licensees on a variable basis using market share calculated by reference to wholesale charges paid rather than turnover or retail customer numbers. This would mean the bigger

licensees met the majority of our costs in line with their share of the business retail market;

- for year 1 (2017-18) of market operation, we would delay the annual invoice (covering both components of the fee) until October and use data from the Market Operator, Market Operator Services Limited (**MOSL**), to allocate variable elements based on wholesale charges paid as at 30 September 2017;
- from year 2 (2018-19) of market operation onwards, we would issue an annual invoice early in the financial year; and
- we should charge WSSL licensees supplying eligible Welsh customers on the same basis as WSSL licensees operating in England.

We recognised that some of the costs associated with the new regime should be allocated to water undertakers and sewerage undertakers (**appointed water companies**), as our work will partly reflect costs relating to WSSL licensees, but other elements will relate to costs associated with appointed water companies. We therefore proposed allocating 50% of our estimated budget costs for the regulatory work related to the new regime to the WSSL licensees and 50% to the appointed water companies, consistent with the approach proposed by MOSL.

Our consultation included the CCWater proposal that its costs for the WSSL regime be recovered in a similar but slightly different way, allocating 64% of its estimated total costs for monitoring the WSSL regime and handling complaints and enquiries to the WSSL licensees and 36% to the appointed water companies.

Our consultation closed on 11 November 2016 and we received 12 consultation responses, including:

- 5 responses from WSSL licensees ;
- 6 responses from appointed water companies;
- 1 response from a consultant working in the water and sewerage sector.

In section 2 below we summarise the key themes raised in the consultation responses and set out our conclusions. The consultation responses have also been published in full on our website.

We have decided to proceed on the basis of the proposals set out in our consultation (with one exception in relation to our method of addressing over- or under- recovery of Ofwat's costs) and will calculate licence fees for WSSL licensees (covering the

estimated costs of both Ofwat and CCWater) accordingly under Condition 9 of Part A of the WSSL standard conditions. In addition, we have concluded that:

- It is appropriate to amend slightly Objective 1 to say “Provide as much certainty **and transparency** as possible to WSSL licensees”;
- The share of Ofwat’s regulatory costs associated with the WSSL regime that we have allocated to appointed water companies will be recovered as part of the renewal licence fees under Condition N and allocated between the relevant appointed water companies on the basis of relative turnover;
- Any over- or under-estimate of Ofwat’s regulatory costs (and increase or decrease in CCWater’s costs) for WSSL licensees should be dealt with in the following financial year, consistent with Condition 9 of Part A of the WSSL standard conditions. For appointed water companies, this would be dealt with in a manner consistent with the current approach under Condition N;
- We do not intend to charge appointed water companies operating wholly or mainly in Wales for their share of Ofwat’s costs of running the WSSL regime;
- With respect to WSSL licensees who enter the market mid-year, we intend to charge a licence fee for each subsequent full quarter. Any material change to CCWater’s costs will be reflected in its estimate of costs for the following financial year. Where a WSSL licensee leaves the market, we and CCWater will not refund licence fees already paid but will not include the former WSSL licensee in the next calculation of the licence fee payment; and
- We intend to deal with the position of non-exited incumbents in line with the position of other appointed water companies. Further, we do not intend to charge separate licence fees (over and above the application fee) to reflect possible costs that may be associated with wholesale or supplementary authorisations, or with self-supply licences, at the present time, but we (and CCWater) will keep this under review.

We have also set out our near final estimates of the relevant licence fees to be allocated based on the principles set out above and will be in a position to finalise these estimates at the end of the 2016-17 financial year.

A table summarising our approach and that of CCWater is set out below.

Costs in relation to the WSSL regime	Ofwat's Costs	CCWater's Costs
Basis of charging for WSSL licensees	Flat fee (10%) per licensee Variable fee (90%) per licensee	Flat fee (10%) per licensee Variable fee (90%) per licensee
Basis of variable fee for WSSL licensees	Market share based on wholesale charges	Market share based on wholesale charges
Allocation between appointed water companies and WSSL licensees	50:50	64% (WSSL licensees): 36% (appointed water companies)
Allocation amongst appointed water companies (excluding, where relevant, such companies whose area is wholly or mainly in Wales)	Allocated on the basis of relative turnover as part of a licence fee under Condition N	Allocated on the basis of relative turnover as part of a licence fee under Condition N
Fee invoices issued for WSSL licensee† <ul style="list-style-type: none"> • 2017-18 • 2018-19 †Fee invoices for appointed water companies will be issued in the usual way in April	October 2017* April 2018 *using data from the Market Operator to allocate the variable element of the licence fee using wholesale charges paid as at 30 September 2017	October 2017* April 2018
Under / overestimates: WSSL licensees	Dealt with when calculating fees for following financial year(s)	Dealt with when calculating fees for following financial year(s)
Under / overestimates: Appointed water companies	Under / overestimates across Ofwat's relevant costs (of which costs in relation to the WSSL regime will only be part) will as now be dealt with through: <ul style="list-style-type: none"> • an in-year special fee (in the case of an underestimate); or • an end of year credit note (in the case of an overall overestimate). 	Dealt with in a manner consistent with the current approach under Condition N.

