Redacted [✂]
22/04/2020

Liquidity and bad debt consultation

Response of Castle Water Limited

Introduction

This is the response of Castle Water Limited to the consultation document issued by Ofwat on 16 April 2020.

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

We broadly agree with the objectives. We note, however, that Objective 2 states that *'Where customers cannot pay on time for reasons relating to COVID-19'*, retailers are not permitted to charge interest or late payment fees, or request disconnection. As noted below in response to Question 2, it is important to recognise that the ban on these activities has had, and will have, wider effects on payment than where they are strictly confined to COVID-19.

There are three key points we would make, relating to internal consistency in the measures implemented; the length and pattern of the lockdown (i.e. will this be a single event or a series of events); and ensuring that measures are robust in the medium term (not just the short term):

Internal consistency: measures to manage bad debt across the market must be internally consistent – requiring retailers to collect a near "normal" level of payment while preventing access to normal collection methods (including disconnection and litigation) is obviously impossible. The targets must take into account the available collection mechanisms, and customer ability to pay. Also, an expectation that retailers access funding from available Government funding arrangements must equally be applied to Wholesalers.

The length of the lockdown and the nature and extent of its release will have a material impact on economic activity, and therefore determine customer ability to pay. This uncertainty must be reflected in measures to manage bad debt in the market. The nature of COVID-19 is not well enough understood to predict whether a further lockdown or recurrent lockdowns will be necessary; when and how any tapering off of restrictions will be permitted – and how far customers, and their customers in turn, will be able and sufficiently confident to resume more normal activity.

Castle Water's understanding of the possible range of developments of the current crisis is that the range of realistic possibilities includes:

- Prolonged lockdown.
- Phased release of lockdown.

- Prolonged social distancing.

- Repeat waves of infection, with repeat lockdown events.

These possibilities, which do not appear to be factored into Ofwat's considerations, reflect our understanding of the COVID-19 virus – we believe it is worth clarifying briefly what we understand so far of the nature of COVID-19.

In summary, coronaviruses in general make up a large family of single stranded ribonucleic acid (RNA) viruses which can infect birds, mammals and humans. Those infecting humans commonly cause respiratory type symptoms ranging from those of the common cold to the more severe symptoms of pneumonia. As such, this enables human to human transmission via: breathing; coughing; sneezing and also the touching of contaminated surfaces. Recent work by scientists from the Greifswald University Hospital and Ruhr-Universität Bochum, both in Germany, compiled information from 22 studies on coronaviruses. Their work showed that:

> *"Human coronaviruses can remain infectious on inanimate surfaces at room temperature for up to 9 days. At a temperature of 30°C [86°F] or more, the duration of persistence is shorter. Veterinary coronaviruses have been shown to persist even longer for 28 d[ays]."*

According to a new study from National Institutes of Health, CDC, UCLA and Princeton University scientists in *The New England Journal of Medicine,* COVID-19 may remain in an inert state outside the body for up to 3-4 days, depending on the surface. This was considered to create a considerable risk of spreading.

Typically, coronaviruses pick up mutations in their RNA with time. This can have implications for both herd immunity and for vaccinations. Projects are already ongoing which track the genetic makeup of global diseases such as Ebola and influenza. Using the same methodology it has been possible to track the evolution of the COVID-19 virus and we can see that relative to, for example, the seasonal flu virus it has a relatively slow mutation rate with 25 mutations/year compared with 50/year for the seasonal flu. This is encouraging from a vaccination standpoint. Mutations may, however, limit the longevity of any immunity.

COVID-19 is a newly emerged coronavirus. It is extremely contagious and has rapidly spread globally. Tackling any disease pandemic requires knowledge of:

- Transmission.

- Diagnosis.

- Prevention.

- Therapeutic strategies.

- Epidemic peak.

New clinical diagnostic symptoms are emerging almost daily. Currently our main therapeutic strategies are supportive. Drug interventions are being trialled and have met with some success, but none have been approved specifically for use.

Without a vaccine to reduce transmission of the virus, for many countries the alternative has been to impose extreme social distancing measures on their populations. Consideration is now being given to what approach to take in the post-pandemic period.

To gain a better insight Kissler et al (Kissler et al., Science, 14.4.2020) modelled possible outcomes of lifting social distancing measures using two alternative coronaviruses. Their model indicated recurrent waves of winter outbreaks of COVID-19 and this was dependant on whether the initial social distancing had been successful and to what extent the healthcare service was overstretched. There was also the question of how long immunity lasted and any cross-reactivity between other coronavirus species.

