business stream
A SCOTTISH WATER COMPANY

Georgina Mills
Director, Business Retail Market
Ofwat
21 Bloomsbury Street,
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21st April 2020

Dear Georgina,

COVID19: Proposals to Address Liquidity Issues in the NHH Market

Thank you for the opportunity to respond to the proposals set out in the above consultation paper. Business Stream's responses to each of the questions posed in the paper are set out in the schedule attached.

Although more information is emerging every week, there is still a great deal of uncertainty about how the COVID19 situation will develop, how long the lockdown period will extend and the impact it will have on the businesses who have been instructed to temporarily close. We're grateful that Ofwat and MOSL are moving fast to address the most immediate issues, but we're conscious that as yet there is very little 'evidence' on which to base decisions that could have a very significant impact on retailers and our customers as we move forward.

It is essential that we consider the issues that are arising and the options for resolving them, but it is equally important that we retain sufficient flexibility so that as an industry, we can adapt to conditions as they develop. As well as paying wholesalers, retailers need to be able to continue running their operations – paying staff and critical suppliers – so that we can continue to provide support and relief to our customers.

The main focus of our attached response is on the considerations around the provision of short-term liquidity by the wholesalers, and how we strike an appropriate balance between customer and wholesaler payments, given that more than 90% of a customer's bill is pass-through of wholesale charges. In relation to the recovery of bad debt, under existing market arrangements, we don't believe that retailers have the financial capacity to bear 'extraordinary' bad debt, but that there could be more options if we also considered making changes to the market arrangements to address the issues that have made retailers so vulnerable to the effects of the current crisis.

I would be happy to provide more information or discuss anything contained in our response, so please don't hesitate to contact me if I can be of further assistance.

Yours sincerely

[redacted]

Rosalind Carey
Regulation and Strategy Director

COVID19: Liquidity in the NHH Market

Responses to Consultation Questions – Business Stream

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

Generally we agree with the objectives set out in Section 3 of the consultation paper, with additional comments as follows:

- Objective 3: We are continuing to bill and collect payments from customers who remain operational, and agree that we should keep cash flowing through the market to the wholesalers to the extent possible. However, it is important to recognise that retailers have financial commitments which extend beyond their wholesaler payments, including the payment of employees and other suppliers critical to our day to day operations (e.g. print providers).

- Objective 4: Other sources of liquidity should not be sought at any cost. We would suggest an additional objective would be to minimise the cost of additional liquidity to the market as a whole to ensure future sustainability.

- Objective 6: The current crisis has illustrated the NHH market's lack of resilience to deal with 'shocks' and that retailers are particularly vulnerable to cashflow disruption and abnormal levels of customer default. Hence we believe that in seeking solutions to the COVID related liquidity and bad debt issues, we should not necessarily be constrained by the existing market set-up. We have an opportunity to review the market arrangements and to consider what needs to change to ensure that it is more robust in the future. For example, over 90% of customer bills is the pass-through of wholesaler charges, consideration should be given to sharing this risk more proportionately.

Provision of Liquidity

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.

As at Friday 17th April, Business Stream's daily cash collection for the last three days was [redacted] of the average daily collection for the quarter prior to 23rd March. The downward trend since lockdown is shown in the graphs below. It will only become clear over the coming weeks whether this position will plateaux or continue to deteriorate.

[Graph removed]

[Graph removed]

At this stage we cannot say with any certainty what proportion of the payments that we are continuing to receive is from businesses that remain operational as opposed to those which are temporarily closed (especially as payments that we are receiving today will, by and large, relate to the period of consumption prior to lockdown). However, there are two key points to consider:

(1) Debt recovery tools: Based on our experience, we would expect to see a deterioration in payment behaviour as a result of the changes to the Customer Protection Code of Practice, even amongst customers who continue to operate, as they prioritise payments to their critical suppliers.

(2) Vacancy flag: It would be wrong to assume that by the end of April, wholesale bills will accurately reflect the extent of business customers' closures. As at 20th April, the proportion of SPIDs that we had been able to positively validate as being temporarily closed as a result of the Government's lockdown instruction was ~12% of our base (excluding Yorkshire, which is much lower). It is apparent from every high street that the number of closed businesses far exceeds this proportion, but it is a huge undertaking to identify with confidence those businesses (from ~200k sites) that are unable to operate. As MOSL has pointed out, SIC code information in the market is very poor so we are having to find alternative data sources as well as trying to proactively contact customers. [redacted]

From a review of CMOS data it can be seen that the speed and extent to which other retailers have been able to switch sites with confidence varies considerably.

