Ofwat Consultation on Business Retail Market Liquidity and Bad Debt: Everflow Water Response

A. Summary response

We are concerned that the proposals put forward by Ofwat do not represent an enduring solution. The measures may be suitable for the next three months but even this is not certain.

In the interests of all parties, we are willing to support two aspects of the proposal for the short term. From our current position we believe a 70% minimum payment threshold is achievable, but that because of the potential for significant change over the next three months this must be subject to regular reviews, on a monthly basis. We also accept that it is reasonable to ask retailers to commit to bearing bad debt amounting to up to 2% of revenue.

Ofwat has developed its proposals on the assumption that retailers can access government schemes such as CBILS or CLBILS. From the evidence we have, we are convinced that as things stand today retailers are unlikely to be able to access this support.

We are also concerned that Ofwat appears to take an optimistic view of how the national and global situation will develop from July to December and beyond.

We urge Ofwat to begin planning for a worst-case scenario where the economic situation is worse in the period from July to December <u>and</u> for the event that retailers cannot secure government support.

Ofwat has stated: "there will be a longer-term need to strengthen the financial resilience of both retailers and wholesalers, and we will return to these issues as we come out of the Covid-19 crisis." Our view is that Ofwat needs to consider the long-term financial resilience of the market now and cannot afford to wait until the current crisis is over.

Improvements to the market are overdue and it is now critical that changes are made. Most importantly:

- Improvements to the cashflow, financing and payment term model;
- Find a more appropriate balance of risk and reward between parties – wholesaler, retailer and customer – including treatment of and exposure to customer bad debt; and
- Provide retailers with the necessary tools to properly manage exposure to customer debt, in particular around the ability of retailers to perform successful disconnections which cap the debt.

We are keen to commit as much resource as possible to supporting Ofwat and the wider market in making these changes.

We recognise the importance of providing the wholesale companies with some assurance around the recovery of the liquidity they are providing to the market, but we do not believe that there is enough data to support a number of the proposals. Specifically, we do not believe there is sufficient evidence to make any decision on the following:

1. **Timescales for repayment of the liquidity**. There is a high level of uncertainty about the scale of the liquidity gap and how long it will take for the gap to close. It may actually increase once the lockdown is lifted and businesses reopen in a significantly weaker financial position.

2. **Changing the minimum wholesale payments threshold from 50% to 70%**. The decision to increase the minimum payment threshold has been made on the basis of data from a limited period of time. Retailers' ability to meet the minimum payments may be materially affected by:
    a. The change to Customer Protection Code of Practice. Ofwat mandated that every retailer amend their Terms and Conditions, which involved writing to every customer to let them know that no enforcement action will be taken in the event of non-payment. We do not know what effect this will have on bad debt. This communication was issued to customers little more than a week ago.
    b. The end of lockdown. As customers reopen their businesses and are no longer considered vacant, they will be in a financially weaker position. We can expect this to have an impact on cash collection and bad debt.

3. **Apportioning Covid-19 bad debt between retailers and customers**. We cannot predict the scale of the bad debt and it is therefore not yet possible to determine how much of the bad debt beyond the suggested cap of 2% may be absorbed by retailers.

We are supportive of Ofwat's desire to reach a decision on these issues, but we think it is too early to make these determinations given how little understanding we have of whether they are realistic for the market as a whole. We are willing to agree to a revised minimum payment threshold of 70% provided this is subject to monthly reviews. We ask Ofwat to delay their decision on the other two points until the summer consultation.

B. Consultation questions

Q1: Do you agree with these objectives as set out, which will guide our decisions about what are the preferred options?

We agree with these guiding principles. We believe that there is one vital objective that is missing. The current crisis is changing every day, and it is not yet a month since the Prime Minister's announcement on 23 March regarding a UK-wide lockdown. We believe it is still too early to confidently predict future trends based on performance over a period of just 4 weeks.

We therefore believe that an objective should be included as follows:

Given the high degree of uncertainty which presently exists within the market as a result of the Covid-19 pandemic, Ofwat is committed to regularly reviewing the changes arising as a result of new developments *over time, to ensure that market arrangements continue to reflect the current situation, and are based on the best and most up to date information.*

This objective could be achieved through monthly RFIs to retailers to ascertain the latest financial position and performance, as well as through the mechanism being discussed by the MOSL sub-group around validation of customer receipts.

