
Reasons for the modifications to Condition B of the licences of the 17 largest water companies

Introduction and background

This notice explains the background and reasons for the modifications that the Water Services Regulation Authority (**Ofwat**) has made to Condition B of the appointments (**licences**) of the 17 largest water companies¹ with effect from 10 November 2019. These modifications have been made under section 13 of the Water Industry Act 1991 (**WIA91**), with the agreement of the companies concerned.

Modifications applying to all 17 of the largest water companies

Following the notice of [the proposal published on 18 July 2019](#) (issued under section 13 of the WIA91), this notice confirms that Ofwat has modified Condition B of the licences of the 17 largest water companies to:

- enable water companies to levy charges to recover shortfalls in revenue in previous charging years, as long as those shortfalls are calculated in accordance with a formula set out by Ofwat (for the 2020-25 period this will be the Revenue Forecasting Incentive (**RFI**)); and
- make clear, for the avoidance of doubt, that our 2019 price review (**PR19**) final determinations can set the opening revenue allowances in the price controls for network plus activities.

The wording of the modifications is the same as that set out in the notice of the proposal.

The modifications have been made for 11 companies holding appointments as both water and sewerage undertakers:

- Anglian Water Services Limited, Dwr Cymru Cyfyngedig, Hafren Dyfrdwy Cyfyngedig, Northumbrian Water Limited, Severn Trent Water Limited, Southern Water Services Limited, South West Water Limited, Thames Water

¹ By “water companies” we mean companies holding appointments as water undertakers and/or sewerage undertakers under the Water Industry Act 1991.

Utilities Limited, United Utilities Water Limited, Wessex Water Services Limited and Yorkshire Water Services Limited.

The modifications have also been made for 6 companies that only hold appointments as water undertakers:

- Affinity Water Limited, Bristol Water plc, Portsmouth Water Limited, South East Water Limited, South Staffordshire Water plc and Sutton and East Surrey Water plc.

Modifications applying only to Hafren Dyfrdwy Cyfyngedig

Following the notice of [the separate proposal published on 18 July 2019](#) (issued under section 13 of the WIA91), this notice also confirms that Ofwat has at the same time also modified Condition B of the water and sewerage licences of Hafren Dyfrdwy Cyfyngedig (**Hafren Dyfrdwy**) to ensure that:

- Performance Measure Adjustments (or in-period outcome delivery incentives (**ODIs**)) can be set for Hafren Dyfrdwy, in the same way as they can be set for other water companies for whom we set price controls; and
- Condition B contains the same wording in its water licence and its more recent (2018) sewerage licence.

The wording of the modifications is the same as that set out in the notice of the proposal.

What licence modifications have we made and why have we made them?

Revenue Forecasting Incentive

We have amended the licences of the relevant water companies so that it is clear that water companies can levy charges to recover shortfalls in revenue in previous charging years that are calculated in accordance with the RFI (or an equivalent formula in future price control periods), despite the limits in relation to charges or revenue that we may set in future price controls for wastewater network plus, bioresources, water network plus and water resources activities.

Ofwat needs to notify the formula for each price control period (and the charging years in which shortfalls could be recovered) to each water company by no later than 31 December in the price review year (i.e. by 31 December 2019 for PR19). The modification will not apply if Ofwat does not notify a formula to a water company.

Where the price controls that Ofwat has determined at a price review are referred to the Competition and Markets Authority (**CMA**), the CMA will be able to make changes to any formula that Ofwat had notified to the water company for that price control period.

We have made this change because it will enable companies to correct revenue forecasting errors more quickly than would be possible without a licence modification. Companies will be able to make good under-recoveries of revenue during the 2020-25 period. Companies may experience a small, but meaningful penalty if there is a significant imbalance between the relevant allowed and actual revenues.

We consider that it is appropriate to allow companies to 'true-up' for under- or over-recovered revenues during price control periods, rather than at the end of the review period, to help smooth changes in customer bills.

Making a modification that applies to future control periods, rather than just the 2020-25 period, reduces the need for future licence changes. This reflects our planned approach as set out in our PR19 final methodology.

Some water companies have made representations about the proposed RFI formula that we published alongside the non-fast track companies' draft determinations, and the proposed licence modification, on 18 July 2019. As explained above, the actual RFI formula for the 2020-25 period is not included in the licence and will be notified to companies when we make our final determinations of price controls. Consequently, we have not altered the licence modification in light of these points, but they are being considered as part of the process for setting our final determinations of price controls and the RFI formula.

Opening revenue allowances for network plus activities

At PR19 Ofwat will, for the first time, set separate price controls for activities that are currently covered by price controls for wholesale water and, for water and sewerage companies, wastewater activities. Wholesale water activities will be covered by separate price controls for network plus water activities and water resources activities. Wholesale wastewater activities will be covered by separate price controls for network plus wastewater activities and bioresources activities.

The network plus controls must, in accordance with Condition B (Charges), be in the same form as the existing controls for wholesale activities. That means inflation plus or minus K controls that limit the percentage change in the charges to be levied by and/or revenue allowed to the regulated business in each charging year in respect of the activities concerned. In accordance with our PR19 methodology we will set controls that limit changes in the revenue allowed to the regulated business in respect of the activities concerned.

We have amended the licences of the relevant water companies to make clear, for the avoidance of doubt, that when setting the first network plus price controls at PR19 Ofwat can set the opening revenue allowances for network plus water and wastewater activities (as well as limits on the change in the revenue allowed to the regulated business in each charging year in respect of those activities).

We have made this change because it makes clear, for the avoidance of any possible doubt, that Ofwat has the power to set the opening revenue allowances when setting the first network plus price controls at PR19.

Modifications applying only to Hafren Dyfrdwy

Modifications have been made to Condition B of Hafren Dyfrdwy's water and sewerage licences to allow the company's price controls to change between price reviews to reflect ODI outperformance and underperformance payments. These payments will reflect the company's performance against specific performance commitments set out at a price review.

We have made these changes to ensure that in-period ODIs can be set for the 2020-25 period (and subsequent price control periods). Our PR19 methodology encourages water companies to make more of their performance commitments subject to in-period assessment of ODIs rather than end-of-period. In-period ODIs can provide a more immediate, and more visible, incentive to companies to improve their performance, by linking their outperformance and underperformance payments more closely in time to the performance that generated them, as opposed to reconciling them at the following price review. This in turn will lead to better performance and greater benefits for customers.

The changes also ensure consistency with the conditions of all the other water companies for whom we currently set price controls

We have also made modifications to Condition B of Hafren Dyfrdwy's water and sewerage licences to ensure that they have common wording. We have done so in the interests of clarity, simplicity and consistency. It is the standard approach for other companies that are water and sewerage undertakers – each of which currently also have common wording for their own versions of Condition B.