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Trust in water

# **Water Supply and Sewerage Licensing Regime: changes to how licence fees are set – summary of consultation responses and conclusions**

## About this document

This document summarises the responses we received to our consultation '[Water Supply and Sewerage Licensing Regime: Consultation on proposed changes to how licence fees are set](#)' which we published on 18 December 2018. It also sets out our consideration of those responses, our conclusions and our next steps.

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## 1. Introduction and executive summary of conclusions

We published ‘[Water Supply and Sewerage Licensing Regime: consultation on proposed changes to how licence fees are set](#)’ on 18 December 2018.

The consultation set out our proposed changes to the current approach to determining licence fees for water supply and/or sewerage licensees (**WSSL licensees**) and water and/or sewerage undertakers (**appointed water companies**).

Our first proposed change was to introduce licence fees for WSSL licensees limited to self-supply. We considered that introducing a fee for WSSL licensees limited to self-supply in order to recover the costs of Ofwat (and not CCWater) would be appropriate to:

- ensure there is no cross-subsidisation of WSSL licensees limited to self-supply by other non-household customers (in the fees paid for by WSSL licensees);
- recover costs from WSSL licensees limited to self-supply whilst also providing certainty and transparency on the costs; and
- minimise complexity, cost and uncertainty by proposing the same approach that we use to calculate annual fees for WSSL licensees.

We proposed that we use the same methodology that is currently used to calculate annual licence fees of other WSSL licensees except that we would exclude the Consumer Council for Water’s (**CCWater**) relevant costs.

The second proposal was to change the allocation of CCWater’s costs between WSSL licensees and appointed water companies’ to enable the percentage split of costs for 2019-20 and subsequent financial years to be adjusted year-on-year to reflect the nature of, and number of, complaints CCWater has received. It was proposed that the split to WSSL licensees would be made using the proportion of complaints that are about retail issues over the previous full three charging years plus the estimates of policy and research costs. This will mean that, going forward, costs would not be fixed at a split of 64% to WSSL licensees and 36% to appointed water companies.

Our consultation also set out the current estimate of our, and CCWater’s, total costs in relation to the water supply and sewerage licensing regime in 2019-20.

Our consultation closed on 21 January 2019 and we received 13 consultation responses, including:

- 6 responses from WSSL licensees;

- 6 responses from appointed water companies; and
- 1 response from a licensed infrastructure provider.

We have decided to proceed on the basis of the proposals set out in our consultation. By mid-March we intend to publish an updated Information Notice setting out the method we will use to allocate a fair proportion of costs to each appointed water companies and the general principles in accordance with which Ofwat will determine each WSSL licensee's licence fee. This updated notice will replace [Information Notice 18/13](#) which was published in June 2018.

This document is structured as follows.

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

In section 3, we set out other comments and issues that were raised in response to our consultation and our views on these.

In section 4, we provide our final estimates of our total costs in relation to the water supply and sewerage licensing regime in 2019-20, as well as the estimated costs of **CCWater**.

In section 5, we include an illustrative example for how licence fees are set. This is an updated version of the example we set out in our consultation.

Finally, in section 6, we set out next steps.

## 2. Summary of responses to our consultation questions

In our consultation, we asked the questions set out in the table below.

**Table 1 – Consultation questions**

Number	Question
1	Do you agree with our proposal to introduce licence fees for WSSL licensees limited to self-supply from 2019-20 and subsequent financial years to recover a contribution towards the costs of Ofwat (but not CCWater) on the same basis as for other WSSL licensees?
2	Do you agree with our proposal that the approach to allocating CCWater's costs between WSSL licensees and appointed water companies' should be changed to enable the percentage split of costs for 2019-20 and subsequent financial years to be adjusted year-on-year to reflect the nature of, and number of, complaints CCWater has received?

In the following sections we summarise the key points raised in the consultation responses we received and we set out our and CCWater's conclusions on the approach to setting WSSL licence fees.

## **2.1 Proposed change 1 – Issuing fees to licensees limited to self-supply**

### **a. What did we say in our consultation?**

We proposed the introduction of fees for WSSL licensees limited to self-supply to contribute towards Ofwat's regulatory costs in relation to the water supply and sewerage licensing regime from the next financial year (2019-20). In relation to Ofwat's costs, we consider that WSSL licensees limited to self-supply have benefitted, and will benefit, from Ofwat's regulatory work in relation to the business retail market.

