

June 2022

Proposal to modify the regulation fee cap in Condition N of water company licences

About this document

The Water Services Regulation Authority (Ofwat) is mainly funded by licence fees paid by appointed water companies¹ and there is a cap on the level of those fees in Condition N of water companies' appointments (licences). This document sets out proposed changes to the regulation fee cap in Condition N to ensure that the budget agreed with HM Treasury as part of the 2021 Comprehensive Spending Review (CSR) can be funded and to future-proof the fee cap.

¹ By "water companies" we mean companies holding appointments as water undertakers and/or sewerage undertakers under the Water Industry Act 1991. This includes regional water and sewerage companies, water only companies and small water companies created under the new appointments and variations (NAV) framework.

Executive summary

Ofwat is mainly funded by licence fees paid by water companies and there is a cap on the level of those fees in Condition N of water companies' licences. When Ofwat was originally established in 1989 it was not part of the UK Government's process for setting central government expenditure. From 2015 Ofwat's budget limit has been scrutinised and set by HM Treasury through the Comprehensive Spending Review (CSR) process. This has set a spending limit for Ofwat's budget that is separate from, and can be different to, the regulation fee cap in Condition N.

In recent years we have taken on additional regulatory functions that have been subject to business case justification through the CSR process based on the outcomes and benefits that we are delivering for customers, society and the environment. For example, our work in the business retail market, in delivering Direct Procurement for Customers (DPC), establishing our Wales office, expanding our role in relation to the environment and in establishing the Regulators' Alliance for Progressing Infrastructure Development (RAPID) to enable longer term infrastructure schemes to be progressed faster. We have secured agreement for budget increases to fund this additional work. Aside from increases to reflect these roles, our budget remains flat in nominal terms, which means Ofwat is required to absorb increases due to inflation through efficiency gains. We note that this will be more challenging with increasing inflation rates.

However, the regulation fee cap formula in Condition N has become outdated because the formula only assumes inflation adjustments to historical budgets, rather than specific adjustments for new projects or regulatory activities. We signalled our intention to revisit this cap in 2019 and agreed to wait until a multi-year CSR was agreed, which concluded late last year. We are therefore consulting on proposed changes to the regulation fee cap to ensure that the budget already agreed with HM Treasury can be funded and to future-proof the fee cap.

There are various ways we could change and simplify the cap to ensure we are able to recover fees in line with what is agreed as the cost of regulation through the CSR. Our preferred option is to replace the historical formula with a new cap that aligns with the decisions made by the Treasury through CSR processes about how much Ofwat can spend. This consultation seeks views on the proposal and asks:

1. Do you agree with the principle of changing the regulation fee cap to ensure that the budget agreed with the Treasury can be funded?
2. Do you agree with the option for changing the regulation fee cap that Ofwat proposes and, if not, which alternative option would you prefer if the regulation fee cap is changed?
3. Do you have any comments on the draft wording for the proposed new regulation fee cap set out in the box in section 2.1?

Responding to this consultation

We would welcome any comments on this document. Please email them to OfwatPandO@ofwat.gov.uk:

The closing date for this consultation is 12 July 2022.

We intend to publish responses to this informal consultation document on our website at www.ofwat.gov.uk. Subject to the following, by providing a response to this consultation you are deemed to consent to its publication.

If you think that any of the information in your response should not be disclosed (for example, because you consider it to be commercially sensitive), an automatic or generalised confidentiality disclaimer will not, of itself, be regarded as sufficient. You should identify specific information and explain in each case why it should not be disclosed and provide a redacted version of your response, which we will consider when deciding what information to publish. At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons why the contents of those written responses remain confidential.

In relation to personal data, you have the right to object to our publication of the personal information that you disclose to us in submitting your response (for example, your name or contact details). If you do not want us to publish specific personal information that would enable you to be identified, our [privacy policy](#) explains the basis on which you can object to its processing and provides further information on how we process personal data.

