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Ofwat
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Via email: covidbusinessretailmarket@ofwat.gov.uk

21 April 2020

Dear Georgina,

Covid-19 and the business retail market consultation: Proposals to address liquidity challenges and increases in bad debt

Thank you for providing us with the opportunity to respond to the consultation to address liquidity challenges and increases in bad debt in the business retail market, resulting from Covid-19.

It is evident that there has been a lot of work in the past few weeks, with constructive engagement via Water UK and the High Level Group, which has enabled rapid progress on this important matter.

Overall, we support the broad objectives set out by Ofwat in the consultation, particularly in recognising the temporary nature of the liquidity support provided by wholesalers to retailers (and the expectation that this will be repaid in full by December 2020), and that this liquidity should not come at the expense of the financial viability of the wholesalers.

The current situation has however increased the level of risk associated with retailer failure. We would therefore strongly support a cap on wholesalers' exposure and this cap should be set at the level that existed pre Covid-19 (which is also commensurate with the exposure assumed in our current price control limits).

Finally, Covid-19 has highlighted the need for reform of the competitive market, and we would like to contribute in future discussions to bring about enduring improvements to the functioning of the market.

I hope you find our response helpful. Please do not hesitate to contact us, should you wish to discuss any of these points further.

Yours sincerely,

[redacted]

Stève Hervouet
Director of Regulation and Strategy, Affinity Water

cc: Pauline Walsh, Chief Executive Officer
Stuart Ledger, Chief Financial Officer
Jake Rigg, Director of Communications, Communities and Corporate Affairs

Consultation Response

Question 1: Do you agree with these objectives as set out, which will guide our decisions about what are the preferred options?

Overall, we agree with the broad objectives set out by Ofwat in the consultation, in particular the recognition of the financial constraints and the temporary nature of the liquidity support provided by wholesalers to retailers. We also welcome the clarification made by Ofwat that additional liquidity should not come at the expense of the financial viability of the wholesalers.

We also support the aims and objectives set out by Ofwat in the Foreword section of the consultation document regarding the following two key principles:

- Liquidity: Liquidity on offer is only for protecting retailers from Covid-19 impacts and is not a way of managing other cash flow issues. Retailers must pay back what they owe promptly, and these payments should include interest on deferred payments.

- Bad debt: NHH customer bad debt concerns will be managed in the business retail market in line with existing market arrangements, with no exposure to wholesalers. Wholesaler's exposure to the failure of NHH retailers should only be in line with the pre-27 March code changes.

As a further point, we would add that under the Revenue Forecasting Incentive (RFI), wholesalers should not suffer financial penalties when the difference between actual and allowed revenues exceed the 2% threshold, as a result of the Covid-19 emergency (subject to demonstrating to Ofwat how these errors have occurred). This is because the forecasts of revenue made at the time of tariff setting could not reasonably have anticipated this event and its effects.

Question 2: Excluding customers with temporary vacancy flags, what percentage of remaining wholesale charges are you currently able to recover from customers each month? Please explain why these customers, who are still open for business, are late paying (or not paying in full). Please also provide evidence to support your response.

Question 3: Please explain how you expect your response to question 2 to change over the next month or two.

Business retailers are better placed to respond to questions 2 and 3 but it should be noted that, as highlighted by Ofwat in the consultation, the use of vacant property flags must be used in line with the intention expressed in recent code modifications, and we strongly support the application of penalties for misuse of Covid-19 vacant flag.

We have noted that the implementation of this measure is still under review (this is being reviewed by MOSL's Sub-Panel Group) and we would strongly encourage Ofwat and MOSL to clarify the process and controls necessary to avoid any potential misuse, as soon as practically possible.

Moreover, and as mentioned in our response to Ofwat's RFI on 'impact of Covid-19 on the business retail market (reduced demand)' submitted on 24 March, it should be noted that misuse of vacant flags could have serious implications for the enduring operation of the non-household market. Once the situation around Covid-19 has stabilised, we have concerns that the process to unwind the vacancy flags could take a disproportionate amount of time and resources for all Trading Parties – further impacting the ability of the competitive market to recover and to ensure accurate settlement processes.

This is particularly relevant in the case of unmetered customers as wholesalers will not receive any primary charges on these properties for the duration of the vacancy period (and wholesalers will most likely find themselves without evidence to dispute any suspected misuse of the flag by retailers).

Finally, we believe that it is MOSL, rather than wholesalers, that should fill the essential role of monitoring the responsible use of the vacancy flag, and we would welcome clarification from Ofwat on this matter.

Question 4: Which option for dealing with the remaining liquidity gap facing business retailers do you think would be in the best interests of customers, the market and best reflects the objectives we are trying to achieve? Please explain your view and provide supporting evidence.

