



Variation of Independent Water Networks' appointment to include Forgewood

On 18 May 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 Southern Water's water supply area and Thames Water's sewerage services area called Forgewood in Crawley ("**the site**"). When fully built, the site will consist of 1,900 household properties. The consultation ended on 15 June 2015. During the consultation period, we received representations from two organisations, which we considered in making our decision. On 5 August 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 Southern Water as the appointed water company and Thames 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 Southern Water and a bulk discharge agreement with Thames 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 Southern Water and Thames 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 Southern Water, while matching Thames Water's sewerage charges and Southern 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 Southern Water and Thames 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 Southern Water and Thames Water.

Effect of appointment on Southern Water's and Thames 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 Southern Water's and Thames 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 Southern Water and Thames 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 Southern Water and Thames 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 Southern Water and Thames Water as a result of IWN serving the site, by estimating the costs that Southern Water and Thames 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 Southern Water's existing customers of between -£0.02 and £0.02 per year, while there may be a potential impact on the bills of Thames Water's existing customers of between £0.00 and £0.02 per year. We are comfortable that these ranges account for the uncertainty in the costs that may be avoided by Southern Water and Thames 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.

While there may potentially be an impact in the short run, due to low capital maintenance associated with a new development, capital maintenance will rise as

the assets on these new developments age. On average, an incumbent will have a mix of old and new assets and this would not materially change if the incumbent served new sites rather than a new appointee. We are therefore of the view that the potential cumulative impacts that concern CCWater will not arise or will not be material.

Environment Agency

The Environment Agency made no objections to us granting this variation, although it made the point that IWN should ensure the Forgewood 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.