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## Variation of Independent Water Networks' appointment to include Martello Lakes

On 27 February 2015, Ofwat began a consultation on a proposal to vary Independent Water Networks' (IWN) appointment to become the water and sewerage services provider for a development in Affinity Water's water supply area and Southern Water's sewerage services area called Martello Lakes in Hythe (**"the site"**). When fully built, the site will consist of 1,050 household properties. The consultation ended on 27 March 2015. During the consultation period, we received representations from two organisations, which we considered in making our decision. On 22 October 2015, we granted IWN a variation to its existing appointment to enable it to supply water and sewerage services to the site.

This notice gives our reasons for making this variation.

### 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 into areas where they are not the appointed company. In this case, IWN applied to replace Affinity Water as the appointed water company and Southern Water as the appointed sewerage company for the site.

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 premises is likely to be supplied with at least 50 mega litres per year (in England) or at least 250 mega litres per year (in Wales) and the customer in relation to each premises consents (**"the large user criterion"**);
- The existing water and sewerage 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:

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

Entry and expansion (and even the threat of such by potential competitors) can lead to benefits for different customers (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 improve its services. We believe the wider benefits of competition through 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 services appointee for the site under the unserved criterion set out in section 7(4)(b) of the Water Industry Act 1991 (“**WIA91**”). IWN proposes to serve the site by entering into a bulk supply agreement with Affinity Water and a bulk discharge agreement with Southern Water.

## **Unserved status of the site**

To qualify under the unserved criterion, an applicant must show that at the time the appointment or variation is made, none of the premises in the proposed area of appointment will be served by the existing appointee. We concluded that the site was unserved based on information provided to us by IWN, who provided us with an independent report which verified the site was unserved. We shared the report with

Affinity Water and Southern Water, who confirmed that they agreed that the site was unserved.

## **Financial viability of the proposal**

We will only make an appointment if we are satisfied that the proposal poses a low risk of being financially non-viable. We assess the risk of financial viability on a site-by-site basis and also consider the financial position of the company as a whole.

Based on the information available to us, we concluded that the proposal was at low risk of being financially non-viable.

We considered the impact of granting this variation on the financial position of the appointee as a whole. Having done this we are satisfied that granting this variation poses a low risk of a significant negative impact on the financial position of IWN.

## **Assessment of 'no worse off'**

IWN will offer customers a 5% discount on the volumetric charge of water compared to that of Affinity Water, while matching Southern Water's sewerage charges and Affinity Water's fixed water charge.

With regard to service levels, we have reviewed IWN's Codes of Practice and its proposed service levels and compared these to the Codes of Practice and the performance commitments of Affinity Water and Southern Water. Based on this review, we are satisfied that customers will be offered an appropriate level of service by IWN and that overall customers will be 'no worse off' being served by IWN instead of by Affinity Water and Southern Water.

## **Effect of appointment on Affinity Water's and Southern Water's customers**

In considering whether customers will be no worse off, we also looked at the potential effects of this variation on the price that Affinity Water's and Southern Water's existing customer base may face.

The calculation necessarily depends on a range of assumptions, and there are clearly difficulties involved in quantifying the effect on customers of Affinity Water and Southern Water. It is therefore necessary to use a simplified set of figures. We have expressed the effect in 'per bill' terms to try and quantify the possible effect in an easily understandable way. Broadly, we have assessed the potential magnitude

of this impact by comparing how much Affinity Water and Southern Water might have expected to receive in revenue from serving the site directly, with the revenues they might expect from serving the site indirectly via bulk supply and bulk discharge agreements with IWN. The lower bound of the range takes into account the benefit to Affinity Water and Southern Water as a result of IWN serving the site, by estimating the costs that Affinity Water and Southern Water are likely to avoid, such as retail costs and capital and operating costs associated with the local network used to serve the site. The upper bound of the range does not take these avoided costs into account. We look at these differences in revenue and costs over a hundred year timeframe to reflect the long-lived assets that will be used to supply customers at the site.

In this case, we have calculated that, there may be a potential impact on the bills of Affinity Water's existing customers of between -£0.01 and £0.03 per year, while there may be a potential impact on the bills of Southern Water's existing customers of between -£0.02 and £0.00 per year. We are comfortable that these ranges account for the uncertainty in the costs that may be avoided by Affinity Water and Southern Water.

This impact does not take into account the potential spillover benefits to customers arising from dynamic efficiencies achieved as a result of the competitive process to win new sites.

## Developer choice

We take into consideration the choices of the site developer. In this case, the developer said that it wanted IWN to be the water and sewerage company for the site.

## Responses received to the consultation

We received two responses to our consultation; from the Consumer Council for Water ("**CCWater**") and the Environment Agency ("**EA**"). We considered these responses before making the decision to vary IWN's appointment. The main points raised in the responses are set out below.

### CCWater

CCWater noted its concerns about the impact that the growth of new appointments could have on water and sewerage companies' existing customers. It does not

consider that the overall benefit of new appointments and variations to existing customers of the water or sewerage companies is clear.

New appointments and variations provide challenge to existing appointees. This drives efficiencies, stimulates innovation and reveals information. They have the potential to benefit all customers, including through:

- lower prices;
- improved service;
- a better range of products and services;
- environmental benefits; and
- greater choice of supplier for developers and large user customers.

Examples of benefits delivered to date include the following.

- There have been cases in which new appointees provided solutions that meant that significant new capital investment was not necessary. This provided benefits for both the environment and to customers through reduced bills.
- New appointees have provided services using more environmentally sustainable, on-site methods of treatment and discharge.
- In some cases, customers are paying volumetric charges that are between 5% and 13% lower than they would have done if they had been served by the existing appointee, while receiving comparable levels of service.

## **Environment Agency**

The Environment Agency made no objections to us granting this variation, although it made the point that IWN should ensure the Martello Lakes development is included in its Water Resources Management Plan (WRMP). We have reminded IWN of its statutory duty to prepare and maintain a WRMP.

## **Conclusion**

Having assessed IWN's application, and having taken account of the responses we received to our consultation, we decided to grant a variation to IWN's area of appointment to allow it to serve the site for water and sewerage services.