We assume that principle 3 would not prevent us from retaining sufficient cash to cover our operating costs and we ask that Ofwat clarifies its intentions here.

There is a tension between principle 2 and principle 3 and we need to find a way to ensure that measures which provide for customers in line with principle 2 do not impair us from meeting principle 3. The impact of Covid-19 will not be short lived and it is possible that our cashflow situation will actually be at its worst several months ahead. In light of this, we are keen that options should be explored as to how we maintain our ability to continue collecting cash from customers who can afford to pay. The blanket protections for customers that were recently implemented in the Customer Protection Code of Practice felt right as a swift and simple measure, but we now need to work through the nuances of how we make appropriate exceptions. Ofwat's requirement to amend our customer Terms and Conditions meant that we had to notify every customer we will not be pursuing any debts, regardless of whether or not they are in a position to pay their bills on time. Our credit control processes have been weakened at a critical moment. This is bad for all customers because it puts the market at risk and it is unfair to those customers who are paying their charges on time and may end up paying for a larger amount of bad debt in future.

Our view is that the protection against disconnection should be maintained for as long as the lockdown continues. However we feel that a distinction needs to be made between:

- Those customers who were able and willing to pay prior to Covid-19, and have now ceased to pay; and
- Those customers who were already not paying and were in arrears prior to Covid-19, and have continued not to pay.

We feel that retaining restrictions on enforcement activity and late payment charges and interest is appropriate for the former, but should be removed from the latter to enable retailers to chase debt appropriately where it is not directly related to Covid-19. This would be in line with the approach supported by both Ofwat and the government in doing whatever we can to support businesses through this time, but ensures that those customers who were already refusing to pay do not receive further clemency.

We further suggest that Ofwat ensures consistency between retailers and customers in line with our answer to question 5. If we are to be charged interest on deferred charges then we should have our right to charge interest on late payments reinstated.

Q2: 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.

Q3: Please explain how you expect your response to question 2 to change over the next month or two.

Current position

Prior to the Covid-19 pandemic, Everflow's monthly revenues from English customers were approximately £Xm.

Following the onset of the pandemic, we experienced a deterioration in collections which has previously been outlined in our consultation responses. The initial impact in March 2020 was a drop in month-end cash of £Xm as a result of failed direct debit collections and lower BACS receipts.

The impact of the crisis so far (to 21 April) has seen:

- Circa X% of customers temporarily closing their businesses, estimated reduction £Xm
- Circa X% of customers cancelling their direct debits, estimated impact £Xm
- An increase in failed direct debit collections of c£Xm seen in March and expected to recur in April based on current run rate
- A reduction in BACS receipts of £Xm experienced in March and expected to recur in April based on current run rate

Therefore excluding the customers who have temporarily closed their business, our monthly revenues now sit at approximately £Xm. The combined impact of the reductions in collections flagged above is circa £Xm, which is our best estimate of the current liquidity gap as at today.

In addition, the cash impact of being unable to collect from customers whose premises are temporarily closed is £Xm of margin which is not being collected during this time.

As seen in the table further down, our current expectation is that we will be able to recover X% of wholesale charges from customers in April 2020.

Future position

As highlighted in our response to Q1, we believe it is still too early to confidently predict future trends based on current performance over a period of just 4 weeks.

Our current performance has been based on the impact of the initial lockdown, temporary closures and cancelled direct debit mandates which resulted. However the recent requirement to notify all customers that we won't be chasing debt or taking further actions if they don't pay on time will inevitably worsen our performance from previous months.

In addition, our historic strong cash collection performance has been based on our ability to collect aged debts. Even before the crisis, we typically received only X% of bills in month 1, and we are reliant on collecting the more aged debt to offset this initial delay. The reductions noted above in respect of BACS reductions, direct debit cancellations and failed direct debit cancellations bring this figure down immediately to X% (being a reduction of £Xm out of £Xm, or X%) even before any further potential deteriorations.

As our ability to collect aged debts has then been severely hampered by the CPCoP restrictions, this throws our ability to collect into further doubt.

Summary of position

Putting all of this together, the table below shows the expected cash balance at the end of each month if all wholesaler payments were made in full between now and the end of July 2020, in order to display the cumulative liquidity gap. These figures include Everflow's entire customer base across England and Scotland.

