

March 2018

Trust in water

Water Supply and Sewerage Licensing Regime – consultation on proposed changes to how licence fees are set

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About this document

This document sets out our proposed changes to how we will set licence fees for water supply and/or sewerage licensees in the future. We plan to build on the approach we used to set licence fees for the current financial year.

We also set out our current estimate, based on the draft forward work programme that we have published for consultation, of our total costs in relation to the water supply and sewerage licensing regime in 2018-19, as well as the estimated costs of the Consumer Council for Water.

We are seeking the views of all interested parties and welcome responses to this consultation by 23 March 2018.

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Responding to this consultation

We welcome your responses to this consultation by 23 March 2018. We would particularly welcome your views in response to the questions we have set out in the relevant sections of this document, which we have also listed for ease of reference in the section [Consultation questions](#).

In submitting your response, please identify which question number(s) your comments are in response to.

Please make sure that you clearly list any additional comments separately.

You can email your response to licensing@ofwat.gsi.gov.uk. You can also submit your response by post to:

Chris Bollington
Ofwat
Centre City Tower
7 Hill Street
Birmingham, B5 4UA

Please also send any comments about CCWater's process and estimated costs directly to CCWater at marketreform@ccwater.org.uk

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Data Protection Act 1998 and from May 2018 the General Data Protection Regulations (**GDPR**), Freedom of Information Act 2000 (**FoIA**), and the Environmental Information Regulations 2004.

If you would like the information you have provided to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' with which public authorities must comply and 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 to be confidential. If we receive a request for disclosure of that 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 or a blanket request for confidentiality will not, in itself, be regarded as binding on Ofwat.

Consultation questions

Questions

1. Do you agree with our proposal to simplify the calculation of licence fees by calculating the flat fee element of licence fees by licence for the costs of both Ofwat and CCWater for 2018-19 and subsequent financial years?
2. Do you agree with our proposal to include wholesale charges associated with transferred businesses in the previous year when calculating market shares for 2018-19 and subsequent financial years?
3.
 - a. What are your views on the principle of Ofwat setting licence fees for self-supply WSSL licensees for 2019-20 and subsequent financial years?
 - b. Do you have any views on how licence fees for self-supply WSSL licensees in relation to Ofwat's costs should be calculated?

1. Background

Water supply and/or sewerage licensees (**WSSL licensees**) are required by Condition 9 (Licence fees) of Part A of the [standard conditions of water supply and sewerage licences](#) to pay annual licence fees in relation to the costs of the:

- Water Services Regulation Authority (**Ofwat**);
- Consumer Council for Water (**CCWater**); and
- Competition and Markets Authority (**CMA**).

We have previously set out¹ that our objectives for the charging regime are to recover the relevant costs whilst also:

1. Providing as much certainty and transparency 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.

The costs of Ofwat and CCWater in relation to the business retail market are shared between WSSL licensees and water and/or sewerage undertakers (**appointed water companies**). 50% of Ofwat's relevant costs and 64% of CCWater's relevant costs are allocated to WSSL licensees (the rest being allocated to appointed water companies)².

Where costs need to be allocated between WSSL licensees, each WSSL licensee's fee (including any adjustment to take account of any under- or over-estimate of the costs in any earlier year) must be determined in accordance with general principles specified and published by Ofwat.

The current general principles are set out in Part B of [Information notice 17/07 – Licence fees for water companies and WSSL licensees](#) published in October 2017. They are that:

¹ We confirmed our objectives in [Water Supply and Sewerage Licensing Regime: consultation on setting licence fees – summary of consultation responses and next steps](#) (Ofwat, March 2017).

² For more information, see our [Information notice 17/07 – Licence fees for water companies and WSSL licensees](#) published in October 2017.

1. Licence fees will be based on (i) a flat fee element per licence and (ii) a variable element based on market share that will reflect the bulk of our and CCWater's estimated costs. 10% of the relevant costs of Ofwat and CCWater will be allocated as a fixed fee, divided equally between the licensees paying a fee³. 90% of the relevant costs of Ofwat and CCWater will be allocated as a variable fee, based on market share.
2. Costs in relation to the business retail market will be shared between WSSL licensees and appointed water companies.
3. WSSL licensees supplying eligible Welsh customers will be charged on the same basis as WSSL licensees operating in England.
4. Where a licence is granted during a financial year, no licence fee would be charged to that licensee until the next financial year. If necessary, the first licence fee then payable by such licensees would reflect a share of any under-estimate of the regulatory costs for the previous year that we recovered in a subsequent year but will not be reduced to reflect any over-estimate.
5. There will be no refund of licence fees paid where a licence is revoked mid-year.
6. Self-supply WSSL licensees⁴ would not be charged a licence fee.
7. The CMA's costs in relation to any licence modification reference involving more than one WSSL licensee will be allocated on the basis of relative market share.