2. Summary of consultation responses

In our consultation, we asked interested parties the following:

Number	Question
1	Do you agree with our objectives for setting WSSL licence fees? Are there any objectives you would like to suggest?
2	Do you agree that we should use a single basis for charging WSSL licence fees for licensees supplying eligible Welsh customers as well as those operating in England? If you disagree, how would you propose we handle WSSL licence fees for licensees supplying eligible Welsh customers?
3	Do you agree with our proposals for reconciling licence fees?
4	Do you agree with our proposals for setting licence fees based on: <ul style="list-style-type: none">• A fixed element covering 10% of the costs of running the WSSL regime; and• A variable element covering 90% of the costs of running the WSSL regime, based on market share?
5	Do you agree that wholesale charges paid is the most appropriate basis for calculating the variable element of the WSSL licence fee?

In the following sections we summarise the key points raised in the consultation responses we received and we set out our conclusions on our approach to setting WSSL licence fees, taking account of the final approach of CCWater. We also set out our conclusion on the appropriate allocation of costs associated with regulating the WSSL regime as between appointed water companies and WSSL licensees. Finally, we provide a near final estimate of underlying regulatory costs which we intend to recover and which will be finalised shortly.

Ofwat's formal Notice under condition 9(6) of Part A of the WSSL standard conditions of the general principles that Ofwat will apply in determining a licensee's share of the regulatory cost of the WSSL regime will be published when the final estimate has been established. This Notice will also be served on WSSL licensees.

2.1 Objectives for setting WSSL licence fees

a. What did we say in our consultation?

The purpose of the WSSL licence fee is to recover each WSSL licensees' share of the costs associated with regulating the WSSL regime (including the WSSL licensees' share of CCWater's estimated costs in relation to the WSSL regime). We want to establish a fair and equitable charging regime that facilitates the realisation of the benefits associated with the new business retail market.

We set out that our objectives should be to recover our costs whilst also:

1. Providing as much certainty as possible to WSSL licensees;
2. Ensuring the licence fee does not act as a barrier to new entrants joining the business retail market;
3. Ensuring there is no cross-subsidisation of the business retail market in England by Welsh customers;
4. Minimising complexity, cost and uncertainty; and
5. Putting in place a simple mechanism to reconcile actual and recovered costs at the end of the financial year for WSSL licensees.

b. What did the responses say?

There was general agreement with the proposed objectives amongst respondents with one respondent suggesting an amendment to Objective 2 as follows:

'Ensuring the licence fee does not act as a barrier to efficient new entrants joining the market, **whilst ensuring that this is not achieved by cross-subsidisation of licensees by appointees**'.

One respondent agreed with Objective 2 but also noted that if fees could validly be levied on WSSL licensees then these are a cost of doing business which must be accepted.

There were also a number of suggestions put forward for new objectives:

- Ensure there is no cross-subsidisation of the costs of other aspects of Ofwat's regulation (i.e. household retail and wholesale);
- The costs of regulating an efficient regime should be minimised and reflect a light touch approach to regulation;

- Ensure the full benefits of the business retail market to customers can be realised through reducing the on-going costs of market operation as the market matures given the scale of the fees across Ofwat, CCWater and MOSL; and
- Demonstrate ‘value for money’ in achieving the stated objectives in line with a light touch approach to regulation.

c. What is our position?

We recognise the key themes in the comments made by respondents and set out below our thoughts on those themes:

- **Reducing or minimising our costs** – the purpose of the WSSL licence fees is normally to recover each WSSL licensee’s share of Ofwat’s costs associated with regulating the WSSL regime, as well as CCWater’s costs for handling complaints and enquiries from business customers as well as monitoring the business retail market. We and CCWater will review our costs on an annual basis to ensure they are appropriate and our estimates are robust and fit for purpose. There may be a reduction in our costs as the market matures, but at this stage we cannot be certain. Therefore, we consider it appropriate to have an objective to minimise, but not reduce, our costs;
- **Ensuring there is no cross-subsidisation of costs** – we recognise the importance of ensuring there is no cross-subsidisation of WSSL licensees by appointed water companies, but consider that the manner in which we have structured the licence fee should address this in a reasonable way by reference to the work each of Ofwat and CCWater anticipate. That is, Ofwat’s costs will be recovered 50% through WSSL licensees and 50% through appointed water companies. CCWater costs will be recovered 64% through WSSL licensees and 36% through appointed water companies. This is based on complaints data over the last three years and estimates of policy and research costs. We consider that this also provides a sufficient level of assurance that there will be no cross-subsidisation by reference to the costs that CCWater considers it is likely to incur. We note the comment concerning other possible cross-subsidisation but consider, as set out above, that through annually reviewing our costs and our estimates to ensure they are robust and fit for purpose, we can ensure that this principle is observed; and
- **Transparency of our costs** – we set out below, and in our consultation, the structure of the licence fee and we recognise the importance of being transparent about the costs that we are recovering. To this end, we set out in

