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Trust in water

# New appointment and variation applications – A statement of our policy

Ofwat

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# About this document

This document sets out our policy regarding new appointments and variations of appointments which allow new entrant water and wastewater companies to serve end customers by becoming the local licensed supplier and replacing the existing incumbent for a specific area.

This statement of policy is consistent with our legal duties, which are primarily set out in the Water Industry Act 1991 (WIA91). In drafting this policy, we have had regard to the Strategic Policy Statements issued by Defra and the Welsh Government.

Throughout this document, we use the term 'new appointments' to refer to new appointments and variations of appointments as appropriate, unless otherwise specified. We use the term 'incumbent' to refer to one of the 17 large water or sewerage companies subject to the price review process.

This document should be read alongside the following documents:

- Application process guidance for new appointments and variations (August 2018);
- New appointments and variation applications – the terms of reference for independent professional advisors providing site status reports (February 2011); and
- Bulk charges for NAVs: final guidance (May 2018).

We will keep this policy under review in response to further developments in the sector, as well as changes in legislation and the wider regulatory framework to ensure the policy remains fit for purpose.

# Contents

# 1. Introduction

New appointments and variations ("**NAVs**") allow companies to offer water, sewerage or water and sewerage services to a specific geographic area instead of the existing incumbent company. As a result, developers and large business customers can choose their supplier for these services and enjoy the benefits that they can deliver.

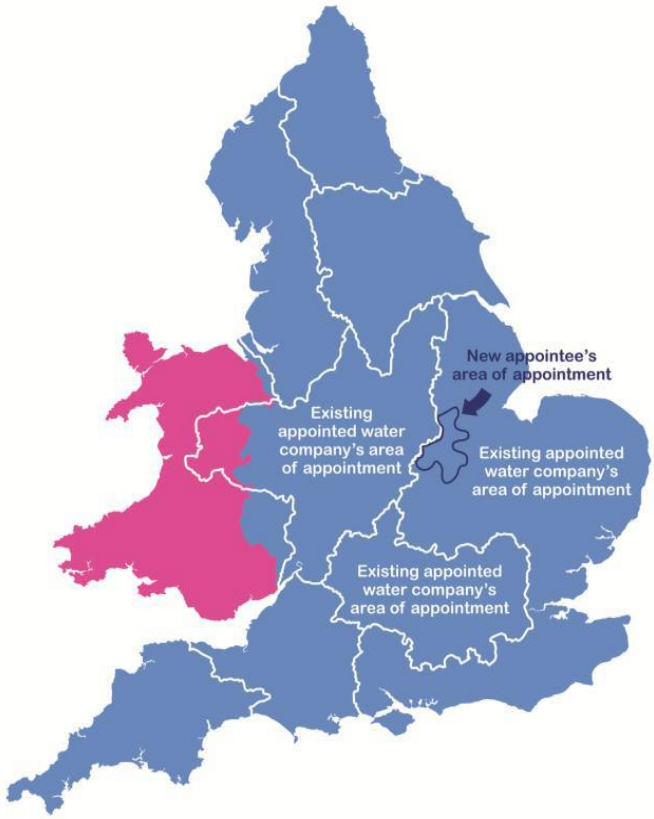
A **new appointment** occurs when we appoint a company for the first time to provide water and sewerage services, water only or sewerage only services for a specific geographic area.

A **variation** occurs when we vary the appointment of an existing appointed company, to extend the areas to which it provides services.

Figure 1 below illustrates an example of how a new appointee's area of appointment could relate to that of existing appointees.1

[1] This example illustrates how a new appointee's area of appointment could relate to that of existing appointees and is not intended to represent the true scale of a new appointee's area of appointment.

**Figure 1: Example of NAV area**




Under section 7(4)(b) of the WIA91, we can appoint a new water only, sewerage only or water and sewerage company. We may grant a new appointment or variation in cases where:

- an area does not contain any premises that receive services from an appointed water or sewerage company (it is '**unserved**');
- a customer(s) uses (or is likely to use) at its premises at least 50 megalitres of water a year (if the area of the relevant appointee concerned is wholly or mainly in England) or 250 megalitres of water a year (if the area of the relevant appointed company concerned is wholly or mainly in Wales) and wants to change its supplier in respect of those premises (a '**large user**'); or
- the existing appointed company agrees to transfer part of its area to a different company (a transfer by '**consent**').

