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Bristolwater.co.uk
0345 702 3797

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Georgina Mills & Dan Mason
Ofwat

By email: covidbusinessretailmarket@ofwat.gov.uk

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Dear Georgina & Dan

Liquidity & Bad Debt Consultation

Thank you for the opportunity to respond to this consultation, and for the helpful Q&A session yesterday. We have been working through Water UK to contribute to their response which we support. Recognising the fast emerging situation and the rapid time Ofwat has had to react in, we also raise a few other thoughts for future consideration, which should not detract from our support for the overall approach you propose.

In summary we support the proposal to extend support to business retailers to the end of July 2020, and for Ofwat to consider extending this further should this be necessary. The key considerations Ofwat set out in the consultation Foreword were very clear and have our support as a set of objectives. Given the changes to the vacancy flag, we also agree with the minimum 70% retailer payments to wholesalers. We think you need to be clear about how retailers will transition from the existing minimum of 50% which applied to March settlement. Ofwat also need to be very clear that the March and April settlement support is not being extended in this consultation beyond the two months originally proposed, given the response of many retailers to only meet the minimum expectations.

With the previous code changes for March payments, we found that some retailers took the 50% as the level they should pay for and others asked us for refunds where they had already settled a higher proportion. Our engagement with them so far indicates that they many will continue to take the minimum level and just reflect this, despite our excellent relationships as a wholesaler in the market to date. We even had suggestions we should accept less than 50%, without any transparency for us on whether they had a cash collection challenge prior to Covid being an issue to show why this should be the case, stating that they were waiting for Ofwat to take a “pay when paid” approach. Therefore, we conclude that Ofwat and MOSL will need to monitor this topic carefully to avoid inappropriate risk transfer to wholesalers and customers. Our focus must be on managing our liquidity and finances to provide our essential public service to society as a whole. We agree with Ofwat that retailers should be utilising Government liquidity support mechanism in the first instance, but given the variety of retailers we recognise that this may not be available to all retailers and additional support may be required. Therefore, based on our experience to date we



would support an approach where the option set out in the consultation become gateways for retailer support that are monitored centrally.

We suggest:

- (i) retailers provide evidence that they have made all efforts including government support and appropriate and accurate use of the temporary vacancy flag before any further deferment of due wholesale charges is allowed;
- (ii) retailers if they demonstrate (i) are allowed to adopt a pay when paid approach. If they demonstrate a track record of doing this (including the proportion of March and April settlement recovery they achieved), and then;
- (iii) they qualify for the minimum 70% payment with the remainder deferred should they require support in future months, because of a short term issue affecting their customer base.

This will retain incentives on retailers and in return it is in wholesaler and wider customer interests to support retailers who meet these expectations as part of the industry protection of customers, which covers the essential service we provide as well as financial support. Some guidance will be required whether retailers should pass on the charges received in respect of the regional wholesaler, or on average across all the wholesalers. We think the former is consistent with the consultation intention and will support any ultimate recovery from non-household customers that is required.

We could not understand from the consultation exactly what the repayment of the deferment proposals were. We think it is important that the 70% minimum payment for each month up to July (or beyond) is not deferred in its entirety to December. We would propose that the maximum cumulative deferment at any point should be 70% of the higher March 2020 pre covid settlement amount for a retailer with each wholesaler and this should decrease to a cumulative 50% by the end of July, 30% by the end of September and 10% by the end of November. This is in addition to the gateway options for how much retailers pay for each month's settlement set out above, which will naturally reduce depending on the appropriate use of the temporary vacancy flag. We do not have information to set the right level at this point, but Ofwat should be able to following the various consultations. We believe the market requires a clear steer as to the limit of wholesaler liquidity support, noting we also then support Ofwat being able to keep this under review and act accordingly.

We think this approach will also help with the "exit" liquidity risk. There is a challenge that if meter readings are not kept up to date, and with the temporary vacancy flag allowed to be set where 5% of volume is still being used, there will be at the end of any Covid lockdown period the risk of an exit risk as usage is recorded that gives retailers (and customers) unexpected bill impacts. Encouraging retailers to improve their understanding through the gateways set out above will reduce market risk from this "exit" risk. The monitoring will allow Ofwat's review of the arrangements that we would anticipate as the consultation does for July.

We support Ofwat's view in the consultation that wholesalers should be compensated for the cost of the liquidity they are providing to retailers. On balance we think the PR19 WACC may provide an



appropriate financing cost, reflecting it is for wholesalers to decide their financing structure. There are arguments to use a margin above base rate or the cost of debt as an alternative. A standard rate, rather than using actual cost, will maintain incentive properties on wholesalers to minimise their finances. However the PR19 WACC is inconsistent between similar companies for reasons even less relevant to Covid than normal circumstances, and this is a factor that remains under dispute. We are confident that Ofwat will make a reasoned judgement for the reality of the current circumstances rather than referencing the outcome of PR19 technical judgements.