We proposed that we use the same methodology that is currently used to calculate annual licence fees of other WSSL licensees after excluding CCWater's relevant costs. We propose that costs incurred by the CMA be allocated based on the same basis.

We proposed that any under-estimate or over-estimate of Ofwat's costs for years prior to 2019-20 will not be included in the licence fees for WSSL licensees limited to self-supply.

### **b. What did the responses say?**

One respondent offered no comment on this proposed change and the other twelve respondents agreed with our proposals and the rationale behind the changes.

One respondent noted that the licensing regime should be kept under review on a regular basis to ensure it adapts to market conditions.

### **c. What is our position?**

We are introducing fees for WSSL licensees limited to self-supply from the next financial year (2019-20) and invoices are expected to be issued for all WSSL licensees (including WSSL licensees limited to self-supply) in April 2019.

We will use the same methodology that is currently used to calculate annual licence fees of other WSSL licensees after excluding CCWater's relevant costs. Any relevant costs incurred by the CMA will be allocated among all WSSL licensees (including WSSL licensees limited to self-supply) based on the same principles and in accordance with the relevant condition detailed in the [Standard Licence Conditions](#) for water supply licences and sewerage licences. Any under-estimate or over-

estimate of Ofwat's costs for years prior to 2019-20 will not be included in the licence fees for WSSL licensees limited to self-supply.

## **2.2 Proposed change 2 - CCWater's fee split between WSSL licensees and appointed water companies**

### **a. What did we say in our consultation?**

We proposed to adjust the percentage split of CCWater's costs between WSSL licensees and appointed water companies, year-on-year from 2019-20 onwards, in order to fairly reflect the nature of, and number of, complaints CCWater has received over the previous three years, plus the estimates of policy and research costs. This proposed change will mean that, going forward, costs would not be fixed at a split of 64% to WSSL licensees and 36% to appointed water companies.

### **b. What did the responses say?**

Eleven respondents supported the proposed change and one did not support the proposal. Of those respondents that agreed overall with the proposed changes, several raised specific comments and questions.

One respondent would like to see the principle of allocating CCWater's costs based on level of previous complaints extended to individual WSSL licensees and appointed water companies i.e. calculating CCWater's fees based on each WSSL licensees' and appointed water company's complaint levels.

One respondent asked for clarity on CCWater's allocation of costs relating to mixed complaints that relate to both a WSSL licensee and an appointed water company. It suggested that a large proportion of complaints reaching Alternative Dispute Resolution (ADR) stage relate to an appointed water company only or have a significant wholesale element.

One respondent stated the benefits of being informed of the proposed adjustment to the percentage split of CCWater's costs between WSSL licensees and appointed water companies in December each year.

The respondent that did not support the proposal did so because it believed that a considerable number of complaints assigned to WSSL licensees are rooted in poor quality market data generated historically by appointed water companies. It suggested that only after industry data quality initiatives have been completed,

should the proposed adjustment to the percentage split of CCWater's costs between WSSL licensees and appointed water companies be considered.

### **c. What is our position?**

CCWater has considered the responses received about its proposal.

The suggestion to calculate its fees based on each individual WSSL licensees' and appointed water company's complaint levels (rather than for WSSL licensees and appointed water companies as a whole) would effectively be a regulatory charge as it would penalise trading parties based on complaints handling and performance. As the retail market is relatively new, and WSSL licensees are developing and learning to respond to market demands, Ofwat and CCWater do not feel it is appropriate to apply a fee based on complaint levels at this stage. Nor do we want to impose a regulatory charge by altering the fee process for appointed water companies. However, CCWater will continue to monitor complaints about the retail and monopoly market and both Ofwat and CCWater will keep the method for recovering CCWater's costs under review.

With regards to the allocation of costs for complaints, CCWater already identifies the complaint by category and assigns the complaint to a WSSL licensee or an appointed water company. Where the root cause of a complaint is clearly wholesaler related, the costs are assigned to appointed water companies. Using customer complaints over a three-year period to allocate CCWater's costs also smooths the effect of temporary rises and falls in complaint levels overall, and ensures a fair allocation of costs.