It is important to note that provision of liquidity from wholesalers is a significant assistance to the competitive market, and it is not in customers' long-term interests for this assistance to jeopardise wholesaler credit rating indicators (these are already under pressure from other Covid-19 emergency costs being managed by wholesalers).

Under the code changes approved by Ofwat on 27 March, we note that retailers have been able to reduce their exposure to liquidity pressures through use of the vacancy flag and payment deferral of 50% of wholesale charges due in March. Moreover, and as mentioned by Ofwat in the consultation, it is expected that retailers will explore other sources of liquidity (for example credit markets, parent companies and government assistance schemes) and these alternatives should further diminish the 'liquidity gap' retailers are currently facing.

Where the liquidity remains acceptable (and the measures mentioned above should have an almost immediate and beneficial effect for retailers), we would therefore support option 1 (i.e. retailers managing liquidity using their own resources) and we note that this is also Ofwat's preference.

Where there is compelling evidence that these arrangements are likely to be insufficient, provision of liquidity by wholesalers should be a 'last resort', and retailers should be incentivised to exhaust all other sources of liquidity before seeking forbearance from wholesalers. The precise figure will need to be determined empirically based on the evidence provided to Ofwat, but we support Ofwat's expectation that at least 70% of wholesalers' charges should be paid each month.

We also support Ofwat being absolutely clear that retailers should pass on to wholesalers at least the wholesaler charge proportion of all customer payments, regardless of whether this is over the 70% minimum threshold (a combination of options 2 and 3 in the consultation). There was no mention in the Code Change dated 27 March (nor in the consultation document) of the mechanism to monitor (or incentivise) retailers payments above the 70% threshold and we would welcome clarification from Ofwat.

As a further point of clarification, we would also welcome confirmation from Ofwat that the effect of deferral is not cumulative over the period during which wholesale charges are deferred (i.e. the calculation for deferral is based on the charges deferred for the month in consideration only).

Question 5: How should we determine the financing costs associated with any liquidity provided by wholesalers? Please explain your view and provide supporting evidence.

Question 6: Do you agree that the financing costs associated with any liquidity provided by wholesalers should be borne by retailers? Please explain your view and provide supporting evidence.

Extension of liquidity is a valuable service and commits financial resources available to us that we would otherwise use to support other functions. Therefore, we strongly agree that retailers should bear the financing costs of the liquidity, over the full period from when liquidity has been extended; that is, from the date that the new market codes became operational.

We support the principle that the charges to retailers for financing costs should be no less than the cost to wholesalers of providing any liquidity. We support using the WACC as the interest rate for liquidity as we consider that this would incentivise retailers to seek other competitive forms of liquidity, and in 'last resort' paying a cost reflective interest rate to wholesalers.

The WACC is cost reflective, in that it reflects our overall cost of capital as recently assessed by Ofwat as part of the PR19 Final Determination.

Question 7: Do you agree that retailers should receive liquidity support at least to the end of July 2020? And that all additional liquidity provided by wholesalers should be repaid by the end of December 2020?

Whilst we support the extension of liquidity support to retailers for an additional period of two months (i.e. June & July in addition to the original March to May deferral period approved by Ofwat on 27 March), we strongly support Ofwat's proposal that liquidity support should be time-limited and subject to regulatory review.

We also agree that unwinding of additional liquidity provided by wholesalers should commence as soon as is practicable and possible (and as highlighted in our response above, financing costs associated with any liquidity provided by wholesalers should be borne by retailers).

We agree with Ofwat's proposal that all additional liquidity provided by wholesalers should be repaid from August to December 2020. It is important for Affinity Water that the liquidity is repaid within the 2020/21 financial year to align with the Company's covenant reporting. However, earlier repayment would be clearly beneficial for all parties (customers, retailers and wholesalers), and we would strongly encourage Ofwat (and MOSL) to define a mechanism to incentivise early payments (rather than waiting until a backstop regulatory requirement).

Question 8: Should retailers incur all bad debt costs from non-household customers defaulting or should some of these costs be recoverable beyond a pre-determined threshold? Please explain your response and provide supporting evidence.

Question 9: If bad debt costs from non-household customers defaulting should be recoverable beyond a pre-determined threshold, then do you agree that retailers should expect to manage all bad debt costs up to 2% of their turnover, or the level of bad debt from their most recently audited level +1%, whichever is the greater?

Question 10: Where bad debt costs from non-household customers defaulting exceed a predetermined threshold, should these costs be shared between retailers and non-household customers, and in what proportion, or should they be born wholly by customers? What relevant precedents are there (including in other sectors)? Please explain your response and provide supporting evidence.

As highlighted by Ofwat in Chapter 2 of the consultation, the respective responsibilities and risks borne by retailers and wholesalers in the business retail market are set out in relevant legislation, regulations and market codes.