Whilst the impact on retailers of customers ceasing to pay their bills is immediate, there will be a considerable lag before we see the associated reduction in wholesale bills as a result of using the COVID vacancy flag (and in practice, we won't be able to find and switch all closed businesses). Hence, until the COVID19 situation unwinds, there will continue to be an imbalance between the size of wholesale bills and the amount of cash being collected from customers. (We consider the impact of this in response to question 4 below).

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

Customer payments: It will only become clear over the coming weeks and indeed months, whether the proportion of customer payments received and daily cash collections have levelled out or whether the position will continue to deteriorate. However, our fear is that as the lockdown conditions are extended, more customers experience financial difficulties and will cease paying their water and waste bills or, given the scale of future uncertainty, seek to hold onto cash to protect the liquidity of their own businesses going forward.

Wholesaler bills: As we continue to identify customers who can legitimately be switched to vacant in the market, we should see wholesale bills reducing to more closely align with the actual consumption in the market. However, as indicated above, this is a huge undertaking and it will take time to do it properly.

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.

Option 1: for the reasons Ofwat cites, the 'do nothing' option is likely to lead to the failure of the market, which will not be in anyone's best interests.

Option 3: we recognise the rationale for Ofwat's proposal that retailers could potentially meet a [70%] minimum proportion of wholesale bills – but this only works if wholesaler bills have reduced (as a result of the vacancy flags) to a level that accurately reflects consumption in the market. As set out at Q2 above, we know that this isn't yet the case, and is unlikely to be for some time. In our case, if, going forward, customer payments have reduced [redacted] but wholesale bills have only reduced by [redacted] a minimum requirement to pay 70% of our wholesale bill would result in having to pay (a) more than we had received in customer payments (before the deduction of any other costs); and (b) more than our customers are actually consuming. It would not be reasonable to expect retailers to find alternative sources of funding to over-pay wholesalers. It is questionable whether retailers would be able to raise funding (without tangible assets and future cashflow uncertainty), or at what cost. It would simply increase the overall cost of the market, for no benefit.

Consequently, we believe that at least initially, Option 2, under which wholesaler payments are based on customer receipts, would be in the best interests of the market. It seems likely that the reduction in customer payments is a relatively good proxy for the proportion of each retailer's customer base that has had to close. Certainly for the moment, it is likely to be more accurate than the proportion of sites that have been marked with the COVID vacancy flag in CMOS. Hence, it should result in payments being made to wholesalers that are closer to the level that bills *should* have been at (had it been possible to identify all closed businesses in this timescale) as well as reflecting each retailer's ability to pay.

Our proposal would be to use a pay-when-paid approach for the payments due in April, which will also give us an opportunity to assess how much cash remains flowing through the market. April's 'exit rate' will give us a better estimation of what we are likely to receive as businesses remain closed, and could be used to introduce a floor for the May payments as proposed in Ofwat's combined (ii)/(iii) option. Having another month of information would reduce the risk that we get it wrong.

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.

As suggested in response to Q1, our aim should be to minimise the cost to the industry of the COVID19 pandemic, and no-one should be unduly disadvantaged or unduly benefit from over-payment or over-inflated financing costs. We should be seeking the cheapest sources of liquidity. It is difficult to imagine that many retailers will be in a position to source finance cheaper than the wholesalers. Hence it would be wrong to inflate the cost of retailers accessing wholesaler liquidity in an attempt to incentivise them to look for other options. The cost of finance made available by the wholesalers should accurately reflect the cost of its provision, although they too should be incentivised to find the cheapest sources – whether this is debt or equity.

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.

There is a clear asymmetry between Ofwat's proposal that retailers should be charged interest on the deferred proportion of their wholesale bills, but would not be allowed to charge customers interest on the associated late payments. Whilst we totally support the ongoing provision of support to customers who need it, retailers do not have much capacity to fund interest payments from the available margins. Business Stream will [redacted] for 2019/20 (before any COVID19 impact) and we don't believe any of the other retailers are in a much stronger position.

