'Revenue forecasting incentive mechanism for AMP6' consultation
Markets and Economics Division
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Dear Sir or Madam

CONSULTATION ON THE REVENUE FORECASTING INCENTIVE MECHANISM FOR AMP6

We welcome the opportunity to respond to your consultation document.

We have summarised our views, as outlined below, on the key areas under consideration in the consultation and include in the attached appendix a response to the specific questions posed.

Flexibility threshold

As companies' price setting processes will have the benefit of more dynamic forecasting i.e. only needing to forecast for the year ahead, then the variance against allowed revenues should be considerably smaller than that observed in AMP4 and AMP5, as illustrated in appendix 7 of the consultation document. In previous periodic review processes companies needed to forecast revenue for up to seven years ahead (forecasts made in 2008/09 in respect of revenue in 2014/15) which undoubtedly resulted in significant variances in certain circumstances.

In the normal course of events, for companies with a stable charging base, we would anticipate that, exceptional circumstances apart, a +/- 2% symmetrical flexibility threshold would be a reasonable bandwidth in which most companies should operate.

That said, our PR14 business plan includes proposals to meter 440,000 household customers over the AMP6 period. This very large programme will substantially increase revenue volatility, i.e. customer switching from paying by rateable value (where revenue can be predicted with a high degree of accuracy) to paying by meter where the accurate forecasting revenue is much more difficult particularly for newly metered customers with no consumption history.

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Cap and collar to trigger further investigations

It is reasonable that if a company's actual revenue is more than +/- 6% outside the allowed wholesale revenue control that Ofwat should conduct further investigation to ascertain the cause and to consider further enforcement action in the event that reasonable management action should have prevented this occurrence. We would suggest that the type of action/potential penalty proposals should be specified in advance of the price control determination, and form part of it.

Retail control

The relatively small proportion of overall revenue accruing from the retail price controls potentially obviates the need to apply a forecast incentive mechanism in AMP6. A true-up being applied to the next price control period should not significantly distort the impact on customer bills between periods. Companies should still use best endeavours to set retail prices to recover the allowed revenue as closely as possible.

2014-15 projections

It seems logical to apply the principles of the wholesale revenue forecasting incentive mechanism (WRFIM) to correct in setting 2016/17 prices for any material differences between the 2014/15 revenue used in the Revenue Correction Mechanism adjustment applied in AMP6 price controls and the actual 2014/15 position.

Please do not hesitate to contact me or my team if you have any questions or comments on our response.

Yours sincerely

Nick Fincham
Director of Strategy & Regulation

Appendix 1 – Detailed responses

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

We accept the concept in principle. The Ofwat proposals incentivise companies to produce and utilise accurate revenue forecasts as part of their charge setting process to ensure that the revenue generated from these charges is within +/- 2% of the allowed wholesale revenue set under the price controls.

We do not agree, however, with the point made in the consultation that it gives companies more scope to smooth changes from unexpectedly high or low demand (relative to projection made in companies' business plans). The relatively small bandwidth, given that there is always a degree of uncertainty in forecast, is unlikely to allow much flexibility for companies to set charges to take these factors into account.

Q2 Do you have any comments on our proposed approach to the Wholesale Revenue Forecasting Incentive Mechanism (WRFIM)?

The mechanics of the proposed approach by which companies will build into prices any under/over recovery of revenues (with a two-year lag) on a NPV neutral basis adjusted where appropriate in the event that a penalty is applied appears sound.

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.

In the normal course of events, for companies with a stable charging base we would anticipate that, exceptional circumstances apart, a +/- 2% symmetrical flexibility threshold would be a reasonable bandwidth in which most companies should operate.

As companies' price setting processes will have the benefit of more dynamic forecasting i.e. only needing to forecast for the year ahead, then the variance against allowed revenues should be considerably smaller than that observed in AMP4 and AMP5, as illustrated in appendix 7 of the consultation document. In previous periodic review processes companies needed to forecast revenue for up to seven years ahead (forecasts made in 2008/09 in respect of revenue in 2014/15) which undoubtedly resulted in significant variances in certain circumstances.

That said, our PR14 business plan includes proposals to meter 440,000 household customers over the AMP6 period. This very large programme will substantially increase revenue volatility, i.e. customer switching from paying by rateable value (where revenue can be predicted with a high degree of accuracy) to paying by meter where the accurate forecasting revenue is much more difficult particularly for newly metered customers with no consumption history.

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 should be no greater than is necessary to encourage accurate forecasting, and thus the proposed level of 3% appears acceptable. Page 22 of the consultation appears to suggest a linkage between the proposed penalty rate of 3% and the wholesale WACC of 3.7%. We are not convinced that there is any obvious connection between the two.

Q5 Do you agree with the use of 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?

The relatively small proportion of overall revenue accruing from the retail price controls potentially obviates the need to apply a forecast incentive mechanism in AMP6. A true-up being applied to the next price control period should not significantly distort the impact on customer bills between periods. Companies should still use best endeavours to set retail prices to recover the allowed revenue as closely as possible.

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

It is reasonable that if a companies' actual revenue is more than +/- 6% outside the allowed wholesale revenue control that Ofwat should conduct further investigation to ascertain the cause and to consider further enforcement action in the event that reasonable management action should have prevented this occurrence. We would suggest that the type of action/potential penalty proposals should be specified in advance of the price control determination, and form part of it.

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

Inevitably there will be some differences between the 2014/15 revenue forecasts built into the Revenue Correction Mechanism and the actual 2014/15 outturn position. On this basis it seems logical to apply the principles of the WRFIM to correct when setting 2016/17 prices for any material differences between the 2014/15 revenue used in the Revenue Correction Mechanism adjustment applied in AMP6 price controls and the actual 2014/15 outturn position. The alternatives are not to apply an adjustment at all or to wait until AMP7 to apply a correction, both of which are less attractive options.

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

The indicative timetable for the iteration process allows time for companies to set the following years prices. The mechanics of the process in respect of the under /over recovery and penalties imposed shown in the Appendix 6 appear valid.