



## **PC21**

**NI Water response to  
'Consultation on a Revenue Cap'  
published by the Utility Regulator  
on 26 Oct 2018.**

**21 Dec 2018**

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## **1 Introduction**

### **1.1 Overview**

- 1.1.1 NI Water welcomes the opportunity to respond to the Consultation on a Revenue Cap published by Utility Regulator on 26 October 2018.
- 1.1.2 In summary, we do not believe there is a compelling case for moving away from the Revenue Adjusted Price Cap regime currently in place. We believe the current arrangement strikes some balance between protecting customers and enabling NI Water to make use of necessary funding as it arises.
- 1.1.3 The Revenue Adjusted Price Cap regime avoids tariff volatility associated with a Revenue Cap. While we agree that a Revenue Cap has the advantage of restricting the impact of a revenue shortfall to one year, on balance we believe the revenue adjusting features of the current regime provide more flexibility to manage our finances within a Public Expenditure budget.
- 1.1.4 Our full response is provided in the remainder of this document. For clarity the format of our response follows the layout of the consultation.
- 1.1.5 For the record, we disagree with the statement on Page 2: 'The price control process must [therefore] start with the public expenditure budget allocation in mind'. It is our view that the PC21 Business Plan should make the case for an appropriate level of funding necessary to safeguard public health, underpin economic growth and protect the environment. Only after the Business Plan has been produced and determined upon can the impact of budgetary constraints be assessed. We welcome that this approach was endorsed by the Utility Regulator in Section 4.1 of the final published Approach document.

## **2 Discussions of Options**

We welcome the acknowledgement by the Utility Regulator of the significant improvements NI Water has made in customer service, drinking water quality and environmental compliance while reducing underlying cost by improving efficiency.

### **2.1 Current arrangements**

2.1.1 We agree that the regime currently operating here can best be described as a 'Revenue Adjusted Price Cap'. Under the current regime, if an over or under recovery of revenue occurs in a price control period, an adjustment can be made to price limits in the subsequent period.

2.1.2 In PC15, our first 6-year price control, the Utility Regulator introduced a Mid Term Review which allows for the adjustment of price caps at the half way point of the 6-year price control period.

2.1.3 In addition to adjusting for forecast variations in revenues, the current regime allows for price limits to be adjusted for other circumstances outlined in the PC15 Memorandum of Understanding and Consequent Written Agreement. Furthermore, the Utility Regulator has in the past, adjusted price caps downwards during PC13 and PC15 to reflect over recovery of certain cost types during PC10 e.g. Transformation costs.

2.1.4 We feel the consultation document does not highlight the revenue adjusting features of the current regime sufficiently.

### **2.2 Overview of options**

2.2.1 In common with other network utilities, NI Water's tariffs are set to recover the average cost of providing water and sewerage services. This means tariffs are likely to exceed the long run marginal cost of production. While this can lead to a divergence between revenue and cost under a pure price cap regime, we believe that the Revenue Adjusted Price Cap regime currently in place ensures any divergence will be corrected.

2.2.2 The correction can happen in the subsequent price control period, which commences a maximum of 5 years after the variance arises, or in the Mid Term Review which happens half way through the price control period.