more detail later in this document the categories of costs that we, and CCWater, expect to recover and our current estimates of the breakdown between them.

In addition to reviewing the level of our costs to ensure they are robust and appropriate, we may also review the principles that we apply to the recovery of such costs should circumstances change (see Condition 9(7) of Part A of the WSSL standard conditions).

Taking into account the above, we propose making one change to the objectives that we set out in the consultation and that is to Objective 1 as follows:

‘Provide as much certainty **and transparency** as possible to WSSL licensees.’

2.2 Single basis of charging for eligible Welsh customers

a. What did we say in our consultation?

In our consultation we proposed that the fees for WSSL licensees serving eligible Welsh customers are set on the same basis as for other WSSL licensees.

We also set out that we did not intend to charge appointed water companies operating wholly or mainly in Wales for a share of the costs we have allocated to appointed water companies for regulating the WSSL regime.

b. What did the responses say?

Three respondents offered no comment on this area and all other respondents agreed with our proposals.

c. What is our position?

We intend to maintain the position that we took in our consultation.

2.3 Reconciling licence fees

a. What did we say in our consultation?

In our consultation we set out that we wished to avoid over-complicating the allocation of costs to the WSSL regime. We intended to set a budget for our work on the new regime and would use this as the basis for charging WSSL licensees for their share of the regulatory costs.

We would also adjust the annual licence fee for WSSL licensees to take account of any underestimate or overestimate in the previous financial year, for example if our actual costs differed from our estimated costs, or if Ofwat over-recovered the costs of regulating the WSSL regime because of a higher level of market entry than was anticipated.

Where a WSSL licensee joins the market midway through a financial year we proposed to charge them a fee for each subsequent full quarter. Where a WSSL licensee leaves the market, we proposed that there would be no refund of fees already paid, but the provider would not be included in the next calculation of the licence fee payment.

We said that we would then address any under or over-recovery of costs by way of a debit/credit note to WSSL licensees at year end. We would calculate the debit/credit note value using the same formula that applies to the calculation of the fixed and variable elements of the WSSL licence fee, i.e. based on our proposals 10% of the value credited would be allocated on a fixed basis, with the remaining 90% allocated using a variable fee based on market share (with that share determined by wholesale charges paid).

b. What did the responses say?

The majority of respondents to the consultation agreed with our proposals for reconciling licence fees. We did, however, receive questions on the following areas:

- It was stated that it is not possible to comment on whether the 10% fixed fee is cost reflective and we were therefore asked, in our final publication, to provide sufficient transparency to ensure those costs are equitable;
- How will under/overestimates be dealt with? There was uncertainty as to whether this would be dealt with by credit/debit notes or whether this would be taken into account in future fees. One respondent considered it would be

more sensible to take account of such differences in future fees as opposed to using credit/debit notes;

- It was suggested that if there are fewer entrants than expected, licence fees could significantly increase and this would affect the cash flows of WSSL licensees. Strong internal budgeting processes and safeguards would be required to ensure this does not occur;
- It was suggested that there should not be an automatic pass through of additional costs of operation. If there is an overspend in the administration of the market, how this should be dealt with should be consulted on with the WSSL licensees;
- The consultation did not specify how the wholesale element of the licence fee was to be recovered. There was an assumption that it would follow a similar process to the existing appointed water company licence fees; and
- We were asked to clarify whether the recovery of CCWater's costs would be structured in the same way.

c. What is our position?

Issue 1: Ofwat's estimated regulatory costs

In our consultation, we set out that we estimated the total cost of regulating the new business retail market to be £0.725m in 2017-18. We proposed allocating 50% of these costs to the WSSL licensees and 50% to the appointed water companies. This was in line with MOSL's approach.

We have since undertaken further work to test and confirm these initial estimates, for example taking account of our more recent work on market monitoring, and this has led us to anticipate a higher budgetary requirement. We now estimate the total costs of regulating the business retail market to be approximately £0.998m. This is a difference of approximately £0.27m. In line with the allocation of 50% of these costs to WSSL licensees and 50% to appointed water companies, this gives a total estimated cost to WSSL licensees of £0.49m.