In addition to our ability to disclose information pursuant to the Water Industry Act 1991, information provided in response to this consultation, including personal data, may be published or disclosed in accordance with legislation on access to information – primarily the Freedom of Information Act 2000 (FoIA), the Environmental Information Regulations 2004 (EIR) and applicable data protection laws. Please be aware that, under the FoIA and the EIR, there are statutory Codes of Practice which deal, among other things, with obligations of confidence. If we receive a request for disclosure of information which you have asked us not to disclose, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

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1. Case for Change

Ofwat is mainly resourced by licence fees – the Annual General Fee and any necessary Special Fee charged to each water company in each year.² These licence fees are subject to the regulation fee cap described in paragraphs N13 to N16 of Condition N of water companies' licences (the wording of Condition N is set out in the Appendix). The cap includes two elements and, in summary, means that the total amount of all Annual General Fees and Special Fees payable by water companies in a five-year period³ cannot exceed:

- a fixed amount based on historical costs for each year that increases in line with inflation (CPIH being the relevant measure used since 2020); and
- a percentage of each water company's average annual regulated business turnover in the prior five-year period.⁴

When Ofwat was originally established in 1989 it was not part of the UK Government's process for setting central government expenditure. From 2015 Ofwat's budget limit has been set by HM Treasury through the Comprehensive Spending Review (CSR) process, which sets a spending limit for Ofwat's budget that is separate from, and can be different to, the regulation fee cap in Condition N.

Spending reviews are led by HM Treasury, and normally set multi-year budgets for departments and arms-length bodies in line with priority outcomes⁵. Our medium-term financial plan and initial CSR submissions are scrutinised and challenged internally through the Board and Audit Committee before being submitted to HM Treasury. These are subsequently reviewed by a spending team in the Treasury before the submissions are sent to HM Treasury ministers, who undertake negotiations and agree final settlements.

The issue in relation to the wording of the existing licence condition fee cap is the underlying assumption that the future looks very much like the past. However, this is not the case because in recent years Ofwat has taken on additional regulatory functions. As part of the CSR we have secured agreement for budget increases to set up RAPID on behalf of other regulators, and for our work on the environment, DPC projects and establishing our Wales office. This means that the regulation fee cap formula in Condition N has become outdated, failing to keep up the costs of additional work and therefore creating tension between what is

² Other regulated entities also pay licence fees but are only required to contribute towards specific Ofwat costs. Retailers in the business retail market (water supply and/or sewerage licensees) pay their share of our costs in relation to the water supply and sewerage licensing regime and the licensed infrastructure provider for the Thames Tideway Tunnel pays for our costs in relation the regulation, monitoring and enforcement of the infrastructure provider.

³ The current five-year period runs from 1 April 2020 to 31 March 2025 and is the same period for which price controls are currently set for water companies.

⁴ For the largest 17 water companies for whom Ofwat currently sets individual price controls this percentage is 0.3%, for other (smaller) water companies it is 0.1%.

⁵ The priority outcomes are set out in the [HMT Spending review 2021: Priority outcomes and metrics](#)

set out in the CSR settlement agreed with HM Treasury and what can be recovered through licence fees.

In the CSR settlement agreed in 2015, Ofwat was required to deliver efficiency savings in line with the Government's commitment to improving efficiency, even though part of the licence fee cap was increasing in line with inflation.

As illustrated in **Table 1** below, through the current CSR period (2022-25) our core regulatory budget will be flat in cash terms, with an uplift in 2023/24 and 2024/25 to accommodate the peak associated with conducting the 2024 price review (PR24). This uplift is set at the same cash level as our previous price control spend, representing a saving given the likely growth in external support costs linked to the cost-of-living challenges and inflation.

Table 1 Outcomes of the CSR 2021 for Ofwat

Ofwat outcomes for CSR 2021	2022-23	2023-24	2024-25	Total
Core Regulatory Budget	31.64	31.64	31.64	94.92
HMT RDEL Funding for Director General Pension	0.16	0.16	0.16	0.48
PR24 (Flat cash)	-	6.5	6.5	13
Additional Items (Environment and DPC)	0.5	0.5	0.5	1.5
Ofwat CSR Total	32.3	38.8	38.8	109.9

Source: Ofwat Comprehensive Spending Review settlement

The cost of Ofwat in 2022-23 is estimated to be £1.22 (£1.20 in 20-21) per customer. We are acutely aware of our responsibilities as a publicly funded body, and we aim to fulfil our responsibilities effectively and efficiently. As we start the current CSR period, we have plans to continue to further improve the way we operate and become more efficient and effective. We will be delivering 5% savings to enable us to reprioritise and deliver the majority of our existing and expanding scope of work over the CSR period within our core budget.