## **2.3 Interaction with public expenditure rules**

- 2.3.1 Under our current governance and funding arrangement, compatibility with the Public Expenditure framework is a key consideration for any price setting regime. Non-domestic customer revenues form part of NI Water's Resource DEL budget; any variance to non-domestic revenue above or below the forecasts used in these budgets will have a Resource DEL impact. Note domestic subsidy is classed as 'Non-Budget' for Public Expenditure purposes. The consequence of a variance in this category is less problematic from a PE perspective so we have focused on non-domestic revenue within this response.
- 2.3.2 The consultation document uses an 'over forecast' scenario to demonstrate the impact of a revenue cap on Public Expenditure (PE), specifically Resource DEL (RDEL). Whilst we agree a revenue cap will automatically restrict the PE impact of a revenue variance to one year, this might not always be optimal.
- 2.3.3 If the situation is reversed and revenues have been under forecast (i.e. actuals exceed forecast), then under a revenue cap this will automatically result in a reduction to revenues the following year. Whilst NI Water would have a RDEL surplus in the year that revenues are higher than forecast, we would experience a RDEL deficit the following year as tariffs are lowered to correct for the previous years over recovery. Such PE volatility would be extremely difficult to manage in a RDEL constrained environment.
- 2.3.4 For example, in 2015/16, the first year of PC15, NI Water's non-domestic revenues were £4.3m higher than forecast as customer demand exceeded expectation. Had a revenue cap been in place, tariffs in 2016/17 would have automatically been reduced to return this over recovery to customers, resulting in a potential £4.3 RDEL shortfall in that year. It is worth noting that NI Water, having realised customer demand was higher than forecast in 2015/16, chose not to increase non domestic tariffs in 2016/17, passing some of the benefits of higher demand back to customers, whilst at the same time ensuring we could live within the RDEL allocation.
- 2.3.5 In summary, we believe the current regime provides NI Water more flexibility to manage the impact on PE in the event of an under forecast as has been the case during PC15. While we agree that a revenue cap has some advantages from a PE perspective by restricting the impact of revenue shortfalls to one year, we think the revenue adjusting features of the current regime provides

sufficient protection to the company in the event of revenues being over forecast.

- 2.3.6 This is a complex area, unique to NI Water. We welcome that Utility Regulator intends to carry out further analysis on the interaction between the price setting regime and PE with DfI and ourselves before making its final decision.

## **2.4 Incentives**

- 2.4.1 A price cap might create an incentive to under forecast, however the revenue adjusting features of the current Revenue Adjusted Price Cap regime, such as the Mid Term Review and correction in the next price control greatly reduce any incentive to systematically under forecast.
- 2.4.2 As the sole provider of drinking water in NI, everyone who can be connected to the network is connected. It is also important that we continue to identify those customers who are connected to the water and sewerage network but who are not currently being billed. To that end, the incentive offered by current Revenue Adjusted Price Cap regime is welcome.
- 2.4.3 Throughout PC10, PC13 and PC15 NI Water has delivered significant cost savings. Whilst it is difficult to ascertain how much if any of this saving is as a result of the incentive to outperform offered by the Revenue Adjusted Price Cap , we see no basis for the Utility Regulator's assertion that a price cap has the potential to divert management focus away from improving efficiency.

## **2.5 Alignment of costs and revenues**

- 2.5.1 Forecast variances are an inevitable feature of ex ante regulation. Both a revenue cap and Revenue Adjusted Price Cap regime will make adjustments to tariffs to correct for these, albeit over differing timescales. A revenue cap will ensure revenues and costs are aligned over the short term, whilst a Revenue Adjusted Price Cap will deliver the same over the short to medium term.
- 2.5.2 The current Revenue Adjusted Price Cap regime, not only ensures that over or under recoveries are corrected from one price control to the next but the Mid Term Review also offers the option of making this correction during a price control. For this reason, we disagree that Revenue Adjusted Price Cap mechanism blurs price signals and shifts the cost burden from one group of customers to another.

2.5.3 As the sole provider of drinking water in NI, every one who can be connected to the network is connected. We do not believe there is scope to realise further scale economies. For this reason we do not believe this is a relevant consideration.

2.5.4 We disagree that the current Revenue Adjusted Price Cap regime only allows the structure of charges to be amended at the time of a price control. Price limits allow for re-structuring of tariffs within each tariff basket, provided the resultant weighted average charge increase does not exceed that baskets price limit.

