

December 2018

Trust in water

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

About this document

This document sets out our proposed changes to how we will set licence fees for water supply and/or sewerage licensees and water and/or sewerage undertakers 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 the current estimate of our, and the Consumer Council for Water's (**CCWater**), total costs in relation to the water supply and sewerage licensing regime in 2019-20.

We are seeking the views of all interested parties and welcome responses to this consultation by 21 January 2019.

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Responding to this consultation

We welcome your responses to this consultation by 21 January 2019. We would particularly welcome your views in response to the questions we have set out in the relevant sections of this document. 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:

Laura Clougher
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Centre City Tower
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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 Freedom of Information Act 2000 (**FoIA**), the Environmental Information Regulations 2004 and, where relevant, data protection legislation.

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.

1. Background

Water supply and/or sewerage licensees (**WSSL licensees**) and water and/or sewerage undertakers (**appointed water companies**) are required 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**).

This requirement is set out in Condition 9 (Licence fees) of Part A of the [standard conditions of water supply and sewerage licences](#) for WSSL licensees and in Condition N (Fees) of their appointments (**licences**) for appointed water companies.

The costs of Ofwat and CCWater in relation to the business retail market are shared between WSSL licensees and appointed water companies.

We have previously set out¹ that our objectives for setting licence fees for WSSL licensees are to recover each WSSL licensee's share of 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.

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 the [Information notice 18/13 – Licence fees for water companies and WSSL licensees](#) published in June 2018. They are that:

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

1. Licence fees will be based on (i) a flat fee element per licence² and (ii) a variable element based on market share that will reflect the bulk of costs.
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 will be charged to that licensee until the next financial year. The first licence fee then payable by such licensees will reflect a share of any under-estimate of the costs for the previous 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 licensees³ 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.

The allocation of costs between appointed water companies must be done in accordance with the method that has been disclosed to appointed water companies. The current method is set out in Part A of [Information notice 18/13 – Licence fees for water companies and WSSL licensees](#).

This consultation sets out our proposed changes to the current approach to determining WSSL licensees' fees and to sharing the costs of CCWater in relation to the business retail market between WSSL licensees and appointed water companies.

Apart from the proposed changes on the sharing of the costs of CCWater in relation to the business retail market, we are not proposing any changes to how we currently determine licence fees for appointed water companies. However, we will also update the description of our method where appropriate to reflect the changes to Condition

² Water supply licences and sewerage licences are counted separately because not every WSSL licensee holds both licences.

³ A WSSL licensee limited to self-supply (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.

N (Fees) [we proposed in September 2018](#) as part of our licence simplification work and to improve clarity.

For 2019-20, we expect to issue invoices for licence fees to WSSL licensees and appointed water companies in April 2019, after we have finalised any changes to our general principles following consideration of the responses to this consultation.

2. Proposed change 1 - Issuing fees to licensees limited to self-supply

In this section, we set out our proposals to start setting licence fees to WSSL licensees limited to self-supply. Our current approach for WSSL licensees limited to self-supply is that they are not charged a licence fee.

In our [June 2018 summary of response and decision document](#) we stated that we were minded to introduce licence fees for this customer group and wanted to consider further the form such fees should take and consult further before making changes. The vast majority of responses were supportive of having licence fees for WSSL licensees limited to self-supply.

We have taken all of the responses to the March 2018 consultation we received into account and used them to help inform our proposals.

We now propose the introduction of such fees to contribute towards Ofwat's regulatory costs in relation to the water supply and sewerage licensing regime from the next financial year (2019-20).

Given that a WSSL licensee limited to self-supply 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 WSSL licensees limited to self-supply a fee; however, it will continue to keep this under review. We agree with that position.

Our regulatory work impacts all types of industry participants and WSSL licensees limited to self-supply are having a more significant market presence than our initial expectations.

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. Examples of this include our work on the market codes that govern the retail market and our work with appointed water companies (as wholesalers) and their provision of services to WSSL licensees.

