1. Billing incentive

As part of the revenue correction mechanism (RCM), we introduced the efficient billing factor (EBF). This provides the companies with a financial incentive to bill all eligible properties. Otherwise, in the long term the companies would accrue the same revenue no matter how many properties they billed.

If a company bills more or fewer properties than we expect, we said that we would set the level of incentive equivalent to a value calculated by multiplying together:

- the difference between the number of properties we assumed the company would bill and how many the company actually billed; and
- an EBF that is equal to 42% of the average bill.

We said that we would exclude from the billing incentive properties that have a bill below 42% of the average bill.

Several companies raised issues with this element of the RCM following the 2010 June return.

Our future approach

We have decided against removing the EBF completely. This is because it could have a significant negative effect on customers. Instead, we will simplify how the billing incentive is calculated.

We will not remove from the billing incentive the number of properties with bills smaller than the EBF (42% of the average bill). We will calculate the billing incentive based on whether the company bills more or fewer properties than we expect. We will set the level of incentive equivalent to the variance multiplied by an EBF that is equal to 42% of the average bill.

We think that this simplified approach will not have a material impact on customers' bills.

The change will mean we will no longer require the companies to report the number of properties with bills smaller than the EBF in their annual regulatory submission ('June return') for 2011.

Impact on the companies' 2011 June returns

We asked each company to report in their main annual data submission for 2010:

- the number of billed properties less than the EBF for the water service in line 18 of table 7; and
- the number of billed properties less than the EBF for the sewerage service in line 11 of table 13.

Our simplified approach to calculating the billing incentive means that we no longer require the companies to report these two lines for the 2011 June return (JR11).

Our reporting requirement for table 23 is unchanged. We require each company to report 'net revenue movement out of the tariff basket' in line 22 of table 23.

2. Back billing

The back-billing incentive was a refinement to the RCM to include an additional incentive for the companies to identify properties that have been charged less than they should have been ('under-billed properties') – and to recover the amount owed ('back billing'). We notified each company about this by writing to them in April 2010.

To provide an incentive to back bill, we said that we would increase the billing incentive by either:

- the future extra revenue billed up to March 2015 as a result of correcting historical under billing; or
- the associated back billing.

We said we would use whichever is the lesser amount.

Limiting the incentive to the future extra revenue means that the companies will be rewarded for identifying any problems as early as possible. Limiting it for the amount of back billing will protect customers because it will stop the companies receiving rewards greater than the extra revenue they obtain from identifying problems.

We said in our April 2010 letter to the companies that we would calculate the future extra revenue (referred to above) by multiplying:

- the difference between the average amount that the customer is charged each day before and after a company identifies a problem; and
- the number of days until 31 March 2015.

We also said that that would only provide an incentive:

- as long as the new volume of the customer remains below the tariff basket threshold; and
- only for problems found up to 31 March 2014.

In addition, we said that for each under-billed property that a company identifies, we would need them to provide us with the following information.

- The date the problem was found.
- The amount of back billing.
- The average daily billing before the company found the problem. This would be based on one year of billing before the problem was found.
- The average daily billing after the company finds the problem. This would be based on year of billing after the problem is found, excluding back billing; and
- The annual consumption after the company finds the problem (consistent with average billing).

Our future approach

To simplify the incentive, we have decided that where a company wishes to claim the back-billing incentive it should simply provide us with the total amount for the back-billing adjustment that they wish us to include in the RCM calculation.

We would expect all companies to calculate this in accordance with the overall principle that it should be either:

- the future extra revenue billed up to March 2015 as a result of correcting historical under billing; or
- the associated back billing.

We said we would use whichever is the lesser amount.

We will expect the companies:

- to take a reasonable, fair and appropriate approach for the back-billed amounts that they are claiming; and

- not to claim for back-billed amounts where the inaccuracy of the charging is the company's fault.

Where an adjustment for a company is material, we may look at it in more detail. We may also seek third party assurance.

3. Social tariffs and the RCM

Section 44 of the Flood and Water Management Act 2010 (FWMA10) allows water companies to introduce reduced charges ('social tariffs') for those customers that have difficulty paying their water and sewerage bill in full. This will be paid for ('subsidised') by increasing the charges that other customers pay.

The introduction of social tariffs depends on the UK and Welsh Assembly Governments issuing guidance on how they should work in England and Wales respectively. The guidance should include the factors that need to be taken into account in deciding whether one group of customers should subsidise another.

Until this guidance is issued, our existing charging policy on social tariffs applies.

We will consider social tariffs for approval if they are cost-neutral. Cost-neutral means that the revenue that a company loses by offering social tariffs should be balanced by the reductions in costs it experiences from introducing them. Cost reductions may include, for example, a decrease in debt recovery costs.

This means that we allow no rebalancing in the principal statement as charges for individual groups of customers should not increase as a result of such tariffs. We do this by excluding these lower tariffs from the calculation of the weighted average charges increase (WACI).

We also exclude from the RCM the revenue losses arising from such tariffs so that the companies are not compensated from them; these losses should already be balanced by cost reductions elsewhere in the business. We will do this by ensuring that the losses are not included in the revenue shortfall that the companies report as part of the RCM.

Ofwat
May 2011