Currently COVID-19 does not appear to be showing seasonality. Social distancing is the only method of prevention or control at this time. The models of Kissler et al would indicate immunity of 2-3 years based on knowledge of other coronaviruses. It is therefore widely recognised that lifting social distancing measures all at once will lead to a second wave and that measures should be gradually relaxed, or lifted for shortened periods, if for no other reason than to maintain a functioning health service.

Any measures in the NHH market must therefore evolve on a rolling basis, with automatic renewal or evergreen clauses, to provide confidence that the uncertainty and risk that these factors create can be managed.

The level of bad debt relating to the period prior to the lockdown will increase as the lockdown continues (or subsequent lockdowns are required). Any realistic mechanism must factor in the declining ability of customers to pay over time.

Any solution must therefore be robust in the medium term, not just a short term fix which fails to provide continuing confidence in the viability of the market.

- The different objectives must be managed in an internally consistent way in order to be effective – there is no benefit in restricting enforcement activity against defaulting customers at the same time as maintaining the fiction that retailers could collect payments under these restrictions.

- Wholesaler financing structures are in some cases unviable, even *absent* COVID-19 (at least five wholesalers publicly stated that their activities were unfinanceable under PR19). Where shareholders and creditors should in any case be agreeing restructuring of overleveraged entities, retailers cannot be used to shore up wholesaler finances – given the low margins in water retail, the benefit of this would be entirely short term, would accelerate retailer default and in turn a greater eventual bail out of affected wholesalers. Wholesalers have access to funds through low cost commercial paper via the Government's Large Company Corporate Finance Facility, with loans available at an interest rate of 1%.

- Retailers (and wholesalers) will have an obligation to demonstrate to auditors that they are a going concern as part of their audit for the end of the financial year (in most cases as of 31 March). Measures which do not provide clarity will result in a failure to evidence this, and therefore could result in rapid default – by both wholesalers and retailers. Wholesalers are dependant for c. 25% of revenue on the NHH market – a flawed market model for retail will result in either the failure of wholesalers or the requirement for a high cost bail-out – wholesalers provide retail services at cost levels around twice that of Castle Water (based on an analysis of published accounts, and due diligence carried out on six wholesaler-owned retailers).

- In order to be robust, proposals must be written to be automatically renewed or have evergreen clauses; and must anticipate the inevitable increase in insolvency and therefore bad debt relating to the period prior to 23 March. It would be wrong for Ofwat to assume that it uniquely understands the trajectory of the virus and the necessary response, especially going into the Autumn where infection rates may spike. Failure to provide a solution which caters for such uncertainty will increase costs to all parties, and reduce customer and investor confidence in the water sector overall – many shareholders in wholesalers actively chose to exit retail activities, and we have seen no evidence that individual shareholders have the funding or willingness to be forced to increase or recommence these activities.

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.

We divide our answer below into Parts A and B. As a preliminary observation, however, it would be wrong to assume there is anything like a bright line between those with vacancy flags and those 'still open for business'. This ignores that:

- To the extent that customers remain open for business, it is obvious that the activities of many are severely curtailed.

- Many are themselves suffering from uncertain and falling demand from, and attenuated payment by, their own customers.

- There are progressively more businesses giving up on maintaining even these limited activities.

- There is no sign of when and to what extent confidence will return to these businesses.

- Financial reasons apart, in many case customers tell us that they are unable to pay at present, or in full because they are prevented from doing so by the logistics of verifying bills against meter readings, or accessing financial systems remotely.

As a result, paying water bills in full, or at all, is at the bottom of customers' current list of priorities, especially given their knowledge that no economic consequences will flow from retailers' actions, however great our efforts to encourage them to pay.

Part A: Excluding customers with temporary vacancy flags, what percentage of remaining wholesale charges are you currently able to recover from customers each month?

As set out in our submission of 7 April in response to Ofwat's RFI on liquidity and debt, the cash collection profile for March 2020 was distorted by:

- Payments (late or otherwise) pertaining to previously issued bills, including those which resulted from our being able to deploy our normal methods of chasing and enforcing payment.

- [✂]

[✂]

- [✂]
- [✂]

The payment did not, therefore, leave us 'holding onto cash' that could have been paid to wholesalers; not does it represent the current position following, notably, developments in the lockdown and the prohibition on normal collection activities. We also note that at present [redacted] of Castle Water SPIDs are marked as Vacant in the market due to COVID-19, compared with [✂].

Our current expectation is that we will be able to pay [✂] of wholesale charges at the end of April.

Looking further forward, as set out in answer to Question 3 below, our current estimate (which is subject to a wide range of uncertainty) is that we might expect our receipts through to the end of July to lie somewhere in the region of [✂] of wholesale charges [✂]. Of course, it is self-evident that this payment level will in part be achievable due to customers knowing that they face higher costs if they do not pay bills.

