July 2023

A consultation on the Revenue Forecasting Incentive

Ofwat

About this document

This document is a consultation on how we will apply some detailed aspects of the Revenue Forecasting Incentive in the period 2025-2030.

The Revenue Forecasting Incentive mechanism incentivises water and wastewater companies to accurately collect revenues and to adjust their charges to customers to account for any under or over recovery of revenue in a previous year. It applies a small but meaningful penalty on companies for each year where it has either over or under recovered revenue outside of a set level of tolerance (for example in recent years penalties have been in the region of £5m annually across all companies).

In this document we set out our position on what that level of tolerance should be and the rate at which we intend to apply the penalty. We also seek views on some of the detailed rules around the application of the mechanism.

Responding to this consultation

We would welcome any comments on this consultation. Please email your responses to PR24@ofwat.gov.uk. **The closing date for this consultation is Tuesday 12 September 2023**.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the General Data Protection Regulation 2016, the Data Protection Act 2018, and the Environmental Information Regulations 2004. For further information on how we process personal data please see our privacy policy.

If you would like the information that you provide to be treated as confidential, please be aware that under the FoIA there is a statutory Code of practice which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

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1. Introduction

In our Final Methodology for PR24 we set out our proposed approach to the Revenue Forecasting Incentive mechanism (RFI). We noted that we would give further consideration to certain issues and implement these in our determinations and associated rule book.

In this document we:

- Explain what the RFI is and how it operates in the current control period (2020-2025).
- Explain how some changes to revenue controls will impact revenues covered by the RFI in the next control period (2025-2030).
- Set out our proposal on how we will apply incentives for the next control period.
- Set out our views on the process for companies to notify us of their intention to voluntarily defer recovery of allowed revenues in order to benefit their customers.

We will take account of responses to this consultation when we implement the RFI in our determinations and associated rule book.

For clarity, this consultation relates solely to our approach to the RFI for the next control period (2025-2030). We are not consulting on how the RFI applies in the current control period (2020-2025).

This consultation also does not cover:

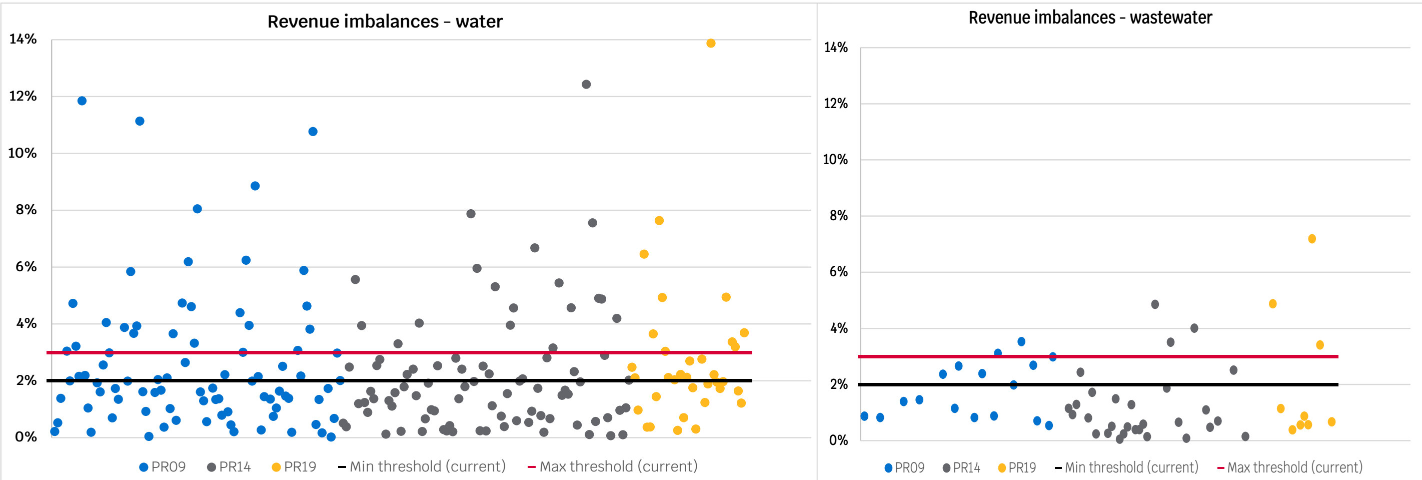
- The factors that we intend to include within the RFI formula for the next control period to allow 2024-25 blind year revenue adjustments to be recovered during 2025-30.
- Any necessary changes to the RFI formula for English water companies to deal with un-invoiced Wholesaler charges in the event of an unplanned Retailer exit from the business retail market.