The likely reality is that retailer funding costs or credit availability will be restricted if there are increased risks placed on retailers. This is likely to result in credit facilities being revoked or constrained, placing further cashflow pressures on retailers and further reducing liquidity.

In any other competitive market, additional costs incurred by suppliers would be passed onto customers as a matter of course. A good example of where the excessive costs of unexpected events are recovered from the customer base rather than the service provider would be the insurance industry. Whilst the recovery of financing costs (and the debt costs considered below) could be done over time to minimise the impact on customers, it is a genuine cost that wholesalers will need to be able to recover. From our discussions with customers over the last few weeks, most of whom have contacted us seeking some kind of payment relief or deferral, we believe that they fully expect that the cost of this support will have to be paid back over time.

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?

Yes we agree that retailers should receive liquidity support at least until the end of July 2020 and that the position should be reviewed as we gather more information about customer payment behaviour during May and June.

Our feeling is that even if the current restrictions are lifted in their entirety in May, it will take many months for business customers to resume 'normal' operation, to restore their cashflows and re-establish pre-COVID19 payment discipline. There will be an enormous administrative exercise for retailers to adjust the bills of the hundreds of thousands of customers who have been closed or partially closed, so there will be an understandable reluctance on the part of customers to pay until (a) they are confident their bills are correct; and (b) they can afford to pay them. We fully anticipate that the impact on retailers' cashflows will continue well beyond the end of the year.

Consequently, the end of December for the full repayment of deferred wholesale charges feels an ambitious target, given the likely size of non-payment. However, we do need to set a date, so we would accept this as our target, providing the position continues to be monitored and the date revised if necessary to reflect the speed of recovery within the market.

Customer Bad Debt

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.

At this stage it is difficult to predict how big an issue the bad debt arising from COVID19 will become – indeed retailers will only write off customer debt after attempting recovery for months, if not years. It is important to recognise that bad debt may not crystalize for some time, and that the effects of COVID19 are likely to lead to higher than normal levels of bad debt well into the future.

Although we don't yet know the size of the problem, it is inevitable that bad debt will be considerably beyond the 'normal' levels allowed in the existing retail price controls. Consequently, unless the arrangements are changed, it would not be viable for retailers to absorb the full impact of bad debt, and so we agree that retailers should be able to recover the 'extraordinary' debt above a 'normal' threshold.

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

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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?

It would be simpler to establish the threshold at 2%, rather than a retailer-specific threshold. However, we believe that we would also need a common approach to bad debt provisioning (i.e. the definition of bad debt), to ensure the threshold, and hence the proportion of extraordinary bad debt to be recovered, is applied consistently across the industry. This can be developed in due course.

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? What relevant precedents are there (including in other sectors)? Please explain your response and provide supporting evidence.

The difficulty at this stage is that we do not know the size of the bad debt that is going to arise and so cannot quantify the size of the 'ask' if retailers were required to share even a small proportion of it. We could not, at this stage, be able to commit to meeting an unknown cost.

Under the existing market arrangements and price controls, we can see no alternative to customers bearing all of the excess bad debt cost. As we have indicated above, this is how it would work in a competitive market. However, the current crisis has highlighted the underlying weaknesses of the NHH market and the need for change. We now have an opportunity to review the market arrangements and to consider how we can ensure it is more robust in the future. For example, given that the substantial proportion of customers' bills is the pass-through of wholesale charges, consideration should be given to sharing this risk proportionately. If we can strengthen the market and the balance of risk and reward within it, the options for the recovery of bad debt may be greater.

Protection against Retailer Default

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?

Our knowledge of the PR19 controls is insufficient to be able to comment on their adequacy for protecting wholesalers from retailer default, but in principle, wholesalers (and potentially other retailers if they are affected) should be protected from the impact of a retailer failure, and the extraordinary/excess costs allowed to be recovered from the market over a period of time so as to minimise the impact on customers.

Customers in most wholesale regions have had the benefit of price reductions from 1st April 2020. If wholesale prices had to increase to recover either customer or retailer bad debt, the impact on customers is unlikely to be significantly above the level that they had been paying prior to 1st April.