In assessing applications for a new appointment or variation of appointment we will seek to ensure that:

- customers are no worse off than if they had been served by the local incumbent and are adequately protected (the 'no worse off' principle);

- appointed companies can finance their functions for the site and wider business; and
- the applicant will be able to fulfil its functions in that the site will be operationally and technically viable.

Alongside this document, we have published our revised process for assessing applications for new appointments and variations. The assessment process covers:

- how to apply for a new appointment or variation;
- an explanation of each of the application steps and the key issues associated with each step; and
- the interactions that usually occur between applicants and existing appointees during the application process. This includes the timescales in which we expect existing appointees to respond to applicants' requests for information and vice versa.

The remainder of this document is structured as follows:

- Section 2 looks at the wider context of NAVs;
- Section 3 sets out our aims for NAVs;
- Section 4 discusses criteria for determining if a new appointee can serve a site;
- Section 5 examines how we go about assessing a NAV application.

# 2. The wider context

New appointments and variations are one of the longest standing market opportunities in the water sector.

The 2011 Cave review[2] recognised that new appointments represent an important mechanism for enabling market entry and recommended reducing entry barriers where this does not reduce the protection customers receive.

The Water Act 2014 (WA14) also recognised the role markets could play in the water sector and built on the Cave review by making significant changes to the sector including introducing the non-household retail market (in England) and allowing Ofwat to make charging rules. The WIA14 also provided for the English and Welsh governments to issue Strategic Policy Statements (SPS) for Ofwat. Ofwat must carry out specified functions in accordance with those statements.

In January 2016, we published #Trustinwater our strategy for the sector explaining how we will work with others for the benefit of customers of water and waste water services as well as wider society. Our Water2020 programme set out how we anticipate harnessing markets, including NAVs, more widely across the sector to help deliver our vision.

However, NAVs' growth remained limited. So in May 2017 we published a Study of the NAV Market by Frontier Economics which looked at barriers faced by new appointees in undertaking more activity in the sector. We committed to undertake a number of actions to address those barriers in our Summary of Findings and Next Steps. These actions include the production of new Bulk charges for NAVs guidance which ensure that where new appointees rely on incumbents for essential access they can gain access on reasonable price terms.

The current Strategic Policy Statement for England[3] also provides important context for NAVs. It highlights resilience as a priority area for Ofwat, to ensure that the sector can meet the needs of people, businesses and the environment now and in the future. It explicitly includes meeting the housing needs of a growing population within this. It says that it expects water companies to achieve timely connections to new developments using, where appropriate, innovative approaches within the charging regime, to ensure there is no delay in getting homes build. The English SPS also stresses that we should promote markets to drive innovation and achieve efficiencies

[2] Competition and innovation in the water markets (Cave review), https://www.gov.uk/government/publications/competition-and-innovation-in-the-water-markets-cave-review

[3] Under the WA14 Ofwat must carry out specified functions in accordance with this statement

in a way that takes account of the need to further (i) the long-term resilience of water and waste water systems and services; and (ii) the protection of vulnerable customers. It goes on to say we should explore the full range of ways in which we can bring competitive pressures to bear in the water market to further these goals.

The current Strategic Policy Statement for Wales[4] also emphasises the importance of resilience and the importance of innovation to deliver services for customers and the environment more efficiently. It says we should encourage and incentivise the sustainable and efficient use of water resources, and the management of waste water and surface water in an integrated and sustainable way. It also recognises the potential role that markets can sometimes play in raising performance standards and driving efficiency. It says we should seek to ensure that there is a level playing field between new appointments and existing undertakers.

[4]Under the WA14 Ofwat must carry out specified functions in accordance with this statement.

# 3. Our aims

## 3.1. Protecting consumers' interests

We have a legal duty to protect the interests of consumers, wherever appropriate by promoting effective competition between companies providing or connected with the provision of water and sewerage services.

We consider that allowing alternative suppliers to compete with the existing appointee to provide services to a particular area protects the interests of customers by providing a challenge to existing appointees. This drives efficiencies, stimulates innovation and reveals information.

Examples of benefits delivered to date include the following:

- There have been cases in which a new appointee 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.
- In several cases, the new appointee provided services using on-site methods which reduce the need for the existing appointee to develop new water resource or expand waste treatment facilities and often lead to environmental benefits.
- In other cases, customers are paying volumetric charges that are lower than they would have done if they had been served by the existing appointee, while receiving comparable levels of service.