We adopt this timescale only because August is assumed by Ofwat to be the point at which retailers might be able to begin to pay wholesale charges in full. The rationale for this timescale is not clear, though one can infer from it certain assumptions about the length of the lockdown, together with a more rapid and fuller resumption of economic activity than can be known at this stage. We note that no other scenarios are tested.

Likewise, the rationale for expecting all Wholesale payments, including deferred amounts, to be made by December is unstated. This date seems inconsistent with anything other than the most aggressive possible collection strategies. Any requirement to make further wholesale payments must be feasible in relation to the collection methods permitted under our licence, and the time required to collect.

It takes on average six months to collect payments through the courts. The only faster mechanism for collection is disconnection, which has a lead time of two weeks but finite limits in terms of capacity. [✂].

[✂].

Business customers behave economically rationally. With no substantial penalty for late payment, and no sanction (such as disconnection or a court judgement), there is no incentive for customers to pay bills. We would expect default rates to increase significantly if no action is taken to enforce collection. Ofwat will be familiar with the significant amount of analysis available on payment levels in Chicago, where there are restrictions on disconnection during Winter, and in effect a payment holiday generally institutionalised in consumer behaviour. These 'moratoria' generally have shown over a long period that:

> "*A moratorium tends to encourage people, who are otherwise disposed to pay their bills, to disregard their utility bills.*"
>
> > [Governor's fuel and utility payment Committee Report to the Governor and legislature of the State of Wisconsin, 1976.]

"According to the consumer survey results, learned behaviours and the idea of not being obliged to pay are also important reasons for non-payment in commercial communities."

['Adapting to higher energy costs: findings from qualitative studies in Europe and Central Asia', the World Bank, 2015.]

Part B: 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.

Since 23 March there has been a significant reduction in the level of inbound calls we have received [✂]. These ordinarily enable us to discuss payment options, collect payment, and quickly answer queries or identify and resolve issues which may be causing the customer to delay payment. We believe that the removal of incentives for customers to pay is one of the main reasons for this.

[✂].

Call driver	Percentage of total calls [✂] – [✂]	Percentage of total calls [✂] – [✂]
Collections activity	[✂]	[✂]
Payment query	[✂]	[✂]
Telephone payment	[✂]	[✂]

Despite massively stepping up our outgoing communications through calls, emails, blogs and use of other social media such as LinkedIn, Facebook and Twitter, it is self-evident that these will not capture all the kinds of queries referred to above, or enable us to target and successfully contact those who might be able to pay but are not doing so.

[✂].

Castle Water has proactively provided briefings to groups of customers which often suffer from difficulty in adjusting to changes in billing and which may be adversely affected if they do not comply with the onerous requirements on identifying temporarily closed premises, including the **[✂]**, the **[✂]**, the **[✂]** and the **[✂]**. In every case we have been told that we are the only water retailer to have provided such information.

The evidence that this extensive customer contact effort has yielded is exemplified below:

- As noted above, many of these customers are working under severely restricted trading conditions and are struggling financially, including in relation to bills issued before the lockdown -

> e.g. [✂] "We are now trying to manage our cash flow, and as a result we are looking to put a freeze on all invoices" and "I need to discuss deferring all payments for [redacted] months."
>
> e.g. [✂] "I must request a temporary payment holiday in our [redacted] arrears clearance. I suggest, in these exceptional circumstances, stopping the payment scheduled for early April and resuming payments in July"`

- Many of the SPIDs without temporary vacancy flags will be associated with businesses which have closed but which have not told us. They are not paying or getting in touch because they may not be on site to view invoices, their employees handling accounts are furloughed, or they have assumed that charges will not be made.

> e.g. [✂]"No admin staff are allowed to remain on the premises so we are working remotely. Unfortunately we cannot process invoices and cheques at the moment"

- Many customers have not paid bills for charges up to the date their business closed. They have not received this bill, or are not paying, for the reasons outlined above -

> e.g. Customer contacted us after receiving their final bill: "We cannot pay the full amount in one payment in 14 days, will this not be divided into monthly payments?"

- In the weeks leading up to the lockdown many customers cancelled their direct debits, cancelling or delaying payments. Customers have indicated that they have cancelled all direct debits (including for water charges) as one of the first measures taken to control cashflow -

> e.g. Customer writes: "Due to the current working practices concerning the Corona Virus Pandemic, we have suspended all direct debit payments to be replaced by BACS payments."

- We have seen an increase in concerns about shared supplies. In the common scenario where the ground-floor business is now closed and the residential flat above is using more water than normal, customers are reluctant to pay in full and in some cases unable to provide meter readings. (In many cases there is no deduction meter so the business is paying for the usage in both parts of the building. In normal circumstances the business scarcely notices the minimal usage of the household part, and there are regularly new cases where the customer did not know they were paying for the water used in the flat.)