Despite our core regulatory budget reducing in real terms and delivering efficiencies if we did not modify the existing cap, we would not be able to set the budget at the level agreed with Government through the CSR and deliver on the additional work the cap does not reflect – in relation to RAPID, DPC and the environment which impact residents of England and Wales. The cap as set out in condition N currently is forecast to be £17m less over the 2020-25 period across the industry, than that agreed with HMT. This equates to the cost of RAPID, environment and DPC work we are undertaking. We would also be constrained in our ability to fund the full costs of a price review for England and Wales in the final year of the current price control and CSR periods (2024/25). We signalled our intention to revisit this cap in 2019 and agreed to wait until a multi-year CSR was agreed.

2. Proposed change

2.1 Proposed change

There are various ways we could change and simplify the regulation fee cap to ensure we are able to recover fees in line with what we agreed with HM Treasury as the cost of regulation through the CSR. Our preferred option is to replace the historical formula with a new cap that aligns with the decisions made by the Treasury through CSR processes about how much Ofwat can spend.

We consider that the simplest option is to set the cap for Annual General Fees and Special Fees by reference to the income limit that the Treasury sets for Ofwat for each financial year which is based on the CSR. It is possible that the Treasury might change the income limit set for a particular year⁶, so the cap would be the income limit at the point in time when the amount of the Annual General Fee or any Special Fee is determined. In practice, we expect that the licence fees paid by water companies as a group will always be less than the income limit because Ofwat may not need to recover the full amount and because there are other sources of income (such as the licence fees paid by retailers in the business retail market and any licensed infrastructure provider(s)).

Although we think it is unlikely that the Treasury will not set an income limit for one or more years, it would be sensible for the fee cap to accommodate this possibility. In those circumstances, we propose that the cap would be set by reference to the most recent income limit set by the Treasury updated in line with inflation (using the relevant measure of inflation used to index water company price controls, currently the all-items Consumer Prices Index including owner occupiers' housing costs (CPIH)).

The box below sets out draft text for the proposed new cap, which would replace paragraphs N13 to N16 of the current text of Condition N (see the Appendix). Condition N in each water company's licence sets a cap for the Annual General Fee and any Special Fee payable by that company. The proposed cap is therefore set in an S x A format (where the overall income limit is divided by the water company's share of all water companies' regulated business turnover in the last but one Charging Year). This is based on the S x A element of the existing regulation fee cap (see paragraph N14.1 of Condition N) and is consistent with the G x A format of the cap for the Consumer Council for Water Fee (see paragraph N10 of Condition N).

⁶ The limit may for example change in year to reflect changes in Civil Service pay and pensions set by the Cabinet Office.

Draft proposed cap on the Annual Fee and any Special Fee

- N13 The sum of the Annual General Fee and any Special Fee in each Charging Year must not exceed an amount calculated as $S \times A$ where:
- N13.1 S is, subject to paragraph N14, the amount of the income limit set by the Treasury for Ofwat for the Charging Year when Ofwat determines the amount of the Annual General Fee or any Special Fee; and
- N13.2 A is the Appointee's Turnover Share for the Charging Year.
- N14 If when Ofwat determines the amount of the Annual General Fee or any Special Fee the Treasury has not set an income limit for Ofwat for the Charging Year then S shall be the amount calculated in accordance with paragraph N15.
- N15 Where this paragraph applies, S shall be the amount of the final income limit for the last Charging Year for which the Treasury set an income limit, as increased from the November immediately before that Charging Year to the November immediately before the Charging Year in which the Annual Fee or any Special Fee is payable using the Relevant Index.

2.2 Other options considered

We might be able to address the issues identified earlier by two other means.

We could increase and re-base the fixed amount (the S figure) in the existing regulation fee cap from the 2015 figure of £18.8 million (which has increased to £22.2 million in line with the link to inflation in Condition N) to a 2023–24 figure of £33.2 million. Alternatively, we could revise the percentage in the part of the existing regulation fee cap that is linked to the average annual regulated business turnover of each water company in the prior five-year period from either 0.1% or 0.3% to 0.7%.

These alternatives would be an acceptable way of dealing with the short-term issue that the existing cap does not align with the budget agreed with HM Treasury. They would do nothing, however, to future-proof the condition and do not recognise role of HM Treasury and the Government in setting our budget. If HM Treasury determines that budget needs to increase or the role and remit of Ofwat expanded, we would have to return to the condition and change it again. Our preferred model for the condition does not contain this shortcoming and does not assume that the regulatory model stays constant over the long-term. It does retain the concept of a cap, however, since the Treasury's spending control processes will always be based on an assessment of the efficient cost required to carry out our regulatory functions.

