

August 2022

**Consultation under sections 12A and 13  
of the Water Industry Act 1991 on  
proposed modifications to Condition N:  
Fees of all water companies' licences**

## About this document

This document invites comments on the proposals of the Water Services Regulation Authority (**Ofwat**) to modify Condition N: Fees in the Instruments of Appointment (**licences**) of all the appointed water companies<sup>1</sup> in England and Wales, collectively referred to as 'water companies' or 'companies' in this document.

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 each company's licence. On 14 June 2022 we published a [consultation](#) on why we thought that the current cap should be changed and identified options, including a preferred option, as to how the cap could change. After considering the responses we received to that consultation, we are now formally proposing to modify all water companies' licences.

We are able to modify the conditions of the licence of a water company whose area is wholly or mainly in England under section 12A of the Water Industry Act 1991 (**WIA91**) subject to the procedural requirements set out in that Act. This document is a Notice under section 12A of the WIA91 in relation to all such water companies.

We are able to modify the conditions of the licence of a water company whose area is wholly or mainly in Wales under section 13 of the WIA91 if it agrees to the changes we are proposing to make. This document is a Notice under section 13 of the WIA91 in relation to all such water companies.

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<sup>1</sup> 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.

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# 1. Introduction

## 1.1 Background

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 now proposing 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.

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 have 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.

## 1.2 Scope and objectives

This proposal applies to all companies holding an Instrument of Appointment as a water undertaker and/or a sewerage undertaker under the Water Industry Act 1991. This includes

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. It does not include retailers in the business retail market, and nor does it include Bazalgette Tunnel Ltd (**Tideway**).<sup>2</sup>

The purpose of these proposed modifications is to bring the cap in company licences on the fees that contribute to Ofwat's funding into line with the budgets allowed by HM Treasury through the government's Comprehensive Spending Review (**CSR**) process.

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.

### 1.3 Implications of making the changes

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 as stated above is a below inflation increase and reducing in real terms for core regulatory work. The increased budget limit 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.

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<sup>2</sup> Retailers in the business retail market and Tideway do not hold appointments as water and/or sewerage undertakers. Retailers hold water supply and/or sewerage licences and Tideway holds a project licence as a licensed infrastructure provider.

## 2. Issues raised in previous consultation

Our [previous consultation](#) on this issue was published on 14 June and ran for four weeks. We advised our principal stakeholders, including all the affected companies, of the consultation directly. We received eight responses to the consultation, all from water companies.

### 2.1 The principle of changing the regulation fee cap

All respondents supported the principle of moving away from the current rigid cap to one which matched the outcome of the government's Spending Review process, of which Ofwat is a part.

### 2.2 The option proposed for changing the regulation fee cap

Respondents agreed that a long-term solution was preferable to one which might have to be revisited in the medium-term. In one case, however, this support was conditional on an appropriate outcome on risk sharing (see section 2.4 below).

### 2.3 The draft wording for the proposed new regulation fee cap

There was a qualified welcome for the draft wording suggested for the new licence fee cap. Six respondents had no comment. Three suggestions were made for amending the text:

- There should be an explicit recognition of other income that Ofwat receives, such as licence fees paid by retailers in the business retail market and the infrastructure provider for the Thames Tideway Tunnel,
- Paragraph N15 should contain a reference to ongoing increasing productivity efficiency, and
- S should be restated as (G + S), the general fee G plus any special fee S, then paragraph N15 should use only G

After careful consideration we consider that suggestions are best addressed as set out below, and do not require changes to the draft wording for the new licence fee cap that we suggested in our previous consultation. In relation to the specific suggestions listed above our view is that:

- Adding a reference to other income, including licences fees paid by other regulated entities, would not provide any additional protection for companies and would increase the complexity of the drafting. Condition N already says that the Annual

General Fee (and any Special Fee) for each company is Ofwat's determination of "a fair proportion" of Ofwat's estimated costs in the relevant Charging Year. We continue to expect that, in practice, the licence fees paid by water companies as a group will always be less than the income limit. We can confirm that we will continue to set licence fees that:

- recover from retailers in the business retail market their share of Ofwat's costs in relation to the water supply and sewerage licensing regime;<sup>3</sup> and
- recover from Tideway our costs in relation to the regulation, monitoring and enforcement of that infrastructure provider.

Our auditors check that we have billed the appropriate share of our costs to the different groups of regulated entities.

- Paragraph N15 sets out how the income limit will be calculated if the Treasury does not set an income limit for one or more years. We think it is unlikely that the Treasury will not set an income limit and the scope for efficiencies is something that the Treasury will consider as part of the CSR process. We will continue to look for scope to improve efficiency and value for money for customers as part of the CSR process. Adding a reference to ongoing productive efficiency would not in itself provide further gains and will increase the complexity of the drafting.
- In the unlikely event that the Treasury does not set an income limit for a year we consider that there should still be a cap that covers both the Annual General Fee and any Special Fee in that year. If the suggestion is Ofwat should not be able to determine a Special Fee in such a scenario, then we do not see why this should be the case just because the Treasury had not set an income limit. We therefore do not think that it is necessary to restate S as  $(G + S)$  and change paragraph N15.

## 2.4 Other issues raised

There were three more generic issues raised, along with one specific query, which were brought up alongside the questions we asked. We provide our responses to these issues below.

