

Variation of Independent Water Networks' (IWN) appointment to include King's Cross

On 23 February 2010, Ofwat began a consultation on a proposal to vary IWN's appointment to become the water and sewerage services provider for a development in Thames Water's area called King's Cross, in London. The consultation ended on 23 March 2010. During the consultation period Ofwat received two representations which we considered carefully in making our decision. We decided on 13 April 2010 to grant IWN a variation to its existing appointment to enable it to serve King's Cross for water and sewerage services, subject to the following three conditions being met:

1. IWN's charges scheme for 2010-11 must be approved (this has now been approved);
2. There must be bulk supply agreements in place between Thames Water and IWN and we must be satisfied that the price terms in those agreements are the same as those used to assess the applications' financial viability; and
3. We must be satisfied that the temporary supply of water for construction purposes has been disconnected.

This notice gives our reasons for this decision.

Introduction

The new appointment and variation mechanism, specified by Parliament and set out in primary legislation, allows one company to replace the current company as the provider of water and/or sewerage services for a specific area. This mechanism can be used by new companies to enter the market and by existing companies to expand their businesses. In this case, IWN applied to replace Thames Water as the appointed water and sewerage company for King's Cross.

A company may apply for a new appointment (or a variation of its existing appointment to serve an additional site) if any of the following three criteria are met:

- none of the premises in the proposed area of appointment is served by the existing appointed company at the time the appointment is made (the 'unserved criterion');
- each of the premises is likely to be supplied with at least 50 Megalitres (Ml) per year (in England) or at least 250 Ml per year (in Wales) and the customer in relation to each of the premises consents (the 'large user criterion');
- the existing water supplier in the area consents to the appointment (the 'consent criterion').

When considering applications for new appointments and variations, Ofwat operates within the statutory framework set out by Parliament, including our duty to protect consumers, wherever appropriate by promoting effective competition. In particular, in relation to unserved sites, we seek to ensure that the future customers on the site – who do not have a choice of supplier – are adequately protected. When assessing applications for new appointments and variations, the two key policy principles we apply are that:

1. customers, or future customers, should be no worse off than if they had been supplied by the existing appointee; and
2. Ofwat must be satisfied that an applicant will be able to finance the proper carrying out of its functions as a water and/or sewerage undertaker.

Entry and expansion (and even the threat of such by potential competitors) can lead to benefits for different groups of people (such as household and non-household customers and developers of new housing sites). Benefits can include price discounts, better services, environmental improvements and innovation in the way services are delivered.

Benefits can also accrue to customers who remain with the existing appointee, because when the existing appointee faces a challenge to its business, that challenge can act as a spur for it to raise its game. We believe the wider benefits of competition via the new appointments and variations mechanism can offset any potential disbenefits for existing customers that might arise. We consider these potential disbenefits in more detail below.

The application

IWN applied to be the water and sewerage appointee under the large user criterion set out in section 7(5) of the Water Industry Act 1991 (WIA91), and in the alternative, applied to be the water appointee for the Site under the unserved criterion set out in section 7(4)(b) the WIA91.

Unserved status of the Site

To qualify under the unserved criterion under section 7(4)(b) WIA91, an applicant must show that at the time the appointment is made, none of the premises in the proposed area of appointment is served by the existing appointee. IWN submitted a report (from an independent professional advisor appointed by it) which verified the Site as unserved for water. Although the Site currently receives a temporary supply of water from Thames Water for construction purposes, IWN has told us it will disconnect this supply of water prior to Ofwat granting it a variation. We consider that as long as a temporary connection of water from an existing appointee that is required for construction purposes is disconnected prior to Ofwat granting an appointment variation, a site will still be classed as unserved. Therefore, we consider that this Site will be unserved for water once the temporary supply has been disconnected. The variation will not be made until we receive written

confirmation from the applicant and Thames Water that the supply has been disconnected.

