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Revenue Forecasting Incentive
Mechanism for AMP6 Consultation
Markets and Economics Division
Ofwat
Centre City Tower
7 Hill Street
Birmingham
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2 June 2014

Dear Sirs,

Re: Revenue forecasting incentive mechanism for AMP6 – a consultation

We welcome the opportunity to respond to this consultation.

This letter, at Annex 1, sets out our views on the eight specific questions as set out in the consultation document.

If you wish to discuss any points raised in this response please do not hesitate to contact us.

Yours sincerely,

Jean Spencer

Jean Spencer
Regulation Director

Annex one – Consultation question responses

Q1. Do you agree with the need for a revenue forecasting incentive in AMP6?
Q2. Do you have any comments on our proposed approach to the wholesale revenue forecasting incentive mechanism (WRFIM)?

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 a different level of flexibility.

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.

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

Q8. Do you have any comments in relation to the details and mechanics of the iteration process?

In summary, we do not think there is a case, on balance, for a revenue forecasting incentive in AMP6. By way of pre-amble it is worth setting out what we understood to be the general framework that Ofwat was proposing when it published its final methodology document last year.

In sum, Ofwat would set revenue controls for each wholesale business for each year in the five year period. The job of companies was to set charges, each year, so as to generate revenue that came as close as possible to equalling allowed revenue, ideally in each individual year of the five year period but more realistically over the course of the whole five year period, given that fluctuations from one year to the next are inevitable.

We saw that this set of proposals had considerable merits. In particular, companies would have flexibility to decide how to recover/compensate variances experienced in one year in charges in subsequent years. They would be in a position to have regard to whether they interpreted a variance as being a "one-off" (e.g. due to extreme weather) or more permanent (e.g. the result of the closing of a large factory). When setting charges for any one year (year *t*, say) they could take into account the out-turn variance for year *t-2*, the latest information on how year *t-1* was expected to turn out, as well as any relevant information as to what was expected to happen in years *t*, *t+1*, and so forth.

In addition, companies would be able to take into account the bill profile, both current and forecast, and how it would be affected by the different options for reflecting the above variances. This would enable it, for example, to smooth an increase over more than one year, rather than recovering all of a revenue shortfall in one year through a comparatively large bill increase, only to reverse it in the following year.

The onus would be on the company to reflect all of this information "in the round" in setting its prices and therefore its forecast revenue for year *t*, all against the backdrop of the over-riding objective of recovering over the five year period exactly the amounts allowed by the regulator, and the importance of bill stability from one year to the next.

We believe this is what was meant by the following statement:

"We would expect companies to use this flexibility to manage revenues appropriately during the price control period, both to ensure bill stability for current customers and also so that future customers will not face significant price disturbances." (Ofwat's final methodology paper, page 43)

Indeed, the current consultation paper at the bottom of page 9 set out:

"These adapted mechanisms will give the companies more scope to smooth changes from unexpectedly high or low demand (relative to the projections made in their business plans) over time, with fewer constraints on pricing adjustments being created by the regulatory decisions at the periodic price review".

Further, it had been our understanding that if it was observed that there appeared to be a systematic variance between allowed and out-turn revenue for any particular company, i.e. that companies were misusing the flexibility provided by the mechanisms, that might be evidence of a lack of capability or some form of "gaming", Ofwat could use its powers to investigate and require remedial action if it appeared that customers interests were at risk.

Against this background there are several reasons why we do not agree with the need for the forecasting incentive, as proposed by Ofwat.

First, we should not lose sight of the fact that, whilst we agree with the principle that companies should be incentivised to set charges that minimise variances between allowed and out-turn revenues, strong incentives to avoid significant fluctuations already exist for the following reasons:

- companies have to manage the relationship with their customers and customer representatives on an ongoing basis. It is not in their interests to put themselves in a position where they have to "spring surprises". In particular, as part of the annual price-setting process, companies will not wish to be in a position where they are saying "we are putting your price up because we didn't charge you enough last year" or "we are putting your price down because we over-charged you last year";

- it is an important driver of companies' legitimacy – especially against the backdrop of concerns regarding the conduct of companies in the energy sectors – that they are setting prices each year in line with the medium term expectations set by the regulatory determination; and
- significant variances between revenue forecasts and out-turns do not reflect well on the company's planning and management capabilities. Barring unforeseen "shocks" (e.g prolonged spells of unusually hot and dry weather) water companies ought to be able to forecast turnover for the coming year within fairly narrow degrees of tolerance.

Second, the proposed incentive mechanism set out in the paper would actually remove most of the flexibility that the earlier final methodology paper had promoted as being in the best interests of customers. As set out in Appendix 6, the proposed adjustment would make a mechanistic adjustment to target revenue in year *t* in order to reflect the revenue variance in year *t-2*, with no reference to the other factors that would have a bearing on customers' interests. For example, it is possible that the variance in year *t-2* was a "one-off shock", in which case it might be better for customers to spread the effect over the remaining years of the quinquennium in an NPV-neutral way, rather than to recover the whole amount in one year. Similarly, there might be other factors relating to revenue performance in year *t-1*, or expected in year *t+1*, that would offset the effect of that "shock", and therefore diminish the net adjustment that needed to be made. Under the original proposals, as we understood them, companies would be encouraged to use all the information available to them, and their best judgment, in arriving at their proposed prices for year *t*. The overly-formulaic approach now advocated would prevent them from doing so.