3. Impacts of the proposal

Companies will continue to contribute the same share of costs as previously.⁷ In cash terms companies will pay no more than agreed in the CSR which as stated above is a below inflation increase and reducing in real terms for core regulatory work. The increase in fees in 2023/24 and 24/25 relate to the increase in resources for PR24 and additional funding for environment and DPC. Ofwat does not retain unspent licence fee income, returning material unspent licence fees back to companies. Ofwat also annually consults on the budget for the following year when we consult on our draft forward programme for that year.

Questions

1. Do you agree with the principle of changing the regulation fee cap to ensure that the budget agreed with the Treasury can be funded?
2. Do you agree with the option for changing the regulation fee cap that Ofwat proposes and, if not, which alternative option would you prefer if the regulation fee cap is changed?
3. Do you have any comments on the draft wording for the proposed new regulation fee cap set out in the box in section 2.1?

⁷ We do not propose to change the method for determining the fair proportion of costs for each water company that is set out in [IN 19/08 – Licence fees for water companies and WSSL licensees \(Ofwat, April 2019\)](#). For example, only water companies for whom we will be setting price controls will contribute towards Ofwat's costs of preparing for or carrying out a price review and only water companies whose areas are wholly or mainly in England will contribute towards Ofwat's costs in relation to the business retail market.

Appendix – Current wording of Condition N and related definitions

Condition N: Fees

Introduction

This condition provides for the payment of fees by the Appointee to cover costs incurred by Ofwat, the Consumer Council for Water and the Competition and Markets Authority and sets out how the amount of those fees will be determined.

Fees

- N1 The Appointee must pay the following Fees to [the Secretary of State OR the Welsh Ministers]⁸ in accordance with this condition:
- N1.1 the Annual General Fee (or such part of the Annual General Fee as is payable under paragraph N2);
 - N1.2 the Special Fee (if any);
 - N1.3 the Interim Determination Fee (if any);
 - N1.4 the Consumer Council for Water Fee; and
 - N1.5 the Competition and Markets Authority Fee (if any).
- N2 Where Ofwat notifies the Appointee of an amount which is payable towards the Annual General Fee, the Appointee must pay that amount no later than 30 days following the notification, provided that:
- N2.1 the total of such amounts in a Charging Year may not exceed the Annual General Fee; and
 - N2.2 Ofwat may not give such a notification more than twice for a Charging Year.

⁸ For Welsh water companies, the wording of Condition N refers to the Welsh Ministers because the relevant functions of the Secretary of State under the Water Industry Act 1991 have been transferred to the Welsh Ministers in relation to water undertakers and sewerage undertakers whose areas are wholly or mainly in Wales. For all other water companies, Condition N refers to the Secretary of State.

- N3 Where Ofwat notifies the Appointee of the amount of any Fee other than the Annual General Fee, the Appointee must pay that amount no later than 30 days following the notification, provided that Ofwat may not give such a notification in respect of any one of these Fees more than once in a Charging Year.
- N4 In this condition any determination by Ofwat of a fair proportion of an amount may only be made in accordance with a method which Ofwat has disclosed to the Appointee in writing.

Annual General Fee

- N5 The Annual General Fee is Ofwat's determination of a fair proportion of its estimate of costs incurred or likely to be incurred by it in the Charging Year in the carrying out of its functions under any enactment, provided that any such determination is subject to paragraph N13.

Special Fee

- N6 The Special Fee is Ofwat's determination of a fair proportion of its estimate of any costs incurred or likely to be incurred by it which:
- N6.1 could have been included in the estimate used by it to determine the Annual General Fee for the Charging Year; and
- N6.2 were not included in that estimate, provided that any such determination is subject to paragraph N13.

Interim Determination Fee

- N7 The Interim Determination Fee is an amount determined by Ofwat which represents its estimate of any costs incurred by it in the previous twelve months in relation to any Interim Determination which it is required to make.

Consumer Council for Water Fee

- N8 The Consumer Council for Water Fee is:
- N8.1 Ofwat's determination of a fair proportion of its estimate of costs incurred or likely to be incurred by the Consumer Council for Water in the Charging Year in

the carrying out of its functions under any enactment, provided that no such amount will exceed the amount calculated in accordance with paragraph N10; or

N8.2 where a direction has been given to Ofwat by the Secretary of State under section 37(8) of the Water Act 2003, any greater amount which Ofwat determines is necessary to give effect to that direction.

