Revenue forecasting incentive mechanism for AMP6 consultation
Markets and Economics Division
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

4th June 2014

Dear Sir,

Revenue Forecasting Incentive Mechanism for AMP6 Consultation

Our responses to the consultation are given below.

Q1 Do you agree with the need for a revenue forecasting incentive in AMP6?

We agree that a revenue forecasting incentive for the wholesale business is desirable to discourage companies from accumulating large over or under recoveries against allowed revenue. This should help avoid large revenue catch-ups at the next price review which would otherwise be a potential source of bill instability for customers. We think investors would also prefer the predictability of revenues that the incentives would encourage.

Q2 Do you have any comments on our proposed approach to wholesale revenue forecasting incentive mechanism (WRFIM)

We think that companies that are making a relatively rapid transition to measured charging may be subject to additional revenue uncertainty because the post-switching demand is not known in advance and requires a number of meter readings taken over time, to establish. Therefore, in addition to the examples of reasons given for revenue deviations – successive wet or dry years and planning delays affecting numbers of new connections - we would suggest also the expansion of metered charging as a relevant consideration.

Q3 Do you agree with a revenue flexibility threshold of +2/-2% of adjusted allowed revenue for the wholesale water and wastewater controls? Please provide supporting evidence and analysis should you wish to propose different level l of flexibility?

We agree with the values for flexibility thresholds proposed as these are based on the evidence available on revenue deviations during AMP4 and AMP5. Provided companies are allowed flexibility to adjust their charges to target allowed revenues we think the deadbands give tolerance that would be acceptable in most circumstances.

Affinity Water Limited | Registered Office: Tamblin Way, Hatfield, Hertfordshire, AL10 9EZ | www.affinitywater.co.uk | tel 01707 268111 | fax 01707 277333

Q4 Do you agree with a penalty rate of 3%? Please provide supporting evidence and analysis should you wish to propose a different penalty rate?

The penalty rate of 3% appears to be appropriate, being broadly consistent with precedents in other regulated industries and similar to WACC, 3.7%, published in the Risk and Reward Guidance.

Q5 Do you agree with the use of separate revenue forecasting incentive mechanism in the retail control? If so do you agree with the use of an equivalent mechanism as in the wholesale control, with the same parameters?

We do not think a separate mechanism for retail revenue forecasting is necessary. As retail revenues are about 10 times smaller than wholesale revenues, the financial values of incentives from an equivalent mechanism are correspondingly smaller. We think it unlikely that these would be large enough to be effective incentives. Further, the retail price controls – being average revenue per customer controls - will automatically adjust total revenues for changes in the size of the customer base. It is likely that a key source for retail revenue uncertainty is already being addressed by the form of control. There is a risk therefore that it could increase regulatory burdens whilst producing little benefit for customers.

Q6 Do you agree with the proposed cap and collar mechanism as a trigger to further investigation to provide additional safeguards to customers?

From the analysis published in the consultation, deviations in revenue as large as the +6%/-6% proposed cap and collar have been extremely rare. It therefore seems reasonable that a company accumulating such a large over or under recovery be required to explain and justify its position, and explain its plans and commitment to rectifying the situation. This would give customers assurance that if financial incentives alone prove less effective than expected, there is a further protection in place.

Q7 Do you agree that we could additionally use the WRFIM to incentivise accurate projections of revenues for 2014-15 in our final determinations?

We suggest that the incentive is brought into force for the first year of AMP6 rather than in the last year of AMP5 to avoid any risk of retrospectively applying this regulation given that our Principal Statement for 2014/15 was drawn up without knowledge of this policy development.

Yours faithfully,

Richard Moriarty
Regulation Director

Affinity Water Limited | Registered Office: Tamblin Way, Hatfield, Hertfordshire, AL10 9EZ | www.affinitywater.co.uk | tel 01707 268111 | fax 01707 277333

Registered in England No. 2546950