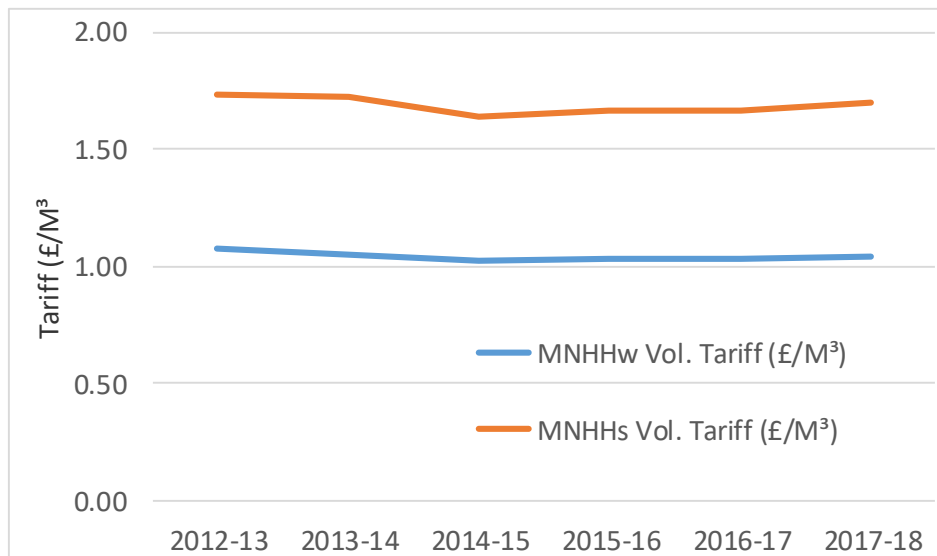
## **2.6 Tariff stability and Predictability**

2.6.1 Stable tariffs are an important benefit of any price cap regime. Revenue cap will inevitably result in more tariff volatility. For example had a revenue cap been in place during PC15, measured water volumetric tariffs would have automatically reduced by 11% in 2016/17 followed by an increase of 7% in 2017/18.

2.6.2 Whilst a Revenue Adjusted Price Cap could lead to the build up of a material revenue adjustment at the end of the price control, the use of revenue smoothing when setting price limits in the following period reduces the risk that it will lead to a significant movement in tariffs from one price control to the next.

2.6.3 Figure 2.1 overleaf shows movements in non-domestic measured water and sewerage tariffs since 2012/13. 2013/14 was the first year of PC13 and 2015/16 was the first year of PC15. As can be seen tariffs remained stable going into PC13 and PC15 and they continue to remain stable in PC15.

**Figure 2.1 – NI Water’s Measured Water and Sewerage volumetric tariffs**



## **2.7 Regulatory Burden**

2.7.1 The consultation document contends that the introduction of a revenue cap would mean forecasting future demand prior to a price control would no longer be important. However, given the significant PE impact a revenue cap regime can cause, we believe forecasting customer demand, in advance of the price control will remain a critical activity which will still require regulatory scrutiny.

## **2.8 Regulatory comparison**

2.8.1 We have nothing further to add.

## **2.9 Impact on Cost of Capital**

2.9.1 Whilst we agree that any potential impact of the price setting regime on cost of capital would be extremely marginal, we believe the revenue adjusting features of the current Revenue Adjusted Price Cap regime, means it would be viewed as low risk by capital investors.



### **3 Conclusion**

In conclusion, we do not believe there is a compelling case for moving away from the Revenue Adjusted Price Cap regime currently in place. We believe the current arrangement strikes some balance between protecting customers and enabling NI Water to make use of necessary funding as it arises.

The Revenue Adjusted Price Cap regime avoids tariff volatility associated with a Revenue Cap. While we agree that a Revenue Cap has the advantage of restricting the impact of a revenue shortfall to one year, on balance we believe the revenue adjusting features of the current regime provide more flexibility to manage our finances within a Public Expenditure budget.

We welcome that Utility Regulator intends to carry out further analysis on the interaction between the price setting regime and Public Expenditure with DfI and ourselves before making its final decision.

In the meantime, if clarification is required on any aspect of our response, we will be pleased to engage further with the team at the Utility Regulator.