When deciding whether to grant a particular new appointment, we must ensure that all customers are protected We must be satisfied that the customers of the new appointment will receive a level of service and price at least comparable to those they would have had if they continued to be supplied by the existing appointee for that area. We must also consider the potential impact of our decision on all of the existing appointee's customers and ensure that services are maintained.

New appointees have the same duties and responsibilities that apply to all existing appointees and we must also be satisfied that the new appointee has the appropriate ability and resources to comply with its legal duties. It is for the companies to ensure that they are meeting both their legal obligations and their customers' expectations.

In addition, as applicable, the Drinking Water Inspectorate[5] (DWI), Environment Agency and Natural Resources Wales (NRW) must be satisfied that an applicant has

[5] The DWI has published a guidance document that sets out how it will assess an applicant's competency to supply water through its supply system for domestic purposes.

the appropriate knowledge, skills and competencies required before an appointment is granted.

## 3.2. Sustainable water and sewerage services

The WA14 introduced an explicit statement that we must further the resilience objective to secure the long-term resilience of water companies' water supply and wastewater systems; and to secure that they take steps to enable them, in the long term, to meet the need for water supplies and wastewater services. Under the WIA91 we also have a duty to contribute towards sustainable development.

By embedding resilience and sustainability within our policies, and encouraging the sectors to take sensible and measured steps to safeguard the future, we can meet the new challenges we all face, including increased water scarcity and a growing population. These challenges were emphasised in the 2018 National Infrastructure Assessment.[6]

To achieve this, we need to encourage the best possible use of our valuable water resources and ensure that water and sewerage services are provided in the most efficient way. New appointments can help to deliver this in three ways. They:

- drive down costs of providing new infrastructure;
- improve the ways scarce resources are allocated; and
- encourage all companies to find better ways of doing things.

## 3.3. Improving services to developers and facilitating home building

NAVs provide an alternative to incumbents and self-lay providers for developers to obtain new connections. Providing developers with more options enables them to pick the provider that best suits their needs. In turn that should accelerate the building of new homes, meeting one of the objectives set out by both the Welsh Government and Defra in their respective SPS.

For example, by exploring and adopting different network designs, NAVs can help developers make hard to connect site easier to serve which in turn facilitates the development of more sites. NAVs that provide multi-utility services can simplify the laying of essential infrastructure and in doing so speed-up the development of sites.

[6] https://www.nic.org.uk/publications/national-infrastructure-assessment-2018/

## 3.4. Clarity for stakeholders – a transparent policy and an efficient process

We have had a policy on NAVs in place since 1999 which was last updated in 2014 to reflect our experiences and feedback from stakeholders involved in the new appointments framework.

Since 2014 stakeholders have told us about a number of issues affecting them. Most notably, Frontier Economics held a number of stakeholder workshops in 2017 which identified a number of issues with our own processes which could be preventing new appointees from competing effectively. This updated policy and process guidance addresses several of the issues identified. In particular:

- new appointees requested greater clarity on our approach to assessing whether a site meets a criteria for a NAV which is addressed in section 4;
- new appointees also wanted a more streamlined application process and one that gave them greater clarity and certainty, we have responded to this in how we go about assessing NAV applications which we set out in section 5.

# 4. Qualifying criteria for a new appointment

## 4.1. The applicant

Under section 7(4) WIA91, we can only grant a new appointment or variation of appointment if the application falls under one or more of the following criteria:

- the unserved criterion (section 4.2);
- the large user criterion (section 4.3); or
- the consent criterion (section 4.4).

Applicants must specify under which criterion or criteria they are applying for a new appointment. If an applicant considers that the proposed area of appointment ('the site') may qualify under more than one criterion, it must make clear under which criterion it is applying (and it may apply under more than one). In every instance it must state clearly which criteria it believes applies and why.

We will consider if the application meets the requirements of the relevant criterion or criteria when we make our assessment.

## 4.2. The unserved criterion

Section 5.3.1 of our application guidance sets out the information that we require from applicants in order to assess if a site is unserved. The decision whether to grant an application made under the unserved criterion rests with us so we must be given sufficient evidence to be satisfied the site is unserved.

