

Revenue forecasting incentive mechanism for
AMP6 consultation
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Dear Sir / Madam

Consultation on the wholesale revenue forecasting incentive mechanism for AMP6

Response from South West Water

We are pleased to provide on the 'wholesale revenue forecasting incentive mechanism for AMP6' consultation. The consultation considers the important topic of how variations against forecast revenues will be dealt with during 2015-20. The evolution from a tariff to a revenue control is an important step for the new regulatory framework. Ensuring mechanisms are in place to continue to protect customers is critical. We therefore support the principle of having protection mechanisms in place.

We believe that the Revenue Correction Mechanism (RCM) that was introduced for AMP5 has been a successful one. The RCM framework allowed South West Water to avoid collecting additional revenues in 2014-15, which would have been then returned to customers from 2015. Instead we implemented a price freeze for 2014-15 to provide the smooth bill profile that customers preferred over 2015-20.

We support the continued use of revenue mechanisms and we recognise that the Wholesale Revenue Forecasting Incentive Mechanism (WRFIM) builds on the approach taken with the RCM, whilst reflecting the additional flexibility companies will have with revenue controls to adjust customer charges as demand and performance factors emerge.

We are pleased that the consultation recognises the limitation with RCM that revenue variation could normally only be adjusted through customer bills at the next review period. With our business plan including both in-period outcome delivery incentive adjustments and the WaterShare outperformance sharing mechanism, we welcome the additional flexibility that WRFIM should allow.

We do however have a number of questions regarding the detail of the approach proposed. In particular we think further clarity is required as to how the mechanism will work in practice with outcome delivery incentives, company performance sharing frameworks and Licence conditions, before the outcome from the consultation is finalised. We would be keen to have further discussion on this point.

With the move to self regulation, Board assurance and ownership of the relationship with customers, the proposal for Ofwat's automatic adjustments to allowed revenue appears contrary to the direction of travel. We believe there would be less risk with companies self-regulating and smoothing out revenue changes to the benefit of customers, rather than having annual "Ofwat prescribed" adjustments automatically applied.

We would also like to explore the option of introducing mid-year or seasonal tariffs to enable required changes to smooth out more gradually for customers. We would welcome further discussion on this.

Our analysis suggests that the level of penalty thresholds suggested in the consultation are lower than in other regulated sectors and only allow for average industry revenue forecasting changes, with no allowance for normal variation. We would expect that one standard deviation from the average variation should not result in a penalty, rather than penalties being based on the historic average variation. Calculations we have undertaken suggest a threshold of at least 3.5% is justified.

Although we can understand the logic of the proposal to include variations in 2014-15 revenues within WRFIM, we do not think it is appropriate to implement this approach at this late stage (after companies have submitted revenue projections for 2014-15). This is particularly as many companies have forgone revenues voluntarily for 2014-15. We believe that the RCM framework as originally announced for 2010-15 should be used for 2014-15 variation to be applied as an adjustment in 2016-17.

In the appendix to this letter we set out our detailed response to the specific questions set out in the consultation as well as a discussion on the general point on how the proposed mechanism will operate within the current Licence framework.

Please do not hesitate to contact me if you require any further information.

Yours faithfully



Susan Davy
Finance & Regulatory Director

APPENDIX: SPECIFIC COMMENTS ON THE CONSULTATION

Before addressing the overall comments on the consultation, there was one aspect which we wished to highlight. This concerns how the adjustments to “K” proposed within WRFIM operate within Condition B of company Licences. Equally, outcome delivery incentive adjustments “in-period”, which are a fundamental part of the PR14 methodology and the enhanced company draft determinations published on 30 April, also need to operate within the Licence and WRFIM framework. Both these points are mentioned in the consultation, and we think it is important to have clarity on the proposed approach. Section A4.1 of the consultation mentions the base WRFIM “*which will follow the same basic form as set out in our final methodology statement, and should be aligned with companies’ own specific delivery incentives*”. We agree this point is worthy of further consideration.

Licence condition B

Clause 9.1 of Licence condition B states that the Appointee shall levy charges to comply with price controls (for wholesale under clause 9.4).

Clause 9.4 of Licence condition B states that prices are controlled through the level of RPI together with the additional factor K, which limits the change in charges to be levied and/or the revenue allowed in each Charging year for Wholesale activities.

