



SSE Water's application for a variation to serve the site at Hunter Avenue, Ashford

On 2 July 2010, Ofwat began a consultation on a proposal to vary SSE Water's appointment to become the sewerage services provider for a development in Southern Water Services Ltd's (Southern Water) Sewerage Services Area called Hunter Avenue, in Ashford (the Site). The consultation ended on 30 July 2010. During the consultation period Ofwat received three representations which we considered in making our decision. On 8 November 2010, we decided not to grant SSE Water the variation to its appointment to enable it to serve this site.

This notice gives our reasons for making that 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, SSE Water applied to replace Southern Water as the appointed sewerage company for Hunter Avenue.

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. 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 company.

The application

SSE Water initially applied to be the sewerage appointee for the Site under the unserved criterion set out in section 7(4)(b) of the Water Industry Act 1991 (WIA91).

However, subsequently Southern Water gave its consent for SSE Water to provide sewerage services to the site and the application was therefore dealt with under the consent criterion set out in section 7(4)(a) of the WIA91.

Basis for our decision

We will only make an appointment if we are satisfied that the proposal poses a 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.

In the consultation in July, we noted that this site carried a relatively high risk of being financially non-viable, in comparison with other sites where new appointments and variations have been granted. We do not define minimum levels of profitability as sufficient to constitute 'viability' as they may reasonably vary depending on the specific application. We need to be satisfied that an appointee will be able to finance its functions on each additional site on a standalone basis. If an applicant cannot demonstrate this, then there is an increased risk that the customers at this site could face increases in price in future years above the level set by the current incumbent. We therefore need to be satisfied that the risk of a site being financially non-viable on a standalone basis is low in order to comply with our policy that a new appointee's customers should be 'no worse off' served by the new appointee than they would have been served by the incumbent. This is particularly important where, as in this case, those customers cannot choose their supplier.

In this case, we took the view that the risk of the Hunter Avenue site being financially non-viable was unacceptably high. We took this view because:

- the forecast gross profit margin as derived using Ofwat's central case assumptions was very low; and
- that margin would be eroded quickly if the assumptions used in the financial model (such as take-up of the WaterSure tariff and bad debt) proved optimistic.

In addition, we noted that this small gross profit margin did not take account of the impact of the costs of taxation, possible future capital expenditure or interest on borrowings or savings. Furthermore, given the small size of the site and the resulting sensitivity of the forecast profit margin to relatively small changes in fixed costs, we had concerns about the effect of costs rising above forecast levels or revenue losses being higher than forecast. Overall, we were concerned that, if we granted this application, SSE Water's customers at this site would face an unacceptable risk of increases in prices in future years above the level set by the current incumbent.

Conclusion

Having assessed SSE Water's application, we considered that the risk of this site being financially non-viable was too high to be acceptable. Therefore, we decided not to grant this variation.