Smarta Water response to:

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

To: Georgina Mills and Dan Mason - Ofwat

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Foreword

Smarta Water welcome the invitation to respond to the consultation paper issued by Ofwat in relation to the impact of Covid-19 on the business retail market.

In providing our response to the proposals presented to address the liquidity challenges and bad debt in the market felt by all participants: Customers, Retailers and Wholesalers alike we have taken a balanced and pragmatic approach.

In reviewing the paper and through discussion with Ofwat and MOSL believe that there does need to be an element of cross market burden sharing in order to keep the market operating however this requires a balanced perspective for Customer, Retailers and Wholesalers alike.

In our response we draw to Ofwat's attention the need to recognise:

- We have fully explored the ability to access the government's main Covid-19 financial support facilities. Our findings from direct enquiries have been supported by external accountants and our bank confirming that we are precluded from the majority of support available. This has been evidenced in previous RFI responses to Ofwat and UKWRC information provided to Defra.
- Where liquidity is sought through deferral of wholesale payments defined in code CW093 we are seeking to maximise payment upon confirmation of payment calculation method which is set to be determined through the outcome of this consultation and workings of the associated subgroup which we believe should be based on the UKWRC proposed DSO method of calculation.
- We have applied the vacant property flags only after following sufficient diligence and direct confirmation with our customers that this is applicable as defined with the code CW091.
- There is a clear mismatch and disparity between the ability for Wholesalers and Retailers through statements made within this consultation focused on Retailers baring the cost of liquidity provision from Wholesalers and maximising payment of wholesale charges whilst also being mandated with the prohibition of active customer debt collection, applying interest charges for late payments and means of limiting the increase of bad debt by ceasing customer disconnections through the recent modification by Ofwat to the Customer Protection Code of Practice.
- A belief barrier and perception of friction has been broken with the mutual interaction and support demonstrated between Wholesalers and Retails with interactions through UKWRC and Water UK steering groups and the RWG. We believe it is imperative for Ofwat and MOSL to support this and utilise as a stimulus for ongoing open and frank discussions seeking out solutions to areas of inefficiency and ineffectiveness within the market, which is still immature in many ways having only recently entered its third year of competition. In undertaking proactive actions of this nature mutual benefits to all market participants Customers, Retailers and Wholesalers can be achieved and ultimately provide enhancement to an often questionable customer experience and benefit of the business retail market.

We believe that a consolidated whole market perspective by Ofwat through the consultation process is imperative not only to address short term Covid-19 related issues but also take a longer term perspective and initiate a review of a longer-term perspective to strengthen the business retail market as a whole and we hope the information we continue to provide is beneficial in attaining balanced, informed and considered solutions.

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

Smarta Water have reviewed the seven objectives defined by Ofwat. Whilst broad agreement to the principles we have highlighted areas of concern for consideration and have responded below to each in turn.

1.1 Protecting customer interests

We agree that for the effective functioning of the business retail market in both the short and longer term that the interest of end user customers should be protected. However, we believe that the focus and balance between Customers, Wholesalers and Retailers needs careful consideration and further refinement and we do not believe there is sufficient balance presented in the consultation in relation to the Retailer perspective and that the onus on customer protection is currently disproportionately high.

1.2 Prohibiting Retailer measures for customer non-payment related to Covid-19

Whilst the changes made by Ofwat Customer Protection Code of Practice are understandable from a wider context of reducing pressure on businesses in the UK it does not align with a fully competitive market.

The changes nullify Retailers ability to chase for debt, charge interest for late payment or initiate disconnection.

With this in place as a Retailer all that remains in place is the ability to remind customers of their obligation to pay whilst measures of enforcement have been removed by the regulator Ofwat. This effectively renders the Retailer a “toothless tiger” in relation to the enforcement of debt collection whilst with current liquidity and debt measures in place remaining fully liable for customer debt and unable to maximise collections for wholesale settlement payments.

As such Retailers are already providing liquidity to NHH customers.

