Our Ref: [redacted]

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By email

For the attention of Rachel Fletcher, Chief Executive

Dear Rachel

Covid-19 and the business retail market: Proposals to address liquidity challenges and increases in bad debt

Many thanks for the opportunity to comment on the business retail market consultation dated 16 April 2020.

I appreciate the acknowledgement by Ofwat of the support provided by wholesalers to date in ensuring immediate liquidity was injected into the business retail market and the recognition of the pressure that this has placed on SES Water (the "Company") and others in the sector. Like Ofwat, our Board and employees have been guided by the core principal of protecting our customers – both household and business – in this time of crisis. Our response to this consultation is guided by this same customer-oriented focus.

We understand the urgent need for another set of arrangements now to deal with the ongoing issues in the business retail market over the coming months, and we will continue to work with Ofwat and Water UK to ensure the support of this market.

We fully support the key considerations that underpin Ofwat's consultation, in particular:

- The expectation that retailers should have fully explored and accessed the Government's Covid-19 financial support facilities before further liquidity pressure is placed on wholesalers.
- The explicit comment from Ofwat that penalties will be applied for misuse of vacant property flags by retailers during this crisis.
- That the financial viability of wholesalers should not be adversely impacted through their support of the business retail market.

The final item on protection of the financial viability of wholesalers is key for our Company as can be noted in our response to this consultation. In particular, we agree with the recommendation that the liquidity support should be time-limited to some degree. The unwinding of the liquidity support provided by wholesalers should commence as soon as practically possible through careful monitoring of the retailers' own liquidity and financial status.

While we are in overall agreement with the proposals Ofwat has articulated in the consultation, there are certain areas of concern for us, as noted below:

- We are supportive of Ofwat's proposals to ensure that the financing costs associated with any liquidity provided by wholesalers should be borne by retailers. Such financing costs should be reflective of the cost that we incur to provide such liquidity. However, Ofwat should be cognisant of the higher costs of debt that smaller water companies, such as SES Water, incur when determining the financing costs to be borne by retailers.
- With respect to potential bad debt exposure, we consider that the existing wholesale price control mechanisms do not provide sufficient protection against the impact of the code changes that were implemented from 27 March 2020 onwards, and which may be extended based on the proposals in this consultation.
- Wholesalers continue to face increased levels of operational and service level risks throughout this crisis, in addition to household revenue, cash collection and bad debt issues, which may impact certain aspects of wholesalers' long-term resilience. Ofwat requires to be careful that any further short-term measures implemented as a result of this consultation do not have adverse long-term resilience impacts for wholesalers.

As Ofwat are keenly aware, our Company, like many others in the sector and across the wider business community, are being adversely impacted by Covid-19 outside of the immediate business retail market effects. We acknowledge that this is a national crisis and that all parties need to share the burden in order to keep not just the business retail market functioning, but to also ensure core service delivery for all customers is not adversely impacted. Therefore, a balance must be struck on the level of support wholesalers can provide to the business retail market and the pressures such companies are facing in managing overall customer, operational and financing matters during this crisis.

As always, please contact me for any questions or clarifications.

Yours sincerely

[redacted]

Ian Cain
Group Chief Executive Officer
SES Water

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

We agree with the objectives set out in Section 3 of the consultation document. In particular, the first stated objective of protecting the interests of all end user customers has been SES Water's key focus in responding to this consultation. We also welcome the stated objective that retailers should be incentivised to explore and access alternative forms of liquidity (e.g. government support) before considering whether to defer the payment of wholesale charges.

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.

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].

As noted above, retailers will be better placed to provide a response to Consultation Questions 2 and 3. However, we do support Ofwat's statement on Pg 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".* There requires to be close monitoring by MOSL to ensure the appropriate use of the vacant property flag mechanism for the interests of all customers, and misuse by retailers of this mechanism should be swiftly and decisively dealt with by the MOSL and Ofwat.

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.

We agree with Ofwat that the preferred option for dealing with the remaining liquidity gap facing business retailers would be a combination of options ii and iii as detailed on Pg 23 of the consultation. In other words, a minimum floor is set each month for retailers to pay a portion of the charges due to wholesalers, but if the retailers have recovered more from their customers, then a larger amount should be paid to wholesalers by such retailers.

This view is based on the expectation that, as documented on Pg 13 of the consultation, certain businesses may be able to still pay in full and on time during the crisis and also, given that retailers can temporarily use the vacant flag in CMOS, it can be expected that such retailers should be able to pay more that 50% of the wholesale charges each month.

However, in recommending the above options:

- We welcome the sub-group commissioned by MOSL to consider additional reporting requirements to understand and monitor the value of the liquidity gap for each retailer, to ensure retailers are paying above the initial 50% levels where they can.
- At our Company level, we do not have any empirical evidence as yet to support a specific percentage of amounts to be paid by the retailer, but would support Ofwat's initial view that at least 70% of wholesale charges should be paid each month, to be monitored going forward. Ensuring retailers can still manage their overhead costs would also need to be considered in deciding the recovery level of wholesale charges.

- Even at 70% minimum payments, this will clearly mean further pressure on wholesaler liquidity levels, which also has implications for bad debt (that we have addressed in our response to Question 11).

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.