Whilst we agree with the principle that wholesalers should only be exposed to the normal pre-Covid arrangements level of retailer bad debt, we struggle to see why and how this should apply in practice. The level of bad debt risk was fundamentally low and limited to alternative payment arrangements (we estimate this as 0.1 – 0.2% of wholesale turnover). However, as soon as the code changes were put into place for March settlement this prevented wholesalers from using the collateral measures available to them. Any incentives on wholesalers to avoid retailer bad debt would work against the protection measures for retailers Ofwat wish to see for the business retail market (otherwise the incentive on wholesalers is to put retailers into default at the earliest opportunity that the market codes allow). To date retailers do not appear to have adapted to the code changes as Ofwat and MOSL intended, and if this continues and there is a risk of wholesaler bad debt, we will need to consider the incentives on us to respond. We would suggest that in these circumstances it is not in the market or customer interests to allocate any retailer bad debt risk to wholesalers, as it would in any case should be de-minimis.

This reflects that wholesalers' main challenge is the absence of revenue for cash flow now, although it is too early to judge the overall impact and how this translates into household or non-household bad debt emerging in the market. Loss of revenue, rather than bad debt, is the most pressing concern that wholesalers and retailers face – cash flow is the most important factor.

We see another risk that Ofwat will have to keep under review, but will be affected by the success of the arrangements subject to this consultation. The Interim Supply Arrangements rely on the presence of retailers in each area who are willing and able to take on the responsibilities for business customers in the event of failure. Over-reliance on incentives may mean that these arrangements become unattractive to the market.

We have a number of technical points of economic regulation which arise out of the consultation. We do not think Ofwat in this timeframe need to answer our points at this time, but raise them now for consideration as Covid-19 develops:

- We see no logic in using the standard totex cost sharing rates set at PR19 that vary between companies in these circumstances. This approach at PR19, which we do not agree with¹, set cost incentives on a difference in view on wholesale costs at various stages of the PR19 process. We think the 75%:25% totex rate used for business rates and EA charges seem

¹ This is now subject to the determination of the CMA in any case.



more relevant to these circumstances, and would be equitable between all companies, given that Covid-19 affects all companies equally.

- Ofwat will also need to consider whether RFI forecasting penalties are appropriate in these circumstances, as it is clearly beyond management control to predict Covid-19 (if it could be predicted, the impact would be mitigated in advance).
- An outcome of PR19 is that WACC and the cost of debt varies between companies, even those with equivalent characteristics, in a way that does not relate to the cost of providing liquidity in these circumstances. Ofwat need to consider carefully whether in these circumstances any adjustments linked to PR19 incentives are appropriate.
- What mechanisms are used to provided for the recovery of wholesaler liquidity, which will need to be outside of revenue controls or RFI to provide for such financing.

For the cap on retailers bad debt, we think there are two aspects that Ofwat will need to consider as this proposal is developed further. First, how any bad debt above the cap is recovered, which we think can only be through a mechanism across retailers to avoid an impact on wholesale finances. It was not immediately clear whether the retail exit code price cap would be effective as a recovery mechanism for retailers given its partial coverage. Secondly, whether the recovery from customers should be on a regional basis, reflecting this long existing principle in the water sector as a matter of Government policy.

We provide our response to the specific questions in the consultation in an annex.

Yours sincerely,

Iain McGuffog

Director of Strategy and Regulation



Annex

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

We not only agree with the objectives, but welcome Ofwat's logical and proportionate approach to applying them to the remainder of the consultation. We do not underestimate the challenge of achieving this in the short time frame available.

Consultation 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.

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

We have not received any information from retailers in our area that would help us to provide an answer to this question. Overall, distribution input into our network is within a range of what would normally be expected, but it is too early to attribute this to households or businesses overall.

It is worth noting that we now have c26% of business properties registered as vacant. This is an increase from c8% at the end of March and c2% before the Covid code change. This varies by retailer, and the range for those with more than 100 SPIDS is from 2% to 67%, but for most retailers c25% - 35% appears a typical impact

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We also show below the degree of deferment by retailer for payments due in March. In total ✂% was paid, ✂% of which related to February 2020 R1 settlement, plus R2, R3 and RF adjustments from the relevant historic pre-Covid months. The overall value of settlement that was paid amounted to ✂%, although the majority of retailers paid 100%. Those retailers who had not paid at the due date were very small balances.

