

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

4th June 2014

Re: Ofwat consultation on the revenue forecasting incentive mechanism for AMP6

Thank you for the opportunity to respond to this consultation.

We support in period symmetric over or under-recovery of wholesale revenue rather than all the recovery in the following period as is the case with the current revenue correction mechanism, this seems to us to be a fair balance of risk between customers and the companies.. We expect that the conversion of a wholesale revenue allowance into wholesale prices should allow increased accuracy of forecasting all other things being equal during AMP6.

Generally though, we do not consider that the introduction of an incentive mechanism is required. The introduction of an incentive implies that the perception is that revenue forecasting inaccuracy is due to lack of management attention, this is not our experience, revenue forecasting inaccuracy is mainly driven by factors outside of management control and foresight such as weather.

Where an incentive is to be used we support symmetrical incentives unless there is a demonstration as to why enhanced penalties are thought to have a greater impact on company behaviour than rewards

More importantly, we believe that the proposal will discriminate against companies with a high level of household meter penetration, as accurately forecasting measured revenues is clearly a more difficult task with considerably more variables in play than with unmeasured revenue.

To assist in the design we have included an alternative proposal in our response to question 1 below which illustrates a penalty threshold that varies with the level of household meter penetration.

We certainly welcome your proposal that if you do introduce these penalties that you will retain your discretion in applying them where companies can convince you that there are relevant exceptional circumstances. As we believe that the major contributor to historical variations in revenue has been due to unusual summer weather patterns which we are not able to predict when we are developing our revenue forecasts.

We also consider that it would be inappropriate to introduce this incentive for the 2014/15 revenue correction mechanism adjustment next summer as this would be retrospective regulation.

Our responses to your specific questions are in the attached appendix.

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Please do not hesitate to contact me if you need any further information relating to this response.

Regards

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Appendix with South East Water responses to specific consultation questions

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

We are not convinced that there is any need for a revenue forecasting incentive in AMP6. The experience of SEW is that revenue fluctuations are often as a result of issues outside the company's control such as summer weather.

Additionally we believe that a revenue forecasting mechanism discriminates against those companies with a high level of household metering penetration as the influence of the weather will have a greater impact on these companies.

Therefore we consider that should Ofwat decide to introduce a revenue incentive penalty that we would expect the trigger level to vary with the proportion on household metering. As an illustration it may be appropriate to have a threshold structured as follows:

Level of meter household meter penetration	Revenue forecast threshold
90% - 100%	6%
80% - 90%	5.5%
70% - 80%	5.0%
60% - 70%	4.5%
50% - 60%	4.0%
40% - 50%	3.5%
30% - 40%	3.0%
20% - 30%	2.5%
10% - 20%	2.0%
0% - 10%	1.5%

The bands are based on the level of household per capita consumption experienced by South East Water and therefore reflect the additional risk in forecasting revenue associated with higher household metering penetration. An approach such as this will ensure that this mechanism does not provide a disincentive to place customers onto a measured charging basis.

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

We would have expected the guidance to include guidance on how the wholesale revenue recovery with respect to prior year under or over recovery will be dealt with.

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.

For SEW 2% of wholesale revenue is around £4m per annum. Currently we have around 65% meter penetration which is expected to increase to 90% by 2020. £4m equivalent is around 10mld which is 3.2% of forecast metered volumes in 2015/16 and 2.5% of metered volume in 2019/20. Our view is that variations in summer demand could cause this sort of variability.

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The table below shows the range of actual per capita consumption for both metered households and unmeasured households since 2007/8 when South East Water merged with Mid Kent Water as an indication of the level of variation in consumption which we consider to be largely weather dependent.

	Measured pcc l/h/d	Variance versus average	Unmeas. pcc l/h/d	Variance versus average
2007/8	143.35	-5.8%	171.62	-1.1%
2008/9	157.50	3.5%	177.32	2.2%
2009/10	155.79	2.4%	179.41	3.4%
2010/11	159.70	4.9%	179.12	3.2%
2011/12	151.66	-0.3%	176.41	1.6%
2012/13	149.98	-1.4%	166.38	-4.1%
2013/14	147.28	-3.2%	164.81	-5.1%
Average	152.18		173.58	

The above data demonstrates that that in four years out of seven that the household per capita consumption is equal to or greater than the 3.2% threshold that is likely to result in a revenue variance in excess of +/- 2%. As a company when we set our tariffs for the following year in early January we have to make an assumption about the measured volumes in the following year. At this point in time we do not consider it is reasonable to have to forecast the impact of the summer weather to within a 2% tolerance.

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.*

As we do not agree with the need for a revenue forecasting mechanism incentive we do not agree with the principle of applying a penalty rate when the revenue threshold is exceeded. However we are pleased that Ofwat is considering making the penalty discretionary and would not apply it in exceptional circumstances. It would be helpful to identify examples of such circumstances. We consider they should include unusual summer weather although we are not sure how straightforward it will be to define what constitutes unusual weather.

If an incentive were still deemed to be needed we see no reason why a symmetrical incentive could not be created..

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?*

Given that a new method of retail price controls is being introduced for AMP6 we do not consider it appropriate given the uncertainty that a revenue forecasting mechanism should be introduced for AMP6.

It is likely that variations in household retail revenue will be largely dependent on variations in household numbers and the proportion of properties metered. The number of new connections is not a parameter that the Company can influence. We have considered local development plans in the forecast used for the Water Resources Management Plan, which has been approved by the

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EA. The number of meters is largely driven by our compulsory metering program and the introduction of a retail household forecasting incentive mechanism could affect management's willingness to change the program schedule, this would be an unwelcome constraint on the programme.

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

A 6% variance would be around £12m in a single year. It is unlikely that we would have a revenue variance of this size in our wholesale revenue unless something very exceptional occurs. Therefore it does not seem unreasonable for Ofwat to undertake an investigation if this threshold was exceeded..

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

Although we do not expect to have variations in excess of 2% of the revenue forecast for 2014/15 we do not consider the introduction of retrospective regulation to be appropriate.

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

No comments

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