The table below provides a broad breakdown of this estimated total by reference to high level categories of cost. It should be noted that for the 2017-18 financial year we do not intend to include costs relating to any future setting of price controls for the business retail market, a category of potentially relevant costs that we highlighted in

our consultation, as any such activity will not be undertaken in the next financial year.

Activity	Cost
1. Management of codes	£292,000
2. Stakeholder engagement including Open Water	£228,000
3. Market monitoring	£242,000
4. Licensing	£90,000
5. Customer enquiries/complaints	£85,000
6. Project management	£61,000
Total	£998,000

In the consultation document we set out how the proposed fee would work for five companies: one with no customers, and then four companies with 15%, 5%, 2% and 1% market share (based on wholesale charges) respectively. This is replicated below but with our revised estimated regulatory costs, rounded for illustrative purposes to £1,000,000, and the approximate number of current WSSL licensees.

Component of estimate	
Estimated number of WSSL licensees	40*
Estimated Ofwat costs of regulating the WSSL regime**	£500,000
Total fixed fee (set at 10%)	£50,000
Fixed fee per WSSL licensee	£1,250
Variable fee (set at 90%)	£450,000
Variable cost per % wholesale charges paid	£4,500

* 41 WSSL licences have been granted as at 6 March 2017

**Allocated to WSSL licensees

Indicative WSSL	Fixed fee (£)	Variable fee (£)	Total fee (£)
Licence but no customers	£1,250	£0	£1,250
15% market share	£1,250	£67,500	£68,750
5% market share	£1,250	£22,500	£23,750
2% market share	£1,250	£9,000	£10,250
1% market share	£1,250	£4,500	£5,750

Issue 2: CCWater’s estimated costs in relation to the WSSL regime

We agree that the recovery of CCWater’s costs may be structured in a slightly different way. Having considered the various categories of its costs, and suitable proportions to be allocated for each category, CCWater considers that its costs of handling complaints and enquiries from business customers and monitoring the retail market should be split 36% (in total) to appointed water companies and 64% (in total) to WSSL licensees as opposed to Ofwat’s split of 50:50. We agree that this seems reasonable by reference to CCWater’s activities and focus.

The amount recovered from WSSL licensees will be split with a 10% fixed element and 90% variable element assessed on the same basis as Ofwat.

CCWater’s total estimated costs associated with WSSL licensees in 2017-18 is £0.284m and £0.164m associated with appointed water companies. The table below sets out CCWater’s estimated costs.

Cost	Cost estimate	Retail (%)	WSSL licensee
Consumer relations	£105,000	56%	£59,000
Communication	£31,000	56%	£17,000
Leadership and engagement	£214,000	56%	£120,000
Policy support	£48,000	80%	£38,000
Research	£50,000	100%	£50,000
Total	£448,000	64%	£284,000

The costs CCWater attributes to retail will also be allocated per WSSL licensee. The share of costs attributed to appointed water companies will be allocated on the basis of relative turnover.

Issue 3: Under or overestimates of our regulatory costs and CCWater's costs

If we either underestimate or overestimate our regulatory costs then we consider that the appropriate mechanism to make adjustments is to adjust the annual licence fee for the subsequent financial year to take account of any such variances in the previous financial year, as reflected in Condition 9(5) of Part A of the WSSL standard conditions.

In terms of consulting with WSSL licensees around any changes in actual costs that may be reflected in any licence fees for the subsequent year, we recognise the importance of providing licensees with as much certainty as possible around costs. This is reflected in our objectives (see Objective 1). However, we must always be in a position to discharge our statutory responsibilities in an appropriate manner and it will not always be possible to anticipate all eventualities and the costs that may be associated with them. As such, if there are any significant additional costs that must be reflected in the following year's licence fees, then we will ensure that WSSL licensees are informed of this in advance.

With respect to WSSL licensees who enter the market mid-year, in line with our consultation proposals we intend to charge them a fee for each subsequent full quarter. Where a WSSL licensee leaves the market, we and CCWater will not refund licence fees already paid but will not include the former WSSL licensee in the next calculation of the licence fee payment.

CCWater's estimated costs are not calculated on the basis of the number of WSSL licensees in the market, but are based on historical complaints data and policy and research costs over the last three years. Any increase or decrease in costs for monitoring the business retail market and handling complaints and enquiries will be recognised in the following year's fees.

Issue 4: Variances to number of licensees

We recognise the concerns put forward by some respondents around the potential variance to the licence fee depending on the number of WSSL licensees that enter the market. However, there are a number of reasons why we consider this will not have a material impact so as to alter our assessment of the suitability of our proposals.

