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Trust in water

# Water Supply and Sewerage Licensing Regime – consultation on setting licence fees

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# Water Supply and Sewerage Licensing Regime – consultation on setting licence fees

## About this document

This document sets out our considerations and proposals for setting licence fees for the new Water and Sewerage Supply licensees from April 2017 after the opening of the retail market for business customers.

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## 1. Responding to this consultation

We would welcome any comments on this document. Please email them to

[FinanceAndGovernance@ofwat.gsi.gov.uk](mailto:FinanceAndGovernance@ofwat.gsi.gov.uk) or post them to:

WSSL licence Fee consultation Response

Ofwat

Centre City Tower

7 Hill Street

Birmingham

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The closing date for this consultation is **11 November 2016**. We will publish responses to this consultation on our website at [www.ofwat.gov.uk](http://www.ofwat.gov.uk), unless you indicate that you would like your responses to remain unpublished.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.

## 2. Executive summary

The advent of a competitive market for business customers in England will introduce a new Water Supply and Sewerage Licensing regime (WSSL). This will replace the old Water Supply Licensing (WSL) regime in April 2017. It is estimated that 1.2 million business customers in England and Welsh customers of undertakers wholly or mainly in England will be eligible to choose their water and sewerage retail supplier from April 2017.

The Welsh Government has a different policy position from the UK Government in respect of the market for business customers. For those non-household customers who use the supply system of an appointed company whose area is wholly or mainly in Wales, the scope of the WSSL regime will remain as it is under the present WSL regime, reflecting the policy position of the Welsh Government. This will enable suppliers to apply for a restricted water authorisation - it will not be possible to provide sewerage services to these customers.

WSSL licensees will initially only be retailers to supply business, charity and public sector customers (business customers), although they may be able to use their own water in certain circumstances. Under the old WSL regime, initially only larger customers in England and Wales (those customers that use more than 50 mega litres (ML) of water per year) could choose their retail water supplier. In 2011 the eligibility threshold reduced to 5ML in England only, whereas under the new WSSL regime all business customers of water and sewerage companies whose areas are wholly or mainly in England will be able to choose their water and sewerage retail supplier. In Wales the eligibility threshold remained and remains 50ML per year.

Ofwat is predominantly funded through licence fees paid by monopoly companies (undertakers). Ofwat's core activity is funded through licence fees that are governed by Condition N of undertakers' licences. WSSL licensees will be obliged under condition 9 of the [standard conditions of water supply and sewerage licences](#) to pay an annual licence fee for "the regulatory cost for that year of the Licensee's water supply licence" (as defined). This means WSSLs funding Ofwat's costs in relation to the WSSL regime, and similarly their share of CCWater's costs in relation to the WSSL regime.

A licensee's share must be determined in accordance with general principles specified and published by Ofwat. The annual fee is adjusted to take account of any under- or over-estimate of the costs of regulating the WSSL regime for any earlier year.

The costs of regulating the WSSL regime are uncertain and are likely to be higher than the previous WSL regime because we expect the WSSL regime to be significantly more effective than the WSL regime in enabling entry to the market, encouraging customers to switch retailer and increasing the number of requests for wholesale prices.

Calculating regulatory costs for WSSLs is also complicated both by arrangements to allow incumbent companies to amend their licences to exit the non-household retail market (which means that some undertakers will not retain their business customers) and the fact that the full WSSL regime will not extend to Welsh undertakers who should not be required to fund the costs of the full WSSL regime.

In considering the model for setting licence fees for WSSLs, we are conscious that turnover is uncertain until the market opens and that cash flows will be uncertain for some time. We need to set fees in a way that minimises uncertainty, encourages market entry and enables Ofwat to recover its costs associated with regulating the WSSLs.

The consultation sets out the key issues we have analysed and the issues which have informed our consideration. The scope of this consultation excludes the future fees for processing applications, which is subject to a separate flat fee.

This consultation does not consider any wider arguments about whether the current licence fee mechanism set out in Condition N of undertakers' licences will remain fit for purpose as markets develop within the water and wastewater sectors. It also does not seek to identify specific opportunities to simplify and update condition N, which forms part of our licence simplification workstream.