This consultation sets out our proposed changes to the current approach to determining WSSL licensees' fees. We do not propose to make any changes to how we set licence fees for appointed water companies⁵.

For 2018-19, we expect to issue invoices for licence fees to WSSL licensees by 30 April 2018, after we have finalised any changes to our general principles following consideration of the responses to this consultation.

³ Ofwat's costs were allocated counting water supply licensees and sewerage licensees separately. CCWater's costs were allocated per licence holder.

⁴ A self-supply WSSL licensee is one that can only supply water or provide sewerage services to its own premises or to the premises of associated persons.

⁵ Part A of [Information notice 17/07 – Licence fees for water companies and WSSL licensees](#) sets out how costs will be allocated between appointed water companies.

2. Proposed changes to how we set licence fees

In this section, we set out the changes we are proposing to make to how we set licence fees for WSSL licensees.

Proposed change 1 – calculating the flat fee element of licence fees by licence for the costs of both Ofwat and CCWater

Water supply licences and sewerage licences are legally separate instruments (someone can hold just one of the licences) and a licence fee is payable under each. Where someone holds both a water supply licence and a sewerage licence we therefore need to determine the appropriate licence fee for each licence.

The flat fee element of licence fees is calculated by dividing 10% of the relevant costs of Ofwat and CCWater equally between the licensees paying a fee. Currently, we allocate Ofwat's costs by counting water supply licensees and sewerage licensees separately and allocate CCWater's costs per licence holder. We consider this adds an extra layer of complexity to the process. We therefore propose to calculate the flat fee element of licence fees by licence (rather than licence holder) for both Ofwat's costs and CCWater's costs for 2018-19 and subsequent financial years.

Question 1

Do you agree with our proposal to simplify the calculation of licence fees by calculating the flat fee element of licence fees by licence for the costs of both Ofwat and CCWater for 2018-19 and subsequent financial years?

Proposed change 2 – including the wholesale charges associated with transferred businesses when calculating market shares

The variable element of licence fees is calculated by allocating 90% of the relevant costs of Ofwat and CCWater based on market share. Previously, we said that the variable element of the fees for 2018-19 and subsequent years would be set using the wholesale charges to a WSSL licensee during the preceding financial year.

This approach would not take account of any significant change in the size of a WSSL licensee's business because of the acquisition of a non-household retail business that occurs during the preceding financial year or in the financial year in question before we determine the appropriate licence fee for that year. The acquisition could arise because of the transfer of a non-household retail business from an appointed water company (a retail exit) or another WSSL licensee. Our current approach therefore means that the licence fee for a WSSL licensee that we knew had acquired such a retail business would not fully reflect the size of its business at the start of the financial year. We want the variable element of licence fees from 2018-19 onwards to be based, as closely as reasonable, on the size of a WSSL licensee's market share at the time we set licence fees.

We therefore propose that when calculating market share for a WSSL licensee for 2018-19 and subsequent financial years we will use:

- the wholesale charges to the WSSL licensee in the preceding financial year (unless those charges will be used in the calculation of another WSSL licensee's market share); and
- the wholesale charges to an appointed water company's retail business or another WSSL licensee in the preceding financial year that relate to a retail business that has been transferred to the WSSL licensee.

For clarity, our proposal is that the variable element of licence fees for 2018-19 and subsequent financial years will be based on a WSSL licensee's share of the relevant wholesale charges in the preceding year, except where a retailer⁶ has exited the market. In those cases, the wholesale charges to the exited retailer will be allocated to the WSSL licensee who has taken on those customers by the time we set licence fees.

We illustrate our proposed approach in the example set out in Table 1. This example sets out the market share of two hypothetical WSSL licensees based on the relevant

⁶ A "retailer" in this context means a WSSL licensee or an appointed water company providing retail services direct to businesses, charities and public sector organisations.

wholesale charges in the preceding year. WSSL licensee A exited the market midway through the year and transferred their customers to WSSL licensee B.

Table 1 - Illustrative example of our proposed calculation with two hypothetical licensees

Month	WSSL licensee A	WSSL licensee B	Sum of WSSL licensee A and B
1	19%	20%	39%
2	18%	20%	38%
3	20%	20%	40%
4	19%	20%	39%
5	20%	20%	40%
6	20%	20%	40%
7	0%	40%	40%
8	0%	38%	38%
9	0%	39%	39%
10	0%	37%	37%
11	0%	36%	36%
12	0%	34%	34%
Average Market Share	9.67%	28.67%	38.33%
Basis for subsequent year charge	0.00%	38.33%	

Where parties are mid-transaction and the transfer has not yet taken place, we do not think it appropriate to apply this approach as the transaction is not certain to occur. We would expect a divesting WSSL licensee to retain a sufficient sum to pay any required licence fee and that this is addressed in any contract with the acquiring WSSL licensee where appropriate.