Large user criterion

To qualify under the large user criterion, each of the premises on the Site must be supplied with (or be likely to be supplied with) at least 50 MI of water in England in any 12-month period (250 MI of water in Wales) and the customer in respect of those premises must consent to the appointment. The same threshold levels apply to new appointments for sewerage services (i.e. new appointments may be made to serve non-household customers who are supplied or expect to be supplied with at least 50 MI of water in England (250 MI of water in Wales), the threshold applying to the amount of water supplied, not effluent discharged).

The Site is under the ownership and control of a single entity. The land within the Site is owned by King's Cross Central Trustees and the Trustees have appointed Argent (King's Cross) Ltd (Argent) to act as their development manager. IWN told us that Argent is in exclusive control of the Site, as it has sole responsibility for developing the Site. For these reasons, we consider the Site to be a single premises for the purposes of assessing whether the criteria set out in section 7(5) WIA91 have been met. Argent, as the customer of services on the Site, consented to the appointment.

IWN provided evidence to us concerning the planned build and occupancy schedule for the Site. The forecast consumption data in that schedule shows that the Site in aggregate (the 2,500 household properties and the 47 non-household properties) is expected to consume in excess of the 50 MI threshold within the first or second twelve month period after the appointment.

We are of the view that the test for the large user criterion has been met in that:

- the Site is under the ownership of a single entity and may be regarded as a single premises;
- the customer for services on those premises is Argent and Argent has consented to the appointment; and
- within the first or second year of appointment, the premises are likely to be supplied with in excess of 50 MI of water.

In addition, we have been told by IWN and by the developer that the developer is likely to remain the landlord (and thus the customer) for large parts of the development in the future and that the consumption for those parts is likely to be about 150 MI per year.

Financial viability of the proposal

We will only make an appointment if we are satisfied that the proposal is financially viable. We assess financial viability on a site by site basis and also consider the financial position of the company as a whole. We have concluded that, based on the information available to us, the proposal is viable. We do not have any concerns about the financial position of the company as a whole. IWN is supported by a market bond and a parent company guarantee that, combined, are sufficient to support the total operating costs of this site and IWN's five other sites. One of the conditions that must be met before we grant this appointment variation is that there must be bulk supply agreements in place between Thames Water and IWN and we must be satisfied that the price terms in those agreements are the same as those used to assess the applications' financial viability.

Assessment of 'no worse off'

IWN proposes to give household customers on the site a 5% discount on the volumetric water charges of Thames Water, while all other charges will remain at the level of those set for Thames Water's customers. We have approved IWN's Codes of Practice and charges scheme and are satisfied that customers will be offered an appropriate level of service. We consider that customers will be 'no worse off' being served by IWN instead of by Thames Water.

Effect of appointment on Thames Water's customers

In considering whether customers will be no worse off, we also considered the potential effect this variation may have on Thames Water's existing customer base.

We have looked at this potential impact by comparing how much Thames Water **might** have received in revenue had it supplied the Site directly, with the revenue it will receive through supplying the Site indirectly via supplies to IWN. The calculation necessarily depends on a range of assumptions and this means it is difficult to quantify the effect on Thames Water and it is necessary to use a simplified set of figures.

When King's Cross Central is fully built in 2022, the 2,500 household properties on this site will potentially make up 0.046% of Thames Water's customer base. We consider that the upper bound of the potential effect could amount to approximately a £0.15 increase per annual bill for each of Thames Water's existing customers by 2022. However, this takes no account of potential cost savings by Thames Water (from dealing with IWN as a single customer for the site rather than many customers individually) or the offsetting of additional benefits to customers that arise from the new appointments mechanism. Thames Water's customers will not, therefore, automatically see their bills increase by this amount. We have expressed the effect in 'per bill' terms to try and quantify the possible effect in an easily understandable way.

In this case, we consider this potential effect is outweighed by the benefits of granting this variation.