Clause 9.4(2) states that Ofwat shall determine “*how the Appointee shall, in respect of each such Price Control applicable to it, demonstrate the compliance referred to in sub-paragraph 9.1*”.

We interpret this Licence clause as requiring the annual values for K (and not an adjustment formula for K such as from WRFIM) to be determined at the 5 yearly Periodic Review. However, 9.4(2) allows Ofwat to determine how compliance with this level of K can be demonstrated. Therefore, rather WRFIM cannot under the licence change the allowed revenues/K within the price review period. According to the Licence, WRFIM has to be described as the determination as how compliance will be demonstrated. Similarly, the mechanism will need to include an element of what allowed revenue changes from outcome incentives the company has calculated in-period in order to demonstrate compliance. Effectively as K / allowed revenues are fixed (before inflation) according to the Licence, in-period rewards will need to be applied and adjusted through WRFIM. The K does not change in-period, but with additional / lower recovery from outcome incentives and WRFIM penalties taken into account in a mechanism that corrects end of period at the following review.

The only Licence approach that allows in period adjustments to wholesale allowed revenue / K other than for inflation is through the Interim Determination mechanisms, which we would do not think are appropriate for either in-period outcome incentive rewards or for WRFIM revenue variations.

The construction of the Licence leads us to the conclusion that effectively WRFIM should be operate as an end of period correction mechanism (set out in a Determination), whilst allowing in-period demonstration of compliance with the wholesale allowed revenue. We are not sure that the Licence wording allows WRFIM to amend determined allowed revenues in period. This appears to be confirmed in Appendix 5 of the consultation document. This is a topic where we think additional clarity and discussion may be beneficial before concluding on this consultation.

We address our other comments through the questions Ofwat set out in the consultation.

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

We agree that a wholesale revenue forecasting incentive (WRFIM) in AMP6 is necessary, in particular for wholesale revenues. The approach Ofwat are considering is a standard approach where we can see parallels with other regulated sectors.

Our opinion is that the approach should work broadly the same as the Revenue Correction Mechanism (RCM) during 2010-15. This does not specifically need to change from the move to revenue controls from price controls. Companies should have flexibility for in period adjustments to correct for any variations in revenue forecasting. All residual corrections (and penalties for poor forecasting if appropriate) should in normal circumstances be end of period rather than on an automatic annual basis. This has advantages as it avoids the iteration and annual approval processes set out in the consultation, although still allows the potential for Ofwat to apply in period penalties should the investigation threshold be breached. However a less proscriptive approach in-period, in line with the general movement towards self regulation would allow for:

- the accountability for charging and the relationship with customers to firmly remain with the company
- companies can take full responsibility for the profile of bill changes, smoothing where appropriate over the price review period without the risk that this could retrospectively result in revenue forecasting penalties
- potential for Ofwat/DEFRA bill stability rules for managing incidence effects on bills
- in period outcome incentives envisaged set out in the PR14 Determinations to be applied by companies without this affecting/complicating the WRFIM calculations (and for South West Water the application of WaterShare)
- potential unintended consequences of behaviour changes that arose from a desire to minimise warranted uncertainty in revenue forecasting would be avoided, including water efficiency measures, compulsory metering and the timing of major housing development schemes

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

We broadly support the approach to adjusting allowed revenue for forecast differences by including both RPI and financing costs within the correction mechanism. We also agree that it is appropriate for a penalty rate of financing costs to be used where actual revenues are different to allowed revenues over time. It is also good regulatory practice to allow a threshold for immaterial changes that are not within management control.

We are concerned that a mechanism that automatically adjusts allowed revenues two years later will act as a barrier to companies anticipating revenue variations and smoothing out bill changes over the price review period. Therefore we believe that penalties (to a threshold) should apply to the residual adjustment at the end of the period only. This will allow companies to calculate in period bill and charges profiles, rather than being dependent on Ofwat annual decisions on adjustments to allowed revenue. Ofwat can still set an annual threshold as suggested in the consultation for investigations should revenue variation not receive sufficient explanation and Board assurance as part of annual reporting.