> e.g. The owner of a hair salon on a shared supply with a residential flat explained the tenant is still using water, but the customer is unable to obtain readings to demonstrate an overall reduction in usage as she is self-isolating.

Customer is refusing to make full payment because they believe the invoice is too high.

- Customers asking for verification of the supply arrangements to be certain they are not charged for their neighbours' usage may delay payment because this verification visit cannot take place at present.

- Customers on an unmeasured tariff whose business activities are reduced are not prepared to pay in full based on their Rateable Value.

- Customers have had an extremely busy few weeks, leading to payment delays -

  e.g. [✂] "I intend to pay the following outstanding accounts at the end of next week 24th April/27th April 2020 – all accounts are prepped this end and just need my boss to sign off. Sorry for the delay - Covid 19 has caused a tremendous amount of work here. Please put accounts on hold and do not send any chasing letters."

- Customers delay or make part payment on the grounds that usage has dropped but they are not able to obtain a meter reading to prove this -

  e.g. Customer writes: "The current situation is that I've requested a heavy lift team to read our meter which is accessible from the road. When this is done and a corresponding bill raised, I'll do what I can to arrange a payment."

  e.g. "These meters require heavy lifting equipment (that we have now acquired). Can't complete until lockdown over."

Underlying the above, there remain significant reasons for non-payment which existed prior to the COVID-19 crisis. The major area relates to meters. Where wholesalers do not comply with Section 4 of the Wholesale-Retail Contract and maintain their meter networks, they end up incorrectly relying on retailers to report metering issues via bilateral forms. Meter readers are not trained to identify specific meter errors, and this *ad hoc* policy by some wholesalers [✂] is seriously flawed. Where meter errors are reported, customers typically refuse to pay any charges until they are corrected.

[✂]. The discrepancy in incentive arrangements in the market, with retailers but not wholesalers paying substantial penalties for failing to read meters, is therefore clearly both unfair and unproductive for customers. It no doubt contributes significantly to the fact that, as noted in our response to the Ofwat consultation mentioned above, [✂] of customers pay only where notice of disconnection or litigation exists; in the continuing absence of good metering and meter reading data only the removal of these constraints will make a short-term difference to this situation.

Achieving high levels of prompt payment by customers in normal circumstances (above 75%) would only be possible with a significant improvement in wholesaler performance regarding maintenance of meters and provision of accurate related data. At present, retailers already carry a triple burden of non-payment relating to meter faults/data errors, where resolution is largely outside our control, i) incurring penalties, ii) incurring the costs of resolution; and iii) paying the working capital cost of delays in receiving payments.

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

This is dependent on the duration of the lockdown: now that the lockdown will continue into May, we would expect default rates to increase to cover all customers other than those providing essential services.

[✂]

- [✂]
- [✂]
- [✂]

[✂]

- Cash collected in early April reflected:
  - [✂]
  - the deployment of collection methods now unavailable to us.
- Lockdown had only just commenced.
- Customers only recently having closed may have been able to settle outstanding bills.

[✂].

[✂].

[✂].

[✂].

[✂].

[✂].

[✂].

Fig. [✂]

This shows:

- [✂].

- [✂].
- [✂].
- [✂].
- [✂].
- [✂].
- [✂].

There is therefore strong evidence to believe that the gap between historical cash receipts and current cash receipts will widen further, and for at least as long as the lockdown remains in place. [✂].

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.

This depends on the length of the lockdown.

A lockdown ending after mid-May: we would not expect the majority of customers to be solvent and able to pay bills. There would not be a realistic possibility of recovering deferred elements of Wholesale charges. At this stage, only option (ii) (pay when paid) would be viable. Failure to implement option (ii) would at that point put a stop to virtually all payments passing to Wholesalers. This would be because of the inevitable delay in restarting billing to customers if a large retailer fails, and difficulty in repopulating accurate billing data – this would be a non-trivial exercise for a large customer base. The economic and financial damage to wholesalers will inevitably be greater if the capabilities of retailers are not available in the market, on anything other than a very short term view. Wholesalers have [✂] worse service levels and worse collection levels, when providing the same services now provided by Castle Water.

A lockdown ending before mid-May: economic damage will be more limited. The approach to liquidity can only be determined in combination with the level of flexibility given to retailers to collect payments, including recourse to disconnection and litigation. We do not see option (i) ("do nothing") as viable, as this would leave retailers in default under the Wholesale-Retail Contract if funding is not available, and therefore result in their disorderly exit from the market.