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Consultation 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.

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

Consultation 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.

Consultation 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?

We particularly welcome Ofwat recognition in the consultation that “Wholesalers may also be in different positions in terms of their ability to withstand shocks and provide liquidity. The provision of additional liquidity to the business retail market should not come at the expense of the financial viability of the wholesalers.”. We are comfortable that we aim to provide liquidity on the basis set out in the consultation, on the basis that the overall impact on wholesalers is limited through the use of a combination of options Ofwat set out in the consultation.

We agree with Ofwat that retailers should in the first instance use the liquidity available from the Government. Together with appropriate use of the temporary vacancy flag, this provides a gateway for wholesaler support, to be managed and monitored by Ofwat and MOSL. Secondly, retailers should pay what they can each month to wholesalers. Thirdly, a deferment total cap set at 70% of March 2020 settlement value, but steadily reducing to 10% should be available to retailers who continue to meet gateways for this support. The way these options are implemented should, as Ofwat propose, maintain incentives to retailers to use the range of liquidity measures made available to them. We suggest an overall approach in the overview of our response.

Unfortunately, our positive and proactive engagement with retailers suggests that despite Ofwat’s best efforts, some retailers may continue to interpret the 50% (and proposed 70%) as a fixed deferment and have not amended their March payments as a result of the clarification. Others have paid 100% and clearly if their circumstances change should have certainty that they will be able to gain access to support should this be necessary. We feel those retailers who have taken full advantage of minimum expectations should not have access to further deferment until they demonstrate that they understand and will make full efforts to use the arrangements appropriately.



We think using the PR19 WACC is the most appropriate cost of financing for liquidity provided by wholesalers. This reflects that companies rely on a mixture of equity retention and debt facilities in order to provide liquidity, and it is not realistic to separate the actual liquidity costs for retailer support from other Covid-19 factors that require financing, such as revenue shortfalls from vacant properties, lower usage volumes from businesses that remain open, or cash flow challenges from deferred receipts from households. However, using the cost of debt or the default market interest rate is unlikely to make a material difference given the limited period of time over which additional liquidity from wholesalers being sought. The value should also recognise this is a normally competitive market and those retailers who do not defer must not have any competitive disadvantage from doing so. This will be limited if the approach we suggest above for the use of the options, with an overall cap of total liquidity support set at 70% of March settlement which could decrease over time.

One area of uncertainty remains on the existing deferment. The consultation was not clear about how the existing code change on deferment would link to this consultation. From the Q&A session, we understand this consultation covers May settlement, which leaves March at a two month deferment and April to a date to be stated by Ofwat. We think it is necessary to clarify this and we assumed March and April are deferred for two months by a maximum of 50% in preparing this response.

We are not comfortable with the extension of the existing deferment of March, and April beyond the two months originally envisaged without a cap and gateway approach as we suggest above. This is because it is far from clear to us that retailers who went for 50% in March had not already received payment from customers, as they have not provided any clear evidence to us other than to refer that 50% was what Ofwat had instructed. We think it is important that the principle of two months deferment is maintained, and this is used to establish the maximum total deferral level, which should increase over time and only be available if retailers meet the gateway conditions. We think the consultation does not provide sufficient certainty that a) retailers will recover past unjustified deferments and it is possible that retailers will assume March and April may now be deferred until December and b) this will not provide wholesalers with enough certainty for financial year ends to avoid an impact on credit ratings, gearing and covenants that would prevent liquidity being provided, or push the cost significantly above PR19 assumptions (which as you know we have asked for the CMA to determine, not least because of the lack of liquidity that arises from the use of a “customer benefits” test that does not allow us to recover the efficient debt financing costs of a small water only company, and means we have a lower allowed WACC than equivalent companies in these same circumstances).

We think it is important that the 70% minimum for each month up to July (or beyond) is not deferred in its entirety to December. We would propose that the maximum total deferment (including March and April) at any point should be 70% of the March 2020 pre covid amount for a retailer with each wholesaler and this should increase to 80% by the end of May and 90% by the end of July. This is in addition to the gateway options for how much retailers pay for each month’s settlement set out above, which will naturally reduce depending on the appropriate use of the temporary vacancy flag.



We think this approach will help with the “exit” liquidity risk. There is a challenge that if meter readings are not kept up to date, and with the temporary vacancy flag set at 95% reduction in use, there will be at the end of any Covid lockdown period the risk of an exit risk as usage is recorded that gives retailers (and customers) unexpected impacts. Encouraging retailers to improve their understanding through the gateways set out above will reduce market risk from this “exit” risk. The monitoring will allow Ofwat’s review of the arrangements that we would anticipate as the consultation does for July.