Views of the developer

Ofwat takes into consideration the choices of the site developer. In this case, the site developer said that it wanted IWN to be the water and sewerage company for the site. Argent wishes to appoint a unified or co-ordinated approach for each provider of all utilities on its site, which it believes will bring substantial efficiencies and significant consumer advantage. It is planning on doing so in conjunction with sister companies of IWN that will supply telecommunications, electricity and gas to the site.

Responses received to the consultation

We received two responses to our consultation, from the Consumer Council for Water (CCWater) and Thames Water. We met Thames Water at its request to discuss its response, after which Thames Water wrote again to us to summarise some of the points discussed and to provide further detail on others. We carefully considered CCWater's response and the views of Thames Water before making the decision to vary IWN's appointment. The main points raised in these responses are set out below.

CCWater

CCWater does not object to the variation being granted, but it made a series of points in its response which are in bold text below, followed by our response to each of them.

Although acknowledging that customers at King's Cross Central will be no worse off being served by IWN rather than Thames Water, it believes the benefits will be limited. It also would like to see Ofwat and the UK and Welsh Assembly Governments carry out a fundamental review of the new appointments system to ensure there is certainty that new appointments will benefit consumers in the longer term.

Requiring applicants to show a demonstrable (and certain) benefit to customers, rather than our 'no worse off' test, would be an unnecessarily high hurdle for new entrants to clear. This policy approach was endorsed by the High Court in the recent 'Llanid' judgment. The Court accepted that our approach of using the new appointments mechanism to further competition is reasonable and accepted our evidence that it has resulted in demonstrable benefits to customers¹. We saw no reason to deviate from our usual policy in this case. However, we are considering this issue further and we aim to report our findings to coincide with the publication of our final statement of policy on new appointments and variations later this year.

¹ *R (oao Welsh Water Ltd) v Water Services Regulation Authority* [2009] EWHC 3493 (Admin), Mitting J, in particular, paragraphs 19 – 21.

It queries how long IWN's 5% discount on Thames Water's volumetric water charge will be in place.

IWN's initial 5% discount will be in place at least until 2014, at which point we may decide to bring condition B of its conditions of appointment into effect and set a specific price limit for IWN².

It expresses disappointment that IWN proposes this discount for household customers only, and not for non-household customers.

Although non-household customers at the site will not enjoy the same price benefit that household customers will enjoy, they will be no worse off than they would have been if Thames Water had served the site.

It has some concerns generally about the impact that the growth of new appointments could have on water companies' remaining customers. It believes it is important that the prices paid by IWN to Thames Water for bulk water and bulk sewerage services reflect the cost of these services and investment in the locality and therefore avoid any cross subsidy from customers of Thames Water.

We consider that the possible disbenefits that may result for Thames Water's existing customer base will be outweighed by the benefits of granting this variation. In this case, Thames Water and IWN have agreed in principle a bulk supply price based on Thames Water's large user tariff and we are satisfied that IWN's proposal is financially viable on this basis. As part of our assessment of this application we considered the impact of this variation on Thames Water's existing customers. We have explained the potential impact under 'Effect of appointment on Thames Water's customers' above.

As King's Cross Central is in an area considered by the Environment Agency to be water-stressed, CCWater looks to Ofwat for assurance that IWN will have a responsibility to promote water efficiency, in line with other water companies.

IWN will have the same duty as all other appointed companies with regards to promoting water efficiency³.

Thames Water

Thames Water objected to our proposal. Its view is that the site is served. Specifically, it considers that:

- **The test used by Ofwat in this case to determine if the site is served is ill-defined and contrary to Ofwat guidance;**

² Condition B deals with the company's obligation to comply with price limits.

³ Section 93A of the WIA91 states that "it shall be the duty of every water undertaker to promote the efficient use of water by its customers".