The approach to compiling these forecast figures has been to try and prepare a 'best-guess' scenario, rather than a worst-case scenario, and therefore there is a significant degree of risk around whether collections performance will be as high as forecasted.

The 'Temporary closures March half-month' line is included because for those customers who closed in March and therefore did not pay Everflow in April, there remains at least half a month's worth of wholesale charges to be paid out for these customers (depending on when they closed). The impact of this should reverse at the end of lockdown, when these charges are subsequently paid, but it is a working capital impact now due to the benefits provided to closed businesses.

£m	**Apr-20**	**May-20**	**Jun-20**	**Jul-20**
Starting balance				
Liquidity gap				
Temporary closures margin				
Temporary closures March half-month				
Other movements				
Ending balance				

Our current performance and forecasts indicate the following is the most likely scenario based on English cash receipts and wholesaler payments:

£m	**Apr-20**	**May-20**	**Jun-20**	**Jul-20**
Net receipts				
Wholesale payments (70%)				
Operating charges				
VAT				
Net cash movements				
% wholesale charges received				

The average percentage of wholesale charges we expect to recover is above the figure of 70% quoted by Ofwat, but we would certainly not be comfortable with increasing the minimum percentage of charges which were required to be paid. There is clearly a significant degree of uncertainty over whether the headroom is sufficient which means that 70% would be the highest level we could consider acceptable.

As indicated above, these forecast figures are prepared on the basis of current information, which is insufficient to draw meaningful trends on which to base the forecasts, and this therefore reflects our response to Q1, where we request regular ongoing reviews to ascertain whether cash collection performance reflects retailer and wholesaler expectations.

We propose that a tolerance below the minimum 70% threshold up to 60% of wholesale charges could be implemented. Any retailers paying within this tolerance would not be considered to have triggered the default process, but persistent payment of between 60% and 70% of charges would be considered to trigger the default process.

Reasons for non-payment

The majority of Everflow's customers are on direct debit. Prior to the crisis, X% of our customers paid via direct debit, however as indicated above this figure has reduced to X%. From contacting the customers who cancelled their direct debit since the lockdown took effect, our findings were as follows:

- We were unable to contact the customers in a significant proportion of the cases; we attempted each customer in this situation 3 times at different points during the day without success. Where this was the case and the type of business was one which was expected to close due to government guidelines, we deemed these businesses to be temporarily closed.
- Where we were able to speak to the customer, invariably the reason for the cancellation was due to cashflow issues as a result of Covid-19. In these circumstances, we offered customers payment holidays or payment plans, and continue to support them as much as possible.

We have also experienced customer non-payment due to the following:

- Failed direct debit collections, which are usually due to either a cancellation of the direct debit, or insufficient funds being present in the bank accounts. The level of these increased from £Xm in February to £Xm in March, which illustrates the impact of Covid-19.
- Cashflow pressures within businesses due to Covid-19 as a result of reduced demand or issues with their supply chain, leading to customers not processing BACS payments.
- Direct requests to Everflow for payment plans or payment holidays.
- Customers who are unwilling to pay in the knowledge that retailers are unable to take meaningful action to recover the debt. This has particularly been true for customers who were already in debt prior to Covid-19.

Q4: 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.

Our preference would be for option 2 – a 'pay when paid' approach which allows for the high level of future uncertainty faced by the retail market. There is a risk that setting a minimum payment requirement will lead to a retailer failing and this would have serious knock-on consequences for wholesalers and lead to disruption for customers.

However, we understand the need for wholesale companies to have greater certainty around minimum payment levels for continuity of the provision of water and wastewater services. Our response focuses on appraising Ofwat's current thinking.

Risks with the proposal

We have some key concerns with Ofwat's proposal.

1. Our biggest concern is with the proposed repayment timescales and we cannot responsibly agree to these dates (see our full response to the question of timescales in question 7).
2. Paying a minimum of 70% of wholesale charges may not be sustainable; especially if businesses start to reopen, and the temporary vacancy status is lifted, but customers' ability to pay their charges is diminished. We cannot predict with any certainty what will happen in the future weeks and months and whether 70% will be the right minimum level for the coming months. This is particularly the case as a result of the changes to the CPCoP highlighted earlier in our response to Q2, which increases the degree of uncertainty.
3. There is a risk involved with paying as much as we possibly can in wholesale charges each month that poor cash collection performance in any given month could lead to a retailer defaulting.
4. No reference has been made to an allowance for operating costs.

