

October 2022

**Decision under sections 12A
and 13 of the Water Industry
Act 1991 to modify condition N
of water companies' licences**

Ofwat

About this document

This document sets out our decision to modify condition N of the Instrument of Appointment (**licence**) of each water company¹, the effect of the modifications, and the reasons for our decision.

The modifications were made under:

- section 12A of the Water Industry Act 1991 (**WIA91**), for water companies whose areas are wholly or mainly in England; and
- section 13 of the WIA91, for companies whose areas are wholly or mainly in Wales.

We [consulted on our proposal in August 2022](#). This document also sets out responses to that consultation, as well as our decisions in the light of the responses we received.

The modification to each company's licence has effect from 1 January 2023.

¹ For the purpose of this document, a reference to a water company or a company means a company holding an appointment as a water undertaker and/or a sewerage undertaker under the Water Industry Act 1991. These are the 17 largest water (and/or wastewater) companies for whom we set individual price controls and all small new entrant water companies created under the New Appointees and Variations (NAV) framework.

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1. Introduction

1.1 Licence condition N

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.

1.2 The problem we are addressing

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.

1.3 Previous steps and context

In June 2022 we undertook a [policy consultation](#) on the 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 Ofwat budget through the CSR. Following that consultation, we decided to take forward our preferred option to replace the existing regulation fee cap with a new cap that aligns with the decisions made by the Treasury through CSR processes about how much Ofwat can spend.

In August 2022 we published a consultation notice to give effect to that option.

The licence modifications will not change the method for determining the fair proportion of our 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.

Companies will continue to contribute the same share of costs as they would if the proposed modifications were not made. In cash terms companies will pay no more than agreed in the CSR which is a below inflation increase and reducing in real terms for core regulatory work. The increased budget limits for 2023/24 and 2024/25 relate to the increase in resources for our 2024 price review (PR24) and additional funding for environment and DPC work. Ofwat does not retain unspent licence fee income, returning material unspent licence fees back to companies through credit notes in relation to the following year's licence fees. Ofwat also annually consults on the budget for the following year when we consult on our draft forward programme for that year.

2. Consultation responses and our decisions

2.1 Consultation responses

Table 2 Responses received

	Company name
Responses received from water companies wholly or mainly in Wales	Dwr Cymru Hafren Dyfrdwy Albion Eco
Responses received from water companies wholly or mainly in England	Bristol Water South East Water Thames Water United Utilities Yorkshire Water

Source: Responses to consultation

All three Welsh water companies agreed that Ofwat could make the proposed licence modifications under section 13 of the WIA91 for those companies. The five English water companies which responded said they had no objections to, or no further comment on, Ofwat making the proposed licence modifications under section 12A of the WIA91 for those companies.

2.2 Our decision

No English water company, nor any other person, has raised any issues which caused us to reconsider our proposals in relation to those companies. We have decided, therefore, to make under section 12A(2) of the WIA91 the proposed modifications to condition A and condition N of the licences of water companies whose areas are wholly or mainly in England.

With the agreement of the three water companies whose areas are wholly or mainly in Wales, we have decided to make under section 13(1) of the WIA91 the proposed modifications to condition A and condition N of their licences.

2.3 The modifications, their effect and the reasons for our decision to make them

The wording of the licence modifications we have made can be found in the [Appendix](#) at the end of this document.

The licence modifications we have made set a new limit on the total of the Annual General Fee and any Special Fee payable by each water company in a Charging Year (a year beginning on 1 April) in relation to the costs that Ofwat incurs in carrying out its functions. The effect of the modifications will be that for each water company:

1. Ofwat cannot determine an Annual General Fee for a Charging Year that is higher than the income limit set for Ofwat by the Treasury for that year (at the point in time when the Annual General Fee is determined) divided by the water company's share of all water companies' regulated business turnover in the last but one Charging Year.
2. If Ofwat also determines a Special Fee for a Charging Year then the total of the Special Fee and the Annual General Fee for that Charging Year cannot be higher than the income limit set for Ofwat by the Treasury for that year (at the point in time when the Special Fee is determined²) divided by the water company's share of all water companies' regulated business turnover in the last but one Charging Year.
3. If when Ofwat determines the amount of either fee the Treasury has not set an income limit for Ofwat for that year then the income limit will be the most recent income limit set by the Treasury increased in line with the Consumer Prices Index (H).

Related changes include:

- The removal of Ofwat's current ability under paragraph N15 of Condition N to ask the Secretary of State or the Welsh Ministers to determine whether the fee cap should be changed (and if so what change should be made).
- The consequential removal from Condition A of the definitions of two terms that are only used in the part of Condition N deleted by the proposed modifications.

We decided to make the modifications to replace the existing Regulation Fee Cap because if the cap was not modified we would not be able to set the budget at the level agreed with the Treasury through the CSR process and deliver on the additional work that the existing cap does not reflect – in relation to RAPID, DPC and the environment. The existing Regulation Fee Cap is currently forecast to be £17m less over the 2020–25 period across the industry than that agreed with the Treasury. This equates to the cost of the 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).

The form of the new licence fee cap introduced by the modifications has been chosen because it future-proofs Condition N and recognises the role of HM Treasury and the

² It is possible that the Treasury might change the income limit for a particular year. The limit may for example change in year to reflect changes in Civil Service pay and pensions set by the Cabinet Office.

Government in setting our budget. If the Treasury determines that the budget needs to increase or that the role and remit of Ofwat should expand we would otherwise have had to return to the condition and propose further licence modifications. Our chosen model does not assume that the regulatory model stays constant over the long-term. It also retains the concept of a cap, since the Treasury's spending control processes will always be based on an assessment of the efficient costs required to carry out our regulatory functions.

2.4 Date when the licence modification takes effect

Following a consultation on a proposal to modify the licence of a water company under **section 12A** of the WIA91, having considered any representations (and unless the Secretary of State has directed us not to), we may decide to modify the licence and we must give notice of that decision. Each modification has effect from the date specified by Ofwat in relation to that modification. Under s12A(11), that date must usually be not less than 56 days from publication of the decision to make the modification. We have decided that the modifications will have effect from **1 January 2023**.

A company whose licence has been modified under section 12A (as well as any other person listed in section 12D(2) of the WIA91, including the Consumer Council for Water) may appeal against our decision to make the modification to the Competition and Markets Authority (CMA).

Modifications under **section 13** of the WIA91 for licences held by Welsh water companies are not subject to the same timeline requirements. For consistency, however, we have decided that the modifications for the three companies concerned will also have effect from **1 January 2023**.

Appendix: The licence modifications

The modifications

1. The definitions in paragraph 3 of Condition A: Interpretation and Construction of the terms "Prior Five Year Period" and "Relevant Five Year Period" are deleted.

2. Paragraphs N13 to N16 of Condition N: Fees are deleted and replaced with the following text:

"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."

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

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