It is important to note that there is a higher than originally expected interest by organisations in the self-supply business model. To date⁴, there are eight WSSL [licensees limited to self-supply](#) operating in the market and we are assessing a

⁴ As at 26 November 2018.

further application to become a WSSL licensee limited to self-supply. We expect further applications for self-supply throughout this financial year and the next.

Ofwat's work to monitor and help ensure the market is working well for this group of licence holders has increased and we expect it to continue to do so going forward. This is why we consider it appropriate to start setting licence fees to WSSL licensees limited to self-supply.

We consider that introducing a fee for WSSL licensees limited to self-supply is appropriate and in line with our objectives for the charging regime in that it:

- ensures 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);
- recovers costs from WSSL licensees limited to self-supply whilst also providing certainty and transparency on the costs; and
- minimises complexity, cost and uncertainty by proposing the same approach that we use to calculate annual fees for WSSL licensees.

We propose 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 consider this to be a transparent and proportionate approach that is in line with our objectives for setting fees. This approach would strike the right balance between having a simple and transparent regime that is proportionate to introduce and maintain, and a regime that is appropriate for all types of WSSL licensees (including those limited to self-supply).

In Table 1, we have used last years' costs for Ofwat to create examples of licence fee estimates. Ofwat's total WSSL costs for the current financial year (2018-19) were estimated to be £1,150,000, half of which are recovered from WSSL licensees and the other half from appointed water companies. The table below illustrates the fixed element of the annual licence fee and the variable element per one percent market share of wholesale revenues. The market share data we have used for the calculations is for April 2018-September 2018.

We have also estimated the total fee for a WSSL licensee, where:

- the total fee is based on the status quo (Estimate 1); and
- the total fee includes introducing fees for WSSL licensees limited to self-supply (Estimate 2).

We have taken the following steps and assumptions for the estimates of the total fee for a WSSL licensee:

- Starting point: assume the WSSL licensee has 1% market share under the status quo (Estimate 1 - WSSL licensees limited to self-supply remaining exempt from licence fees). The market share calculation excludes WSSLs limited to self-supply as they are not charged a licence fee;
- Change in fixed fees: the WSSL licensees will face a lower fixed fee element under estimate 2 compared to the status quo, as there will be more licence holders in total to which the costs will be allocated under that approach;
- Change in variable fees: the variable fee element for the WSSL licensees will also decrease under estimate 2 compared to the status quo. This is due to the fact that WSSLs limited to self-supply are included in the market share calculations under that option. In effect, as for the fixed element, the costs recovered by the variable fee element will be allocated to a greater number of licence holders. So, for the WSSL licensee that has 1% market share under option 1, the market share would fall to 0.99% under option 2.
- Number of licences: assume the WSSL licensees hold 2 licences each.

Table 1: Illustrative WSSL fee estimates (excluding CCWater costs)

	Estimate 1: Status quo	Estimate 2: Introducing fees for self-suppliers
Number of licences	60	76
Estimated costs (Ofwat)	£575,000	£575,000
Total fixed element (set at 10%)	£57,500	£57,500
Fixed element per WSSL	£958	£757
Variable element (set at 90%)	£517,500	£517,500
Variable cost per 1% wholesale charges paid	£5,175	£5,175
Market share for a WSSL licensee that has a 1% market share under the status quo.		0.99%
Total cost of a WSSL licensee holding two licences	£7,092	£6,638

Please note annual licence fees for WSSL licensees other than WSSL licensees limited to self-supply will be higher than the numbers given in the table above because they will include a contribution towards the costs of CCWater as well as Ofwat.

Under our proposal to introduce licence fees for self-suppliers (Estimate 2), we estimate that the largest self-supply organisations in terms of wholesale revenues would face Ofwat fees of about £3,500 in total (including both fixed and variable elements for water and sewerage licences). We note that those fees would decrease over time on a unit basis, as more WSSL licensees and WSSL licensees limited to self-supply enter the market.

In Table 1 under Estimate two, we have set out estimated costs if there are sixteen more licences to which fees will be allocated. This would translate into a reduction in both fixed and variable fees for retailers compared to the status quo. The fixed fee element would decrease by about £400 for a retailer that holds a licences for both water and sewerage. The variable fee component for those organisations would decrease by about £50 per one percent of market share of wholesale revenues (combined water and sewerage fee).

