



The revenue forecasting incentive mechanism for AMP6

An Ofwat consultation paper

1 Introduction

1.1 The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage consumers in England and Wales. CCWater has four regional committees in England and a committee for Wales. We welcome the opportunity to respond to Ofwat's consultation on the proposed incentive to improve water companies' revenue forecasting for the 2015-20 price control period.

2 Executive Summary

2.1 CCWater supports the principle of a revenue forecasting incentive mechanism because:

- Customers should benefit from more accurate revenue forecasting by companies, as this would lead to a reduced customer bill impact caused by revenue corrections.
- The +/- 2% parameter outside of which revenue will be adjusted with a penalty for over or under forecasting is based on clear analysis of actual and forecast revenues in the current and previous price controls.

2.2 However, we have some concerns about the detail of the incentive mechanism that we would like Ofwat to address:

- There is a risk to customers of bill instability within a price control if the charging rule changes in the Water Act 2014 allow wholesale charges to be adjusted within the price control. Customers have told us that they prefer certainty around their bills to help them budget. As such, we call upon Ofwat to consider ways in which bill instability can be prevented or, at the very least, minimised.
- There is a risk of companies deliberately reducing or increasing revenue if companies are faced with actual revenue falling outside of the +/- 2% parameters and a penalty being applied in the following year. Such company behaviour could have a detrimental impact on customers, and Ofwat needs to guard against it.

3 Questions

Question 1 - Do you agree with the need for a revenue forecasting incentive in AMP6?

- 3.1 Yes, this will help reduce the risk of customer bill increases at future price controls being driven at least partly by allowances Ofwat makes to account for the difference between forecast and actual wholesale revenue in the preceding price control period.
- 3.2 While the separation of retail and wholesale revenue controls from 2015-16 should help more accurate forecasting, the implementation of a penalty only incentive should lead to a reduction in future revenue adjustments and subsequently reduce the bill impact caused by revenue corrections. Appendix 1 of the consultation paper shows that there have been some instances where revenue forecasting errors in AMP5 beyond +/- 2% will have led to a significant adjustment incorporated into price controls in AMP6, and we agree that this evidence shows the need for more accurate forecasting by companies.

Question 2 - Do you have any comments on our proposed approach to the wholesale forecasting incentive mechanism (WFIM)?

- 3.3 The consultation is clear on the general approach to the incentive, showing how differences year on year between actual and forecast revenue outside of +/- 2% would incur a penalty
- 3.4 However, the consultation paper is less clear on the potential customer bill implications of this incentive mechanism. Appendix 1 of the consultation paper states that some flexibility may be allowed from the changes to charging rules in the 2014 Water Act, though this will be subject to consultation. Appendix 5 then goes on to say that there will not be a mechanism in place for Ofwat to adjust wholesale allowed revenues (K factors) within a price control period (unless a review occurs to allow this), so therefore any year by year revenue adjustments would not affect prices until the subsequent price review (in this case, PR19).
- 3.5 While there is a customer benefit in encouraging companies to be more accurate in revenue forecasting, bill adjustments within a price control period caused by changes to wholesale charges would lead to instability for customers. Research in PR14 and earlier price reviews shows how customers prefer stability across a price control period. As such we call upon Ofwat to consider ways in which bill instability can be prevented or, at the very least, mitigated.

Question 3 - 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.

- 3.7 Yes, on the basis that the parameters are based on evidence presented by Ofwat that +/- 2%, is based on analysis of AMP4 and AMP5 error margins, and is a suitably challenging parameter for companies to adhere to.

Question 4 - Do you agree with a penalty rate of 3%? Please provide supporting evidence and analysis should you wish to propose a different penalty rate.

- 3.8 Based on Ofwat's explanation of the effect this penalty rate would have on 'year ahead' revenue and the Return on Regulated Equity, 3% is appropriate. This is also consistent with similar mechanisms in other regulated sectors. We suggest that should this be implemented, customers should be informed about how companies are being driven to improve revenue forecasting and the subsequent benefit this should deliver to customers at future price reviews.

Question 5 - 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 in the wholesale control with the same parameters?

- 3.9 It is difficult to see how an equivalent incentive for the retail business would deliver the same benefits as the wholesale revenue forecasting incentive because
- from 2017, non-household retail revenue in England will be driven by limits set by default tariffs, and the introduction of retail competition which should limit the

potential for customer bill increases. This means an equivalent incentive for this market is not needed; and

- as retail revenue represents only a small part of the combined business (total retail revenue is approximately 14% of the equivalent wholesale revenue), the potential benefits on customers' bills of such an incentive may be negligible. It is also questionable whether, proportionately, the 3% penalty applied to household retail revenue in England and non-household retail in Wales would adequately drive more accurate revenue forecasting for this far smaller element of the overall business.

Question 6 - Do you agree with the proposed cap and collar mechanism as a trigger to further investigation to provide additional safeguards for customers?

3.10 Yes. We agree that +/- 6% or more of the forecast should warrant investigation as to whether there is robust evidence of exceptional factors such as extreme weather to justify an adjustment on the scale suggested. However, we would like to see Ofwat consult CCWater and others should this situation arise. Companies should carry risks associated with uncertainties and should not receive a significant adjustment outside of the suggested parameters unless there is compelling evidence that without an adjustment service delivery is at risk.

Question 7 - Do you agree we could additionally use the WRFIM to incentivise accurate projections of revenues for 2014-15 in our final determinations?

3.11 Yes, as this will mean revenue forecasting challenges to companies will start sooner.

Question 8 - Do you have any comments in relation to the details and mechanisms of the iteration process?

3.12 We are concerned that if a company finds that actual revenue is higher or lower than forecast, with a risk of a penalty being applied, it may attempt to reduce or increase revenue through activities that could have detriment to customers or the service they receive. For example, an under-performance in revenue may lead to more aggressive debt recovery that could lead to some customers in genuine financial hardship facing disproportionate recovery action from the company. We would like to see greater clarity in Ofwat's approach to the incentive mechanism to show what regulatory actions can be taken to safeguard against this risk.

4 Enquiries

Enquiries about this consultation response and requests for further information should be addressed to:

Steve Hobbs

Tel: 0776 817 8006

Email: steven.hobbs@ccwater.org.uk