We intend to consult on the full formula for the next price control period when we publish our draft determinations.

2. How the RFI applies to the 2020 – 2025 period

Companies set and publish charges for their customers in advance of the start of the year. They use the best information available to set their charges at a level that will recover the "correct" total amount of revenue (that is, the amount of revenue that they are allowed under their revenue controls). Because the charges are set in advance and there are factors that they cannot fully control, it is not unusual for the revenue recovered to vary from the revenue allowed. Figure 1 shows the revenue imbalances as a percentage of allowed wholesale water and wastewater revenue.

Figure 1: Revenue imbalances over time (2010 – 2022) and the current thresholds for applying a penalty



Source: Ofwat analysis of Annual Performance Report (APR) data. Revenue imbalances for water include all water and wastewater companies. Wastewater revenue imbalances exclude data for Hafren Dyfrdwy.

However, there are also risks that companies can control, such as the quality of their forecasting. We want to motivate companies to set charges as accurately as possible by focusing on the risks that they can control, so that variations in the revenue recovered from that allowed are kept to a minimum. Where companies over-recover revenue they may benefit from this at the expense of their customers. Where they either over or under recover over a sustained period, they will need to reset their charges to adjust for the variation and this can lead to substantial changes in the level of customer bills, which is at odds with the principle of stability set out in our charging rules.

2.1 The Revenue Forecasting Incentive mechanism

To address this challenge, we have used forecasting incentives to encourage accurate revenue forecasting. The current mechanism we use is called the Revenue Forecasting Incentive mechanism (RFI).

The mechanism itself incentivises companies to adjust charges within the price control period to account for previous over or under recovery of revenue. So, for example, if a company over recovers revenue in the first year of the control, it can adjust its charges later in the control period so that it recovers less revenue to make up for this previous over recovery. This reduces the risk of needing a big adjustment at the end of the period, and therefore helps smooth changes in customer bills.[1] We confirmed in our final methodology for PR24 that we intend to retain such a mechanism in a similar form for the 2025-2030 period.[2]

The mechanism applies to the water resources and water network plus controls for all companies. For wastewater companies it also applies to the wastewater networks plus control.[3] Collectively, these controls make up the bulk of companies' regulated revenues from residential customers and retailers and from developers for services provided in relation to new connections.

The incentive created by the RFI is to avoid over or under recovering revenue beyond a set limit of tolerance (called a "deadband") after which a financial penalty adjustment applies. In PR19 we set the dead band at a level of +/-2%. This means that where companies either over or under recover revenue by more than 2% of the amount that they forecast they should recover in each year, they will be subject to a financial penalty (although this does not prevent them from adjusting charges in future years to "correct" for the revenue variation).[4] The maximum penalty equates to 3% of the revenue variance.[5]

[1] Details of how the current RFI operates is set out in our PR19 Final methodology, appendix 7, section 4.2. Ofwat, 'Delivering Water 2020: Our methodology for the 2019 price review Appendix 7: Network plus water and wastewater controls,' December 2017; and Ofwat, 'PR19 Reconciliation Rulebook: Guidance Document,' August 2021.
[2] See section 3.3 of Ofwat, 'Creating tomorrow, together: Our final methodology for PR24,' December 2022.
[3] It does not apply to retail controls (all companies) or bioresources controls (wastewater companies) as these have separate mechanisms. For Thames Water, it also applies to the separate Thames Tideway Tunnel control.
[4] The PR19 RFI formula also allows adjustments to allowed revenues to make any correction related to outturn performance for the PR19 blind year (2019-20).
[5] In simple terms, if a company over recovered £1m from customers (beyond the dead band) it would face a £30,000 penalty. However, there is a "grading" of the penalty for variances between 2% (where the penalty applies) and 3% (where the maximum penalty rate – which also happens to be 3% - applies) of variance from the target revenue.