On the specific question about WSSL licence fees, we are proposing that:

- the most appropriate basis of charging combines a flat fee per licensee with the bulk of our costs allocated through a variable element based on market share;
- a fixed fee enables us to recover costs from all licensees including those with a very low or minimal customer base but if set at a low level it should avoid the fee becoming a barrier to entry; we propose that 10% of Ofwat's budgeted costs for overseeing the WSSL regime will be allocated to the fixed fee element, then divided equally between the licensees;
- the other 90% of the fee will be allocated to licensees on a variable basis based on their market share, calculated by wholesale charges paid rather

than turnover or retail customer numbers; this means that the bigger licensees meet the majority of our costs in line with their share of the market;

- for year 1 (2017-18) of market operation, we will delay the annual invoice until October and use data from the market operator to allocate variable elements based on wholesale charges paid as at 30 September 2017;
- from year 2 (2018-19) of market operation onwards, we will issue an annual invoice early in the financial year; and
- we charge WSSLs supplying eligible Welsh customers on the same basis as WSSLs operating in England.

Our consultation questions are:

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"> <li>• a fixed element covering 10% of the costs of running the WSSL regime; and</li> <li>• a variable element, covering 90% of the costs of running the WSSL regime, based on market share?</li> </ul>
5	Do you agree that wholesale charges paid is the most appropriate basis for calculating the variable element of the WSSL license fee?

## **3. Options and issues for consideration in setting licence fees**

### **3.1 Issues**

#### **3.1.1 Government rules on setting fees and charges**

UK and Welsh Government guidance on fees and charges requires public sector organisations to pass on the full charges of the cost of providing services. This guidance covers compulsory levies, such as licence fees for statutory regulators.

The general approach intends to ensure public sector bodies neither profit at the expense of those paying fees and charges, nor that taxpayers or consumers effectively subsidise losses. Charges – in the form of levies on industry - also need to be set in such a way as to avoid cross-subsidisation, which is directly relevant to WSSLs to ensure Welsh consumers are not indirectly funding the retail market for businesses in England. The guidance in [Managing Public Money](#) and [Managing Welsh Public Money](#) is clear that it may be appropriate to charge different levies to different kinds of licensees, depending on the cost of providing different kinds of licences.

#### **3.1.2 Encouraging new suppliers to join the retail market**

One of our primary concerns is to provide as much certainty as possible to the new WSSL licensees. Many are new organisations, with uncertain turnover and potentially small margins associated with retail activity.

To maximise the benefits to customers of competition, we want to avoid the WSSL licence fee becoming a barrier to entry, especially in the formative years of the new market.

The second key factor is that we have no data on which to estimate customer numbers or turnover by WSSL licensee. To benefit from the new market, customers will be incentivised to switch retailer, and so there will be ongoing changes in the number of customers each WSSL serves.

#### **3.1.3 Our objectives in setting WSSL licence fees**

The purpose of the WSSL licence fees is to recover all of Ofwat's costs associated with regulating the WSSL regime, and to establish a fair and equitable charging

regime that facilitates the realisation of the benefits associated with the new retail market.

Our objectives are to recover Ofwat's costs while 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 market;
3. ensuring there is no cross-subsidisation of the business 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.

<b>Q1</b>	<b>Do you agree with our objectives for setting WSSL licence fees? Are there any objectives you would like to suggest?</b>
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### **3.1.4 Estimating our costs**

Estimating the costs of regulating the new market is inherently uncertain – we do not know how many items of casework the new market will generate, or the complexity of the issues that will be raised.

The costs of regulating the WSSL regime – and consequently the licence fees we charge - will be higher than the costs of regulating the WSL regime. This is because we expect the WSSL regime to be much more effective than the WSL regime in promoting new entrants to the market, customers switching retailer and requests for wholesale prices. All of these factors drive additional regulatory costs when compared with the costs of regulating the WSL regime which did not produce a dynamic supplier base or encourage customer switching.

The costs comprise:

- setting any price controls for WSSLs which have acquired non-household retail business from relevant undertakers for the period from 2020;
- managing changes to the codes governing the retail market, and managing interim supply codes in the case of a WSSL licensee failing;
- core regulatory work relating to disputes between WSSL licensees and undertakers, which is part of Ofwat's Casework programme;
- enforcement work relating to WSSLs, including work relating to the Guaranteed Service Standards;

- some costs associated with casework relating to WSSLs (some of these costs are likely to relate to the behaviour of wholesalers or existing non-exited retailers), including commissioned customer research to test whether the market is operating for customers;
- managing relationships with the market operator and other stakeholders involved in the WSSL market;
- financial monitoring and work associated with WSSL mergers as part of our Finance and Governance programme; and
- legal costs associated with the above work packages.

