Wholesale and retail charges consultation
Markets and Economics Division
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

By email: price.review@ofwat.gsi.gov.uk

Tuesday 3rd June 2014

Dear Sir or Madam,

Consultation on the revenue forecasting incentive mechanism for AMP6

Thank you for the opportunity to respond to this consultation. Please see below our views on the specific consultation questions.

Yours faithfully

Mike King
Regulatory Director

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

We support the principle that it is important that companies' revenue projections are accurate, and that significant variations may have adverse impacts on future bill levels. We agree that it is fairer that correction to revenues takes place in period, rather than waiting until the following period as is the case with the current Revenue Correction Mechanism.

We are not entirely convinced that the imposition of a new incentive mechanism represents a proportionate response to the issue, and may not be consistent with Ofwat's intention to reduce the regulatory burden. We would suggest that it may be more appropriate for companies to be responsible for adjusting bill levels to maintain consistency with allowed revenues, without the need for a formal incentive mechanism. However, we make no specific objection to the introduction of this incentive mechanism.

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

We agree that the proposed approach sounds sensible.

We would disagree with the assertion made in table 7 (page 20) that an increase in meter penetration would improve companies' ability to forecast wholesale revenues. We expect the reverse to be the case, as metered demand is clearly more variable than income from unmeasured customers that does not vary as a result of demand.

We would also suggest that by only reviewing the accuracy of forecasts on an annual basis then the cumulative effect of discrepancies might not be corrected for.

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.

During AMP5 our performance has been within the ±2.0% threshold. However, we suggest that the threshold should be increased to ±3%, to better account for the impacts of weather on demand.

A hosepipe ban that reduces demand by 5% for measured households, would reduce wholesale revenue by around 3% for a company with a high level of meter penetration. In addition, hot weather can add 5-10% to measured customer demand. Given this, the proposed bands of 2% seem narrower than potential reasonable annual variation. Increasing the bands to 3% would remove all but very large climatic effects.

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 3% rate is proposed to remove most of the time value of money element from companies under or over recovery of revenues.

We consider that a penalty rate of 2% might be more appropriate. This is effectively the proportion of companies' returns that accrue to shareholders (5.65% *37.5%). The company will incur the debt costs directly as a result of the revenue difference, and therefore an incentive rate that is greater than the equity share would unduly impact shareholders beyond the scale of the error being sought to be incentivised.

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 the consultation notes, retail revenue will be primarily influenced by the number of customers served. Any variation in this is likely to be due to external economic factors beyond the influence of the company, and therefore an incentive would not seem appropriate. We would suggest that encouragement to correct for differences in-period is sufficient.

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

We agree that it is appropriate for Ofwat to undertake engagement and investigation with the company to ascertain the reason for differences between forecasts and actual revenue before seeking to apply a penalty. In our response to question 3 we suggest that a threshold of ±3% is appropriate for revenue flexibility. Given this, a cap & collar at 6% should be appropriate.

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

We consider that it is not appropriate to attempt to retrospectively incentivise forecasts that have already been made.

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

We agree with the proposed approach.