Firstly, as of 6 March 2017 we have granted 41 WSSLs (most applicants have applied for both a water supply licence and a sewerage licence) and we are continuing to process further WSSL applications. We made an assumption at the outset that there would be 35 WSSLs.

Secondly, in terms of the impact of a reduced number of WSSL licensees, the biggest impact will be on the fixed element of the licence fee. However, as the fixed element only accounts for 10% of the licence fee we would anticipate the impact to be relatively small. For example, based on the current licence fee assumptions (approximately 40 WSSL licensees) the fixed fee is £1,250. If the number of WSSLs decreased to, for example, 35, the fixed fee would increase by £179. Even if the number were to drop to 30, the impact in nominal terms would be relatively modest with an increase of £417. Likewise, if there are more than 41 WSSLs then the fee will decrease.

For the variable element of the licence fee, any variation to the predicted number of WSSL licensees will also not necessarily translate into an increase in licence fees. We have no evidence to suggest that any increase in both market share and revenue arising from a WSSL licensee acquiring more customers from an exiting licensee would not adequately compensate for any such increased fee.

As CCWater's overall estimated costs are not calculated on the basis of the number of WSSL licensees in the market, variances to the number of licensees will not affect the recovery of their costs in year but will be reflected in the following year's fees.

Issue 5: How will appointed water companies' proportion of the costs be recovered?

For appointed water companies, their proportion of the costs incurred by both Ofwat and CCWater will be recovered in a different manner to the costs recovered from WSSL licensees. There are two ways in which this will differ:

- a. We propose to invoice appointed water companies for their share of estimated regulatory costs in April 2017 as part of their licence fee and in accordance with Condition N. Pursuant to licence Condition N we also have the option of issuing another invoice part way through the year should that be required. We therefore intend to retain a contingency to manage, amongst other things, the risk that our costs of regulating the WSSL regime are higher than anticipated (with the facility for Ofwat to provide a credit note in the event its overall costs have been overestimated); and
- b. We will recover these costs (both Ofwat's and CCWater's) in the same manner as we currently recover appointed water companies' licence fees, that

is, based on relative turnover. We consider this is appropriate at this stage, given that the amount to be recovered from appointed water companies is relatively small compared to the overall level of their licence fee. More generally, there is merit in an approach consistent with the wider setting of appointed water companies' licence fees.

Furthermore, as set out in section 2.2 above, we and CCWater do not intend to charge appointed water companies operating wholly or mainly in Wales for their share of costs of running the WSSL regime.

2.4 WSSL licence fees based on a fixed and a variable element

a. What did we say in our consultation?

In our consultation document we proposed that there would be a fixed element covering 10% of the costs of running the WSSL regime and a variable element, covering 90% of the costs of running the WSSL regime, based on market share (using wholesale charges data).

b. What did the responses say?

The majority of respondents to the consultation agreed with our proposals. One respondent did not agree with a fixed element but did not provide any details as to why.

We also received the following comments:

- The consultation does not mention the effect of non-exited appointed water companies on the recovery of licence fees. A non-exited appointed water company will retain a significant embedded market share yet the consultation does not specify whether that incumbent then takes a share of the variable element of Ofwat's fee. If non-exited companies do not bear a share of the licence fee, then this increases the variable element of the licence fee for retailers as the market share is distorted; and
- The full scope of water companies' profit should be included in our calculations.

c. What is our position?

After considering the above comments, we intend to maintain the position we took in our consultation. That is, we will base the WSSL licence fee on a fixed and a variable element. CCWater agrees with this approach and their costs will be charged on the same basis, with a 10% fixed fee and 90% variable fee based on market share calculated by reference to wholesale charges.

With regards to the comment we received on the full scope of water companies' profit being included in our calculations, this would not be appropriate as our calculations are based on the regulatory costs that we expect to incur.

Issue 6: Non-exited incumbents

A non-exited incumbent is an appointed water company who has not exited the new retail market for business customers. In doing so, the appointed water company will continue to serve its existing business customers as a retailer and will also act as a wholesaler for any WSSL licensee operating within that region. As the appointed water company will not (and cannot) hold a WSSL licence for retail activities, customers from outside the company's area will not be able to switch to it, i.e. it cannot compete outside its appointed area.

Taking into account the above, as non-exited incumbents will not hold a WSSL licence they will not pay a licence fee as a WSSL licensee. As an appointed water company they will, however, pay 50% of our regulatory costs as set out above. As an appointed water company they will also pay a portion of CCWater's costs.