One company asked for evidence for the level of efficiency challenge applied to Ofwat's proposals in the CSR process. HM Treasury's [Autumn Budget and Spending Review 2021](#) report says " In April, the government launched an efficiency and savings review to interrogate departmental spending and consider how to capitalise on any productivity gains from the COVID-19 response. SR21 confirms savings of 5% against day-to-day central departmental budgets in 2024-25 that have been reinvested into priority areas." In Ofwat's

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<sup>3</sup> The general principles in accordance with which we will determine a retailer's share (as a water supply and/or sewerage licensee) are set out in [IN 19/08 - Licence fees for water companies and WSSL licensees](#) (Ofwat, April 2019).

case that resulted in a real terms reduction on the core budget, which is flat in cash terms. This provides an efficiency challenge that we will need to meet over the next 3 years.

There were a handful of comments on engagement in the budget-setting process for Ofwat. Ofwat is not able to constrain or direct HM Treasury on how it carries out its spending review processes. However, we note the suggestions that the Welsh Government is likely to have a view on the appropriate level of expenditure in relation to Ofwat's carrying out of its duties in Wales, and also that water companies may be able to provide views on cost pressures facing the regulator, and the activities it proposes to undertake. For our part, Ofwat will continue to consult on its annual Forward Programme, including with the Welsh Government and with companies, amongst others. We agree with the company which said "Ofwat's continued commitment to consult on its budget annually as part of its draft forward programme, [...], therefore becomes a critical part of future fee discussions."

Three water companies suggested that if changes are made to the existing cap some or all of the licence fees payable under Condition N should be treated as unmodelled costs for the purposes of Ofwat's price reviews and the price controls we set (in a similar way to abstraction charges). This is not a matter for this licence modification consultation, but it is something that we will consider in relation to the current consultation on the [draft methodology for PR24](#). Interested parties can include representations on this point in their responses to that consultation, which closes on **7 September 2022**. One company further asked about the potential for alignment of the five-year price control determinations with the HM Treasury outcomes of the CSR. We do not intend to change the normal five-year duration of price controls for PR24, but the start of the next price control period (April 2025) will coincide with the start of the next CSR settlement period. The duration of CSR settlements is a matter for the Government, but they sometimes only cover one year rather than multiple years because of political or other events.<sup>4</sup>

One respondent asked how, if HM Treasury increased the income limit for a particular year after the amount of the Annual General Fee and Special Fee was determined, any shortfall would be treated. They assumed that it would be included in the following year's Special Fee (which would be subject to consultation in the draft forward programme).

Condition N only allows Ofwat to determine one Annual General Fee and one Special Fee for a water company for each Charging Year (although Ofwat can require the Annual General Fee to be paid in two instalments). If both fees had been determined for a Charging Year then no

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<sup>4</sup> For example, the Government decided that the 2020 spending review, originally intended to outline plans for the remainder of the current Parliament, would be a one-year spending review for departments in order to prioritise the response to Covid-19 (see: [Spending Review to conclude late November - GOV.UK \(published 21 October 2020\)](#)).

other fee would be payable by a water company in that Charging Year in relation to Ofwat's costs unless there was an interim determination.<sup>5</sup>

Whether or not any unutilised part of an income limit is carried forward would be a matter for the Treasury, which sets an income limit for each year and would decide whether or not the income limit for the following year should be changed to reflect any unutilised amount in the previous year. Multi-year CSR settlements typically include some flexibility for Ofwat to move amounts between the budget limits for the years covered by the settlement. We will consult on the budget for the following year when we consult on our draft forward programme for that year. Under the proposed licence modification the income limit set by the Treasury for a year (whether or not it reflects any unutilised amount in the previous year) will limit the total amount that can be recovered from water companies through both the Annual General Fee and any Special Fee.

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<sup>5</sup> Condition N allows Ofwat to recover an Interim Determination Fee from a water company in relation to any costs we incur in making an interim determination under Part 4 of Condition B of its licence as to whether the level of the company's price controls should be changed and, if so, by how much.

### 3. The changes we are proposing, their effect and the reasons why we are proposing them

Following the earlier policy consultation, the licence modifications we are proposing to replace the existing Regulation Fee Cap in Condition N are set out in the box below. They will 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 proposed 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 determined<sup>6</sup>) 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 are proposing licence modifications to replace the existing Regulation Fee Cap because if the cap is not modified we will 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 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

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<sup>6</sup> 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.

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 proposed licence modifications has been chosen because it future-proofs Condition N and recognises the role of HM Treasury and the 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 to return to the condition and propose further licence modifications. Our preferred 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.

### **The proposed 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."

## 4. Next steps

Any representations on, or objections to, the proposed modifications may be made not later than **Thursday 6 October 2022**.

We also ask water companies whose areas are wholly or mainly in Wales to indicate their acceptance or otherwise of the proposed modifications by this date.

If, after considering any representations or objections that are duly made, Ofwat decides to make the proposed modifications then we expect that the modification for each water company will come into force in early 2023. This will be subject to:

- In the case of a modification under section 12A of the WIA91, any appeal under section 12D of the WIA91 to the Competition and Markets Authority (which may choose to suspend the effect of Ofwat's decision, in full or in part, pending the determination of the appeal); and
- In the case of a modification under section 13 of the WIA91, the agreement of the water company concerned.

## 5. Making representations

Any representations on, or objections to, the proposed modifications may be made no later than **Thursday 6 October 2022**.

We also ask water companies whose areas are wholly or mainly in Wales to indicate their acceptance or otherwise of the proposed modifications by this date.

You can email responses to [RegFeeCap@ofwat.gov.uk](mailto:RegFeeCap@ofwat.gov.uk).

We intend to publish responses to this consultation document on our website at [www.ofwat.gov.uk](http://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.

**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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