Proposed mitigations

We would be willing to commit to paying a minimum of 70% of wholesale charges for the next three months (May to July) if the following mitigations were in place:

1. A commitment to regular reviews as highlighted in our response to Q1. This will be essential as there is high degree of uncertainty around how the global economic situation will unfold. The reviews should consider whether 70% is the right minimum level; whether or not liquidity support can be ended in July; and when deferred wholesale charges can start to be repaid.
2. We suggest that the minimum percentage should be applied as a rolling average, so as to incentivise passing on as much cash as possible in line with principle 3 and allow for a bad month or any deterioration in cash collection. Settlement does not perfectly mirror billing

and we should allow tolerance from month to month. For example, a retailer might be able to pay 85% in May, only 65% in June, but recover to 75% in July.

3. The inclusion of a tolerance between 60% and 70% to reflect the uncertainty around future collections arising from matters raised in our responses to Q2 and Q3.
4. Retailers should be allowed to cover their operating costs before making wholesale payments.

Further clarifications

We also wish to highlight the following areas where clarification is needed:

- As a retailer operating across England and Scotland, we are very aware that the markets have adopted differing strategies to support wholesalers, retailers and customers through this crisis. Everflow serves English, Scottish and cross-border customers, and receives receipts from all of these on a monthly basis. Any mechanism which is ultimately implemented to validate the proportion of receipts due to be paid to the wholesaler needs to take account of this and ensure that retailers are not disadvantaged in either market due to differing regulatory strategies.
- Retailers need clarity on the value of charges to be billed by wholesalers on a monthly basis. If this is less than 100%, then this would mean that the VAT on the deferred proportion of the invoice would not be recovered from HMRC until subsequently invoiced, which would further reduce retailers' cashflows.
- Some wholesale charges are due at the end of the month, while others are due a few days into the following month. The value of customer receipts needs to take into account the timing of these receipts to ensure that wholesalers are not disadvantaged based on when their bills are due.
- Any mechanism should take into account net receipts, being receipts from customers less refunds to customers.

Q5: How should we determine the financing costs associated with any liquidity provided by wholesalers? Please explain your view and provide supporting evidence.

Q6: 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 inconsistency between allowing wholesale companies to charge retailers interest on deferred charges while retailers cannot in turn charge their customers interest or fees for late payment. We need consistency to keep liquidity in the market. In line with principle 2, if it is important that customers are not charged interest for suffering the effects of the Covid-19 crisis then wholesalers should not be charging interest to retailers for deferrals either. Neither wholesalers nor retailers should be seen to profit from this situation.

We also note that as our current cost of financing is X%[1], and interest rates quoted to us in the market prior to the onset of Covid-19 range from X% to X%[2], the interest charges proposed to be levied on retailers by wholesalers would not act as an incentive to obtain financing sooner, but would merely be an additional cost to be borne by retailers at this time.

We would be happy to provide supporting documentation which evidences both our current cost and the interest rates quoted to us on an ongoing basis if this would help Ofwat in its decision-making.

Q7: 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 cannot agree to the timescales Ofwat has suggested at this stage. We feel Ofwat is taking an optimistic view of how events will unfold from July to December and we are concerned by the apparent assumption that the effects of the Covid-19 crisis will be somehow reduced by July.

There are no guarantees that government support will be available to retailers in time to support the liquidity gap and repayments after July. We believe the liquidity gap could get worse towards the year end as a result of a recession and we do not know what the additional funding gap might be. There could also be a further outbreak of the coronavirus in the winter months. The market needs to prepare for a worst-case scenario where the economic situation for businesses worsens after July. This needs to include consideration of how to build in contingency even after wholesale repayments begin, given that banks are clear that funding available from the government scheme cannot include any degree of contingency for the situation worsening.

Whenever retailers do start to make repayments, we suggest that this should be in conjunction with the following code changes:

1. The recent code change CPW095, which was approved to counterbalance the benefits retailers gained through CPW093, should be reversed at the point where retailers start to pay their deferred wholesale charges (if not at the point when the benefit of liquidity support provided through CPW093 ends – if this is sooner).
2. Payment performance unsecured credit allowance (CPW086) should come into effect at that time. This would further incentivise prompt payment of charges and repayment of deferred wholesale charges (which could be incorporated into the definition of late payment), and would improve liquidity for unassociated retailers in particular without affecting the risk profile.