- **Parliamentary debates on the 1989 Water Bill highlight that this criterion was intended to be a narrow exception providing for competition in relation to greenfield sites only;**
- **There is no basis for distinguishing between permanent and temporary supplies;**
- **There is no basis for concluding that a temporary disconnection, even of building supplies, is sufficient to render a site unserved;**
- **Ofwat's unserved test implies that *any* premises, where water is used for building purposes, may be eligible for an inset. An appointee's capability to serve premises cannot reasonably be tested by what an end water user chooses to do with their own water or their own pipes; and**
- **Ofwat's identification of Argent as the customer undermines its conclusion that the Granary premises are unserved.**

Thames Water's concern with our conclusion that the site is unserved for water is based on a misunderstanding of our position. We are not saying that IWN can temporarily disconnect the supply before the appointment is made provided that at some stage during the development a permanent disconnection is made. Rather, we have sought from IWN, and obtained, an assurance that prior to the appointment variation it will permanently disconnect the temporary building supply.

In order to satisfy ourselves that the supply has been disconnected, we have requested the following from IWN:

- A copy of the letter from the developer to Thames Water asking for the supply to be disconnected on a specified date; and
- A copy of the letter from Thames Water to the developer that confirms that the supply has been disconnected and the date on which the work was carried out.

Thames Water argues that the unserved criterion was only intended to cover 'greenfield' sites. We disagree. Although section 7 is typically used for 'greenfield' sites, there is nothing in the Act or the Parliamentary debate to say that the criterion was exclusively for 'greenfield' sites. This interpretation is confirmed by the judgment of Mitting J in the *Llanilid* decision.⁴

The existing temporary supply is only being used for construction purposes. If Thames Water's interpretation were correct, it would be very difficult for any company to ask for a new appointment or variation under the unserved criterion, because any new development, whether 'greenfield' or 'brownfield' would be likely to need a temporary supply of water during its construction.

⁴ See paragraph 12 of the judgement referred to in footnote 1.

We also consider that a more restrictive interpretation may cut across the aim of the legislation which is to introduce competition in this area to the benefit of consumers.

Thames Water proposes an alternative "demolish" test to determine whether a site is unserved and it asks Ofwat to consider redrawing the boundary of the proposed King's Cross inset to remove the Granary premises.

Thames Water does not provide much detail about how a "demolish" test would work, but when we met the company on 25 March 2010, it explained its view that if all buildings on a site were demolished it would agree that the site was unserved as soon as an application was made to Ofwat for an appointment or variation to serve that site. This is relevant here because the development at the Granary is utilising the shells of some of the existing buildings on the site.

We have applied our usual policy in deciding that the Kings Cross site is unserved and we see no reason to depart from our current policy in this case. We do not consider that we should re-draw the boundary as Thames Water suggests because we are satisfied that the site (including the Granary building) will be unserved for water once the temporary supply of water is permanently disconnected.

Thames Water's view is that the large user criterion has not been met. It considers that Ofwat's conclusion that the large user criterion is met is unfounded because:

- **It extends the meaning of 'premises' in a way not recognised by the WIA91;**
- **Ofwat uses contradictory approaches in its interpretation of 'premises' in the context of the unserved and the large user criterion;**
- **Ofwat defines 'customer' in a way not recognised by the WIA91. It is the end user's consent that should be sought and not the consent of the developer;**
- **The threshold of 50 MI is met not by the developer, but only by aggregating the consumption of all users on the site. This makes Ofwat's position contradictory and untenable; and**
- **Ofwat's statement that Argent is in "exclusive control" of the site is contradicted by a report commissioned by Ofwat in January 2010 which states that the developer had not yet obtained possession of the whole of the King's Cross site because Network Rail was carrying out station improvement works at the southern end of the site.**

We consider that the requirements for the large user criterion have been met because the current customer has consented to the appointment and the

premises are likely to receive over 50 MI in a 12 month period. In our view, it is not relevant that the identity of the end user may change. However, we have been told by IWN and by the developer that the developer is likely to remain the landlord (and thus the customer) for large parts of the development in the future and that the consumption for those parts is likely to be about 150 MI per year.