Third, we think that Ofwat's proposed mechanism does not follow, in the way that it suggests, from its empirical analysis of revenue variances in the past. On page 19 it states that the average annual forecasting error by companies during AMPs 4 and 5 was typically 2-3%, and goes on to suggest that these results justify the proposed new mechanism for AMP6 and the way in which it is calibrated.

However, Ofwat is not comparing "like with like". For AMPs 4 and 5 companies were making forecasts in their Business Plans, typically finalised round about Christmas of year 4, that covered all of the subsequent six years. In arriving at its determinations Ofwat made adjustments to those forecasts, in some cases very significant ones, and produced its own forecasts of revenue that are the ones with which it now compares out-turn performance in the paper. It does not follow that one should use companies' out-performance or under-performance of revenue compared with the regulator's determinations in one period to inform tolerance levels for forecasting accuracy in an incentive mechanism that is due to be introduced in another, and which will relate to companies' ability to accurately forecast the charge multipliers (customer connections and demand per customer group) up to 6 months in advance of the relevant charging year, in order to set charges to hit a known revenue target.

The question then follows: if an incentive mechanism is to be introduced, what tolerance levels should be used. We believe this question is inexorably bound up with the issue of the proposed "penalty", and the level at which it is set.

Looking at the proposed scheme overall, what we believe Ofwat is proposing can be summarised as follows:

- so long as turnover is within 2% of forecast for year $t-2$, no penalty is payable and revenue is adjusted mechanistically in year t;
- if it is more than 2% out a penalty would be payable, although Ofwat would be willing to use its discretion to waive the penalty if a company could put forward evidence to the effect that the variance was due to specific factors beyond companies' control; and
- if it were out by an even greater margin – 6% - then stronger regulatory action might be required and an investigation would take place.

As noted above, we do not believe that the derivation of the 2% figure is valid. Certainly it is no indicator of what tolerances might be reasonable for a water company forecasting revenue a few months in advance of the start of a charging year, and could reasonably be expected to vary between companies depending upon levels of meter penetration (with higher levels of metering suggesting greater potentially variability in revenue compared to companies billing primarily on unmeasured charges).

In addition, however, we are not convinced of the merits of an arrangement that is both formulaic but with a "carve-out" for exceptions that is specified in only the most general terms. In fact, we believe that there is a question mark over the wisdom of seeking to design a "fix" for a theoretical problem that may arise in connection with a set of arrangements that is not yet operating and therefore has not yet been tested.

As an alternative, we would propose a strategy along the following lines:

- companies will be obliged to set charges each year in the manner they calculate will deliver their target revenue for the year (that target being determined with regard to the allowed revenue per the final determination from the regulator for each remaining year of the AMP and the actual performance against allowed revenues for years completed);
- there would be regulatory oversight of this process, and indeed the understanding from last year's consultation was that companies would be required to demonstrate, on an ex-ante basis, that their wholesale charges would recover no more that their allowed wholesale revenues, most probably through a mechanism similar to the current Principal Statement, and it would therefore be reasonable to expect adjustments to prior year performance to be reconciled to allowed revenue in this way;
- Ofwat will monitor variances each year, and can use its powers to investigate in any circumstances where it appears that a company has misused the flexibility that the new arrangements have been designed to allow; and
- as experience is gathered over the next few years, evidence will emerge as to the magnitude of "normal" revenue variances, and potentially "unusual" events as well, and their impact. Where a company is found to have misused flexibility, the order of magnitude involved will also be known (and Ofwat's proposed threshold of 6% therefore tested).

In effect if, in due course, the need for an incentive mechanism is demonstrated, it can be introduced at the next price review and calibrated on the basis of relevant evidence. Ofwat will also be in a better position to judge the appropriateness of the proposed 3% penalty rate. In the meantime we do not think customers' interests are at risk, but if a company does misuse the flexibility provided Ofwat has both the information and the tools to address it.

Q5. Do you agree with the use of a 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?

As noted above, we are not convinced of the need to introduce a formulaic incentive mechanism for wholesale revenue forecasting straight away, if at all. In any event we do not believe that there would be a case for a retail incentive mechanism, in particular for the reasons set out by Ofwat on page 25 and 26.

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

Prices for 2014-15 have already been set, and several companies have already submitted their revenue forecasts to Ofwat as part of their final Business Plans. Incentivising accurate forecasts is therefore not possible.

However, as a separate matter, we do not object to Ofwat's proposal to address any outstanding residual AMP5 RCM variances that had not been taken into account in final determinations in December 2014, by means of an adjustment to allowed revenues in year 2 of AMP6.