1.3 Retailers utilisation of funds collected to fund wholesale payment

We welcome the cross sector collaboration and introduction of CPW093 that permits the deferral of payments between Retailers and Wholesalers on a percentage of payments invoiced, but not yet due in March 2020, and on settlement in April and May 2020.

We see this as an important vehicle to enable the market as a whole to assess the impact of Covid-19. Equally we believe this current consultation and RFIs on bad debt position in the interim should be focused on established a consistent method of ongoing payment calculation and provision from Retailers to Wholesalers.

We believe that it is in the best interest of the market to ensure cash flow and prevent buffering by Retailers retaining funds when they are in a position to make payments to Wholesalers. based upon the revenues they are able to collect and also allowing Retailers to

retain adequate levels of revenue to fund the cost of ongoing business operations. As such it is our belief that the DSO mechanism proposed by UKWRC prevents a fair mechanism that can be utilised consistently by all Retailers and in doing so provides a traceable and transparent mechanism should auditing of its application be required. In stating this we also acknowledge that further work is required on this mechanism to have sufficient detail for implementation and audit for compliance.

1.4 Retailers access to alternative forms of liquidity (e.g. Government)

We agree that Retailers should be incentivised to explore and access alternative forms of liquidity (e.g. Government support) before considering to whether to defer payment to wholesale charges and be incentivised to pay deferred wholesale charges back within a reasonably agreed period.

As an organisation Smarta Water has reviewed alternative forms of liquidity. In previous information submission to Ofwat Request for Information under Standard Licence Condition A8, 2nd April 2020, question 3 with supporting evidence. In response to this question we have clearly outlined the very limited options within the Government support that we are eligible for. This information has also been presented as part of the UKWRC response to information requested by Defra. This was again highlighted on a call between UKWRC and Ofwat on 17th April 2020.

Whilst it is fully appreciated that the position of Smarta Water as a new entrant, unattached Retailer, is not representative of the whole of market it does highlight that the Government Support available in its current form does not provide a panacea solution and in some cases the liquidity provision by Wholesalers provides welcome support in these unprecedented times. To date we have been concerned by a number of verbal statements made that by members of Ofwat in relation to access for Retailers to Government support and request a more thorough review is undertaken and understanding gained during this consultation to ensure appropriate and due consideration can be undertaken in relation to this matter.

1.5 Retailers and Wholesaler capability of withstanding changes in business cycle

We believe that in light of the extreme circumstance the market as a whole through collaboration between Wholesalers, Retailers and regulator with appropriate contribution from customers should be capable of withstanding the changes in business cycle, but only with additional consideration and collaboration.

With current measures in place the interim support of wholesale payment deferral has allowed the initial impact to be absorbed in the short term. This current consultation should then focus on the whole of market ensuring that it does not come at the expense of any single party with cost of bad debt facilitated and financed through application of competitive market factors.

The current interim measures alleviate customers by removing elements of Retailer debt collection with no upside whilst this consultation payment highlights the ability of wholesales to apply fair charges for provision of liquidity while Retailers have limited bad debt provision. In a normal competitive market, the cost of interim support and recovery of bad debt would be passed to the market to recover without restriction.

1.6 Risk management – Retailers NHH default and Wholesalers with Business Retailer default

We agree with the existing market arrangements associated with non-household customer defaulting and Wholesalers managing the risks associated with business Retailers defaulting. We do believe the course of events triggered by Covid-19 have stimulated sufficient discussion and debate to initiate review the market arrangements in order to consider what needs to change to ensure that it is more robust in the future.

1.7 Recovery of Covid-19 related bad debt

We believe there will be a requirement to recover costs from NHH customers. This would be the normal circumstance in an open competitive market. It's our belief that this is best applied through a charge applied to wholesale charges and spread over time. It is clear that there is an expectation for recovery of the cost for provision of liquidity by Wholesalers from Retailers. Current interim arrangements see full suspension of Retailer ability to recover cost from NHH customers which in unbalanced and the net result is Retailers are disadvantaged on both sides.