We are not sure what mechanism is proposed to allow for recovery of wholesaler liquidity support from retailers, or whether this can be backdated to March 2020. The level will need to be notified by Ofwat or MOSL to wholesalers, and for this to be dealt with as revenue outside of RFI, as otherwise wholesalers will receive not recompense for the cost of liquidity they are providing.

Consultation 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.

Consultation 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?

Consultation 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?

We agree with the principle that wherever possible, retailers should bear bad debt costs from non-household customers, as retailers are best placed to manage these costs and retailers accepted bad debt risks when they entered the market

We recognise however that in the current exceptional circumstances, retailers’ ability to effectively manage bad debt costs has been constrained by regulatory requirements. Given this, it is reasonable 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. 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. However, our primary concern is the protection of wholesale services to all customers, which requires retailers to focus on effective management of revenue. Therefore, we think Ofwat should consider whether the level of risk to retailers for above average bad debt should relate to their



revenue recovery performance. We would suggest using performance against the gateways we suggest in response to question 4.

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. However, it should depend on the evidence Ofwat gain on individual retailer response to the incentives to minimise liquidity sought from wholesalers. Retailers who choose to do the minimum now (whether to access government support, parent company support or customer engagement), should be exposed to more bad debt risk later. We support any measures Ofwat see fit to maintain the strength of incentives that is in the underlying principles of the consultation.

Consultation 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? Please explain your response and provide supporting evidence.

We think the principle of regional recovery from non-household customers should be maintained. This assumes that retailers take a regional approach to “paid when paid” in terms of wholesaler liquidity support.

We are of the view that because of the changes to the market that Ofwat implemented rapidly in March 2020, this estopped wholesalers from using any collateral available in the retail market and therefore made any attempt to suggest that wholesalers had a normal share of bad debt risk in these circumstances unreasonable. We do not think it is in customers long term interests to use either the totex sharing rate (50% or PR19) or the standard RFI mechanism in these circumstances. Therefore we think option (iii) is the only possible approach available, which we calculate at between 0.1% and 0.2% of annual wholesale charges to business retailers, based on alternative payment arrangements for small balances which is the only location where market bad debt risk exists.

Given the low normal likelihood of retailer failure, even this approach provides incentives on wholesalers to trigger retailer default in the market which will provide a “Covid exit” issue. We therefore think it is in the market interest to accept the principle of estoppel now applies on now bad debt risk should apply to wholesalers for the duration of these arrangements. Otherwise, wholesalers will be incentivised to trigger retailer default as soon as any non-compliance with the arrangements by retailers arises, even if only temporal and trivial (in case it escalates).



Recovery of retail market bad debt arrangements and wholesaler liquidity should be from non-household customers. Recovery of unbilled revenue through RFI should be over the customer base as a whole.

The degree of liquidity that wholesalers need to provide in the current market is some magnitude larger than is being subject to the issues in this consultation. There is a significant lag of c18 months as a minimum before RFI recovery, and it may also be necessary to smooth out missing revenue over a number of years. Totex does not get recovered until 2025. We do not think the RFI or totex mechanisms were designed for the current circumstances so we believe it may be better for Ofwat to consider separately how Covid related impacts arising from the market code changes are treated. We think the specifics of the wholesale totex mechanism will be less of a concern, because this is far more within company control, including the impacts of capex deferral and the ability to use Government support mechanisms to retain employment where activities temporarily are not possible (as both retailers, the supply chain and developers will have to do).

However, RFI is a forecasting incentive and not suitable for use in further COVID smoothing corrections, in our view. We note the concerns with a number of companies concerning WRFIM at PR19 where there were technical issues with forecasts that in their view was not aligned in their view with the purpose of the incentive. Ofwat will need to consider the operation of the incentive mechanisms to provide confidence that the recovery mechanisms that are the subject of this consultation will achieve their objectives. We are happy to leave this with Ofwat to consider after this consultation is concluded and implemented, but at some convenient point would look for the principles to be set out in case they do not implement in the way intended, given the complexity of the PR19 regulatory framework and the experience of WRFIM noted above.

The key point that we repeat in closing our response is that wholesaler liquidity to provide essential services to all customers, as well as to provide support to retailers that require and deserve it, relies on maintaining investment grade credit ratings and restoring cash flow for lost revenue without this creating affordability issues to customers. The clearer Ofwat can be that the regulatory framework supports this necessity, the easier it will be to achieve the objective (e.g. with investors, debt providers and ratings agencies), and this will provide confidence to end customers and Government. This is the shared objective for the sector that these business retail market support proposals are a sub-set of.