Question 2

Do you agree with our proposal to include wholesale charges associated with transferred businesses in the previous year when calculating market shares for 2018-19 and subsequent financial years?

Proposed change 3 – issuing fees to self-supply licensees

Our current approach is that self-supply WSSL licensees should not be charged a licence fee. We are not proposing to charge self-supply WSSL licensees a licence fee for 2018-19, but we are consulting on whether to start charging a licence fee that relates to Ofwat's costs for 2019-20 and subsequent financial years.

In our [consultation response document](#) to our October 2016 consultation – 'Water Supply and Sewerage Licensing Regime: consultation on setting licence fees', we concluded that self-supply licensees would be effectively supplying themselves and so they should not pay a licence fee. We set out our expectation that we would not 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. We said that any such costs over and above the licence application fee which such licensees will pay are likely to be minimal and seeking to distinguish them would add unnecessary complexity at that stage.

We said we would keep this position under review and that if we considered we needed to revise our approach, we would address it.

Given that a self-supply WSSL licensee is one that can only supply water or provide sewerage services to its own premises or to the premises of associated persons, CCWater does not currently incur costs. As such, CCWater does not consider it appropriate to charge self-supply WSSL licensees a fee; however, it will continue to keep this under review. We agree with that position.

In relation to Ofwat's costs, we consider that self-supply WSSL licensees have benefitted, and will benefit, from Ofwat's regulatory work in relation to the business retail market. Examples of this include our work on the market codes that govern the retail market and our work with wholesalers and their provision of services to WSSL licensees. Contrary to our initial expectations, recent trends suggest that we can expect to see the number of self-supply WSSL licensees increase significantly over time. Ofwat's work to monitor and help ensure the market is working well for this group has increased and we expect it to continue to do so going forward. We therefore consider that there is a case for introducing some level of licence fee for self-supply WSSL licensees.

However, the entry of self-supply WSSL licensees has been one of the most innovative aspects of the business retail market that we have seen so far. We do not want to introduce an unnecessary barrier to entry or burden on this group. We are also conscious that, for the same reasons we previously decided that self-supply

WSSL licensees should not be charged a licence fee, it may not be appropriate for a self-supply WSSL licensee to pay as large a share of Ofwat's costs as other WSSL licensees.

At this stage, we are therefore consulting on whether to start charging self-supply WSSL licensees a licence fee that relates to Ofwat's costs for 2019-20 and subsequent financial years. We also welcome views on how, if introduced, such a fee should be calculated. If we decide that it is appropriate to start charging a fee, we intend to carry out a further consultation on our chosen option for the calculation of such fees in time for us to change the principles and set licence fees for 2019-20.

Question 3

- a. What are your views on the principle of Ofwat setting licence fees for self-supply WSSL licensees for 2019-20 and subsequent financial years?
- b. Do you have any views on how licence fees for self-supply WSSL licensees in relation to Ofwat's costs should be calculated?

Please note there is an ongoing consultation that relates to the application process for self-supply licences, [[Revised application process for Water Supply and Sewerage Licences limited to self-supply: a consultation](#)]. Reflecting the lessons we, applicants and other regulators involved in the application process have learnt from the first self-supply applications we have received and assessed, we are consulting on a revised application form and guidance document that is tailored to self-supply licence applications.

3. Estimating costs in relation to the water supply and sewerage licensing regime

This chapter sets out the currently estimated costs of Ofwat and CCWater in relation to the water supply and sewerage licensing regime for the 2018-19 financial year. Ofwat's and CCWater's costs are based on the respective draft forward work programmes that have been published for consultation. These estimates may change before we set licence fees.

3.1 Ofwat costs

The costs of Ofwat in relation to the water supply and sewerage licensing regime comprise:

- review of the Retail Exit Code (REC) to decide on appropriate protection for customers of exited firms after PR16 expires in March 2019;
- 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;
- enforcement work relating to WSSL licensees, including work relating to the Guaranteed Standards Scheme;
- some costs associated with casework relating to WSSL licensees (some of these costs are likely to relate to the behaviour of wholesalers or non-exited retailers);
- managing relationships with the market operator and other stakeholders involved in the water supply and sewerage licensing market;
- ongoing monitoring of the market to identify potential problems and help determine the appropriate responses, including the customer insight research we commission;
- reviews and studies into the market and targeted interventions where the evidence supports it; 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 market for business customers, and any external expenditure associated with our regulation of the market, for example specialist consultancy advice.

