Consultation on the wholesale revenue forecasting incentive mechanism for AMP6
Northumbrian Water response
19 May 2014

Introduction

We welcome the opportunity to comment on the wholesale revenue forecasting incentive mechanism (WRFIM) proposal.

In broad terms we support the proposed WRFIM, subject to the comments made in response to specific questions below.

From the last two paragraphs on page 32 of the consultation document we infer that the correction for over or under recovery of revenue in each year during 2015-20 will be applied in the PR19 price control process and not annually as previously implied in the PR14 methodology documents. However, much of the consultation paper appears to have been written on the basis of annual adjustments. This change, if confirmed, is important and is rather lost in the consultation paper. It is important that Ofwat clarifies its intentions regarding the timing of revenue adjustments.

We believe Ofwat's position may be influenced by the fact that in period annual adjustment would require a licence change. Licence Condition B is constructed such that the adjustment factor "K" must be fixed at the Final Determination (FD) whereas annual correction for over or under recovery of revenue in previous years would mean that the "K" is no longer fixed.

We do recognise that in the case of over recovery companies may choose to apply corrections when setting the following year's annual charges and this might then negate the requirement for an adjustment at the next price review. However, this option is not applicable for under recovery since companies cannot choose to recover more than the allowed price cap to compensate for previous years under recovery.

In principle, the NPV of revenues should be the same regardless of the timing of adjustments (in period or at end period). It is not clear that Ofwat's calculations demonstrate this. In general we feel the consultation document provides insufficient clarity on the timing of adjustments and the detailed calculation.

It is important that the Final Determinations is clear regarding the mechanism and timing of revenue correction adjustments including all the key components relating to the WRFIM, such a price bases and threshold limits.

The Revenue Correction Mechanism (RCM) calculation spreadsheet was shared prior to the PR14 FD which allowed all companies to be clear exactly how any adjustments would operate. Following closure of this consultation, we believe a similar approach would be beneficial.

Response to Questions

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

We agree that, with a revenue cap price control, some form of correction for over and under recovery of revenue is required. An incentive scheme that aims to encourage accurate forecasting and limit the scale of over or under recovery of revenue in a single year is appropriate.

Page 11 of the consultation states that a revenue forecasting incentive is required to limit the errors in forecasting seen during 2010-15. It should be noted that the 2010-15 price control was a price limit, which did not allow for annual corrections to prices to keep revenues in line with the PR09 forecasts. The RCM was designed to manage this. The 2015-20 price control will be a revenue cap, which will allow companies to adjust their prices annually, and will therefore allow companies to ensure that each year their forecast revenues are close to the PR14 allowed revenues. This should reduce the total variance in revenue over the 2015-20 period compared to that seen over 2010-15.

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

The proposed approach to the WRFIM seems appropriate. We have a number of areas where further information is required for clarity.

WRFIM formula
The WFRIM formula may be applied slightly differently if applied annually or at PR19. The current formula is specified as being applied annually, and corrects for the two year delay between forecasting revenue and applying the adjustment, by applying a RPI and I adjustments for two years.

If this formula is applied at PR19 then each year's revenue adjustment needs to be corrected to a common PR19 point, which would mean a different I and RPI adjustment for each year. This is comparable to the NPV calculations in the RCM spreadsheet.

Price bases
The allowed revenue that will be published in the FD will be in 2012/13 prices. Reported recovered revenues will be in outturn. The WRFIM formula is not clear whether and how the FD allowed revenue will be inflated to outturn or the recovered revenue is to be deflated to the same price base as the FD.

If the adjustment is to be applied at PR19, a further adjustment would also be required to bring the adjustment value to the PR19 price base.

Precision
The formula set out on page 15 is relatively clear, however specific details for each of the variables are required. In some cases it is not clear whether a figure should be referred to as an integer, number or a percentage (i.e. 3, 3% or 0.03). This can be inferred, but could potentially lead to misunderstanding. The following variables require further clarity:
- PR, I and RFT: the formula requires these variables to be entered as an integer, where they are actually expressed as a percentage in the text.
- RPI: the definition on page 16 mentioned Retail Prices Index, which is a figure, such as 241.5. The figure used in the wholesale price controls is the percentage change in the RPI between the current and previous year November. The WRFIM implies that the index number is required as an input, not the percentage change.
- RFT: it is not clear whether RFT is a revenue figure, a percentage, a percentage expressed as an integer or a number.
- All variables need the t subscript appended as they all may change over time. Even I and RFT may change if this mechanism rolls over to the 2020-25 time period.
- t is not defined in the variables. Is t the year in which the adjustment is being made, or the year in which the revenue variance occurred? If the adjustment is applied at PR19 then t

would be the year for which the variance is being calculated, applies to all variables and no t-2 is required. If the adjustment is applied annually then t, t-1 and t-2 apply for different variables. The formula needs to be clear on which of these apply.

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.

We agree with the proposal for a revenue flexibility threshold, and that a percentage limit is appropriate as it is proportionate to the level of allowed revenue. A 2% threshold seems reasonable.

We agree that the same percentage threshold should be applied to the water and waste water wholesale price controls.

To calculate the revenue variance from the allowed revenue, we believe that all revenue figures should be assessed in outturn, as the revenue threshold will need to vary with revenue over time.