We recognise the issue outlined above in general terms. However, even within a non-exited incumbent's area of appointment, we would not expect relative licence fees to have a material impact on competition and any differential or impact should diminish over time. We will, however, keep this position under review. It should also be noted that their relatively higher turnover compared to exited incumbents will also mean that non-exited incumbents will pay a relatively higher proportion of the costs allocated to appointed water companies than would otherwise be the case.

2.5 Wholesale charges as the basis of the variable element

a. What did we say in our consultation?

In our consultation document we set out four different factors on which we could base the variable fee or variable element of a part-fixed, part-variable fee, which could be combined. These four factors, or approaches to estimating a WSSL licensee's market share, were:

- customer numbers;
- wholesale charges paid;
- number of supply points (known as 'SPIDs'); and
- turnover.

We noted that turnover was likely to be difficult to calculate in real time and a licensee's turnover may also involve revenues unrelated to the WSSL regime. This could introduce complicated and burdensome reporting and assurance arrangements whose benefits were unlikely to justify their costs.

We commented that customer numbers and the number of supply points were a good proxy for cost drivers in that the number of customers did drive regulatory activity and the number of interactions between the WSSL licensee and the undertaker. However, customer numbers may mask the true market share given the variation in the size of customers and their consumption (which can be measured by wholesale charges paid).

We also noted that the advantage of using wholesale charges as a basis for estimating the appropriate market share was that it recognised the size of the customer, reflected customer numbers to some extent, and was likely to provide the strongest correlation with WSSL revenues. We expected the Market Operator to be able to provide data on wholesale charges, and that an on-going code change proposal would formalise this.

b. What did the responses say?

Six respondents agreed with using wholesale charges as the basis of the variable element with one respondent noting that it would give a better measure of market share given the variation in consumption of customers.

Three respondents provided no comment.

Three respondents did not agree with using wholesale charges as the basis of the variable element. These three respondents instead considered that using the number of supply points (known as ‘SPIDS’), or customer numbers, would be more appropriate.

The main reasons put forward for not using wholesale charges were:

- **Variability** – a retailer who supplies a lot of customers in, for example, the South West Water area would pay more than one who supplies the same number of customers of the same type in, for example, the Northumbrian Water area, as the wholesale charges in the former area are presently higher;
- **Market distortion** – there is the potential for the market to be distorted as this could make acquisitions in certain regions of the country more attractive than others;
- **Scale** – a retailer who has only one very large industrial customer would pick up a larger proportion of the WSSL fees, yet its actual burden in terms of WSSL costs to Ofwat may be considerably lower than that of a retailer that has hundreds of customers; and
- **Volatility** – charges will be less predictable for retailers, with charges moving based on elements outside of their control or influence.

The main reasons put forward for using customer numbers or SPIDS were:

- **Correlation with underlying cost drivers** – certain elements of the costs of administration, such as the disputes, enforcement work and casework, are a function of customer numbers as opposed to wholesale charges or volumes. For example, work related to GSS is likely to be directly proportional to the number of eligible premises affected, irrespective of their size;
- **Interactions** – it reflects the number of interactions between the WSSL and the undertaker;
- **CMA** – using SPIDs would be more in line with the CMA definition of market size;
- **Equity** – using customer numbers would better align to the equitable objective; and

- **Certainty** – using customer numbers would give certainty to retailers as they could factor in the changes in fees with customer acquisition (or loss) with more certainty.

c. What is our position?

Issue 7: Wholesale charges or SPIDs/Customer numbers

As set out above, there is broad agreement amongst respondents on setting the licence fee based on a fixed and a variable element with the variable element being determined based on market share. We recognise that there are valid arguments for all the suggested options for determining market share and we have considered the options carefully.

Nevertheless, on balance, we consider that the following advantages of using wholesale charges as the basis for calculating market share support our retention of this approach at present, although we have the ability to revisit this in future years, if appropriate. In particular, wholesale charges:

- recognise the size of the customer;
- reflect customer numbers to some extent; and
- are likely to provide the strongest correlation with WSSL revenues.

We deal briefly with the points raised by respondents below:

- **Variability and market distortion** – we recognise this may be an issue in general terms. However, we are not persuaded at this stage this is a material risk, given the relative sums involved and that we would expect higher wholesale charges to be reflected in higher retail prices. Further we expect a number of retailers will seek to compete on a broader basis across the country, thereby also mitigating any such effect.
- **Scale** – as set out in our consultation, we consider that scale (size of customer) is important and that an advantage of using wholesale charges is that a retailer with, for example, one very large customer will pay for an appropriate share as opposed to only paying a relatively small variable fee if we based the allocation on customer numbers. While the number of customers can be relevant in terms of relative regulatory activity, we do not consider that it necessarily follows that the regulatory burden on Ofwat as between a retailer with a few large customers and one with many smaller customers will be materially different; and

- **Volatility** – we agree that using customer numbers or SPIDs is more in the control of retailers when compared with using wholesale charges. However, while we recognise the point of principle, we did not receive representations that any variances to wholesale charges that may arise would be so large as to cause significant issues for retailers.

