SOUTH WEST WATER

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Dear Sirs

CONSULTATION ON WRFIM ISSUES

The PR14 reconciliation rulebook policy document contained a further consultation on the consistency of the wholesale revenue forecasting incentive mechanism (WRFIM). In my letter of 8 July 2015 to Tim Griffiths, we stated that we did not support an asymmetric adjustment to the WRFIM formula. As the application of the formula stated in the FD required clarification and if Ofwat could not use discretion within the current wording of the Licence, then we suggested that a Licence amendment could be implemented.

The WRFIM section of the PR14 rulebook policy document provides a good explanation as to why discretion and treatment as WRFIM as ancillary parts of the price control are unlikely to be effective solutions, given the limited exceptions to Ofwat's statutory duty to take enforcement action for Licence breaches. We therefore support an amendment to Licence Condition B to accommodate WRFIM. As you have proposed, this should be constrained to the affected charging years (2017/18 to 2019/20) and the sub-paragraph itself should also be time-limited.

We do not think that companies should be able to choose between the original and revised WRFIM formula. We think that the WRFIM formula should remain consistent with FD14. In the event that companies do not agree to a licence change, they face the risk of penalties under WRFIM from not being able to recover previous under-recovered revenue. They have this option and may have valid reasons for preferring it, without this presenting any detriment to consumers.

We would hope that there is consensus for the Licence change, but given it is specific and time limited do not think this precludes it being implemented on a specific company basis.

We think the drafting of the Licence change proposed in the consultation is sufficient to have the intended effect and have not identified any concerns.

On a related matter, we continue to have concerns with the rigidity that Ofwat now plan to apply for the recovery of revenues and related WRFIM penalty impacts. Our response to the WRFIM consultations made it clear that there should be no new limitations or disincentives placed on companies to under-recover revenue from wholesale revenue controls where this is in customer interests. The intention in the consultations was clear – to protect customers from swings in bill levels by incentivising accurate revenue forecasting (as bill profiles and smoothing with regulatory mechanisms such as PAYG rates was considered and acceptability consulted on with customers at PR14). The WRFIM consultation (April 2014) stated:

"We recognise that there may be unexpected and exceptional circumstances during the regulatory period which are not within the range of typical business planning risks remunerated by allowed returns. Likewise, company business plans include a range of different performance commitments and delivery incentives that are also aimed at allocating risks between the company and customers, which we will be considering for inclusion in price controls. For this reason, our proposed approach is not mechanistic. We will retain our discretion in applying any penalty where companies provide convincing evidence of relevant exceptional circumstances in their annual regulatory reporting."

This was clearly intended to include (and confirmed to us in correspondence such as over 2015-16 charges) where company commitments (such as a pledge for bill changes to be below RPI, voluntary sharing with customers such as WaterShare and returning 14/15 revenue variations to customers early as 2016/17 was originally assumed) mean it is in customer interests to do so.

The conclusions from the WRFIM consultation were in the August 2014 draft determination Appendix 8 risk and reward. This allows discretion in the WRFIM application for exceptional circumstances, but does not limit it to the "beyond the control of efficiently managed companies". This reflected the concerns of respondents, including CCWater, that voluntary revenue sharing and innovation may be constrained by mechanical application in all circumstances.

Yours sincerely

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Chief Economist