Full list of consultation questions

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

SUMMARY

During these unprecedented times when the country, the industry and our market have faced serious challenges, PWS has focused on maintaining a high level of service to its customers while keeping its people safe and positioning the business to be sustainable in the long run.

There is plenty of learning from this experience that has seen excellent coordination and cooperation between Retailers, Wholesalers and Regulators for the good of customers. This needs to be taken forward beyond this epidemic to help secure an effective NHH market that serves all customers effectively and efficiently.

PWS supports this consultation, especially the speed of change that Ofwat wants to implement changes by. There is also an opportunity to take the current levels of cooperation to set up a high level group in the future to address the fundamental challenges the market faces.

In responding to the consultation we have tried to identify the framework of solutions for Ofwat to consider and we do believe the key challenges facing us from these proposals are:

- The potential over reliance placed on the liquidity relief offered by the temporary Vacants process when the evidence barrier is quite significant
- The sustainability of PWS requires tariff changes to recover bad debt losses, and repay any additional borrowing needed during this phase of the economic cycle.
- The level [70%] proposed payment of wholesale bills due or a proportion equivalent to the payments received from NHH customers whichever is greater. (especially if Vacants recorded are below actual)
- A 2% bad debt cap exceeds our own experience and our preference is for a cap for PWS based on our actual performance and risk which is more in line with the PR14 level of 1% of turnover

Thank you for the opportunity to respond and to help to identify solutions in the long-term interest of all customers and the market.

PWS RESPONSE

We understand the objectives, intentions set and agree with the principles. However, we would like to draw your attention to some specific observations relating to objectives 4,5 and 6.

In objective 4, it is clear from the consultation that the focus is for Retailers to pursue government loan schemes or independent sources of finance. The consultation does not address the recovery of such finance, so the financial viability of the market improves to enable new loans to be repaid. There is an opportunity here for the establishment of a high level group to address the long term issues with the market and address it's long term viability. Specifically, for PWS, we only option is to pursue additional loan facilities from our parent companies due to our parent group structure.

In objective 5, the code changes do not improve the long-standing position allowing Retailers to withstand the changes in the business cycle. The paper requires Retailers to absorb higher financing costs by providing longer credit to customers and take on more leverage. There is no provision to cover the future increased cost to serve. For this to happen Retailers should have greater margin to capture the true cost of bad debt and allow investments to drive efficiency and technology improvements in the market.

In objective 6, The available toolbox to manage this risk is being restricted without clarity when the controls will be lifted. The regulatory change makes a blanket assertation that the retailers provide water, without penalty, of either disconnection or interest charges. In making this decision, there is no end date to the rule. We propose two operational solutions to this situation whilst the protection remains in place, which is covered in our response to question 3.

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.

Based on the current run rate data of cash receipts in April. PWS expects to be able to pay between 65% and 100% of the wholesale invoices received. It is possible that we will be able to pay 100%. Predominantly the smaller, long tail of customers have delayed or stopped paying PWS. The delay in payment is across multiple industries, notably Public Houses and some Retailers. Of our larger customers, national accounts have continued to pay us and we have not suffered a bad debt loss. This delay is accentuated by the increased temporary customer protections which we are supportive of. However, to improve our position and protect the customers that are paying their bills this protection needs to be withdrawn in a timely manner and Ofwat to consider our proposed solutions outlined in our response to question 3.

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

PWS's response captures the following assumptions:

- The temporary vacancy code change is challenging because it requires a high level of certainty, and evidence, that businesses are closed. To date we have amended a low percentage of our SPID count with the required evidence in the code. If the evidence requirement is relaxed and we can apply a sampling model this would reduce administrative burden and our liquidity challenges.

- Meter reading has ceased, the data points to accurately capture future wholesale charges are fewer than during the ordinary course of business. We expect CMOS data to overstate the expected volume consumption based on the changes that have been made to date.
- Our cash receipts are down on trend but we are collecting February and March invoices. In April we will be issuing bill for March consumption which was largely unchanged by customer shutdowns.
- We expect a further deterioration in May, as we start to bill lower April consumption. We expect the payment of the May wholesale run to be lower and closer to the minimum proposed under the regulations.
- We are concerned about May and June payment runs because we are not confident that government loan schemes are providing the anticipated benefits and we are closely monitoring the payment habits of our customers. There is an indication that customers who know they cannot be cut off push their water bill to lower priority.
- To enable a reasonable judgement that a Retailer is collecting Pre-Covid-19 debt we propose the following additions to the collections process whilst the customer protection measure remain in place:
    - Disconnection is threatened only on a debt that by its size and age relative to the customer consumption can be concluded it is pre-COVID-19 debt
    - Disconnection is threatened after another addition to the recovery process where the Retailer has established that the customer is in a position to pay their bill. Once evidence is established the Retailer can threaten disconnection. Evidence can be based on criteria such as:
        - There is evidence of activity sourced from calls and website checks
        - Consumption levels have returned to normal or are normal
        - Field visits (as lockdown is phased out),

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.

Outside of the very short term, the Retailer market must be able to operate under option i. Contemplating option ii and iii suggests the market is unsustainable because the level of bad debt risk is high and the market is unattractive for investors to allocate capital.

For option i to be achievable, Retailers must have the flexibility to set tariffs which captures true cost to serve, bad debt losses in the market and influence customer behaviours. Controls should pass to the retailer, such as being allowed to disconnect customers and drive innovation based on the true cost to serve and improved digital product offering.