While we continue to be supportive that – in the interests of all customers – short-term liquidity is required to be provided into the business retail market by wholesalers, we do agree with Ofwat that such liquidity comes at a cost (of finance) to the wholesaler.

From our perspective, the financing costs to use when wholesalers provide additional liquidity to the business retail market should be reflective of the cost that we incur to provide such liquidity. While the weighted average cost of capital (WACC) set at PR19 may be a starting point for this calculation, it does not fully reflect the higher cost of debt that SES Water – as a smaller water only company – incurs as compared to the cost of debt incorporated in the standard WACC. In addition, the PR19 WACC does not incorporate current market conditions in the post-Covid-19 markets. We therefore recommend that the basis of the financing cost calculation is reflective of the higher financing costs we incur at our Company level to fund this liquidity gap at present and in the future.

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 the financing costs associated with any liquidity provided by wholesalers should be borne by retailers.

While, as a wholesaler we have, and will continue, to support retailers through bearing the liquidity burden in the short-term, this incurs an immediate financing cost, which in our case may be utilisation of debt facilities that carry an interest cost that would otherwise have not been incurred.

However, as Ofwat has noted, the best way for retailers to avoid such financing costs would be for such retailers to be incentivised as much as possible to access other forms of liquidity (such as government support). Wholesaler liquidity should be considered as a last resort, as it may result in a more expensive form of liquidity to retailers than other options. Such a liquidity burden will be mitigated further by incentivising retailers to collect as much cash as possible and ensuring it is paid to wholesalers where possible.

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?

As noted by Ofwat in the consultation, extending retailer liquidity support beyond a certain point in time could come at the expense of wholesaler financial viability.

Therefore, we support the recommendation that the liquidity support should be time-limited to some degree. The unwinding of the liquidity support provided by wholesalers should commence as soon as practically possible through careful monitoring of the retailer's own liquidity and financial status.

While we do not have the various data points to specify when this point may be, we support Ofwat's initial judgement that retailers should be required to start to repay the deferred amounts from August 2020 and that all additional liquidity be repaid by the end of December 2020.

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.

Wherever possible, we believe that bad debt cost from non-household customers defaulting should be borne by retailers. This most closely aligns to the current market arrangements, acknowledges the fact that the retailers accepted a risk of bad debt when entering into the market and also preserves the incentives for the retailers to manage such bad debt risk.

However, as Ofwat's notes, temporary changes have been made to the Customer Protection Code of Practice which have removed many of the tools retailers have to manage bad debt. Therefore, combined with the unprecedented deterioration of the business retail market, we agree that some of these bad debt costs should be recoverable beyond a pre-determined threshold and borne by non-householder customers. Retailers will be in a better position to provide specific evidence in this regard.

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?

We do not have the evidential evidence available to ascertain the reasonableness of the pre-determined thresholds provided by Ofwat as noted above. Ofwat would have to determine whether the retailers' currently available liquidity facilities, combined with governments' Covid-19 support, would enable such retailers to manage all bad debt costs up to 2% of their turnover. However, the approach by Ofwat to determine such thresholds appears reasonable and logical, but given the substantial liquidity risks that we understand are currently being faced by retailers, 2% may not be a sufficiently high enough threshold.

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.

We are unaware of any relevant precedents for determining who should bear bad debt costs once the pre-determined thresholds have been exceeded. While we could reasonably understand that there may be a view that such excess bad debt costs should be borne by both the retailers and business customers to an extent, the final amounts and proportionate cost sharing should be based on Ofwat's assessment of evidence it has obtained from engagement with retailers. Any proposed national or regional mutualisation of bad debt would require careful consideration to ensure equitable – and that it would take account of particular companies' current efficiency and financial challenges. We do not believe that the current price control totex sharing mechanism could be utilised as a basis of this proportionate cost sharing – such PR19 price control mechanisms do not take into account the unprecedented Covid-19 circumstances.

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?

We agree that wholesalers should be protected from the bad debt exposure associated with the recent liquidity measures, starting at the point when the initial code changes were introduced (27

March 2020). At that point in time, the bad debt exposure started to increase for wholesalers on the deferred portion of their wholesaler charges, and will continue to increase should the extension deferral proposed in this paper be implemented.

Wholesalers continue to face increased levels of operational and service levels risks throughout this crisis, in addition to household revenue, cash collection and bad debt issues. Therefore, protection again wholesaler bad debt exposures (that have manifested directly as a result of the recent code changes to protect the business retail market) is appropriate. Such protection will aid the stability of the wholesaler market so it can continue to deliver core water and waste services to all customers.

Existing wholesale price control mechanism do not provide sufficient protection against the impact of the code changes that were implemented from 27 March 2020 onwards, and which may be extended based on the proposals in this consultation. Such Covid-19 related circumstances, and the required code changes for protection of the business retail market, were not contemplated under the current wholesaler price control. In addition, the existing mechanism for wholesalers' protection from default in the current price control only operate with a significant time lag (whether via revenue recovery or totex sharing), which creates additional liquidity pressure for wholesalers. Further dialogue between Ofwat and wholesalers would be needed to understand if adjustments to totex sharing factors or capping of bad debt exposure based on wholesalers' revenues would address future bad debt exposure.