Options (ii) and (iii) are both viable, depending on the details of the mechanism. It should be noted that a major reason for non-payment is wholesaler failure to complete required work (such as meter repairs). It is clearly not tenable to place obligations on Retailers to collect payments whilst having no recourse to normal collection methods and placing no incentive on wholesalers to carry out work required to enable customers to be correctly billed.

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.

Wholesalers are experiencing a windfall gain in cashflow by being unable to carry out parts of their capex programmes; opex reductions through not using contractors such as meter readers; and increased invoicing of domestic customers. At the same time, they are eligible to participate in the Government's Large Corporate Finance Facility, which is providing debt at a cost of c. 1%. To the extent that wholesalers are providing liquidity, the principle in the consultation document is that this should be provided through the appropriate Government financing structure – we would concur with this.

Customers are overwhelmingly supportive of Castle Water. [✂]. Over the past two years 90% of Trustpilot reviews have rated Castle Water 4* or 5*. Since 1 March 2020, this proportion has been 92%. Customers, especially very small customers and large public sector bodies, would respond very negatively to the exit of Castle Water from the market – many have seen our effectiveness in correcting longstanding errors and complaints. For example, Castle Water developed a uniquely effective billing solution for Trade Effluent, which we call TEIP. [✂].

[✂]. Castle Water's provision of retail services is demonstrably both significantly lower cost and higher quality than can be provided by Wholesalers.

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

It would be perverse to impose a cost of debt on retailers to the extent that low collection rates are a result of following Ofwat requirements not to enforce payment. This would be penalising retailers for following Government policy. No debt payments should be required for the period of such restrictions, and for a follow-on period of two months (it takes at least some two months for collection activity to be effective, in this case following reinstatement).

By comparison, in the Scottish market the wholesaler has proactively offered to defer all wholesale payments, and is not charging any late payment interest. Our understanding is that the English and Scottish markets are seeking to align as far as possible, and we would expect the positive example shown by Scottish Water to be replicated by their counterpart wholesalers in England. As noted above, wholesalers are experiencing a windfall gain on cashflow, opex and revenue, and at the same time can access low cost Government funding by issuing commercial paper – a route not open to any retailer (retailers are all too small to gain the necessary credit rating to issue commercial paper).

Wholesalers, via WaterUK, have argued in principle that they can fund liquidity. Wholesalers should not be able to profit from restrictions Ofwat has placed on retailers – this would be morally questionable. It is unclear why, where retailers are prevented from recovering debt from customers, wholesalers uniquely should be remunerated for delayed payment, and not retailers. This would also run counter to responses from infrastructure providers in other sectors, such as commercial property landlords.

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?

Retailers should receive liquidity support for the period up to:

- The end of a material level of restriction on business activity (we accept that judging this is complex given the rapidly moving understanding of the crisis); and

- The end of restrictions on using normal methods of collection, including disconnection and litigation; and

- The end of a period of 6 months after this, the realistic minimum timeframe to effect collections.

The resilience of individual retailers to the crisis will be determined both by efficiency, and by the credit quality of their customer base.

[✂].

- [✂].
- [✂].
- [✂].
- [✂].
- [✂].

[✂].

In the short term, there is no ability to manage the insolvency risk of customers. However, a prudent retailer will determine the margin to apply to customer contracts in relation to its credit characteristics. This is similar to the way that bond markets will assess bond pricing be reference to credit ratings.

There are significant differences in costs between retailers. [✂].

The alternative to providing a suitable margin, and obligations to pay wholesale charges which are genuinely commensurate with restrictions on collections, to enable an efficient and prudent retailer to remain in operation, will be to increase significantly costs across the market. This would inevitably transfer risk and cost to customers and Government.

We have outlined above our views on the realism of relying absolutely on a return to normal levels of customer payment and hence liquidity arising by August, and of repayment of all deferred wholesaler charges by end-December.

Much depends on the length of the lockdown, whether it is strengthened or relaxed, the extent of any continuing restrictions, and whether there is a subsequent tightening of these or a re-introduction of lockdown conditions. See the exposition of the factors affecting these outcomes in response to Question 1 above.

Without knowing the potential impact of these factors, however, it is not possible to give a definitive answer. The only responsible approach to avoid damaging both wholesalers and retailers is to implement liquidity support proposals on a rolling basis, i.e. for a three month period, automatically extending for two months past the substantive end of any lockdown. Rather than a cliff-edge, it is more realistic to use a rolling-basis to unwind any deferred payments, as this reduces significantly the risk of an unnecessary shock. The level of payment expected can be adjusted in the light of any partial release of the lockdown.