We have developed a set of planning assumptions to enable us to estimate the likely costs of our people working on the regulation of the new market for business customers, and any external expenditure associated with our regulation of the market, for example specialist legal advice.

Some of the costs of this work should be allocated to undertakers, and the work regulating the WSSL regime will partly reflect costs relating to WSSL licensees but other elements will relate to the work of undertakers.

We estimate the total cost of regulating the new market will be £0.725m in 2017-18. In line with MOSL's approach, we have allocated 50% of these costs to the WSSL licensees and 50% to the undertakers, giving a total estimated cost to the WSSLs for 2017-18 of £0.363m.

These are indicative cost estimates which may change as we refine our planning for 2016-17, and over time as we get better information about the new market and the costs associated with regulating the new WSSL regime.

### **3.1.5 Allocating WSSL costs to companies operating wholly or mainly in Wales**

For those non-household customers who use the supply system of an appointed company whose area is wholly or mainly in Wales, the scope of the WSSL regime will remain as it is under the present WSL regime, reflecting the policy position of the Welsh Government. Those customers who meet the 50ML threshold requirement will continue to be able to choose a different supplier for water retail services. All retailers wishing to participate in this market will have to apply for a WSSL with a restricted retail authorisation allowing them to provide water retail services to eligible Welsh customers (it will not be possible to provide sewerage services to these customers).

The threshold of 50ML will continue to apply for those business customers that are served by a water company whose area is wholly or mainly in Wales. There will be no self-supply licences and no sewerage licences – the eligibility and type of licences for WSLs in Wales will carry through to the new WSSL regime. This threshold means the number of eligible customers in Wales is relatively small. Where WSSL licences apply to Wales, we will need to charge the licensees for their share of costs.

We could seek to identify specific costs of regulating the Welsh market separately from the English, or simply use the same basis for charging fees to WSSLs operating wholly or mainly in Wales with a restricted retail authorisation allowing them to provide water retail services to eligible Welsh customers.

We believe the regulatory costs will not vary sufficiently for WSSLs serving eligible Welsh customers to justify a separate charging regime for WSSLs with a restricted retail authorisation for eligible Welsh customers. The complexity of varying the arrangements is likely to be disproportionate to the benefits.

In the interests of simplicity, we are proposing that the fees for WSSLs serving eligible Welsh customers are set on the same basis as for other WSSLs. We note that predominantly variable fees based on customer numbers will ensure accurate allocation of costs to licensees. This means that in Wales, WSSLs would only be liable for variable costs associated with eligible Welsh customers switching water supplier. Given the low number of eligible customers in Wales, licence fees relating to those customers in Wales are likely to remain very low.

Reflecting the more limited scope of the WSSL regime in Wales, at this time we do not intend to charge companies operating wholly or mainly in Wales for their share of the costs we have allocated to undertakers for running the WSSL regime. We reserve the right to review this position should the situation change.

<b>Q2</b>	<b>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?</b> <b>If you disagree, how would you propose we handle WSSL licence fees for licensees supplying eligible Welsh customers?</b>
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### **3.1.6 Consumer Council for Water licence fees**

The independent consumer watchdog for the water industry in England and Wales, Consumer Council for Water (CCWater), is also funded through licence fees.

CCWater proposes that its costs for the WSSL regime are recovered in a similar but slightly different way to that proposed for Ofwat's costs for regulating the new market. CCWater estimates the total cost for monitoring the WSSL regime and handling complaints and enquiries will be around £0.43m in 2017-18. CCWater has allocated 64% of these costs to the WSSL licensees and 36% to the undertakers, giving a total estimated cost to the WSSLs for 2017-18 of £0.28m.

If you have any queries about CCWater's proposed fees please contact the watchdog directly. Please email all comments to [marketreform@ccwater.org.uk](mailto:marketreform@ccwater.org.uk).

### **3.1.7 Wholesale and supplementary authorisations**

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 expect to have the power to grant new water supply licences with wholesale and/or supplementary authorisations from 1 November 2016.

It is therefore a possibility that our formula should accommodate this. We need 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. We intend to clarify a final position in our published response to this consultation.

### **3.1.8 Wider licence simplification**

The changes discussed in this document are specifically aimed at the recovery of costs of regulating the WSSL regime through licence fees. However, we do recognise the potential for change to Condition N:

- current and future changes to the water and wastewater sector may mean we need to change how condition N operates; and
- our licence simplification workstream may identify ways to simplify the condition N.