### 4.2.1. Legislative requirements

We can grant a new appointment under this criterion if none of the premises in the proposed appointment area are:

- supplied with water by means of a connection to a distribution main of the existing water company (in the case of an application to supply water); or
- drained by means of a public sewer or lateral drain of the existing sewerage company (in the case of an application to discharge sewage).[7]

[7] Sections 7(4)(b) and 36 of the WIA91 and see section 219 of the WIA91 which defines the terms 'drain', 'lateral drain', 'sewer', and 'public sewer'.

In this case:

- ‘served’ means served by the existing appointee. A site will not be served if it receives water or sewerage services from someone other than an appointed water or sewerage company. For example, a developer may provide sewerage services to the site by way of a private sewerage system including on-site sewage treatment works. This will not render the site served;
- it is not enough for premises to be capable of being supplied with water or drained – there must be an actual supply of water or actual drainage for the premises to be supplied. For example, if a developer installs sewerage pipes that will drain to a public sewer of the existing appointee, this will not render the site served if the pipes are plugged until after the appointment is made;
- our assessment is based on whether the site contains premises that are served at the time the appointment is granted. Knowing that a site contained premises that were served in the past may help us to identify the existence of on-site assets. This applies particularly to disused sites that are redeveloped over time. But it is not directly relevant to our decision on whether the site is served at the time the appointment is made; and
- it is possible that premises are served for one service (such as sewerage) but unserved for the other.

### 4.2.2.The meaning of ‘premises’

The WIA91 does not define ‘premises’, so must take its meaning from the legal context in which it appears. In ‘R oao Thames Water Utilities Ltd v Water Services Regulation Authority’[8], the court accepted that in the context of section 7(4) of the WIA91 premises may mean buildings, land or both.

Examples of different premises are:

- The ‘premises’ of a farming business might comprise a group of farm buildings with or without the attached farmland.
- The ‘premises’ of a small firm or company might comprise one or two rooms on an upper floor of a much larger building.
- The ‘premises’ of a large corporation might consist of the entirety of a large office block and the adjacent car park.
- Depending on the circumstances, a development site or an industrial park may comprise a single premises.

[8] [2010] EWHC 3331 (Admin) at paragraph 19. See also [2012] EWCA Civ 218 at paragraphs 29 and 30.

From the above examples, it is clear that what constitutes ‘premises’ may change over time. So, for example, a large building that comprises of more than one premises may be bought by a single corporation and may become one premises. Similarly, a development site may constitute one premises during the development and a number of separate premises afterwards.

We will refer to the description of the premises as contained in the relevant conveyance or planning permission to determine the boundaries of served premises. We will also consider ownership or occupation, and the purpose of the premises. In addition, we will consider the extent of the land or buildings that benefit from a water or sewer connection.

If it can be demonstrated that there is a connection to an existing appointee’s network somewhere within the applicant’s proposed area of appointment, the whole site will be served unless the applicant chooses and is able to carve out of the appointment area the premises served by that connection.

If an applicant redraws a site boundary to exclude served premises, the remainder of the site may be regarded as unserved if no part of the remainder benefits from a relevant water or sewer connection. We adopt a pragmatic approach that deals with each site on its own merits. We will not allow a carve-out of areas of a site if that gives rise to practical or operational difficulties. To assess applications that carve out individual premises or clusters of premises within the wider site boundary we will consider the following points:

- the areas of the different undertakers should be capable of clear demarcation. The applicant and the incumbent should seek to agree a boundary demarcation, which will be acceptable to all parties and which will ensure customers are no worse off. Generally, this will mean that an area that is carved out of the site will be on the boundary of the site. If an application proposes inserting an internal boundary line within a proposed site boundary, we will consider internal boundaries that provide clear and identifiable areas that can be served by the incumbent without operational difficulties;
- the applicant and incumbent must have considered and addressed the complexity of having infrastructure of two companies on the same wider site and the impact this may have on customers. The current incumbent may have buried infrastructure (such as pipes, hydrants and valves) which will run through the land of the proposed appointment area, even if the buildings are excluded through the use of internal boundaries; and
- the customers on the site and of the incumbent must be no worse off as a result of the carving out process. In determining whether customers are no worse off

the issue of having infrastructure of two companies serving one area will be a consideration.

### 4.2.3.Greenfield sites

The legislation does not distinguish between undeveloped (greenfield) sites and those that are undergoing redevelopment (brownfield sites). But in practice different considerations apply.