Retailers' responsibilities include reading meters, billing end customers, managing bad debt and collecting revenues from customers and for paying charges to wholesalers (whilst wholesalers' key responsibilities include the delivery of safe and reliable water and wastewater services to end users, maintenance of the physical assets that they own and to manage interactions with retailers).

The cost of bad debt arising from non-payment of non-household customers is therefore the retailers' responsibility and we strongly support Ofwat's view that it must continue to be managed in the business retail market in line with existing market arrangements (not less because retailers accepted these risks when they entered the market and are best placed to manage these costs).

We however recognise that the current exceptional circumstances have caused unprecedented economic conditions, and that these conditions are beyond reasonable expectations of what any prudent retailer could have predicted or allowed for (worth noting however that these observations apply equally to wholesalers). We also recognise that in the current circumstances, retailers' ability to effectively manage bad debt costs has been constrained by regulatory requirements.

Given this situation, we agree that in unprecedented circumstances such as Covid-19 it is not unreasonable for retailers' liability for bad costs arising from customer non-payment of bills to be limited, and for some or all of the liability above this limit to be borne by non-household customers. The appropriate limit, and the proportion above this limit to be borne by customers should be based on Ofwat's assessment of the evidence it has obtained from engagement with retailers including relevant RFI responses.

We would tend to concur with Ofwat's view that retailers might reasonably be expected to have the financial resilience to deal with some level of bad debt above 'average', either through their own facilities or accessing other forms of liquidity such as the Government's Covid-19 financial support.

The thresholds outlined in the consultation appear to be a reasonable attempt to balance the extraordinary impact of the Covid-19 pandemic – which retailers could not reasonably have anticipated – with the need for retailers to anticipate more general economic pressures that are likely to emerge from time to time in any business environment. Our understanding is that any recovery from non-household customers which is viewed as being appropriate will be borne and managed by retailers through retail charges only.

Finally, it should be noted that appointed undertakers may face an increased household customer bad debt as a result of Covid-19, which could exceed the amount assumed in price controls and for which a regulatory remuneration process would need to be considered.

Question 11: Do you agree there is a case for protecting wholesalers from the bad debt exposure associated with the liquidity measures? To what extent do you think the wholesale price control mechanism provide sufficient protection to wholesalers for COVID-19 related bad debt? Do you think we should amend the totex sharing factors or introduce a cap – for example, a proportion of wholesaler business market turnover?

Wholesalers' key responsibilities in the NHH market (under normal circumstances) include managing bad debt associated with the failure of a retailer counterparty, in line with regulations and provisions of the market codes, and we therefore accept that wholesalers have always had a degree of exposure to risk from retailer failure.

This exposure is commensurate with the credit terms that were in place prior to the 27 March code changes. We further note that the existing wholesale price control mechanisms were predicated on the codes as they were before 27 March and therefore do not provide protection for the impacts of those changes or the changes that might result at the end of this consultation.

As mentioned by Ofwat in the consultation document, it is not reasonable for the liquidity arrangements that are being introduced to support the business market to compromise wholesaler financial resilience. Given that the risk of retailer failure has undoubtedly increased as a result of the current situation, option 1 proposed by Ofwat ('Do nothing – wholesalers continue to receive the price control protections associated with a business Retailer defaulting') is clearly not appropriate.

We therefore strongly support the case that the exposure accepted by wholesalers by way of stabilising the market should be capped, and the cap should be set at the level of exposure that existed just prior to the 27 March code change.

<u>Other considerations in relation to retailer failure</u>
As mentioned above, wholesaler exposure to bad debt will arise in the event of a retailer failure, though this is mitigated by existing arrangements (e.g. collateral posted by retailers, recovery from Administrators, recovery via the Totex sharing mechanism and/or through the RFI mechanism).

Should retailer(s) failure indeed occur, the Interim Supply Code (ISC) contains a process which allows retailers to 'opt in' to provide retail services in a wholesale supply area. However, this is optional and, once in, retailers may 'opt out'. In the current environment, it is possible that no retailer would be willing or able to take on customers should one or several retailers fail – or at least any organisation willing to do so may take several months to scale-up the necessary systems, processes and people to enable them to do so.

Recent changes have increased the level of debt a wholesaler would need to recover should a retailer fail, but due to the lack of robustness of the ISC arrangements, wholesalers could face lengthy periods where they are unable to collect payment for services provided in the event of a retailer failing. During this period, the wholesaler would be unable to issue an invoice (and therefore unable to reclaim payment) for the services provided to the non-household customers served by the failed Retailer.

Furthermore, it should be noted that the Exit Regulations seem to prevent wholesalers which have exited the non-household retail market from providing retail services – further increasing the regulatory uncertainty around retailer failure.