Thames Water alleges that we are being inconsistent in how we interpret 'premises' for the purposes of the unserved criterion and the large user criterion. Having discussed this with Thames Water⁵ we believe Thames Water has misunderstood the wording in our consultation document. We are in fact proposing the same interpretation for both – namely that the site as a whole comprises one premises. We made this clear to Thames Water at our meeting.

Our consultation is clear that by referring to "exclusive control", we mean that Argent has sole responsibility for developing the site. A temporary restriction on access by a third party does not alter Argent's responsibilities to develop the site.

Thames Water identified two billed accounts for customers other than Argent on the King's Cross site and challenges our conclusion that Argent is the "customer" for the purposes of the large user criterion on this basis.

We do not consider that either of these supplies identified by Thames Water affects our view of Argent being the customer on the site for the purposes of the large user criterion.

The first billed account was mentioned in the site status report submitted by IWN. That report concluded that this account (plus those to six other properties on the site) did not affect the unserved status of the site because the buildings concerned had either been demolished, never billed, or were temporary supplies. In Thames Water's response to this report, it did not disagree with that conclusion. Because Thames Water has acknowledged that it does not provide a service to that customer, we do not consider that its view regarding a possible billable supply to this customer has any impact on our view of Argent in relation to the large user application.

From the information provided to us by IWN, the second billed account is for the building used by the developer as a site office. This building has been excluded from the area of the proposed variation for both the unserved and large user applications. Therefore, we do not consider that this supply has any impact on our view of Argent in relation to the large user application.

There is a lack of clarity as to which report from the independent professional Ofwat relies on, and it is unclear which temporary supplies are being referred to by Ofwat.

⁵ Meeting between Thames Water and Ofwat at our offices on 25 March 2010.

We are of the view that the two reports by the independent professional advisor appointed by IWN must be read together and that when read together they provide sufficient evidence for the conclusion that the site is unserved. They also make it clear which areas of the site receive temporary supplies.

It is not clear which guidelines Ofwat has applied to decide that the site is unserved for water.

Our 1999 guidance and the policy letter of January 2009 must be read together. Where the 1999 guidance is silent on an issue but that issue is dealt with in the January 2009 letter, it is clear that the January 2009 letter reflects current policy. Our approach to temporary building supplies is clearly set out in the January 2009 letter. That letter clearly states that where a site requires a temporary connection for building supplies, we will regard it as unserved, providing there are no customers requiring a supply. We have confirmed to Thames Water (at the meeting on 25 March 2010) that we are assessing this application on the basis of our current policy (the 1999 guidance as clarified in the 2009 letter) rather than the policy on which we are currently consulting.

The definition of the site boundary is unclear, and the evidence on which Ofwat relies for concluding that the site is unserved is questionable.

IWN's application under the large user criterion was based on the same area as its application under the unserved criterion. We have explained this to Thames Water⁶. Any ambiguity in respect of the site area could have been resolved by Thames Water requesting this information from IWN, which it did during the consultation process. During the consultation we provided a copy of the relevant site maps to Thames Water. Thames Water's representations do not say why the ambiguity remains or why any prior ambiguity prevented them from commenting on the consultation notice. We asked Thames Water specifically at our meeting in March 2010 whether it considered that what it saw as a lack of clarity on the site boundary has hindered its ability to make representations to us and it said it had not – it just needed to be clear for the purpose of bulk supply negotiations.

Conclusion

Having assessed IWN's application, and having taken account of the responses we received to our consultation, we have decided to grant a variation to IWN's area of appointment to allow it to serve King's Cross Central once it has met the three conditions set out at the start of this document.

When we are satisfied that those conditions have been met, we will grant the variation for water under the unserved criterion and, in the alternative, under the large user criterion. We will grant the variation for sewerage services

⁶ Meeting between Thames Water and Ofwat at our offices on 21 January 2010.

under the large user criterion. We will issue a further short notice when the conditions have been met to confirm that we have granted the variation.