We have estimated that the total licence fee for a retailer that has one percent market share and both water and sewerage licences would be about £450 lower if we introduce fees for WSSL licensees limited to self-supply.

We note that the effect on fees for retailers is likely to become more pronounced over time, if we decide to introduce annual fees for WSSL licensees limited to self-supply. We expect the market share WSSL licensees limited to self-supply to double over the course of next financial year – increasing from approximately 1% to 2%. Given the continuing interest in the self-supply business model, it is likely that over time those types of licensees may represent an increasing proportion of the business retail market.

We propose that costs incurred by the CMA will be based on the same principle and condition detailed in the [Standard Licence Conditions](#) for WSSL licensees and WSSL licensees limited to self-supply.

We propose 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.

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?

3. Proposed change 2 – CCWater’s fee split between WSSL licensees and appointed water companies

CCWater’s costs in relation to the retail market are shared between WSSL licensees and appointed water companies. In the first two years following market opening, 10% of its relevant costs were allocated to the WSSL regime. This was based on the percentage of non-household (NHH) customer complaints it received as a proportion of all complaints over the previous three-year period from April 2014 to March 2017 and an assumed increase in complaints due to the new market. This approach is set out in the March 2017 [‘Water Supply and Sewerage Licensing Regime: consultation on setting licence fees – summary of consultation responses and next steps’](#).

Using customer complaints over a three-year period to allocate CCWater’s costs is considered to be appropriate to smooth changes, whilst still apportioning costs fairly between WSSL licensees and appointed water companies.

CCWater will continue to allocate relevant costs based on the percentage of NHH customer complaints as a proportion of all complaints it receives over the previous three-year period. For 2019-20 charges, this period spans from April 2015 to March 2018, resulting in 12% of its relevant costs.

In both 2017-18 and 2018-19, 64% of CCWater’s relevant costs for the water supply and sewerage licensing regime were allocated to WSSL licensees and 36% to appointed water companies. This was based on its analysis of the nature of the complaints data over the three-year period from April 2014 to March 2017 and estimates of policy and research costs. Whilst costs relating to handling complaints and enquiries, and monitoring the retail market, will rise and fall depending on the number of complaints received, policy costs relating to the work of the CCWater policy team are relatively fixed. 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.

To date⁵, NHH complaints in 2018-19 are proportionately higher than in previous years. In addition to the increase in NHH complaints as a proportion of all complaints, those regarding retail issues, rather than wholesale issues, have increased in 2018-19. In order to fairly reflect this shift, CCWater has proposed that the percentage split of costs between WSSL licensees and appointed water companies should be adjusted year-on-year from 2019-20 onwards. It is proposed that the split to WSSL licensees will be made using the proportion of complaints that

⁵ As at 12 December 2018.

are about retail issues over the previous full three years complaints data plus the estimates of policy and research costs. This will mean that, going forward, costs will not be fixed at a split of 64% to WSSL licensees and 36% to appointed water companies. Instead, it is proposed that costs should be allocated on the following basis:

Handling complaints and enquiries	WSSL licensees: percentage of complaints about retail issues in the relevant three-year period Appointed water companies: percentage of complaints about wholesale issues in the relevant three-year period
Monitoring the WSSL regime	
Policy support	Allocated to WSSL licensees and appointed water companies based on policy support for the retail market
Research	All relevant costs associated with research into the retail market allocated to WSSL licensees

In line with the proposed 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 approximately 66% of these costs will be allocated to WSSL licensees and approximately 34% to appointed water companies.

Each year the percentage split of CCWater's fees will be clearly communicated to WSSL licensees and appointed water companies before invoices are despatched. For example, CCWater writes to WSSL licensees and appointed water companies about their licence fees each year. The letters will make clear the percentage split and the relevant amount of CCWater's costs, in terms of fixed and variable fee elements, for each WSSL licensee.

Question 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?

