

Variation of Independent Water Networks' (IWN) appointment to include Berryfields

On 7 May 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 the Thames Water Utilities Ltd (Thames Water) area called Berryfields, in Aylesbury (the Site). The consultation ended on 4 June 2010. During the consultation period Ofwat received one representation which we considered in making our decision. On 21 June 2010, we granted IWN a variation to its existing appointment to enable it to serve Berryfields for water and sewerage services.

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 their businesses. In this case, IWN applied to replace Thames Water as the appointed water and sewerage company for Berryfields.

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 is 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 megalitres per year (in England) or at least 250 megalitres per year (in Wales) and the customer in relation to each premises consents (the 'large user criterion');
- the existing water or 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 that:

1. customers, or future customers, should be no worse off than if the site 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 company.

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 unserved criterion set out in section 7(4)(b) of the Water Industry Act 1991 (WIA91). IWN proposed to serve the Site by taking a bulk supply of water and sewerage services from Thames Water.

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 and sewerage services. We shared this report with Thames Water, which agreed that the Site is unserved and we are satisfied that the Site is unserved.

Financial viability of the proposal

We will only make an appointment if we are satisfied that the proposal is at low risk of being financially non-viable. We assess financial viability risk on a site by site basis and also consider the financial position of the company as a whole. Before consulting we had concluded that, based on the information available to us at that time, the proposal was of low risk of being financially non-viable. We are satisfied that the financial position of the company as a whole is sound.

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 on the Site 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. As such, we have expressed the effect in 'per bill' terms to try and quantify the possible effect in an easily understandable way.

When Berryfields is fully built in 2022, the 3,600 household properties on this Site would potentially have made up 0.062% of Thames Water's customer base. We consider that the upper bound of the potential effect could amount to approximately a £0.07 increase per annual bill for each of Thames Water's existing customers by 2022.

However, these calculations do not include costs saved by, or the value of efficiencies adopted by, Thames Water as a result of the competitive impact of new entry and the threat of new entry on unserved sites. The calculations also take no account of potential cost savings by Thames Water for the provision of bulk water supply and discharge services (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. From this we concluded that Thames Water's customers will not, therefore, automatically see their bills increase by this amount.

In this case, we considered this potential effect to be outweighed by the benefits of granting this variation.

Developer choice

Ofwat takes 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.

Response received to the consultation

We received one response to our consultation, from the Consumer Council for Water (CCWater). We carefully considered CCWater's response before making the decision to vary IWN's appointment. CCWater did 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 responses to each of them.

It would expect new appointees to provide consumers with prices, services and service guarantees that match, and ideally better those of the existing company.

We are satisfied that customers on the Berryfields Site will be no worse off served by IWN than they would have been had they been served by Thames

Water. 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. Our 'no worse off' policy approach was endorsed by the High Court in the recent Llanilid judgment.¹ 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 customers.

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.

Taking into account the scale of the possible disbenefits that may result for Thames Water's existing customer base and the wider benefits we consider the new appointments regime brings for customers, we consider it likely that the disbenefits will be outweighed by the benefits of granting this variation. In this case, Thames Water and IWN have agreed a bulk supply price based on Thames Water's large user tariff and we are satisfied that IWN's proposal on this basis poses a low risk of being financially non-viable. 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 Berryfields is in an area considered by the EA to be water-stressed, CCWater looked to Ofwat for assurance that IWN will have a responsibility to promote water efficiency, in line with other water companies.

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

IWN will have the same duty as all other appointed companies with regards to promoting water efficiency².

It would like to see Ofwat, 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.

In the Llanilid case we set out our view that the new appointments regime brings benefits to customers and we presented evidence in support of this. This was accepted by the Court as reasonable. We are reviewing the effects (costs and benefits) of granting new appointments, and aim to report our findings to coincide with the publication of our final statement of policy on new appointments and variations later this year.

Conclusion

Having assessed IWN's application, and having taken account of the response we received to our consultation, we have decided to grant a variation to IWN's area of appointment to allow it to serve the Berryfields Site. This variation became effective on 21 June 2010.

² 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."