We will look to take these forward separately from the specific question about cost recovery through WSSL licence fees which is covered by this consultation.

### 3.1.9 Options

There are three main bases on which to set Ofwat’s licence fees, as set out below. We have considered and discounted the option of Ofwat recovering all of its regulatory costs from wholesalers, with retailers then compensating wholesalers by paying a fee per customer set with reference to Ofwat’s costs. We have judged this too complex and lacking transparency for public spending to meet the standards of Managing Public Money.

Option	Description
1 - Flat fee	Set a flat fee for each WSSL by dividing total estimated cost by estimated number of WSSLs
2 - Flat fee plus variable fee	Divide total costs into two elements, one providing a flat ‘base’ fee, the other an element relating to market share, calculated with reference either to turnover, wholesale charges paid or customer numbers
3 - Variable fee	WSSLs pay a share of costs based either on the proportion of total customers or total turnover of the WSSLs

There are four bases on which we could set a variable fee, which could be combined:

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

### 3.1.10 Estimating the number of WSSL licensees

One of the main uncertainties in estimating the potential licence fee cost is that we do not know exactly how many organisations will apply for a WSSL, nor the proportion of applications that will result in the award of a licence.

In addition, WSSLs may merge or combine and it is likely there will be some changes in the market, whether through consolidation or diversification.

We know that there are 12 WSLs under the current regime, and that MOSL has around 30 applications in train. Not all of these will result in a WSSL licence being issued. With those figures in mind, our working assumption is that there will be 35 WSSLs.

We have therefore used 35 WSSLs as the basis for our simple modelling of licence fee structures. Should the number of licensees differ significantly from this number, there is a risk that we would over- or under-recover our costs. In such circumstances, we would need to use credit or debit notes to correct any over- or under-recovery of WSSL licence fees at the end of each financial year.

### **3.1.11 Reconciling licence fees**

We do not propose to over-complicate the allocation of costs to the WSSL regime. We intend to set a budget for our work on WSSLs and can be confident in producing robust figures. We would use these as the basis for charging WSSLs for their share of the regulatory costs. We would adjust the annual licence fee to take account of any under- or over-estimate 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 additional market entrants than anticipated.

Where a supplier joins the market midway through a financial year, we will charge them a fee for each subsequent full quarter. We will refund WSSL licensees by way of a debit/credit note at year end for any under- or over-recovery of costs. 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 to be allocated on a fixed basis, with the remaining 90% allocated according to variable fee based on market-share (based on wholesale charges paid).

If a licensee leaves the market, we will not refund licence fees already paid but will not include the provider in the next calculation of the licence fee payment.

<b>Q3</b>	<b>Do you agree with our proposals for reconciling licence fees?</b>
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### 3.1.12 Criteria

We have used five criteria to assess the four options for setting WSSL licence fees. These are:

<b>Criteria</b>	<b>Description</b>
Fairness	The basis for setting fees provides an equitable allocation of regulatory costs to WSSL licensees
Certainty	The basis of setting the licence fee provides a reasonable level of certainty for WSSLs about their overheads
Market participation	The basis of setting the licence fee does not create a barrier to market participation and encourages entrants
Simplicity	The basis of the licence fee is simple, easy to understand and cheap to operate (both for Ofwat and WSSLs)
Effectiveness	The basis of the licence fee serves its purpose by meeting the objectives set out in section 3.1.3

## 4. Analysis

We have assessed the three options set out in section 3.1.9 against the criteria set out in 3.1.12.

In the early stages of the market, there is considerable uncertainty about customer numbers, market share and turnover. As a result, options 2 (flat fee plus variable fee) and 3 (variable fee) are weaker in terms certainty and simplicity but are strong in terms of fairness, market participation and effectiveness.

Option 1 (flat fee) has the benefit of being very simple and very certain but is inherently unfair because it would set flat fees for smaller WSSLs which could act as a barrier to entry and advantage larger suppliers. Ultimately, this could affect the extent to which the benefits of competition accrue to customers, and so may be a barrier to market participation and effectiveness.

The initial lack of data about the operation of the new market makes it more difficult to set a fee for WSSL licensees. However, this should become less of an issue once the market has commenced operation as data will be readily available from the market operator.

After the market has been operating for two or three years, we expect to have good data about customer numbers, turnover and market share. This should allow us to set a licence fee with exclusively or substantially variable elements using data about market share.