3. The RFI in the next control period

In our Final Methodology we confirmed that the way in which the RFI operates will continue in a similar form for the 2025-2030 period.[6] Our intention is that the RFI should apply to revenue that sits within the relevant revenue controls.

There are changes to our controls that we set out in the PR24 Final Methodology that will have an impact on the scope of revenues covered by the RFI for the 2025-2030 period which we explain below.[7]

We also stated in our PR24 Final Methodology that we would "give further consideration to our approach to applying penalties and the associated 'dead band'". We have subsequently considered whether there is a case for adjusting either. In this chapter we explain why **we are proposing to maintain the dead band at its current level of +/-2% of forecast revenues and apply a flat penalty rate of 3% on actual revenues that fall outside of the dead band.**

3.1 Changes to controls that will affect the RFI

In the Final Methodology we confirmed following changes that will impact the scope of revenues covered by the RFI.

- We will exclude water site specific developer services revenue for English companies and wastewater site specific developer services revenue for all companies. These services will be excluded from the water and wastewater network plus price controls in the 2025-2030 period.
- Non-section 185 diversions will be included in the water and wastewater network plus price controls in the 2025-2030 period. They will also be included in the third party-services end-of-period reconciliation mechanism being introduced at PR24.
- We will allow for in-period adjustments relating to un-invoiced revenue from failed retailers.[8]

We are clarifying our position as set out in section 3.3.4 of our Final Methodology, where we stated that "in line with the removal of some developer services from the price control, we will exclude site specific developer services revenue" from the RFI. Our intention is that the RFI will not cover site specific developer services revenue that has been excluded from price controls. This means that it will not apply to water site specific revenue for English companies

[6] This will include factors within the RFI formula set at PR24 to allow 2024-25 blind year revenue adjustments to be recovered during 2025-30. We anticipate that this will be of similar form to those used for 2019-20 blind year revenue adjustments.
[7] See section 3.3 of Ofwat, 'Creating tomorrow, together: Our final methodology for PR24,' December 2022.
[8] We outlined our proposals in relation to this in Ofwat, 'Business Retail Market: Dealing with un-invoiced Wholesaler charges in the event of an unplanned Retailer exit,' November 2022.

and not apply to wastewater site specific revenue for all companies. Water site specific developer services revenue for Welsh companies remains within the relevant revenue controls and, consistent with this, we intend for it to remain within the scope of revenues covered by the RFI. We consider that this is a proportionate approach that will avoid undue complexity in relation to the operation of the RFI formula.

3.2 The deadband

We have considered whether company revenue is likely to become more or less volatile over time as a result of factors beyond companies' control, which would inform a decision on the size of the dead band. We have considered the main types of revenue that companies are in receipt of and to which the RFI applies.

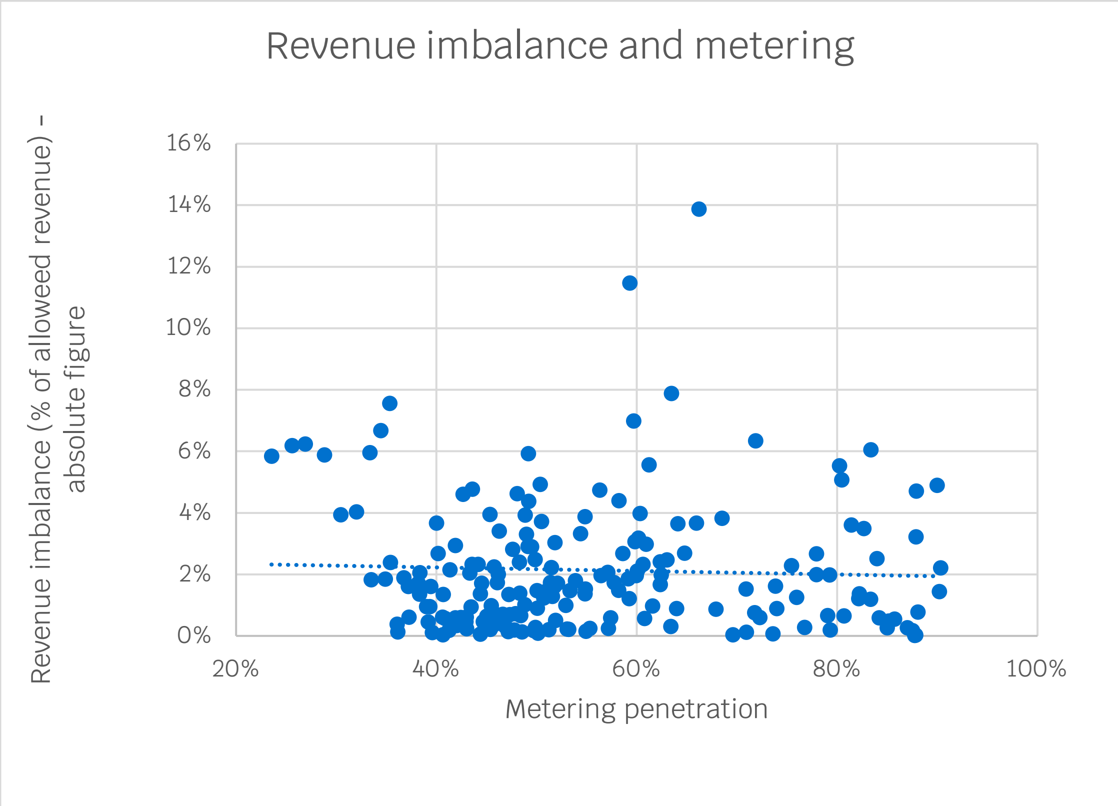
Typically, a company is in receipt of revenue from:

