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BY EMAIL TO: covidbusinessretailmarket@ofwat.gov.uk

Covid Business Retail Market
Ofwat

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Please ask for Helen Orton
Our Ref [redacted]
Your Ref

Dear Sir/Madam,

Introduction

As the provider of a key public service our overarching objective, in response to Covid-19, is to maintain the provision of high-quality water supplies to Portsmouth Water customers - both Household customers (HH) and, as a wholesaler through retailers, to Non Household customers (NHH). During these difficult times we continue to aspire to maintain our industry leading levels of customer service and particularly in extending support to those experiencing difficulties as a result of Covid-19.

Together with the wider industry, we have supported the extension of additional liquidity to NHH retailers. We recognise that this is in the best interest of NHH customers, given the significant detrimental impact that a retail failure could have both upon services to NHH end customers and the NHH market as a whole.

However, we also recognise the significant potential adverse impact, both operationally and financially, that the Covid-19 pandemic will have upon wholesalers. We explained this further in our response to the recent Ofwat wholesaler request for information.

We entered the current AMP with limited financeability headroom particularly in the first two years. This is predicted to be further challenged due to the combination of difficulties in the NHH retail market, HH affordability issues and incremental Covid 19 related operating costs in areas of the business. This downward pressure impacts liquidity and more significantly key financial ratios and covenants and will be mitigated by further cost and cash flow reductions. This is now a critical area of focus for the business.

As such, whilst we have been supportive of the extension of liquidity to wholesalers, we also recognise the importance of understanding the future implications of the code change and the extent that the financial impact will have upon the Company.

In developing our response to this consultation, we have worked closely with Ofwat and other wholesalers through Water UK. We have very much appreciated the collaborative working approach that Ofwat has taken to this matter, the development of understanding and approach by Ofwat and the urgency with which this consultation has been launched.

We welcome Ofwat's recognition that the provision of additional liquidity to the business retail market must not come at the expense of the financial viability of wholesalers. In this respect our response particularly draws out the need to ensure that wholesalers are fully reimbursed for the Company's incremental costs as a result of advancing liquidity. As a small company we are concerned that this reflects the Company's specific incremental costs and not a "one size fits all" industry assumption.

In line with the Water UK response we also feel very strongly that there should not be a "re-writing" of the balance of risk of bad debt (both the exposure to NHH end customer debt and the materially increased risk of retailer default) – as a result of the code changes made.

We note that the comprehensive response provided by Water UK on behalf of the wholesalers is representative of our position. We do not disagree with any material components of the positions set out in that paper although we have a slightly modified view on relation to Question 5.

We have not reiterated the points made in the Water UK consultation response except where we have company specific aspects or additional points to make.

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

We support the aims and objectives set out by Ofwat in both the Foreword and Chapter 3 of the consultation. We consider that these are well aligned to the principles of good regulation such as transparency, predictability, targeting and proportionality.

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 believe that retailers are best placed to make this assessment.

Consultation question 3: Please explain how you expect your response to question 2 to change over the next month or two. [NB these questions are aimed at retailers but we would welcome views and evidence from other stakeholders].

We believe that retailers are best placed to make this assessment. However, we note the following;

<u>Use of the vacant flag</u>

In the context of recent use of the vacancy flag, we welcome and support Ofwat's statement on page 1 of the consultation that:

> '*The use of vacant property flags must also be used in line with the intention of the recent code modifications. There will be penalties for misuse'*

Our recent experience has shown extensive use of the new Covid-19 vacant flag. To date we have only been able to undertake limited validation work in relation to the appropriate use of this flag (involving cross referencing against the premises meter industry code). This exercise identified premises that were likely to still be operating despite the current lockdown restrictions (e.g. pharmacies) and initial site visits have shown the majority of these queried premises were open for business. We recognise that recent clarifications have been published in relation to the use of the Covid-19 vacant flag and we will work with retailers to feed back the discrepancies that we have identified.

<u>Application of extended credit terms</u>

In the consultation document Ofwat also notes that "*Anecdotal evidence implies there has been some misunderstanding of the intention behind this code change, which some trading parties have interpreted as retailers only having to pay 50% of wholesale charges".* We have experienced this apparent understanding and saw 5 retailers, [redacted] paid 50% of the wholesale charges due.