We think this approach will improve the ability of WFRIM to meet the objectives set out in the consultation, in particular for additional charging flexibility. As currently drafted we think there is the potential for innovation to be constrained, as companies may be dependent even in normal circumstances on a retrospective case for "exceptional circumstances" to be accepted by Ofwat for avoiding a penalty. We explain this through the examples below:

Example A: RPI and bill stability pledges.

A company may choose to smooth out revenues so that the changes in charges to customers are less than RPI. With demand changes as a result of weather (i.e. customer choice on usage, the impact of which is higher for companies with more metering), the average bill will be reduced in a year when demand falls (e.g. by 3%), which might lead to a higher than RPI increase in the following year, even before considering any real terms allowed revenue change.

If there are regulatory bill stability requirements, or if companies smooth out bill changes, these obligations may conflict with the WRFIM penalty approach. In the example below, if a company knows of the demand change in year 1 in time to smooth this out through bills in year 2, the automatic adjustment of the year 1 variation in revenue into the allowed revenue for year 3 means that any demand variation during year 3 would result in a further penalty on the company. This provides a disincentive for the company to smooth out changes in revenues such that are generally outside of management control or forecasting.

(Ignoring inflation – assumes year 2 allowed and actual revenue / average bill of £500)	Year 1	Year 3	Increase in av. Bill (from year 2)	Increase in tariffs
Allowed revenue / Average bill	500	520	2%	2%
Actual bill with 3% demand fall due to wet summer in Year 1 – not recovered in year 2	485	520	7.2%	2%
Actual bill with 3% penalty applied because of WRFIM	485	518.30 (ie forecasting penalty reduces allowed revenue by £1.70, plus the unrecovered amount from 2 years previous)	6.9%	1.95%
Bill stability / bill smoothing policies – cap average bill change at lower of 5% and RPI*	485	509	3%	1.8%
With bill stability policies for Year 3, effective range of demand variation to be within 2% WRFIM	508 – 529 (ie -0.2% - +3.8%) – further penalty for year 3 likely with normal demand forecast variation because of bill smoothing or bill stability rules			

* Assumes any RPI or bill stability rule would run from previously announced bill of £500 + 3.2% RPI, not actual £485 + 3.2% = £501

Example B: Double penalty from smoothing out bill changes

The automatic adjustment to allowed revenue approach within WRFIM could also see customer bill swings and act as a disincentive to smooth charges across the period. In the situation with a

demand fall, if companies increase bills in year 2 to spread the impact to customers out over a number of years, with the knowledge that demand has been lower in year 1, then as well as a penalty for year 1, an additional penalty would apply in year 3. Effectively the company is penalised for providing customers with a smoother change in bills.

Before inflation	Year 1	Year 2	Year 3	Year 4	Total penalty
Allowed revenue original	500	500	500	500	
5% demand variation in year 1 due to unusual weather	475				
Allowed revenue in WFRIM if not corrected in year 2	500	500	524	500	£0.75m
Company smooths out tariffs / revenues having known about demand change	475	508	508	508	
WRFIM then applies to year 2 – allowed revenue year 4		OK – 1.6%, but potential for penalty with more demand change	NOT OK – 3.1% so smoothed bills results in further WRFIM penalty	OK – allowed revenue adjusted from year 2 to 508	Additional +0.5m penalty from smoothing out bill changes before WRFIM applied

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.

Weather impacts for highly metered companies can generally be as much as +/- 3%. We note in Figure 2 in the consultation that regulatory precedent suggests a much higher threshold has been used in other sectors, e.g. 6% for electricity and gas distribution and 4% for gas transmission. Much less revenue forecasting variation should be expected for these network only businesses from a “source to tap to sea” water and sewerage industry which is subject to more end consumer and weather related demand impacts. The key statistics on page 5 and 6 of the consultation appear to show average demand forecasting variation of 0 – 2% and no statistically significant upwards or downwards bias. However this is likely to average out weather impacts, and a confidence interval range, for instance based on 1 standard deviation might be a better approach. This would suggest the following thresholds:

Absolute value of average + 1 Standard deviation	AMP4	AMP5	AMP4 and 5
Water unadjusted	3.84%	4.92%	4.54%
Water adjusted	3.43%	3.61%	3.55%
Wastewater unadjusted	3.45%	3.57%	2.99%
Wastewater adjusted	3.25%	3.35%	2.85%

This produces a simple average for a threshold of +/- 3.6%. We would therefore suggest this should imply a revenue flexibility threshold of +/- 3.5% in line with normal weather demand variation expectations and precedence from other sectors. A higher figure of 5% may be justified if Ofwat do expect to implement any bill stability rules for 2015-20 for the annual changes in charges, in order to prevent inconsistent regulatory requirements being placed on companies.