- Customers who are unmetered. This accounted for around 35% of total industry wholesale revenue in 2021-22.[9] These customers pay a fixed annual bill based on charges that are fixed per property or on the rateable value of a property.
- Customers who are metered (both household and non household). This accounted for 62% of industry wholesale revenue in 2021-22. These customers' annual bills depend on their usage. Companies set variable (£/m3) and fixed (£/property) charges in advance of each charging year to recover revenue from metered customers.
- Developers (such as housing developers, self-lay providers (SLPs) and new appointees (NAVs). This typically accounts for around 3% of industry wholesale revenue. This revenue is variable as it is dependent on how much development work is taking place in a companies' region.

At PR19 we noted that we did not consider that there was a correlation between the level of metering penetration and the ability of a company to accurately forecast its revenue. We have undertaken further analysis, comparing the level of metering penetration and the level of revenue imbalance over the past 10 years. We did not find a correlation between the level of metering and the level of revenue imbalance.

[9] Ofwat analysis of companies' 2021-22 annual performance reports (APRs), table 2E. Note that the percentage of metered and unmetered household customers varies quite widely across companies.

Figure 2: Revenue imbalances and metering penetration (2011-12 to 2021-22)



Source: Ofwat analysis of APRs and PR24 cost models[10]

In the light of this we consider that companies appear to adapt well to forecasting variable income from customers. As such, we do not think there is a material increase in risk that companies should be at greater risk of incurring an RFI penalty either from the projected increase of metering during the PR24 period, or the roll out of innovative tariffs to customers.

We have also considered the impact on revenue volatility of the reduction in developer services revenues that will arise from our decision to remove some site specific developer services from the scope of the RFI. Over the 2015 – 2020 period, developer services revenue accounted for about 3% of total revenue governed by the wholesale price controls, with relatively little variation in revenue across the industry from year to year (although individual companies may have experienced volatility).[11] For PR24 we assume that the reduction in the amount of developer services revenue subject to the RFI will reduce the level of potentially volatile revenue that individual companies are exposed to compared to the current and previous review periods.[12]

[10] This range sits across 3 control periods – the final 3 years of PR09, the whole of PR14, and the first 2 years of PR19.
[11] Ofwat analysis of companies' annual performance reports (APRs), tables 2I and 2E. Grants and contributions from developers varied between c£300 and £400m, including s.185 diversions, which is between 2.9% and 3.4% of total wholesale revenues governed by the price controls.
[12] Developer services revenue subject to the RFI is likely to be less than half of its current level as a result of removing a large proportion of service from the price controls and the introduction of end -of-period adjustment