We would be happy to share our experience in more detail if helpful.
It is important that this principle is applied, and we will look to MOSL, in particular, to both provide further clarity on the mechanism to monitor this principle and to see further tightening of the guidance in terms of the specific application.

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.

To the extent that the liquidity gap is expected to be material, we are supportive of the need to ensure that retailers, and by extension the NHH retail market, are appropriately supported.

However, we also feel it is important that retailers are incentivised to utilise available liquidity in the appropriate order and not simply "default" to drawing on additional wholesaler liquidity as the primary liquidity source. Accordingly, we welcome Ofwat's principle

> *"Retailers should be incentivised to explore and access alternative forms of liquidity (e.g. Government support) before considering whether to defer payment of wholesale charges. And they should be incentivised to pay deferred wholesale charges back as soon as possible*."

We believe that retailers should be encouraged to utilise available liquidity in the following order of preference;

1. Existing retail liquidity including appropriate ongoing debt collection activities and use of funds paid by NHH customers.
2. Additional commercial facilities accessible by retailers.
3. Additional Covid relief accessible by retailers
4. Extension of Wholesaler liquidity.

Therefore, whatever mechanism is implemented to support additional liquidity should have appropriate transparency and incentives that this principles is being followed.

It should also be considered that where the wholesaler liquidity is used this could represent that the wholesaler is becoming the "lender of last resort" where other commercial terms cannot be accessed. This could imply that wholesalers are being exposed to a proportionally higher risk of default than other lenders into the retail market (many ow which may be prioritised in the event of default). This is closely linked to the points raised under the Water UK response to Question 11 in particular as a point of principle that the exposure wholesalers face should be capped, and the cap should be set at the level of exposure that existed before the 27 March code change.

To the extent that liquidity is provided by wholesalers, this should be based upon appropriate empirical evidence from retailers' assessment. We would hope that additional ongoing transparency of the need could be provided through regular reporting, by retailers, of both the outturn and any changes in the forecast level of liquidity support required.

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.

In prosaic terms, it should be possible to determine, based on settlement data, the additional value and number of days of liquidity that has been advanced by wholesalers over and above that which would have been provided prior to the code change. The relevant billing data can be used to calculate settlement values using the "pre code change" methodology and compared to actual amounts settled/outstanding with the Wholesalers for each retailer. The cost of financing could then be applied in order to determine the financing costs.

In this regard it may be appropriate for additional reporting information to be provided by the trading parties and MOSL in order that the level of liquidity being extended can be tracked – in part for the purpose of calculating the associated financing costs but also in order to track levels of liquidity being advanced and compare this outturn to base and forecast assumptions.

However, in reality the actual financing costs incurred by the wholesalers are likely to be greater than this. This is because wholesalers are unlikely to have sufficient available liquidity themselves (particularly given the wider Covid-19 pressures they are facing) to service the entirety of the retailers' liquidity requirements. As such they will need to estimate the additional liquidity needs of the retailers and draw down on debt facilities to cover this. Accordingly they will most likely have an incremental cost to carry of maintaining the liquidity headroom for the retail market.

In addition, wholesalers will also have their own additional financing requirements as a result of the Covid-19 impact on their own businesses (setting aside the Retail market). They will therefore also be forecasting wider business liquidity needs and using additional facilities and other ways to manage liquidity. For example the Company's response to mitigation of Covid-19 will have an impact on dividend payments. This will clearly make it difficult to "unpick" the impact from extending liquidity to the retailers from that required for the companies' own response to the Covid pandemic. This may also support the argument that an appropriate WACC should be applied in calculating the financing cost in recognition that the liquidity may well be funded by a basket of activities including an impact on the return to equity.

As such this potentially complicates the approach to determining the associated incremental financing costs. As a minimum there should be a recognition that there will be an incremental cost of carry, or additional days' debt drawn down, for the wholesalers where they are utilising debt facilities to finance retail liquidity.

On balance, we feel that to ensure that there are no "winners and losers" this financing cost should be set at the company specific WACC or company specific cost of debt.

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.