It is usually relatively straightforward to determine if a greenfield site is unserved. But we will still need to make sure that the site has no connections and is not served, even if there are no buildings on it.

For example, greenfield site may be served if:

- the surface water drains into a lateral drain or sewers of the existing appointee; or
- it is farmland that the existing appointee supplies with water (for example, by irrigation or to supply a cattle trough).

On new developments, it is usual for underground pipes to be installed before houses are built. Depending on the timing of the appointment, this may render a greenfield site served. Generally, if developers lay a pipe network before we have finished processing an application, they ensure that the network does not connect to the existing appointee's infrastructure until after the appointment has been made so as not to jeopardise the unserved status of the site.

If a connection from the existing appointee's infrastructure is made 'live' before an appointment is made, that may render the premises served (for example, a permanent connection to a show home or site office).

A temporary supply of water from the existing appointee (for example, installed to facilitate the construction process or supply a site office), will not in itself mean a site is served. This also applies to temporary drainage.

### 4.2.4.Brownfield sites

Brownfield sites are more complex to assess and there are fewer applications for them.

We will take a common-sense approach to determine if a brownfield site is served. The Appeal Court supported this approach in *R oao Thames Water Utilities Ltd v*

*Water Services Regulation Authority* where the court said the following in relation to a brownfield site:

"The unserved criterion is in my judgment met when the premises in question are not in substance served by the sitting undertaker, and it will be for Ofwat to judge whether in any given circumstances the test is satisfied."[9]

We will consider all relevant factors in determining the state of affairs on the site. For example, we will take into account when the site stopped receiving services from the existing appointee and the reason (or reasons) for this. We will also consider if buildings on the site have been demolished and if pipes have been disconnected.[10]

If buildings are demolished and all existing connections removed, those premises will be unserved. In the case of extensive refurbishments (for example, if the shell of a building remains), the premises will be unserved if all pre-existing connections are removed.

But even if buildings are demolished, a site may be served if a water connection is available for use on the remaining land. It may also be served for sewerage purposes if surface water drains either directly or indirectly through an intermediate drain or sewer to a public sewer or lateral drain of the existing appointee.

As with greenfield sites, a temporary supply of water from the existing appointee, installed to facilitate the construction process, will not mean the site is served.

### 4.2.5.Surface water drainage at unserved sites

We consider that premises will be served for sewerage purposes if surface water drains into a drain or private sewer, which then discharges into the existing appointee's lateral drain or a public sewer. This is regardless of whether the lateral drain or public sewer is on- or off-site.

Similarly, we consider that premises will not be served for sewerage purposes if there is no on-site infrastructure to drain surface water and it goes directly into the ground or runs off the premises via a hard surface (such as a road).

[9] [2012] EWCA Civ 218 paragraph 20.

[10] *R oao Thames Water Utilities Ltd v Water Services Regulation Authority* [2012] EWCA Civ 218 paragraph 24.

## 4.3. The large user criterion

A company may apply for a new appointment to serve a customer that uses (or is likely to use) at each of its premises: at least 50 million litres of water a year if the area of the relevant appointee concerned is wholly or mainly in England; 250 million litres of water a year if the area of the relevant appointed company concerned is wholly or mainly in Wales. The customer concerned must consent to the appointment.

Typically, the customer is a large industrial user but the Appeal Court has held that[11] a development site may qualify under the large user criterion if it can be shown that:

- the site can be regarded as a single premises, served by the existing appointee;
- the developer, as customer of the existing appointee, consents to the appointment; and
- the premises are, or are likely to be supplied with at least 50 million litres of water in a 12-month period.

The same threshold levels apply to new appointments for sewerage services, in terms of the volume of water supplied, not the amount of effluent discharged.

Section 5.3.2 of our application guidance sets out the information we require from applicants in order to assess whether an application meets the large user criterion.

## 4.4. The consent criterion

This criterion applies when an existing appointee consents to transfer a specific part of its supply area to another appointee. The 'other' appointee could be a new or existing appointee, whose existing area of appointment could be varied to include this additional area.

Section 5.3.3 of our application guidance sets out the information we require from applicants in order to assess whether an application meets the consent criterion.

[11] R oao Thames Water Utilities Ltd v Water Services Regulation Authority CO/6799/2010 paragraphs 26 to 36.