N9 Any estimates which are used in the determination of the Consumer Council for Water Fee will be arrived at following consultation with the Consumer Council for Water

N10 A Consumer Council for Water Fee determined under paragraph N8.1 shall not exceed an amount calculated as $G \times A$ where:

N10.1 G is the amount of £7.65 million, as increased from November 2015 to the November immediately before the Charging Year using the Retail Prices Index (for any period up to November 2019) and the Relevant Index (for any period thereafter); and

N10.2 A is the Appointee's Turnover Share for the Charging Year.

Competition and Markets Authority Fee

N11 The Competition and Markets Authority Fee is an amount determined by Ofwat (in accordance with paragraph N12) which is the sum of:

N11.1 Ofwat's estimate of the costs incurred by the Competition and Markets Authority in the previous twelve months in relation to any reference under section 12 or section 14 of the Water Industry Act 1991, where the reference related solely to the Appointed Business; and

N11.2 Ofwat's determination of a fair proportion of Ofwat's estimate of the costs incurred by the Competition and Markets Authority in the previous twelve months in relation to any reference under section 14 of the Water Industry Act 1991, where the reference related to the Appointed Business and the appointed businesses of other relevant undertakers.

N12 Any estimates which are used in the determination of the Competition and Markets Authority Fee will be arrived at following consultation with the Competition and Markets Authority.

Cap on Annual General Fee and Special Fee

- N13 The sum of the Annual General Fees and any Special Fees in a Relevant Five Year Period must not exceed the Regulation Fee Cap.
- N14 Subject to paragraph N16, the Regulation Fee Cap is an amount which is the sum of:
- N14.1 the sum of the amounts calculated as $S \times A$ for each Charging Year in the Relevant Five Year Period, where:
 - N14.1.1 S is the amount of £18.8 million, as increased from November 2015 to the November immediately before the Charging Year using the Retail Prices Index (for any period up to November 2019) and the Relevant Index (for any period thereafter); and
 - N14.1.2 A is the Appointee's Turnover Share for the Charging Year; and
 - N14.2 an amount equal to [0.3% OR 0.1%] of the average of the annual turnover of the Appointed Business, as shown in the accounting statements prepared by the Appointee under Condition F, over the Prior Five Year Period.
- N15 Ofwat may refer to [the Secretary of State OR the Welsh Ministers] for determination the question of whether the Regulation Fee Cap should be changed in relation to any Relevant Five Year Period (and if so what change should be made).
- N16 The Regulation Fee Cap shall be changed to the extent required to give effect to any determination which:
- N16.1 has been made following a reference made under paragraph N15; and
 - N16.2 is made before the start of the Relevant Five Year Period to which it relates.

Terms used in paragraphs N13 to N16 of Condition N that are defined in Condition A: Interpretation and Construction

"the Appointed Business" means the business consisting of the carrying out by the Appointee of the Regulated Activities;

"Appointee's Turnover Share" means, in relation to a Charging Year, the amount calculated as t / T where:

- (a) “t” means an amount equal to the turnover of the Appointed Business as shown in the accounting statements prepared by the Appointee under Condition F for the twelve month period ending twelve months before the start of the Charging Year; and
- (b) “T” means an amount equal to the sum of the turnover of the appointed businesses of all relevant undertakers, including the Appointee, as shown in their accounting statements prepared under Condition F, and the provisions of appointments which are equivalent to Condition F, for the twelve month period ending twelve months before the start of the Charging Year;

“Charging Year” means a year commencing on 1 April;

“Prior Five Year Period” means the period of five consecutive Charging Years immediately before the Relevant Five Year Period;

“Relevant Five Year Period” means, as the context requires:

- (a) the period from 1 April 2015 to 31 March 2020; or
- (b) the subsequent period of five consecutive Charging Years starting on the relevant five year anniversary of 1 April 2015.

“the Relevant Index” means –

[...]

- (b) for any period including, or after, 1 April 2020, the Consumer Prices Index (H),

[..]

**Ofwat (The Water Services Regulation Authority)
is a non-ministerial government department.
We regulate the water sector in England and Wales.**

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA
Phone: 0121 644 7500

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