Accessing government support

[1] REDACTED
[2] REDACTED

We have serious concerns over the potential inability to access government support in the form of the Covid Corporate Financing Facility (CCFF), Coronavirus Business Interruption Loan Scheme (CBILS) and the soon to be launched Coronavirus Large Business Interruption Loan Scheme (CLBILS).

We have already held a number of detailed conversations with our current bank, regarding the potential availability of the scheme. The key question which needs to be answered for the application to be successful is whether the loan is affordable and serviceable. This is borne out in the FAQs for the CLBILS scheme, which state that an SME must "have a borrowing proposal which, were it not for the current pandemic, would be considered viable by the lender, and for which the lender believes the provision of finance will enable the business to trade out of any short-to-medium term difficulty."[3]

We are fully aware based on discussions with other retailers and our own internal benchmarking exercises that very few of the other retailers in the market are profitable, and therefore our concerns are not limited to our own ability to obtain this funding, but to other retailers as well. We know from one retailer that because they are lossmaking, they are already unable to access the government scheme.

We also make reference to the video within the link below[4] from a profitable energy supplier, who discusses the low probability of obtaining a government loan from the schemes referenced above, further supporting our views that the government schemes may not be accessible for retailers.

Based on Everflow's December 2019 financial information, the business had recurring EBITDA of £Xk for the year, and net interest costs of £Xk. Our expectation is that the total additional funding required at the end of July 2020 may be around £Xm, and that the interest cost of obtaining this funding would be between X and X%.

Ofwat's proposal

Our understanding of Ofwat's proposal is that the additional funding (from whatever source the funding is ultimately secured) would support the liquidity gap for a period of time while the aged debt was either recovered or written off. Assuming the 2% bad debt cap was implemented as suggested in this consultation, the potential outcome for aged debt would be one of the following:

1. The aged debt is fully recovered from customers and cash is used to pay down the funding
2. The aged debt becomes bad debt which is not recovered by the retailer as it is under the 2% threshold
3. The aged debt is not recovered and becomes bad debt which is recovered by the retailer as it is above the 2% threshold (less any proportion borne by the retailer)

[3] https://www.british-business-bank.co.uk/ourpartners/coronavirus-business-interruption-loan-schemes/clbils/faqs-for-businesses/

[4] https://youtu.be/di2XufBQclk

If these are the three potential outcomes, then as retailers we are immediately acknowledging a proportion of the funding we are requesting will never be recovered. These further unrecoverable losses to the retailer make the prospect of lending even more unpalatable for the banks.

Our view

We support principle 4 - that retailers should be incentivised to make full use of government support to remove the need for wholesalers to provide liquidity and to enable payment of deferred wholesale charges to be made – both at the earliest possible time. However, the issues outlined above are likely to prohibit access to government support and must be addressed to avoid retailers being left with a debt to wholesalers which cannot be repaid.

1. In order for any additional funding to be serviceable, there has to be an increase in margin within the market to support the level of debt. Even if we were able to access government support, failure to increase retailers' margins will lead to an increased level of gearing and losses, but no ability to service increased debt, which will lead to retailer failures.
2. In addition, if Ofwat wishes retailers to access the government support which is being made available, then providing an explicit statement to that effect which retailers can use as evidence in discussions with the banks is also critical.

Personal guarantees

As part of the terms of the government scheme, retailers may also be expected to put personal guarantees in place for 20% of the loan[5]. Given that retailers are asset-light businesses, there is not a significant degree of security in existence within the businesses, and in a number of cases (including ours) existing lenders already have charges in place over the assets of the business. Therefore personal guarantees are likely to be required, and this is certainly the indication given to us by our bank. This would be personal risk being taken on by directors of retail companies within the market, which is unprecedented for a regulated water utility.

This level of risk needs to be acknowledged by Ofwat, and any further interventions in the market need to take account of this. There is a risk that if solutions are not fit for purpose, then directors may be forced to choose between taking out large loans which attribute significant personal risk, which are unserviceable, unable to be repaid and which may not be sufficient if market conditions worsen, or entering administration, which may initiate a domino effect on the entire market.

Q8: 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.

[5] https://www.british-business-bank.co.uk/ourpartners/coronavirus-business-interruption-loan-schemes/clbils/clbils-for-businesses-and-advisors/

In most markets, bad debt amounted during a financial crisis would reduce profit in the short term and financial losses would then be recovered over time through price increases - with competition often acting as a price-moderating influence.