# 5. Assessing applications

This section sets out our broad approach to assessing NAV applications. In all cases, we look at the impact of the proposed changes directly on customers in terms of charges and service standards, and indirectly in terms of the financial viability of the companies involved and their operational viability. The information we require and assessment we perform is different for applications made by new or existing appointees.

For applications from new entrants, our assessment of the impact on customers focuses on the no-worse-off principle which we discuss in section 5.1. Our assessment of the financial viability is discussed in section 5.2 - this includes a discussion of recent applications were we have adopted an assessment of the viability of several sites as a package. Finally, operational viability is discussed in section 5.3.

Our assessment of applications from incumbents wishing to serve a site out of its existing area is likely to be different to that for new appointee. The form of any assessment will depend on the scale of the area being transferred. How we will conduct such an assessment is discussed in section 5.4.

We aim to be flexible in assessing NAV applications and to adopt the most appropriate approach that enables us to fulfil our duties. That means that our approach to assessing NAVs is constantly evolving as evidenced by the recent assessment of financial viability on packages of sites. Where a NAV proposes an alternative assessment we will consider how it ensures customers will be protected.

## 5.1. Assessing the impact on customers of new appointee

In deciding whether to grant an application by a new appointee, we will consider the overall effect that a new appointment may have on customers. This includes the price for customers on the site, the service for these customers, and whether higher prices merit a higher service. We also look at customers remaining with existing appointees. These points are discussed in turn below.

### 5.1.1. Price for on-site customers

When assessing a NAV application we will compare the existing appointee's charges scheme with the applicant's proposed charges scheme to satisfy ourselves that, in

general, customers on the site will not pay a higher price for water and sewerage services than they would have done if the existing appointee had supplied them. [12]

We will take into account any social or special tariffs that the existing appointee offers when assessing if customers on the site will be no worse off overall. The new appointee should ensure that it offers tariffs that are, on balance, on terms at least as favourable to the relevant customers as the relevant tariffs of the existing appointee.

Along with other appointed water companies, new appointees are legally required to comply with the regulations made under section 143A of the WIA91.[13] These regulations provide that charges schemes must comply with requirements to provide help to customers who may struggle to pay their bill.

The onus is on the new appointee to ensure that they include social tariffs within their charges scheme and to ensure that the published terms of such tariffs comply with the relevant regulations.

If an applicant does not offer as many tariff options as the existing supplier, this does not automatically mean that as a result customers will be worse off. This is because we do not consider it to be proportionate to expect new appointees to duplicate every service offering of the existing appointee as long as, on balance, we are satisfied that its customers will receive a service that is comparable to that provided by the existing supplier.

After a NAV licence is granted, Condition B of new appointees' conditions requires that it sets tariffs each year that are no higher than the local incumbent's relevant tariff (as set out in the local incumbent's charges scheme). Where there is not a clear comparator or an incumbent does not have a relevant charge (for example where a new appointee installs domestic non-potable supplies and the incumbent does not offer a comparable service) we expect the new appointee to ensure that customers do not pay more overall than they would have had they been supplied by the incumbent. The new appointee could achieve this by comparing average bills for different usage profiles for customers on their site. We may also ask for evidence in the NAV application from the applicant that its customers do not regard the service as significantly worse and that there is no significant adverse impact on any particular class of customers.

[12] We do not require that customers on the site be better off being served by the new appointee rather than the incumbent but we do require that they will be at least no-worse off. This approach has been upheld by the High Court, see: R (oao Welsh Water) v Water Services Regulation Authority [2009] EWHC 3493 (Admin).
[13] Water Industry (Charges) (Vulnerable Groups) (Consolidation) Regulations 2015.

Our charging rules require new appointees to consult on proposed charging schemes and to publish tariffs along with board assurance each year. The onus is on the new appointee to keep tariffs under review and demonstrate how they continue to ensure customers are no worse off while their charges are compared to the existing appointee.

### 5.1.2.Service standards for on-site customers

New appointees' customers should benefit from levels of service that are at least comparable to those that they would have received had the existing appointee supplied them.

We will take a balanced approach when we assess the service offering of applications received for new appointments. As part of the application, the applicant should provide evidence to us that customers would be, overall, 'no worse off' as a result of us granting an appointment. This does not mean we require new appointees to duplicate every service offering of the existing appointee.