3.1 Ofwat's allocation of costs

Ofwat's costs in relation to the business retail market are shared between WSSL licensees and appointed water companies. 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.

Given the nature of our regulatory work, we have been recovering 50% of our costs related to the business retail market through WSSL licensees and 50% through appointed water companies. Having reviewed the costs for the first 18 months in the market, we consider Ofwat's split of costs to remain reflective of the work.

4. Appointed water companies that have not exited the non-household retail market

In response to our [March 2018 consultation](#), one respondent suggested that appointed water companies that have not exited the non-household retail market should pay a contribution towards the costs of Ofwat and CCWater that are allocated to WSSL licensees as they were still serving their non-household customers. The respondent noted that, originally, almost all appointed water companies had indicated their intention to exit either at market opening or shortly afterwards, meaning that over 98% of the market would be served by WSSL licensees. However, in March 2018 three of the largest English appointed water companies⁶ still served non-household customers.

Our current approach is that appointed water companies whose areas are wholly or mainly in England contribute towards the costs of Ofwat and CCWater in relation to the business retail market. For example, 50% of Ofwat's relevant costs are allocated to those appointed water companies (the rest being allocated to WSSL licensees).

Our [June 2018 consultation response document](#) was clear that we did not propose to make any changes to how we set licence fees for appointed water companies for 2018-19. We said that Ofwat and CCWater would keep our position under review and consider this issue before we set licence fees for 2019-20.

Having reviewed our position, we do not propose changing our current approach at this time. We consider changing how licence fees are set would introduce additional complexity in relation to the calculation of licence fees and is not a proportionate change. The reason for this is that the number of English appointed water companies that have not exited the non-household retail market is declining. Of the three largest appointed water companies that operated in the non-household retail market, only one now remains as Severn Trent Water Limited and South East Water Limited exited in 2018-19⁷.

⁶ Severn Trent Water Ltd, South East Water Ltd and Yorkshire Water Services Ltd

⁷ See Defra's [list of relevant undertakers with permission to exit the non-household retail market](#). South East Water Limited exited the non-household retail market on 1 May 2018 and Seven Trent Water Limited did so on 1 July 2018

5. Estimating costs in relation to the water supply and sewerage licensing regime for 2019-20

This section sets out the currently estimated costs of Ofwat and CCWater in relation to the water supply and sewerage licensing regime for the 2019-20 financial year. Ofwat's and CCWater's costs are based on the respective draft forward work programmes. These estimates may change before we set licence fees.

In our summary of responses document (expected to be published in February 2019) we intend to set out illustrative examples of indicative fees, based on Ofwat's and CCWater costs, for appointed water companies and WSSL licensees with different percentages of market share.

5.1 Ofwat costs

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 current estimate is that Ofwat's total costs of regulating the market will be in the region of £1m in 2019-20. 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 2019-20 of £0.5m.

These are indicative cost estimates which may change as we refine our planning for 2019-20.

5.2 CCWater 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 2 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 the work of the CCWater policy team are relatively fixed. 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 estimates the total cost for the water supply and sewerage licensing regime will be around £0.58m in 2019-20.

In line with its proposed 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 approximately 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 2: CCWater estimated costs for 2019-20

Cost	Cost Allocation	Retail %	WSSL Licence Fee
Handling complaints and enquiries	£290,000	63%	£184,000
Monitoring the WSSL regime	£161,000	63%	£102,000
Policy support	£80,000	60%	£48,000
Research	£45,000	100%	£45,000
Total	£576,000	66%	£379,000

CCWater’s estimated costs for 2019-20 of £0.38m are higher than those of £0.36m in 2018-19 due to the increase in complaints received by CCWater, and to account for its proposed increased budget in 2019-20.

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.

6. Next steps

We are seeking feedback and comments on the proposals set out in this consultation, and invite comments no later than 21 January 2019.

We will reflect on comments received and expect to notify our stakeholders of the approach to setting licence fees in February 2019, along with an update on the estimate of the licence fee for WSSL licensees and WSSL licensees limited to self-supply. We expect to issue invoices for 2019-20 licence fees to WSSL licensees by 30 April 2019.

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

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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