We agree with the proposal in Appendix 4 of the consultation document, that the revenue flexibility threshold should not be a mechanistically applied.

Revenue based on unmeasured properties is very predictable and stable, whereas revenue from measured properties is subject to the variances in demand, which are wholly driven by customer use, and is not controllable by water companies. As meter penetration increases, revenues will become more variable than today, which is the opposite to the information shown in table 7 on page 20 on the consultation document.

In any year, change in customer use of water, as seen in 2012/13, can have a significant impact on revenues, and companies should not be unduly penalised for this as they have no control over such a wholesale change. On top of this natural variation, any unexpected closures of large customers could push revenue variance outside the allowed threshold. Companies should retain the ability to explain why variation has occurred including identifying issues that could not reasonably have been foreseen by the company when setting charges, rather than a penalty being automatically applied.

Page 21 of the consultation document notes that "…the level of flexibility allowed for annual changes to the charges to wholesale and retail customers will be in scope for the charging rules…". We understand that Ofwat are minded to set, in the charging rules, a threshold whereby any change in customer charges over 5% will require a higher level of scrutiny. We will respond to this point in the consultation on charging rules, which is expected after Royal Assent of the Water Bill. The charging rules threshold is about looking at the percentage change in customer charges. This figure is not the same as the percentage change in revenue each year, and neither is it related to the variance between allowed and recovered revenue. Therefore the charging rules threshold has no impact, or bearing on the WRFIM.

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% seems appropriate. However the proposed calculation of the penalty imposes a cliff edge approach to applying the penalty, which does not seem reasonable. A single

penny change in the revenue variance could be the difference between a zero penalty and a 3% penalty.

We would propose that the penalty should be gradually increases from zero to the maximum amount. This could be applied as follows:

If % revenue variance <= - penalty start then

PR = $\underline{\quad [\text{ abs (} \% \text{ revenue variance) } - \text{ penalty start }]}$ * maximum penalty rate
(penalty threshold – penalty start)

If % revenue variance between penalty start and penalty threshold then

PR = 0

If % revenue variance >= penalty start then

PR = $\underline{[\text{ abs (} \% \text{ revenue variance) } - \text{ penalty start }]}$ * maximum penalty rate
(penalty threshold – penalty start)

Where

% revenue variance = (RR / AR) - 1
Penalty start = the point at which a penalty begins to be applied
Penalty threshold = the point at which the maximum penalty is applied

One way in which this could apply is shown below.

Penalty start = 2%
Penalty threshold = 2.5%
Maximum Penalty = 3%

If the penalty start is at 2% and the penalty threshold where the maximum penalty is applied is 2.5%, then a graduated penalty is applied when the percentage variance between allowed and recovered revenue is between 2% and 2.5%. The table blow summarises. The penalties are symmetrical for positive and negative revenue variances.

% Revenue variance	PR
1.5%	0.0%
1.6%	0.0%
1.7%	0.0%
1.8%	0.0%
1.9%	0.0%
2.0%	**0.0%**
2.1%	**0.6%**
2.2%	**1.2%**
2.3%	**1.8%**
2.4%	**2.4%**
2.5%	**3.0%**
2.6%	3.0%
2.7%	3.0%
2.8%	3.0%
2.9%	3.0%
3.0%	3.0%

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?

We do not believe that a revenue forecasting incentive mechanism is required for the retail price controls.

The allowed revenue for household retail price control is dependent on the forecast of the number of properties, which if carried out annually should mean that the outturn variance in household retail revenue should not vary too much from that forecast.

The allowed revenue for the non-household price control is calculated on an average cost per customer plus a margin. As this is calculated annually the variances should be reasonable.

We do think that investigation into the accuracy of revenue forecasts by Ofwat would be appropriate for both retail price controls if recovered revenues varied by more than the 6% threshold.

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

Yes. Ofwat has the powers to investigate any perceived misreporting already, but it is useful to have clarity on when Ofwat feel this power should be triggered. The 6% revenue variance threshold seems appropriate.

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

The PR14 RCM corrects 2013/14 revenues, and therefore no correction for over or under recovery will be required when calculating the allowed revenue for 2015/16.

The PR14 Business Plan included an updated revenue forecast for 2014/15, which is already corrected for as part of the RCM calculations. The only outstanding potential revenue variance is therefore between the PR14 2014/15 revenue forecast and the 2014/15 recovered revenue.

We do not believe that the difference between PR14 2014/15 revenue forecast and the 2014/15 recovered revenue will be material enough to require a further adjustment.

To minimise any potential variance, an updated 2014/15 revenue forecast could be provided before the FD, for example in October 2014. This would mean that six months of actual 2014/15 revenues will be able to inform the full year forecast, and further reduce the materiality of any variances between the revenue correction made as part of PR14 and the recovered 2014/15 revenues.

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

We understand from the consultation document that the intention is to analyse the variance between the PR14 FD allowed revenues and the recovered revenues after the recovered revenue is reported at year end in the Regulatory Accounts. Our interpretation is that Ofwat will look at the

reported revenues, determine what adjustment for that year's revenue will be allowed at PR19, taking into account the applied penalty rate. This will then be published and companies will have an opportunity to discuss this amount through a consultation.

We agree that confirming the annual adjustment each year as you progress through the price control period is appropriate as it avoids surprises and provides transparency.