### 5.1.3.A higher price for a higher level of service

We consider that a better standard of service for a higher price may not be inconsistent with the 'no worse off' principle. However, if there are existing customers on the site, we will only grant such applications where the applicant presents clear evidence of customer support, along with a clear statement from the applicant as to how they would deliver the proposed service.

Where a new appointee intends to charge a higher price for a higher level of service this may require an amendment to licence condition B which prevents new appointees from setting tariffs higher than the relevant tariffs of the incumbent. In considering whether to consent to higher tariffs we will expect the new appointee to demonstrate, and keep under review, that customers are overall no worse off than if they had been supplied by the incumbent. As discussed above we would expect the new appointee to demonstrate that any differences in tariffs do not adversely impact different classes of customers.

For applications made under the large user criteria where no household customers are affected, we expect contractual arrangements to be in place to ensure that new appointees would deliver the higher standard of service on offer.

### 5.1.4.Customers remaining with the existing appointee

When considering a NAV application we also assess the impact it is expected to have on the customers that remain with the existing provider. That includes an assessment of the potential bill impact as well as a consideration of whether there may be an impact to service standards. Our assessment of the bill impact examines how the average cost of serving customers in the incumbent's existing area would change if it was to serve the site rather than the new entrant. The assessment of the impact on service standards is typically qualitative and looks at whether the incumbent's service standards to existing customers would be expected to change if it served the site.

We also consider that some of the benefits from NAVs including environmental impacts, incumbents' cost reductions, and improvements in regulation overall will accrue to these customers.

## 5.2. Assessing financial viability of new appointee

Under section 2(2A)(c) of the WIA91, we have a duty to ensure that efficient companies can finance their functions. To fulfil this duty, we will look at the financial viability of the site and the applicant's wider business to determine if the company as a whole will remain financially viable if it serves the site, or sites, being applied for.

Our assessment of financial viability will ensure that the (reasonably) projected costs of operating the site will be covered by the (reasonably) projected revenues but we will also need to be satisfied that the new appointee has access to a sufficient level of finance to deal with any unexpected cost pressures.

Our approach to the financial viability assessment and the financial security requirements are discussed below.

### 5.2.1. Financial Viability Assessment

When fulfilling our duty to ensure companies can finance their functions, we want to minimise the risk of creating obstacles to companies entering the market with profitable, and potentially innovative, business models.

We therefore apply our financial viability assessment in different ways depending on the circumstances. These approaches are based on:

- Assessing the financial viability of an individual site;
- Assessing the impact on the whole company of adding an additional site; and/or
- Assessing the impact on the company of adding a package of new sites.

For applicants without existing sites we can only conduct a site specific assessment. However, as new appointees grow and become better established, we may have enough information about the company to do a less stringent site analysis and to focus more on the company as a whole, looking at actual financial results from sites already granted to examine the profitability of the company overall. This means that we do not have to make judgements on the detailed commercial decisions of the applicant. But where an applicant's portfolio is nascent, we will also complete a site-specific assessment as the impact of the new site on the companies' overall finances will be greater.

For applicants with an existing portfolio of sites we may also consider a package of applications, examining the stand-alone package rather than each individual site, as well as looking at the impact on the company as a whole. This is a new development in our approach to assessing applications. The ability to combine several sites into a single NAV application could streamline the application process for an applicant and enable it to account for economies of scale or scope in serving several additional sites which may be greater than just serving a single additional site.

However, basing an assessment of financial viability on a package of sites introduces the risk that the more profitable sites are delayed or cancelled. This could leave the new appointee with a less financially resilient portfolio, which in turn increases the risk that it may face financial difficulties and reduce customers' protection. If a NAV applicant intends to rely on a package-based assessment we expect it to be able to demonstrate how customers will continue to be protected from any additional risk. In particular we expect the applicant to set out in its NAV application (in Supporting Document 9):

- how financially resilient its existing portfolio is;
- an assessment of the incremental risk if individual sites are delayed or an application for a site is withdrawn, and the impact on the package;
- how the applicant will manage and mitigate the risk of more profitable sites being delayed, not going ahead or being less profitable than forecast;
- how the existing portfolio is sufficiently robust and of sufficient scale to accommodate the additional risk if only a subset of sites goes ahead; and
- that the revenues from each site at least cover the operating costs of serving the site even if there is no contribution towards common costs of the company – or where this is not the case, the new appointee has a contractual agreement with the developer that allows it to cover costs if one or more sites in the package does not proceed as anticipated.