In terms of the suggested advantages of using customer numbers or SPIDs:

- **Correlation with underlying cost drivers** – having considered this further, we do not consider it is sufficiently clear that there will be a necessary correlation between customer numbers or SPIDs and the nature of our enforcement work either initially or over time. For example, our enforcement work in future is likely to focus predominantly on those cases of strategic significance and these are likely to arise more as a function of customer size, which will be better reflected through wholesale charges;
- **Interactions** – while using customer numbers or SPIDs may better reflect the number of interactions between the WSSL and the appointed water companies, we do not consider customer interactions to be the primary driver behind our regulatory costs;
- **Market definitions** – we consider that how markets are defined in the context of, for example, a case under the Competition Act 1998 would be dependent on the facts of the case in question. It would therefore not be appropriate to use it as the basis of our approach at this stage;
- **Equity** – we consider that using wholesale charges is also consistent with our stated objectives in Section 2.1; and
- **Certainty** – we agree that using customer numbers would allow retailers to factor in changes in fees more readily. However, we consider that retailers could also do so if this element of the fee was based on wholesale charges. For example, if a retailer lost a number of customers, then it could calculate the resulting loss of customers based on the wholesale charges it paid for such customers, as well as customer numbers.

While one option to address the different considerations set out above would be to adopt a combined approach, we consider that adopting such an approach to the variable element of the WSSL fee would add an additional layer of complexity and, as per our objectives, we want to keep complexity to a minimum.

Taking into account the comments we received from respondents, we are not sufficiently persuaded at the present time that there is sufficient reason to change our proposed approach from basing the variable element of the licence fee on wholesale charges. CCWater agrees with this approach.

3. Other comments and issues

3.1 Wholesale and supplementary authorisations

a. What did we say in our consultation?

In our consultation we noted that water supply licensees can apply for a wholesale or supplementary authorisation that would allow the licence holder to input their own water to supply non-household premises consuming at least 5ML or, in the case of Welsh supplementary authorisations, 50ML of water a year. Although this may not involve many customers (because of the volume restrictions and the continued application of the costs principle), we expected to have the power to grant new water supply licences with wholesale and/or supplementary authorisations from 1 November 2016.

We considered, therefore, that this was a possibility that our approach to WSSL licence fees should accommodate. We needed to do further work on how this might operate in practice and what data might allow us to build these costs into our licence fee calculation.

b. What did the responses say?

One respondent set out that where a WSSL licensee has a water supply licence with a wholesale authorisation, it believed that the costs to Ofwat of operating this element of the licensing regime should be assessed, and levied, through another licence fee arrangement. That is, any additional licence fee arrangement for water wholesale authorisations should be distinct from the setting of licence fees in relation to the activities authorised by retail authorisations (WSSL licensees) and Welsh restricted retail authorisations.

c. What is our position?

From November 2016, we have had the power to grant water supply licences with wholesale and/or supplementary authorisations. In terms of the costs of regulating the activities authorised by a wholesale or supplementary authorisation, we do not yet have a clear picture of how many water supply licences with wholesale and/or supplementary authorisations there will be, or how that segment of the market will develop. As such, neither we nor CCWater know with any degree of certainty what the associated costs are likely to be. However, we can take this into account, as appropriate, in subsequent years. CCWater may adjust its estimate of its costs in

subsequent years to reflect any costs related to the activities authorised by the wholesale or supplementary authorisations of water supply licences.

3.2 Self-supply

a. What did we say in our consultation?

We did not make any specific reference to ‘retail restricted to self-supply’ authorisations in our consultation and we did not receive any comments regarding ‘retail restricted to self-supply’ authorisations in response to our consultation.

b. What is our position?

As self-supply (or retail restricted to self-supply) WSSL licensees will be effectively supplying themselves, we do not consider that they should pay a licence fee. Furthermore, we would not expect to monitor such licensees in the manner in which we would monitor other licensees, nor would we expect to process complaints on a similar scale to other licensees as they will essentially be both retailer and customer. Therefore any such costs over and above the licence application fee which such licensees will pay are likely to be *de minimis* and seeking to distinguish them would add unnecessary complexity at this stage.

We will keep this position under review and if we consider that we need to revise our approach, we will address this at the relevant time. CCWater agrees with this approach.

3.3 50:50 Wholesale (appointed water companies)/Retail (WSSL licensee) split

a. What did we say in our consultation?