Our current estimate is that Ofwat's total costs of regulating the market will be £1.47m in 2018-19. In line with our current approach to setting licence fees, 50% of these costs would be allocated to the WSSL licensees and 50% to appointed water companies, giving a total estimated cost to the WSSL licensees for 2018-19 of £0.735m.

The estimated costs of £0.735m to the WSSL licensees for 2018-19 are higher than the estimated costs for WSSL licensees of £0.49m in 2017-18. The increase reflects the expansion in market activity, coming both from new and expanding market entrants, and from customers engaging in the market. They also reflect the fact that as the market starts to mature, our monitoring and liaison with industry is giving us clearer sight of areas where changes may be needed to ensure that the market operates as effectively as possible. This brings with it the need for increased activity as we investigate and make those changes.

These are indicative cost estimates which may change as we refine our planning for 2018-19.

3.2 CCWater costs

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

The costs of CCWater in relation to the water supply and sewerage licensing regime comprise:

- work associated with handling complaints and enquiries from business customers about the retail market and WSSL licensees;
- monitoring the WSSL regime, including receiving, analysing and publishing complaints data;
- policy support; and
- researching the views of business customers, and tracking their levels of awareness on the retail market.

CCWater estimates the total cost will be around £0.56m in 2018-19.

In line with our current approach to setting licence fees, 64% of these costs would be allocated to the WSSL licensees and 36% to appointed water companies, giving a total estimated cost to the WSSL licensees for 2018-19 of around £0.36m.

CCWater's estimated costs for 2018-19 of £0.36m are higher than those of £0.28m in 2017-18 due to the increase in complaints received by CCWater about WSSL licensees in 2017-18, the increase in retail market research, and to account for its increased budget in 2018-19. As the costs are estimated, the costs may change before Ofwat's and CCWater's licence fees are set.

If you have any queries about CCWater's estimated costs please contact the watchdog directly. Please e-mail marketreform@ccwater.org.uk.

4. Illustrative example of proposed approach to setting licence fees for WSSL licensees

We will calculate each WSSL licensee's market share using the wholesale charges for the previous financial year recorded and supplied to us by the market operator as at 31 March 2018 and the end of each subsequent financial year. Because we expect to issue invoices for licence fees by 30 April 2018, we will not be able to take into account any subsequent alterations that the market operator might make to its records after it has supplied wholesale charge information to us.

For each licence, the market share will be calculated as a proportion of the total wholesale charges to the WSSL licensees for whom we are setting licence fees. For example, the market share of a water supply licensee would be calculated as a proportion of the total market size in terms of wholesale charges to all water supply licensees and sewerage licensees other than self-supply WSSL licensees. The same method would apply for a sewerage licence.

As set out above, we are consulting on whether we should charge self-supply WSSL licensees a licence fee in 2019-20 and subsequent financial years.

In accordance with our current approach of calculating a fee using a flat fee element and a variable element, the fixed element will be set at a level that recovers 10% of the relevant estimated costs, based on the expected number of licences. Based on relevant estimated costs of £1.095m for Ofwat and CCWater, and assuming a total of 50 licences (both water supply licences and sewerage licences), this would mean a fixed element per licence of £2,190 and variable costs of £985,500 in total.

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

Table 2 - Illustrative example of proposed approach to setting licence fees for WSSL licensees

Component of estimate	Ofwat	CCWater
Estimated number of licences	50	50
Estimated costs payable by WSSL licensees	£735,000	£360,000

Total fixed element (set at 10%)	£73,500	£36,000
Fixed element per WSSL	£1,470	£720
Variable element (set at 90%)	£661,500	£324,000
Variable cost per % wholesale charges paid	£6,615	£3,240

Indicative fee for each licence (combined total for Ofwat and CCWater)	Fixed element	Variable element	Total element
15% market share	£2,190	£147,825	£150,015
5% market share	£2,190	£49,275	£51,465
2% market share	£2,190	£19,710	£21,900
1% market share	£2,190	£9,855	£12,045
Licence but no customers	£2,190	£0	£2,190

We recognise for a transparent process the importance of licensees being able to verify that the calculation of their licence fees is correct. We aim to share the information necessary for licensees to do this as far as is possible within the legal framework and subject to respecting commercial confidentiality.

5. Next steps

We are seeking feedback and comments on the proposals set out in this consultation, and invite comments no later than 23 March 2018.

We will reflect on comments received and notify our stakeholders of the approach to setting licence fees in April 2018, along with our final estimate of the licence fee for WSSL licensees. We expect to issue invoices for 2018-19 licence fees to WSSL licensees by 30 April 2018.

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