CCWater recognises the benefits of early information on the proposed adjustment to the percentage split of CCWater's costs between WSSL licensees and appointed water companies. In March or April each year, CCWater writes to WSSL licensees and appointed water companies about their licence fees, and will continue to do so. The letters will make clear the percentage split, and for WSSL licensees they will set out the relevant amount of CCWater's costs in terms of fixed and variable fee elements. In response to the request for early information, CCWater will endeavour to send additional letters to WSSL licensees with indicative costs and the estimated percentage split as soon as possible in each year. This will usually be in December and is subject to agreement of its Forward Work Programme and budget in March each year.

CCWater and Ofwat have considered the suggestion to wait until industry data quality initiatives have been completed before applying the proposed change to CCWater's costs allocation split. CCWater is concerned about the quality of market

data and the impact this is having on customer service in general. It notes that aging complaints may be rooted in poor data transfer pre-market opening, and is pressing trading parties to work together to resolve this issue as a matter of urgency. However, this is a wider market issue. Therefore, Ofwat and CCWater consider that it is not appropriate to wait until the quality of market data is improved to apply the proposed approach to the split of fees. Using customer complaints over a three-year period to allocate CCWater's costs smooths the effect of rise and fall in complaint levels overall.

The percentage split of CCWater's costs will be adjusted between WSSL licensees and appointed water companies, year-on-year from 2019-20 onwards. This will reflect the nature of, and number of, complaints it has received over the previous three years, plus the estimates of policy and research costs. For 2019-20 this will mean that 66% of costs will be allocated to the WSSL licensees and 34% to appointed water companies. Further details on the breakdown of the costs can be found in section 3.2.

### **3. Estimated costs**

Following on from our consultation, this section sets out the final estimated costs of Ofwat and CCWater in relation to the water supply and sewerage licensing regime for the 2019-20 financial year. We expect to use these estimates to set licence fees.

If we either underestimate or overestimate the costs of Ofwat and/or CCWater then we will adjust the annual licence fee in a subsequent financial year to take account of any such variances in the previous financial year(s), as required by Condition 9(5) of Part A of the WSSL standard conditions. This will ensure that the regulatory costs continue to be appropriately allocated between WSSL licensees and appointed water companies in the appropriate proportions.

#### **3.1 Ofwat costs**

As set out in our consultation, we have 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 final estimate is that Ofwat's total costs of regulating the market will be £1.06m in 2019-20. In line with our current approach to setting licence fees, 50% of these costs will be allocated to the WSSL licensees and 50% to appointed water companies, giving a total estimated cost to the WSSL licensees for 2019-20 of £0.53m.

These are our final cost estimates which we will use to issue fees for 2019-20. We set out the breakdown below.

**Table 2 – Ofwat estimated costs**

<b>Activity</b>	<b>Cost</b>
1) Codes, licensing, customer complaints and enquiries	£275,076
2) Policy, including the Retail Exit Code	£311,347
3) Monitoring, programme management, and engagement including Open Water	£557,125
<b>Sub total</b>	<b>£1,143,548</b>
Minus expected WSSL application fee income	<b>£81,000</b>
<b>Total</b>	<b>£1,062,548</b>

### 3.2 CCWater's costs

CCWater's costs 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 water supply and sewerage licensing 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.

A breakdown of the costs for each activity is shown in Table 3 below. Whilst costs relating to handling complaints and enquiries, and monitoring the retail market, will rise and fall depending on the number of complaints received by CCWater, policy costs relating to the work of the CCWater policy team are expected to be relatively constant. Research costs relate to the actual CCWater spend on research about the water supply and sewerage licensing regime in the relevant year. These costs will vary depending on the nature and number of engagement activities carried out.

CCWater's estimate of the total cost for the water supply and sewerage licensing regime will be around £0.58m in 2019-20.

In line with the approach to setting licence fees, whereby the split will be annually adjusted to fairly reflect the number of complaints that are about retail issues and the number of complaints that are about wholesale issues, in 2019-20 66% of these costs will be allocated to the WSSL licensees and 34% to appointed water companies.

The total estimated cost to the WSSL licensees for 2019-20 will be around £0.38m.