The end date must also be set on a rolling basis, with a provision to restart it in the event of a further lockdown – in particular, we have no idea how the Coronavirus will manifest in the Autumn/Winter, and whether a renewed or stricter lockdown may be necessary.

If the dates postulated by Ofwat were to be used as hard stops and enforced as such, there is a clear risk of multiple retailer default, collapse of the NHH market and consequent bail-out of a number of wholesalers with already fragile finances.

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.

Retailers have been allowed a very thin margin in England, averaging 6% gross margin; 0% net margin. Even the most efficient retailers only achieve a net margin of 1%.

By comparison, the gross margin in Scotland is c.30%.

Customers benefit from the ability to choose their supplier, price competition, and significant improvements in service. It is reasonable that for a limited time some of the costs of bad debt should be shared by customers – either directly, or through normal mechanisms of Government intervention.

If the "recovery" paid by customers is based on the level to support an efficient retailer with prudent credit-risk management, customers will not be penalised by imprudent or inefficient retail activities in the market.

The alternative, allowing the market to fold, would result in a combination of:

- Immediate service deterioration.
- Increased prices – we know that other models (such as wholesaler provision of retail services such as invoicing) were significantly higher cost.
- No long term benefit to offset the increase in prices.
- A hiatus in collection of bills from NHH customers, resulting in a requirement for alternative (Government) support for wholesalers.

Alternative Proposal

An alternative mechanism to determine capacity to assume responsibility for bad debt would be to adopt the methodology seen in financial restructurings, and use known financial capacity for financial payments to creditors and shareholders, other than senior debt.

This gives a consistent approach across companies, and also has the merit of treating consistently dividends and interest on shareholder loans, where such loans are often a form of structuring equity investment.

In a financial restructuring, this would normally be achieved by (i) placing a hold on payment to shareholders, and (ii) where this is not sufficient, by placing a hold on servicing and repayment of subordinated debt (including structurally subordinated). [✂]. This approach could form a rational and objectively tested approach to assessing responsibility and capacity for assuming bad debt across all water companies.

It is reasonable to assume that payments made in previous financial years to (i) shareholders, in the form of dividends; and (ii) to holding companies in the form of interest on intercompany loans, are subordinated and should be capable of being restructured. Reviewing the accounts of Castle and its main wholesalers (those where Castle provides services to 80%+ of the wholesaler's customers) to identify these payments, and allocating a proportion of the expenses against the NHH revenue as a percentage of total revenue, we can therefore produce a fair and reasonable method to calculate the level of bad debt which can be assumed from the NHH market.

[✂].

[✂].

Under our proposal this would mean that:

- Castle Water should assume £[✂].
- [✂].

[✂].

Bad debt above this level should be added to the retail margin and the wholesale tariff, to be recovered over a future period to be defined.

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?

There are two options here: one is to allow a margin which covers bad debt costs; the second is to cap bad debt costs. The two could be implemented in combination.

We see merit in Ofwat's proposal of capping bad debt at 1% above the level shown in the last audited accounts. However, this would only be viable for bad debt experienced while retailers are permitted to collect using normal methods. The current retail margin is c. 9%, but the margin for bills up to end March 2020 was 6%. With 20% of SMEs expected to be insolvent, this would result in a 10% level of bad debt – the longer it takes to allow payment to be enforced, the higher the resulting bad debt.

Ofwat cannot justify an extended period with restrictions on enforcement at the same time as limiting the cap on bad debt to "normal" recession levels.

There are almost no close modern-era analogues of which we are aware for such a major reduction in commercial activity outside of wartime. The only close data we have relates to the closure of coal mines in north east England in the early 1990s. This resulted in an overall demand reduction in the region of 3%.

As set out in our Alternative Proposal above, we believe that there is a rational and consistent way to judge capacity for retailers to assume bad debt, although this mechanism may in practice require a cap and floor.

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

It is essential that customers continue to receive responsible customer-centric service, and correct bills, and pay these bills. Castle Water has achieved this for c. 25% of businesses across England. [✂].

The overall level of debt which should be assumed by retailers should equate to that which can be borne by an efficiently managed retailer with a prudent approach to credit risk. Any amount of liquidity which cannot reasonably be expected of an efficient and prudently funded retailer must be borne by one or more of the wholesaler, the customer or Government.

The extent of this gap will be determined by the length and nature of the lockdown, combined with the duration of any restrictions on enforcement.

It must be remembered that the current average net margin of water retailers Is under 1%. This does not allow for significant flexibility to expect the water retail sector to assume bad debt.

[✂].

In normal commercial arrangements, where there is an unexpected shock counterparties will cooperate to revise their contractual arrangements in a way which is mutually acceptable. We have been involved in a number of such renegotiations, for example on the purchase of power turbines and mining equipment; and currently as commercial landlords.