We agree that retailers should bear the incremental financing costs associated with the provision of any additional liquidity by wholesalers. As set out in the Water UK paper, we recognise that, in setting the appropriate cost to be borne by retailers, there may be a degree of tension between cost reflectivity and maintaining appropriate incentives.

As noted, in part, under question 5 above, the challenge will be in determining and compensating the incremental financing cost that each wholesale Company has suffered. This is to ensure that wholesalers are made whole for the ***additional*** liquidity extended (beyond that which was inherently recognised in the original code and hence the wholesale margin).

Analysis provided, in the Company's recent wholesale RFI, shows that in mitigation of the overall Covid-19 impact will result in the Company accessing a range of different mitigations including drawing down on the revolving credit facility, termination of dividend payment and potentially other debt or equity raising (eg through the CCFF).

As a small company we are particularly concerned to ensure that the approach taken remunerates wholesalers for the company's incremental cost of advancing liquidity. As such Ofwat has previously recognised that smaller companies have a higher cost of debt. This may be compounded by the fact that wholesalers have had to act quickly to respond to the impact of Covid and, as such, may have utilised higher proportions of (relatively more costly) short term debt facilities. Accordingly a "one size fits all" approach is likely to result in winners and losers in terms of compensation of the incremental cost incurred and any approach taken needs to recognise some flexibility to reflect such challenges.

As we noted in respect of the previous question, we feel that to ensure that there are no "winners and losers" this should be set at the actual company specific WACC or company specific cost of debt. This is a slightly modified position from that set out in the Water UK paper.

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 with the principle that liquidity support should be time-limited and subject to ongoing regulatory review. For this reason we have commented, in previous responses, on the need to carefully track outturn and rolling forecasts from retailers of cash receipts and liquidity requirements.

We also agree that unwinding of additional liquidity provided by Wholesalers should commence as soon as is practicable and possible. In terms of priorities retailers should be incentivised to ensure that this repayment takes place ahead of any retailer dividend or third party debt payments being made. We would support the regulatory approach where repayment was made when possible rather than waiting until an end stop date.

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.

We agree with the concept that, in line with the market principles, wherever possible, retailers should bear bad debt costs from non-household customers, as retailers are best placed to manage these costs.

However, we also recognise that in the current exceptional circumstances bad debt exposure is likely to be significantly higher than would be expected even in a severe economic downturn. We also recognise that retailers' ability to effectively manage bad debt costs has been constrained by regulatory requirements. Given these factors, it would not be unreasonable for retailers' liability for bad costs arising from customer non-payment of bills to be limited, and for some or all of the liability above this limit to be borne by non-household customers.

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?

The appropriate limit, and the proportion above this limit to be borne by customers should be based on the underlying assumptions made at the time that the balance of risk and return for retailers was set as part of market principles and Ofwat's assessment of the evidence it has obtained from engagement with retailers.

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.

Our view is entirely consistent with that set out in the Water UK industry response. As noted under question 9 above we recognise that, given the current exceptional circumstances, it would not be unreasonable for retailers' liability for bad debt costs to be limited.

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?

Our view is entirely consistent with that set out in the Water UK industry response.

As also noted in the Company's response to the Wholesaler RFI, we reiterate that wholesalers, out-with the NHH market risks, are currently exposed to significant additional risks as a result of COVID-19. Consequently wholesalers are already feeling 'pain'. We therefore represent strongly that there should be no "changing of the rules mid game" to reallocate retail risk to wholesalers both after those risks have crystallised and in a different way to that which the market principles set.

Given the already tight regulatory settlement – and its impact on financeability – we feel that the company is already exposed to increased financial risk as a consequence of Covid impacts. Actions, that may been seen by the rating agencies as undermining a stable and predictable regulatory regime, could have further adverse implications on the financeability for the business.

Wholesalers are also already clearly exposed to an increased risk of retailer failure, compared to the expectations when the market was established. We therefore feel it is entirely inappropriate that this risk exposure should be increased further as a result of the 27th March code changes or an allocation of excess NHH bad debt.

In conclusion we have appreciated the extensive dialogue that the industry has had with Ofwat colleagues and the speed with which the consultation has been developed. We would be happy to discuss further any of the points raised in our response.

Yours faithfully,

[redacted]

HELEN ORTON
Finance and Regulation Director