The approach proposed by Ofwat in the consultation is similar to the allowed revenue correction factors used in other regulated sectors. It recognises that regulated companies will not typically recover precisely their allowed revenues in individual years, e.g. because they cannot precisely anticipate demand and sales volumes. The objective is to correct future allowed revenues so that ultimately there is no over or under-recovery. However, there is a difference in the water as the revenue is directly linked to the end customer (due to vertical integration), and that variability of revenue varies between companies from on tariff structures (such as the degree to which customers have requested to be billed on a metered basis, which increases demand variability and is not in most cases a management decision as to how customers are charged).

We understand that in other regulated sectors penalties are often only applied to over rather than under recovery, which is different to Ofwat's approach, or under recovery has a lower rate of interest used (e.g. RIIO-T1 used Bank of England Official Bank Rate for under-recovery and Bank rate + 400 basis points for over recovery).

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.*

We agree with the consultation calculation that the incentive value is more sensitive to the penalty rate than the flexibility threshold. Therefore we can understand Ofwat's choice of 3%. We think that it is more important for the success of the new incentive to get the correct revenue flexibility approach, as success will be for customers to get the bill profile they prefer with companies being able to forecast and adjust revenues in a way that is in customers' interests. If this occurs then the penalty rate will not need to be applied. We think this would be boosted by self-regulation rather than a mechanical in period adjustment to allowed revenues (where companies would have to make an annual case to Ofwat for bill smoothing / revenue sharing adjustments, with annual uncertainty for customers and companies as to whether the regulator will agree with this judgement).

We would note that Ofwat propose to use a much higher benchmark rate of interest (WACC + RPI) than that used in other regulated sectors (Bank of England Official Base Rate). The penalty rate of 3% is also higher than that in other sectors, where 1.5% to 2% is often used, with a higher rate of 3% to 4% only used for higher levels of over and under recovery (e.g. above the 6% investigation threshold suggested by Ofwat in the consultation).

Therefore although we see a strong case for a lower penalty rate of 2%, 3% would be appropriate for the end of period only penalty adjustment that we propose (except for higher threshold variations that are not justified by customer interests).

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 agree that a separate revenue forecasting incentive mechanism is required for retail household (not retail non-household). We think that option 1, with an adjustment at the next price control review is justified, as the drivers of revenue variation are narrower for household retail than for wholesale.

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

A cap and collar approach with trigger mechanism for further justification (and potential regulator intervention) represents good regulatory practice where customers require safeguarding, based on equivalent application in other sectors.

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 can understand the logic of this proposal, we do not think it is appropriate to implement this approach at this late stage (after companies have submitted revenue projections for 2014-15). This is particularly as many companies have forgone revenues voluntarily for 2014-15. We believe that the RCM framework as originally announced for 2010-15 should be used for 2014-15 variation to be applied as an adjustment in 2016-17.

Section A4.3 of the consultation states that *“Reflecting our confirmation of the impacts for the RCM and WRFIM as appropriate, companies would then be able to adjust 2016-17 charges in line with the flexibility offered by the relevant price controls and subject to the prevailing charging rules”*. This statement highlights the discussion set out at in our response of the need to avoid conflict between charging rules (yet to be specified and consulted on) and the WRFIM mechanism. Therefore where annual variation is below the lower 6% threshold, after adjusting allowed revenues for adjustments allowed in the Determinations, including outcome delivery incentives and voluntary sharing mechanisms specified in the Determinations such as WaterShare, we think automatic WRFIM adjustments / penalties should only be applied end of period to minimise conflict in the short term with prevailing charging rules.

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

As set out above we do not believe an iteration process is necessary below the 6% investigation threshold, although Ofwat should retain the potential for this approach to compel companies to achieve an acceptable approach to revenue adjustments (with a penalty being applied in period) where they have not being able to convince Ofwat (or customers / stakeholders) that this higher level of revenue variation from forecast is justified and in customers' wider interests.