In the short term, PWS is supportive of the implementation of options i and iii, but remains concerned about number iii because the percentages are arbitrary judgements and not actual consumption. At this time, PWS has made adjustments on c3% of customers following the spirit of temporary vacancy and consumption code even though we believe there are c25% that could be made vacant, we expect the next payment run to overstate our true consumption in the market. Therefore, applying a percentage to consumption, which is partially correct is concerning. Overall we expect the April wholesale charges to be overstated.

Our concern with option ii is that the administrative burden will be too great once controls and procedures are developed. It will just add cost to the Retailer without improving service or improving financial metrics such as cash collection.

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.

The regulator should consider in equal measure the additional costs to wholesalers and retailers for the additional cost of financing our respective businesses. Effectively the change in regulations whereby retailers are not allowed to charge interest to customers whilst Retailers should provide a saving to our customers is unbalanced and potentially unfair.

In considering a charge to retailers for liquidity. The calculation should not assume that the P1 between April and June is correct. This is because without meter reading data when water is being consumed, CMOS will make inaccurate estimates of consumption. On the basis that meter reading will recommence in June, the normal settlement process ensures the differences between actual and estimated consumption are evened out through the R1 to Rf process. No interest is charged between Retailers and Wholesalers during this process and it is unclear why interest is being introduced now when the data is less accurate and consequently impacting any settlement calculation. Interest could be due from Retailer to Wholesaler and vice-versa due to overpayments in March and April.

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.

Yes, this is entirely fair providing PWS and other retailers receive clarity when the interest free period on late invoices to customers will be lifted. It would be equitable for wholesalers to share the same interest free period. Additionally, a true and fair assessment on the liquidity being provided must be based on actual consumption data and not based on the assumption that any P1 wholesale invoice is accurate during the lock down period and the intervening time period until a meter reading takes place. PWS is wholeheartedly following the spirit of the code and not making blanket judgements on property vacancies, therefore, in the case of overstatement of consumption in CMOS, the relevant wholesaler will potentially owe PWS money in return.

It is worth noting, current market mechanisms between retailers/wholesalers; wholesalers do not receive or pay interest on the longer dated R3 or Rf.

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

We agree to the timelines subject to confirmation from the UK Government of the timing when the national lock down ends, as well as evidence that the government initiatives are delivering the benefits anticipated. The initial feedback, is that attaining government loans is not straight forward. As stated in our previous RFI, we think the water retail market will see some lag until cashflows start gradually increasing. We expect these to be a full quarter after controls are lifted and normalisation of business processes. We believe the potential for bill disputes and inaccurate billing will drag on cashflows until a full meter reading cycle is complete. Our scenario modelling pointed toward cashflow improving in January / February 2021.

Ending liquidity support by December 2020, also needs to be reviewed against the timing of a complete wholesale / retailer settlement process. In setting a December 2020 deadline, the relevant R2 and R3 settlements should be completed early so the market fully rebalances from the current challenges and a new equilibrium is found.

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.

Firstly, we are concerned about the comparison to the financial crisis in 2008 in making assumptions how the Covid-19 epidemic will evolve in the coming months. At this time, the number of people and businesses impacted by Covid-19 casts a much broader spectrum. The financial crisis, restricted the availability of borrowing and reduced risk tolerance, unemployment peaked almost 3 years later just below 9% between September and November 2011. The immediate data on Covid-19 shows a sharp shock is being felt, with potentially 25% of businesses temporarily closed. Of the remaining 75% of businesses, potentially 21% have furloughed staff. The point is, the financial costs of the 2008 crisis were spread over a three year period. In the situation of Covid-19, the impacts may be felt over a much shorter time period and the long term recovery will evolve. The regulatory framework needs to reflect this.

Referring to objective 6 and option i, a retailer must be able to stand alone as an independent business accepting the risks and rewards of operating a sustainable business model. The inability to recover all bad debt losses will not deliver on Objective 6 as laid out at the beginning of the consultation.

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?

For PWS, our historic bad debt charge has been significantly below the 2% threshold of revenue proposed, having focused on trying to recover as much debt as possible. If our bad debt charge had been this high, the cost of bad debt would be equivalent to 30% our total costs (vs 10% in actuals), which is far beyond the assumptions in the allowed cost to serve during market opening. For a good Retailer, who has been proactive in managing debt risk, we believe the thresholds proposed are unfair and do not capture the potential challenges that will be faced during year 2020 /21. Our historic bad debt metrics have no link on this current economic challenge and how we can remain a viable market participant.

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

In order for the market to deliver on Objectives 5 and 6, for Retailers to be able to withstand changes in the business cycle the costs associated with of bad debt will need to be recharged in future tariffs. The relevant precedent in the electricity market is that there is a much wider range in tariffs set than in the water industry. This wide range allows the industry to build tariffs capturing the different bad debt risk profiles. Currently the water retail market applies the allowed cost to serve at a regional level.

For example, for our smaller customers, the average annual bill in PWS is £1,300, with an allowed cost to serve ranging between £15 and £50 in our different regions. Capturing the point that the bad debt risk is estimated 2% of sales, implying the allowed cost to serve capturing bad debt £26.

For PWS, where the £26 bad debt element is greater than our allowed cost to serve. The assumption means that for some customers we are loss making and for other customers, 50% total cost is for bad debt charges. This suggests the regulated allowed cost to serve is understated.

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?

PWS cannot comment on this question.