We may be more willing to accept a package of applications if the applicant has put in place additional financial safeguards.

In sections 5.6.1 - 5.6.3 of our Application Guidance we set out the information that we require applicants to provide, to allow us to carry out our assessment of financial viability. The level of information is dependent on the type of application (new appointment/ variation) and the number of previous applications we have received and granted from the applicant.

In all cases – whether site by site, company-based or package approach - we have not specified a "hurdle rate" (for example amount of profit) that a site would need to meet in order for us to consider it financially viable or non-viable. We consider this would mean we lose the flexibility to make judgements about proposals that inevitably involve factors not apparent from consideration of a single measure of an applicant's financial performance and position.

### 5.2.2. Financial Security Requirements

When we consider the financial position of the applicant we need to be satisfied that it will have continued access to sufficient resources to fulfil its duties and obligations and to protect its customers to deal with any unexpected cost pressures. This could include, by way of example, the availability of external and group finance, and the financial security or guarantees that are in place to protect the appointee's customers.

The level of financial security should be linked to the forecast operating costs for the business. In general, we will use the following formula for calculating the minimum level of financial security required from new appointees:

> One year's annual operating costs required to supply the number of connections the business is projected to have in two years' time (as included in granted applications and current applications) = minimum level of financial security.

As their business develops, new appointees are responsible for continually monitoring the minimum level of financial security they need to ensure they meet our requirements. The level of security required will increase over time as the new appointee's number of connections increases.

In calculating 'operating costs' in the above formula, applicants must include bulk supply costs. This is because the bulk services that new appointees purchase from

existing appointees are an essential component of the operation of the new appointee's business.

Financial security may take various forms including Parent Company Guarantees or bonds. We will consider alternative mechanisms for providing financial security based on the applicant's specific circumstances and the application in question. The new appointee should explain to us how its proposed approach provides an appropriate level of financial security. We would also need to consider the business model adopted, along with any use of associated companies to provide services.

Where a new appointee has a proven track record of financial stability while delivering services to a significant number of customers in the water and/or waste water sectors, we may consider reducing the minimum level of financial security that we require them to hold. However, this will be determined on a case by case basis following engagement with the relevant appointee.

## 5.3. Assessment of operational viability of new entrants

It is important that new entrants are able to ensure that customers receive a good level of service. As part of a NAV application we expect the new entrant to demonstrate how it will provide services to the new area. Section 5.7 of the Application Guidance sets out in detail the information we require as part of an application.

Where a new entrant already serves customers at other sites, it can explain how resources at those sites can be deployed to maintain services at the site (or sites) that are included in the application. Where a new entrant is applying for an initial licence, or where the site is far away from existing sites, the application should explain how services will be maintained and what distinct resources will be in place.

## 5.4. Our assessment of applications by incumbent companies

Our process does not distinguish between applications made by an incumbents or new entrant. But our information requirements do differ slightly. For example, we would not normally require information from an existing appointee on its financial security or operational viability because this is tested as part of the price review process. There are exceptions to this. For example, if the site it wishes to supply is not nearby geographically or if the scale of the new sites is so large as to raise the potential that it may impact the financial viability. The information we require from new and existing appointees is set out in our Application Guidance.

Incumbent companies that apply to serve a new site should engage with us at the pre-application stage on their charging proposal for that new site. This will help avoid delays arising while we process the application.

We will consider whether to require incumbent companies to adopt their existing prices or match the prices of the current provider on a case by case basis. For example, for new development sites applied for under the unserved criterion, it may be appropriate for incumbent companies to charge new customers consistently with the rest of their existing customer base (rather than to match the charges of the previous incumbent) if the site intersects with the incumbents existing area of appointment. However, if an incumbent company is taking over existing customers with the agreement of an another incumbent, under the consent criterion, it is likely to be fairer for the new company to match or better the prices offered to those customers to ensure that existing customers are not made worse off.

We expect incumbent companies to always adopt their existing service levels and performance commitments/ODIs rather than matching those of the incumbent in whose area they are applying. This is because amending performance commitments and associated ODIs that are already in place would be highly complex and would only apply for the remainder of a price control period before being reset.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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