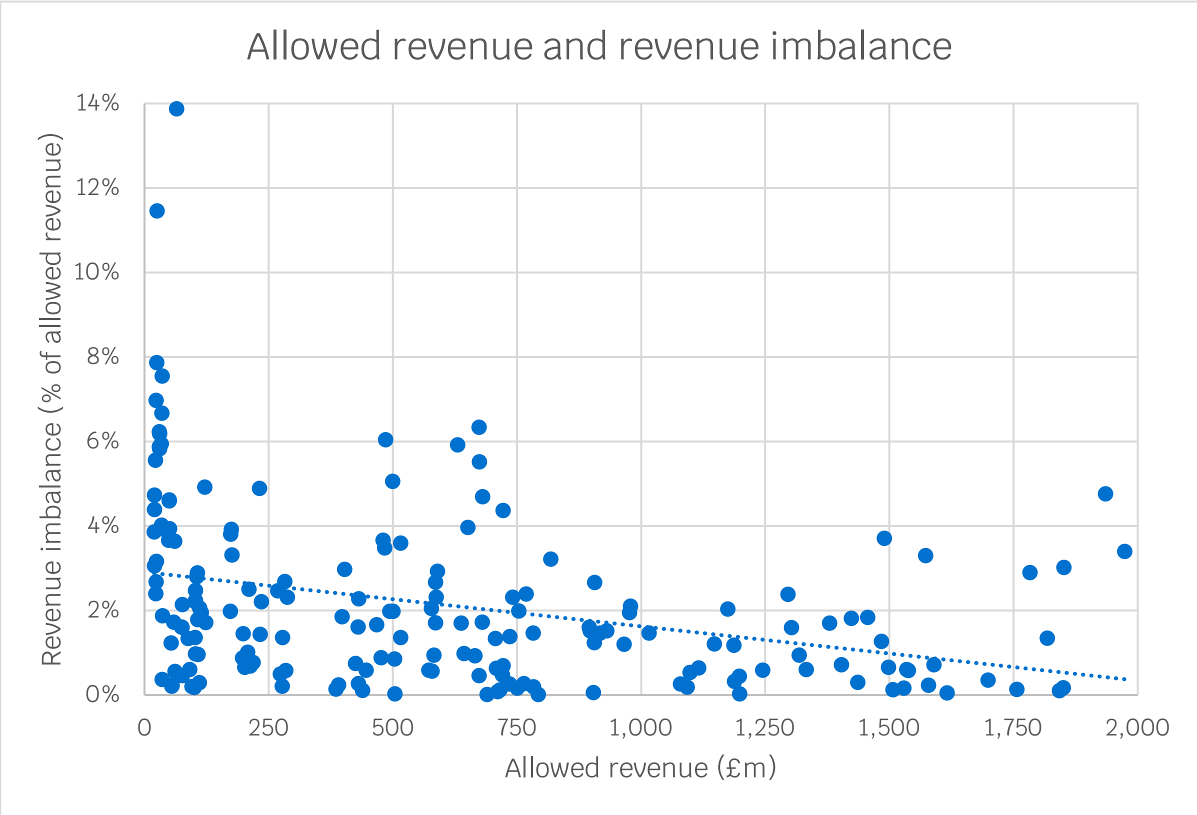
3.3 The penalty

The reasoning we gave when we set the penalty level was that it should be small, but meaningful, in order to focus management attention on forecasting. Given that some factors that may impact imbalances sit outside of the control of the company we do not consider it appropriate to set a larger penalty.

We have considered whether the penalty might be more sharply graded such that larger imbalances attract a proportionately larger penalty (there is already a modest level of grading between the dead band of +/-2% and variances of +/-3%, with variances above this level receiving a flat 3% penalty).

Having examined the relationship between the level of overall revenue recovered and the level of variance from the penalty, we have noted that there is a degree of correlation. The largest rates of variance have tended to correlate with smaller overall revenues.

Figure 2: Revenue imbalance by company allowed revenue (2010-11 to 2021-22)



Source: Ofwat analysis of APRs and PR24 cost models

mechanism for diversions at PR24 (this could result in a reduction of developer services revenue subject to the RFI to less than £200m a year on average – based on the total revenues from developer services in the end of the PR14 price control period).

Given this finding, we do not consider it appropriate for the penalty to be more sharply graded. The evidence appears to suggest that this would disproportionately target companies with smaller revenues.