Although we have no direct involvement in high street retail, we note what appear to be accurate reports that retailers in some cases are cancelling orders, but covering their suppliers' costs. This includes [redacted] (who are making part payments to cover employment costs), and [redacted] (who are covering all costs). We also note that [redacted] is reported to have cancelled all contracts and is proposing to make *no* payments. Obviously the level of support required from the wholesalers will be scrutinised by other sectors, and set a benchmark, just as Network Rail's positive example of giving rent holidays set the precedent in the commercial property sector.

It is difficult to see the position of the English wholesalers as being anything other than seriously abnormal – along the lines of [redacted] rather than most other retailers - in insisting that they have no interest in the viability of retailers, who are in fact their major customers. Compare this with the position of property landlords where high street retailers are seeking rent renegotiation – rent holidays are offered of c. three months as a matter of course, with no required catch-up in payment.

The shareholders of Castle Water are also significant investors in commercial property, and have adopted a completely different approach to their tenants at the current time, providing rent holidays (in line with other commercial landlords, such as Network Rail). [✂].

[✂].

The following table is commercially confidential, and shows the support measures offered by commercial landlords in London:

Landlord	Tenant support	Source
[✂]	[✂]	[✂]
[✂]	[✂]	[✂]
[✂]	[✂]	[✂]
[✂]	[✂]	[✂]
[✂]	[✂]	[✂]
[✂]	[✂]	[✂]
[✂]	[✂]	[✂]
[✂]	[✂]	[✂]
[✂]	[✂]	[✂]
[✂]	[✂]	[✂]
[✂]	[✂]	[✂]

Consultation question 11: Do you 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?

It is vital that there are no interruptions to the supply of clean water and the safe removal of waste.

However, the current financing structures of a number of wholesalers are unviable in light of a systemic reduction in consumption of water, under current price controls. Trying to maintain these structures through an attempt to pass extraordinary levels of risk on to retailers, who have an average net margin of under 1%, is doomed to failure. Measures which inevitably result in the failure of Retailers will ultimately cause greater damage to Wholesalers and customers, as it will not be possible in a finite timescale to replicate invoicing and collection activity; and wholesalers were less effective or efficient at these activities.

Wholesalers are experiencing a windfall gain from a reduction in capex and opex, and increased domestic billing. In addition, they are able to access finance via the Government's Large Corporate Finance Facility. Wholesalers therefore currently have a heightened ability to manage increased customer debt, and should fulfil a part of the market obligation. Wholesalers benefit from the market interaction, with retailers providing essential services to customers, and in absence of a retail market would have to invest significantly to develop services [✂]. It is in the interests of wholesalers to pro-actively support the market, including by assuming some responsibility for debt.

We are concerned that the debate about debt has been viewed as a zero sum game between retail and wholesale. [✂]. It would be normal for an entire supply chain to cooperate to support each other – we have had discussions along these lines with some (smaller) wholesalers [✂].

It is inevitable that wholesale financing needs to be addressed. It would be entirely counter-productive to torpedo the retail market – service, invoicing, collection – in an attempt to shore up unviable Wholesaler financing structures. In any case, this would only give a short term benefit to Wholesalers, as it would result in the collapse of NHH customer payments [✂].

Fundamentally, the idea that the NHH market is somehow separate from the wholesalers is nonsense – it is obvious that the existence of the market has removed some of the cost of the crisis from wholesalers already, with retailers acting as a buffer. It is equally obvious that retailers cannot take all the pain. It is outlandish and morally questionable to maintain that shareholders in wholesalers should be insulated from the effect of COVID-19 on retailers and end-customers, in effect because they are already dangerously over-leveraged; and that therefore the adverse impact on businesses using water should be borne by retailers and customers only. The example of Scottish Water shows that a different approach can be taken, as does the behaviour of Castle Water's shareholders in their commercial property investments [✂].

Additional observations

We believe it is appropriate to take this opportunity to discuss a necessary change of focus in the NHH market, to align incentives and structures across the market, making invoicing and collection better understood and more efficient.

Communication with Customers – Ofwat's role

Customers remain confused about the market. Although Castle Water provides advice, publishes details on its website and uses social media extensively, not all customers will accept this as being authoritative. Ofwat could improve customer perception of the market and reduce costly misunderstandings by providing more detailed briefings on key issues:

- Bilaterals.
- Ownership of and responsibility for maintaining meters.
- The deemed contract.