We operate in a price-capped market which allows for a very slim profit margin (and many of our competitors are not operating profitably); therefore we are unable to price the risk of elevated bad debt levels into contracts or recover from a financial crisis without the cap being lifted. Retail companies will not recover from the economic impact of Covid-19 without recovering a proportion of the costs of non-household customers defaulting through future bills.

We believe that customers are benefitting significantly in the current climate from the changes to the water market. In particular, the temporary closure changes meaning that customers do not bear charges while they are not occupying their premises, as well as the changes to the CPCoP, including in particular the communication to all customers which ensures they are aware of the restrictions being placed on retailers, are a significant cashflow benefit to customers at this present time.

Given the likelihood that lockdown will be in place for a reasonable degree of time, it is clear that the benefits that additional cashflows and support from retailers and wholesalers have provided should be paid for in some way by customers.

We would argue that the situation is similar to the wider economy, which the government is supporting through unprecedented measures to support businesses. The measures which have been implemented in the water retail market in the last month are similarly designed to support businesses at a time when they need it most, and while not all businesses will require these measures, supporting businesses and the wider economy will benefit all of us in the longer term. In the same way that taxpayers will ultimately pay for the measures undertaken by the government, it seems only right that customers should pay for the benefits afforded to them.

In our response to the consultation on late payments[6], we indicated that our best estimates of total bad debt were between £Xm and £Xm. This compares to an expected run rate of £Xm per annum, being approximately X% of revenue. The difference which would require financing would therefore be between £Xm and £Xm.

If the bad debt costs were ultimately recovered on a straight-line basis over the next 3 years through whatever mechanism is agreed, our expected interest costs on the loan required to finance these bad debt costs would be between £Xk (£Xm at X% as quoted in response to Q6) and £Xk (based on £Xm at X%) over this period. As indicated in our response to Q6, servicing these additional financing costs purely for the bad debt element of the liquidity gap would be challenging, and this does not take into account the wider financing required.

Q9: 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?

We agree that customers should not be expected to cover all bad debt costs and that a responsible company should be financially resilient enough to absorb a 'normal' level of bad debt

[6] Everflow Water response to call for inputs on impact of COVID-19 on late payments in the business retail market (25/03/2020)

and cope with financial shocks, at least in the short-term. We have previously explained[7] the measures we have in place to protect against an unexpected shortfall in revenue and how financially resilient we are to shocks. However, the scale of the impact of the current situation is unprecedented. It has shown the water retail market to be vulnerable in the way it was established. Financial resilience was not given sufficient consideration at the time of the first price review when the market was created and Ofwat has ignored repeated calls from the retail companies to review the price cap.

The current suggestion that bad debt of up to 2% of turnover should be borne by the retailers is feasible, even though this is more than three times the level of market-leading bad debt performance, and will require a significant level of additional funding. We appreciate the need for Ofwat to provide a degree of certainty to wholesalers and retailers regarding the level of bad debt to be borne by trading parties. However we suggest that there is no immediate requirement to determine the share of bad debt charges between retailers and customers above the 2% threshold at this stage, as there is simply not enough data to determine an appropriate apportionment.

We propose that Ofwat should review the level of crystallised bad debt in 12 months and consider an appropriate apportionment at this time when more data is available. This would be consistent with Rachel Fletcher's message to wholesalers regarding performance commitments, where she said this would not be looked at during the crisis but would be looked at "in the rear-view mirror" i.e. from an informed position.[8]

We would also reference our response to Q8, where we point to other markets' approach to recovering charges of this nature through subsequent price increases for customers when their contracts expire, with market competition then ensuring that these price increases remain appropriate and competitive for customers. We would support such an approach in this market but we should ensure the cost increases that will pay for bad debt are spread across all customers, and that the costs do not fall more heavily on those who are actively engaged with the market (i.e. switching or renegotiating contracts) as all customers are benefitting from a the protective measures that have been put in place.

Recovery of bad debt post-lockdown

One of the main ways in which the impact of the crisis can be mitigated and reduced is to ensure that when lockdown ends and businesses reopen, that debts can be recovered quickly from customers who are unwilling to pay yet continue to use water. For the avoidance of doubt, we are distinguishing between customers who are unwilling to pay despite repeated calls to do so, and those customers who require our support as they trade out of lockdown and return to prompt payment.