**Table 3 – CCWater estimated costs for 2019-20**

<b>Activity</b>	<b>Cost Allocation</b>	<b>Retail %</b>	<b>WSSL Licence Fee</b>
Handling complaints and enquiries	£290,380	63%	£184,038
Monitoring the WSSL regime	£161,207	63%	£101,537
Policy support	£80,000	60%	£48,000
Research	£45,000	100%	£45,000
<b>Total</b>	<b>£575,587</b>	<b>66%</b>	<b>£378,575</b>

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

We thought it would be helpful to set out an illustrative example of how we will set licence fees for 2019-20 based on the estimated costs set out in section 4 and the current number of licences.

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 (MOSL) as at 31 March 2019 and the end of each subsequent financial year<sup>1</sup>. 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 WSSL licence, the market share will be calculated as a proportion of the total wholesale charges to the WSSL licensees who are contributing to the relevant costs. For example, in relation to Ofwat's costs 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. The same method would apply for a sewerage licensee.

In accordance with our current approach of calculating, the fee has a flat 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 current number of licences whose holders will be contributing to the relevant costs<sup>2</sup>.

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

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<sup>1</sup> The wholesale charges provided by the market operator will be based on the R1 settlement report.

<sup>2</sup> The current list of WSSL licences is available on our website: <https://www.ofwat.gov.uk/regulated-companies/ofwat-industry-overview/licences/#wssl>

**Table 4 - Illustrative example of proposed approach to setting fees for WSSL licensees**

<b>Component of estimate</b>	<b>Ofwat</b>	<b>CCWater</b>
Current number of licences	77	59
Estimated costs payable by WSSL licensees	£531,274	£378,575
Total fixed element (set at 10%)	£53,127	£37,858
Fixed element per WSSL (water and sewerage combined)	£690	£642
Variable element (set at 90%)	£478,147	£340,718
Variable cost per % wholesale charges paid	£4,781	£3,407

Tables 5 and 6 illustrate the approximate fees per licence. If a WSSL licensee holds two licences (one for water and one for sewerage), the fixed fee element presented below will be multiplied by two.

**Table 5 - Illustrative example of total fees for a WSSL licence other than a WSSL licence limited to self-supply**

<b>Indicative fee for each licence (Ofwat and CCWater)</b>	<b>Fixed element</b>	<b>Variable element</b>	<b>Total element</b>
15% market share	£1,332	£122,830	£121,161
5% market share	£1,332	£40,943	£42,275
2% market share	£1,332	£16,377	£17,709
1% market share	£1,332	£8,189	£9,520
Licence but no customers	£1,332	0	£1,332

**Table 6 - Illustrative example of total fees for a WSSL licence limited to self supply**

Indicative fee for each licence (Ofwat costs)	Fixed element	Variable element	Total element
2% market share	£690	£9,563	£10,253
1% market share	£690	£4,781	£5,471
Licence but no customers	£690	0	£690

The market share calculations for the costs of Ofwat and CCWater will have minor differences, as Ofwat’s costs are applicable to all licence holders while CCWater’s costs are not applicable to self-supply licensees. The fees for Ofwat and CCWater will be calculated separately before consolidating them in a single invoice for each licence. At present the market share of self-supply licensees is low, so the variable fee elements in Table 6 above provide a good indication of a typical fee.

Table 7 illustrates estimated fees for:

- A WSSL Licensee that holds WSSLs for providing water and sewerage services and has 1% market share; and
- A WSSL Licensee that holds water and sewerage WSSLs limited to self-supply and has 1% market share.

**Table 7 - Illustrative example of total fees for a company providing both water and sewerage services that has 1% market share**

Indicative fee for a company holding one water and one sewerage WSSL	Fixed element	Variable element	Total element
WSSL not limited to self-supply, 1% market share	£2,663	£8,189	£10,852
WSSL limited to self-supply, 1% market share	£1,380	£4,781	£6,161

We recognise the importance of licensees being able to verify that the calculation of their licence fees is correct for a transparent process. 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 have set out in this document our views on the principles to be applied to the structure of the WSSL licence fee. We have decided to proceed on the basis of the proposals set out in our consultation. In mid-March 2019, we intend to publish an updated Information Notice setting out the method we will use to allocate a fair proportion of costs to each appointed water companies and the general principles in accordance with which Ofwat will determine each WSSL licensee's share of costs and any under-estimate or over-estimate.

For 2019-20, we expect to issue invoices for licence fees to WSSL licensees and appointed water companies in April 2019.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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