It is notable that Ofwat has written to retailers regarding charging for consumption at vacant sites, but has not communicated this to customers more generally – we have checked Ofwat's website and this is not featured as far as we can see. Aligning communication to retailers and customers is essential to make the market work effectively, and for customers to be able to participate on an informed basis. Whilst we accept that as a retailer we have an obligation to inform customers, lessons from other markets (e.g. financial services) show that clear and authoritative guidance from regulators is necessary to support customers.

Castle Water sought to be involved with the industry groups responsible for communication with customers ahead of market opening. Neither Ofwat nor MOSL facilitated this involvement. We believe that our close interaction with customers gives clear insights into the type of communication required by customers.

Simplifying the market

The market can be simplified in three key areas, which would increase efficiency, customer confidence, and cashflow from customers through retailers to wholesalers.

Tariffs

- Customers do not understand the market or pricing – tariffs can be simplified by removing regional differences in structure, and notably in retail margins/cost allowances, as well as outdated concepts such as rates-based charges.

- Unmetered charges are a predatory rip-off, and should in all cases be replaced by Assessed charges.

- Remove Leak Allowances – these provide a perverse incentive on customers to delay payment and to not maintain their buildings. It is difficult to reconcile the target/penalties for networks with the largesse given to customers – this ultimately is recovered from other customers.

Codes

- Reduce the period prior to an RF to 6 months, and realign the Code of Practice so there is no customer expectation of continuous reassessment of charges post this date. The very high operating costs of retail relate in large part to the level of interaction post-event.

- In tandem, enforce the current Codes restrictions on unilateral retrospective changes to Wholesale data items. These impose unreasonable high costs on customers and retailers. The Codes are correctly drafted in this respect, but neither Ofwat nor MOSL has had the inclination and/or ability to seek to enforce them.

- Remove the cap on retailer performance charges (this can only be appropriate if the point below is also applied).

- MOSL/Ofwat have been unwilling and/or unable to procure performance by wholesalers to SLAs. There needs to be an effective approach, to stop the transfer of cost from Wholesaler to retailer, and the resultant damage to customer benefits from the market. Apply an equivalent penalty to wholesalers across any bilaterals where there is a penalty on retailers – e.g. for a breach of a B bilateral (relating to metering), to properly align incentives.

- The Panel is clearly dysfunctional, and failing to fulfil the aims set out under its Terms of Reference. The Panel's main aim is to ensure that the market works efficiently to the benefit of customers. A review of the minutes of all Panel meetings shows that almost no Panel members have ever referenced customer interests in their determination of proposed changes. Panel governance must be reformed.

Customer protection

- Align the expectations of customers and the requirements of the market for working capital - at present, many customers expect only to be charged based on actual meter readings, but the market requires payment in advance to secure the position of wholesalers.

- Customers should not be able to reject bills without an annual meter reading where retailers have no ability to require wholesalers to fix metering deficiencies or to require customers to provide readings.

- Require all meters to be fitted with AMR, and data to be made available by the wholesaler to retailers and customers. Wholesalers actually need this data to manage their networks, leakage and costs. The antiquated approach to metering in the water market, which is similar to soviet-era energy pricing, is overdue for change.

- Put in place an Ombudsman to provide rapid and specialist binding determination of customer complaints up to a value of £10,000, which can determine the basis of contractual disputes (CCWater does not seek to do this, and a consecutive process of referral to CCW, referral to ADR, dispute through the courts is too lengthy and expensive for all parties).

- GSS is out of date, and a largely irrelevant model. Customers want problems fixed immediately, and don't expect a legalistic reply after 10 working days. The level of payment is trivial – some customers find it insulting – in the case of high bills or serious service failures (such as foul flooding). Customers have no recourse to challenge wholesaler decisions, and ADR is ineffective in resolving wholesaler failures.

- Vacant consumption - Ofwat is aggressively seeking to treat "any consumption" as evidence of occupancy, but this cannot be justified. There are a number of current situations where a site is vacant but consuming water with no occupier liable for charges, including: squatters; sites with plumbing defects; sites where leases have been repudiated without water being turned off (for example, following a rapid insolvency and appointment of administrators). Ofwat's position is at odds with the Water Industry Act (WIA), and bills cannot be enforced based on charging where there is no legal "occupier".

- Ofwat should resolve discrepancies between the WIA, the Codes and licences. As well as vacant sites, this also effects Ofwat's eligibility guidance regarding shared supplies to premises including a domestic supply, and a number of other areas. This could be done in one of two ways: first, by reviewing all documents referenced under the licence regime for compliance with the WIA; alternatively, by including (as is done in the Codes) an order of precedence in each relevant document (such as the CoP) clarifying that the WIA and applicable law take precedence. This is not a trivial issue, as disputes relating to bills where these discrepancies exist are tortuous and expensive to resolve, for all parties concerned.