Ofwat has already indicated its desire to work with MOSL and market participants to remove frictions and improve the way the market works and the benefits it provides to customers. One of the key areas of the market which does not currently serve retailers, wholesalers or the majority of end customers is the debt recovery process, in particular disconnections.

[7] Ibid

[8] https://utilityweek.co.uk/dont-give-water-firms-free-pass-failure-coronavirus/

We raised issues around the disconnection process in a meeting with Georgina Mills and Dan Mason in December 2019, specifically the fact that retailers are not able to obtain warrants themselves to disconnect customers and must do so through wholesalers. The non-primary charges from wholesalers is uneconomic, ranging from £800[9] for Yorkshire Water to £1,650[10] for United Utilities. Other wholesalers provide a price on request, but these are similar to those provided above. Accredited Entities are unable to obtain warrants for disconnection, and as such, based on our experience with using Accredited Entities, success rates we have experienced have been as low as 4%. Other issues exist around disconnections which we have discussed with other retailers, and would be happy to discuss in detail with Ofwat to achieve an enduring solution to this issue.

We have spoken to our contacts in the energy industry, including a company who specialise in isolations and disconnections within the energy industry. They have confirmed that energy companies are already preparing for the end of lockdown by working more closely with isolation and disconnection companies to mitigate the increased bad debt risk which will result. It is important that water companies are able to plan in the same way to mitigate their bad debt risk.

While this consultation is not specifically designed to raise and address the market frictions, if Ofwat wishes to reduce the impact of bad debt on non-household customers, then ensuring that retailers can take steps to mitigate their own bad debt risk will inevitably result in a lower market-wide bad debt charge. Failure to do so could mean that the liquidity gap and bad debt both increase materially, increasing the likelihood of retailer failure and of higher customer charges.

Points for clarification

We would urge Ofwat to clearly define Covid-19 related bad debt, given the potential lasting impact of a global recession. We would not be satisfied with a definition which only includes bad debt from the immediate crisis (for example, debt incurred during the period that the temporary restrictions on credit control in the Customer Protection Code of Practice apply).

We would like clarification on what 2% of turnover means. Would this be based on turnover in a fixed 12-month period? Otherwise, this could act as a disincentive for companies to grow their customer base and thereby reduce competition and choice for customers.

Q10: 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.

In our view customers should bear any bad debt costs beyond a pre-determined threshold, albeit through small and affordable price increases over a set period of time. Our customers are already

[9] https://www.yorkshirewater.com/media/2250/29697_yw_wholesale_charges_book_2020_aw-web.pdf
[10] https://www.unitedutilities.com/Business-services/wholesale-charges/

benefitting now from a number of financial protections which come at the expense of retailers and wholesalers, and it is right that they pay for this in future.

In the limited time that we have had to respond to this consultation, we can name a small number of precedents which support our view:

- **Wholesale water charges after the 2008 financial crisis.** The wholesale companies were allowed to recover the higher bad debt costs following the 2008 financial crisis in subsequent price reviews.
- **Energy retail market.** In our response to Q8, we have highlighted the fact that where economic shocks such as this occur, prices for new contracts and renewals are increased to factor in the additional risk which exists in the market and wider economy. We have confirmed through our various contacts in the retail energy sector that this is already occurring and would be happy to provide evidence of this through these individuals as required. The reason this approach is not currently viable in the water sector for all parties is due to the Retail Exit Code, and this limits retailers' ability to price the additional risk in on an ongoing basis.

We should ensure the cost increases that will pay for bad debt are spread across all customers, and that the costs do not fall more heavily on those who are actively engaged with the market (i.e. switching or renegotiating contracts) as all customers are benefitting from the inability of retailers to disconnect etc.

We actually suggest the excess costs should be recovered through increased wholesale charges as opposed to purely through increased retail profits. This will ensure that any excess that customers are being charged is clearly passed on to the wholesalers in repayments and retail companies are not seen to be profiting from the crisis. This will also ensure a level playing field between existing retailers and new entrants – as otherwise existing retailers who are burdened by debt could be priced out of the market.

Q11: 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?

We have no objection to restricting wholesaler risk on retailers failing given their commitment to the market. We are relaxed about the mechanism that is used given it will not directly affect us.