In our consultation, we estimated the total cost of regulating the new market would be £0.725m in 2017-18 and we proposed to allocate 50% of these costs to the WSSL licensees and 50% to appointed water companies.

b. What did the responses say?

We received the following comments on our 50:50 split of regulatory costs:

- How has Ofwat arrived at the 50:50 split of costs?
- From Ofwat's own Regulatory Accounting Guidelines ([RAG 2.06 – Guideline for classification of costs across the price controls](#)) the guidance for allocation of regulatory costs is 1/9th to retail for water and sewerage companies, and 1/5th to retail for water only companies. Is the allocation of these regulatory costs sufficiently different and transparent to justify a 50:50 split of the new WSSL regulatory costs?
- Given the lack of evidential information on the proportion of costs that are attributable to the regulation of the new WSSL regime, compared to other market related costs, the 50:50 split is reasonable;
- It was not clear whether we intended to allocate £362,750 (50% of our proposed regulatory costs) in relation to the share of total wholesale revenue (both water and wastewater, excluding contributions from developers);
- the proportion of costs should be reviewed alongside the annual reconciliation exercise; and
- CCWater's 36:64 (wholesale:retail) proposed split of costs was more appropriate given the nature of the regulatory issues each constituent (WSSL licensees and appointed water companies) may generate.

c. What is our position?

We set out in our consultation the tasks that would be covered by the licence fee and, as set out in the table above in section 2.3, we consider that a large majority of those tasks cannot be reasonably attributed to either retail or wholesale. We

consider that setting price controls for WSSL licensees could be attributed solely to retail, however, we also consider it is reasonable to say that the purpose of setting price controls is to benefit, or support the successful operation, of the whole business retail market and, in any event, this would not be relevant to the next financial year, 2017-18. As such, we do not consider this to be a reason to alter our suggested allocation of costs between WSSL licensees and wholesalers.

CCWater has concluded that it should allocate its costs 36% to appointed water companies and 64% to WSSL licensees. Its underlying reasoning for the broad resulting split is the relative cost associated with handling complaints and enquiries, and policy and research, as shown in the table in section 2.3 above.

However, equally this does not mean that Ofwat's allocation as between WSSL licensees and appointed water companies should be identical given the different and broader types of work that we expect to undertake and, other than potentially licensing where the estimated costs are relatively small, we have no reason to believe that the balance will not be broadly even and in any event, such activities are, in our view, of benefit to a well-functioning market as a whole.

As regards whether the 50% allocation to appointed water companies would be allocated according to total wholesale revenue (both water and wastewater, excluding contributions from developers), as we set out in section 2.3 above, this will be recovered from appointed water companies based on relative turnover. That is the same manner in which we currently recover appointed water companies' licence fees. As set out in section 2.4 above, it will be recovered from WSSL licensees based on a 10% fixed fee and 90% variable fee, which is based on market share calculated by reference to wholesale charges.

Based on the above, we consider that the allocation of costs set out in our consultation remains reasonable. We note that one respondent considered we should review this allocation alongside any potential reconciliation of our regulatory costs. If the evidence appears to us to warrant a change in approach, we will consider this in future years.

3.4 Payment options

a. What did we say in our consultation?

WSSL licensees will be obliged under condition 9 of Part A of the WSSL standard conditions to pay an annual licence fee for ‘the regulatory cost for that year’ of the licence (or each of them if they hold both a water supply licence and a sewerage licence). For more information see the WSSL [standard conditions](#).

b. What did the responses say?

One respondent considered that it may be appropriate to allow retailers to smooth the payment of the licence fee over the year and that, based on this, quarterly payment options should be considered.

c. What is our position?

Whilst we set out in our consultation that WSSL licensees will be obliged to pay an annual licence fee, we did not specify how this could be recovered other than that we would issue an annual invoice. However any other approach would require a change to the WSSL standard conditions.

As we only received one comment on this issue, and given the current WSSL standard conditions, we will be collecting the licence fee (including CCWater’s fee) on a yearly basis. However, we are open to the possibility of considering licence modifications that would allow the licence fee to be collected through quarterly, or monthly payments in the future.

3.5 Review of all fees associated with the new market

a. What did the responses say?

One respondent recommended that we launch an enquiry into all on-going fees collectively, as the scale of on-going fees is detrimental to a well-functioning market in the customer interest.

b. What is our position?

We have a specific objective to minimising our costs, and we and CCWater will review our own expected future costs on an annual basis to ensure they remain appropriate.

4. Next steps

In terms of the next steps, we have set out in this document our views on the principles to be applied to the structure of the WSSL licence fee. We propose to publish and to issue the formal Notice to WSSL licensees under Condition 9(6) of Part A of their standard conditions shortly, once we have finalised our estimates.