Instead, **we are proposing to apply a penalty at a flat rate of 3% on revenues that fall outside of the dead band**. This will remove the current modest grading that applies between 2 and 3%, thereby reducing the complexity of the mechanism. To illustrate the impact of this change, had we applied this approach for 2021-22, we estimate that total penalties would have increased from £4.8m to £5.2m (or around 9%).[13] While, all other things being equal, this would increase the overall quantum of penalty levelled, we consider that in practice the quantum of penalty would be similar or reduce, in particular because of **our proposed position of maintaining the dead band at its current level of +/-2%** despite the exclusion of site-specific developer services revenue.

[13] This is based on data from the latest APRs covering 2021-22, including imbalances for both wholesale water and wastewater allowed revenue. However, we did not make an adjustment to exclude the relevant site-specific developer services revenue that would be excluded in PR24, so this represents a high-end estimated increase.

4. Other areas of consideration

4.1 Bill smoothing

A number of respondents to our PR24 draft methodology commented on the ability of companies to defer the recovery of revenue in order to provide a smoother bill profile for customers and the risk in doing so of incurring a penalty under the RFI. The benefits of bill smoothing are recognised within our charging principles.[14] One respondent noted that the RFI does not currently have a formal mechanism to address circumstances where companies voluntarily defer wholesale revenue for the benefit of customers. It argued that the mechanics of the revenue reconciliation model can be relatively easily amended to base the penalty calculation on the level of revenue on which prices were set, while still basing the main revenue adjustment on the gross level of allowed revenue prior to any voluntary deferral.

We have considered this point. We want companies to do the right thing by their customers.[15] However, we remain to be convinced that the current arrangements are unworkable in this regard and our default position would be to not introduce a formal mechanism. Nevertheless, we welcome constructive views on how arrangements could be improved. We consider that any arrangements to smooth revenue profiles would need to only be available for significant adjustments, allow for advance notification to Ofwat, justify benefits to customers and ensure that there is a way to hold companies to account for delivering what they have proposed.

4.2 Interactions with outcome delivery incentives

As set out in Appendix 8 of the PR24 final methodology, we are considering streamlining the overall in-period determinations process, which could include a 'lighter touch' approach where revenue adjustments linked to how companies perform against their performance commitments and outcome delivery incentives would be managed through the RFI.[16]

We intend to consult further on this in the draft determinations, but welcome views from stakeholders on this issue given its interactions with the RFI. As now, any annual revenue adjustments due to outcome delivery incentive payments would be reflected in the level of the RFI dead band to avoid penalising companies for collecting revenue in line with their outcome delivery incentive payments.

[14] See paragraph 8 "Bill stability" in Ofwat, 'Charges Scheme Rules from April 2023,' December 2022
[15] Ofwat/CCW, 'Supporting customers through cost of living pressures', October 2022
[16] Pages 84-86 Ofwat, 'Creating tomorrow, together: Our final methodology for PR24 Appendix 8 Outcome delivery incentives,' December 2022

4.3 Next steps

We noted in the final methodology that we would consider detailed changes suggested by stakeholders for the PR24 rule book. Stakeholders suggested a number of changes in response to the draft methodology, such as clarifying the treatment of Direct Procurement for Customers (DPC) allowed revenue. We will consider any further proposed technical changes raised by stakeholders in response to this consultation. Any changes we make will be included in the PR24 rule book.

Consultation questions

1. Do you agree that the RFI should apply to revenue that sits within the relevant revenue controls (noting that, as such, site-specific developer services revenue would be treated differently for English and Welsh companies)?
2. Do you agree with our proposal that the existing deadband set at +/- 2% should be retained and to apply a penalty at a flat rate of 3% for the RFI for the 2025-2030 period?
3. Do you have views on whether arrangements to smooth revenue profiles could be improved, noting that any such improvements would need to only be available for significant adjustments, allow for advance notification to Ofwat, justify benefits to customers and ensure that there is a way to hold companies to account for delivering what they have proposed?
4. Do you have any comments on whether we should apply outcome delivery incentive payments through the RFI formula for the 2025-2030 period and any views on how this should be done?
5. Given the intended scope of the RFI at PR24 set out in this consultation, do you have any views on whether detailed changes are required to the RFI formula for the 2025-2030 period or whether the PR24 rulebook would need to be different from the PR19 rulebook in relation to the RFI?

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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