There are some significant downsides associated with an exclusively variable fee – some WSSLs are likely to have very low customer or consumption levels but will drive certain regulatory costs. On that basis, there is a case that all licensees should contribute some sort of fixed fee to cover the fixed costs associated with regulating the WSSL regime. Nevertheless, our analysis strongly suggests that the bulk of our costs should be recovered on a variable basis according to market share. This has led us to conclude that, in our judgement, the best balance of our objectives is achieved by a fee combining flat and variable elements.

## 5. Proposed approach to setting WSSL licence fees

Based on our conclusion that a flat plus variable fee is the most appropriate option, our modelling suggests we should set the fixed fee at a level that recovers 10% of the total estimated cost of regulating the WSSL regime, based on the expected levels of licensees. Based on estimated regulatory costs of £0.36m, and assuming 35 WSSLs, this would mean a fixed fee of £1,036 and variable costs of £326,000 in total, at a cost of 27p per customer (based on 1.2 million customers).

We have identified four bases we could use to set the variable fee or variable element of a part-fixed, part-variable fee (section 3.1.9), which could be combined:

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

Turnover is likely to be difficult to calculate in real time and a licensee's turnover will involve revenues unrelated to the WSSL regime. This could introduce complicated and burdensome reporting and assurance arrangements whose benefits are unlikely to justify their costs.

Customer numbers and the number of supply points are a good proxy for cost drivers in that the number of customers does drive regulatory activity and the number of interactions between the WSSL 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).

The advantage of wholesale charges is that it recognises the size of the customer, reflects customer numbers to some extent, and is likely to provide the strongest correlation with WSSL revenues. We expect the market operator to be able to provide data on wholesale charges, and that an ongoing code change proposal will formalise this.

We favour using as simple a mechanism as possible to set the variable fee. On that basis we believe that the variable element should be calculated with reference to wholesale charges paid, and to avoid the licence fee becoming a barrier to entry, the majority of the licence fee should be set on a variable basis. The use of a fixed fee enables us to recover costs from all licensees including those with a very low or minimal customer base. If we set the fixed element sufficiently low, we can avoid the fee becoming a barrier to entry. Our assessment is that 10% of the regulatory costs should be recovered from fixed fees, and 90% recovered on a variable fee basis.

We believe that we will need a bespoke approach in Year 1 of the market's operation (2017-18) before moving to our longer-term approach from 2018-19. This would mean we would:

- a. issue invoices to WSSLs in October 2017, allocating the costs to the WSSL licensees based on a fixed fee of 10% of the budgeted costs of regulating the WSSLs, with the remaining 90% allocated on a variable basis according to market share based on wholesale charges paid as at 30 September 2017 (using data supplied by the market operator); and
- b. from 1 April 2018, we will set licence fees on the same fixed and variable basis, using on each firm's proportion of market share based on wholesale charges paid (using data supplied by the market operator) as at 31 December 2017 and each year thereafter.

We will review the operation of the WSSL licence fee, including its specific operation in Wales, no later than the end of the 2018-19 financial year.

The following table sets out how the proposed fee would work for five companies, one with no customers, and companies with 15%, 5%, 2% and 1% market share (based on wholesale charges).

Component of estimate	
Estimated number of WSSLs	35
Estimated costs of regulating WSSL regime	£362,750
Total fixed fee (set at 10%)	£36,275
Fixed fee per WSSL	£1,036
Variable fee (set at 90%)	£326,475
Variable cost per % wholesale charges paid	£3,265

Indicative WSSL	Fixed fee (£)	Variable fee (£)	Total fee (£)
15% market share	1,036	48,974	50,010
Licence but no customers	1,036	0	1,036
5% market share	1,036	16,325	17,361
2% market share	1,036	6,530	7,566
1% market share	1,036	3,265	4,301

<b>Q4</b>	<b>Do you agree with our proposals for setting licence fees based on:</b>
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	<ul style="list-style-type: none"><li>• a fixed element covering 10% of the costs of running the WSSL regime; and</li><li>• a variable element, covering 90% of the costs of running the WSSL regime, based on market share?</li></ul>
Q5	Do you agree that wholesale charges paid is the most appropriate basis for calculating the variable element of the WSSL license fee?

## **6. Deadline for responses and next steps**

We are seeking feedback and comments on the proposals set out in this consultation, and invite comments no later than 11 November 2016.

We will reflect on comments received and notify our stakeholders of the approach to setting licence fees in Q4 2016-17, along with our final estimate of the licence fee for WSSLs.

If you would like to discuss any aspect of this consultation document, please use the contact details in Section 1 of this document.