As referred to in 1.6 we believe that the Covid-19 situation prompts for a wider review of the market arrangements. The current crisis has illustrated the NHH market's lack of resilience and that Retailers are particularly vulnerable to cashflow disruption and abnormal levels of customer default.

Hence, we believe that in seeking a solution for bad debt we should not necessarily be constrained by the existing market set-up. We now have an opportunity to review the market arrangements and to consider what needs to change to ensure that it is more robust in the future. This might include measures to:

- reduce market overheads and the costs of operating in the market;
- address market inefficiencies and reduce the complexities;
- more appropriately align the balance of risk and reward between parties – Wholesaler, Retailer and
- customer – including treatment of and exposure to customer bad debt;
- improve the cashflow, financing and payment term model;
- align and improve performance incentives; and
- improve meter reading arrangements – cost, quality and capacity.

If we can strengthen the market and the balance of risk within it, the options for recovery of bad debt may be greater.

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

2.1 Monthly Recovery of Wholesale Charges

Smarta Water have provided Ofwat details of customers with temporary vacancy flags which we believe our recovery of wholesale charges over the coming months will be affected and decreased due to areas highlighted in section 2.2 of our response below.

2.2 Customer Reasons for Non, Partial or Late Payments

With customers who are still open for business that are late paying the reasons include:

2.2.1 Maintaining business liquidity

The prime reason provided by customers where we have indication there may inability to either recover invoice payments in full or on time is reflective of their own financial position and liquidity position to make supplier payments.

2.2.2 Staff Availability and Systems Access

Staff availability is influenced by those taken ill by Covid-19 and unable to work, self-isolation preventing staff work or staff furloughed not allowed legally to work. This has led to a number of customers experiencing staff shortages and delays in resource available to undertake financial management and therefor a knock on effect to handling payments to suppliers and their own revenue collection to provide liquidity to make payments.

In some instances, staff not able to work from their main business premises are restricted in systems access through systems availability i.e. enablement of full system access for remote workers and/or internet capability to enable connectivity to remote systems whilst working from home.

Ability to contact organisations has in some cases been impacted by the speed and lack of continuity maintained through implementation of social distancing and lockdown resulting in some organisations either closing the business and there being nobody present to communicate with or limited staff remaining who have limited knowledge or authority to deal with their water Retailer or insufficient contact details to enable the water Retailer to contact the customer in their re-convened working environment at home.

2.3 Ofwat Customer Protection Code of Practice

An additional detrimental influencing factor in this area is the modification of the Ofwat Customer Protection Code of Practice which dramatically reduces Retailers ability to chase for debt, charge interest for late payment or initiate disconnection.

With this in place as a Retailer all that remains in place is the ability to remind customers of their obligation to pay whilst measures of enforcement are removed by the regulator Ofwat

effectively rendering the Retailer a “toothless tiger” in relation to the enforcement of debt collection whilst with current liquidity and debt measures in place remaining fully liable for customer debt.

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

The UK business community has faced disruption on a scale not seen previously. The ability to trade normally for the majority of Wholesalers, Retailers and customers in the NHH market has been impacted through social distancing measures imposed by Government which has seen enforced the temporary closure of many businesses.

The initial impact has been for businesses to take short term actions to survive and this is ongoing as organisations confirm and enable Government support measures such as furlough and the impact it has on their cash flow.

We believe that while this will stabilise over the next few months seeing a form of stabilised Covid-19 operating rhythm within the market we also anticipate the potential of further bad debt to enter the market through business failure that as yet will not be quantifiable for consideration by Ofwat when reviewing this consultation paper.

The lockdown/social distancing has now been extended for a further three weeks and a process of unwinding from this is yet to be defined. The unknown nature of addressing the pandemic itself leading to the phased unlocking makes it imperative in our opinion that a mechanism for regular and systematic review of the application of code changes, the timing and their longevity resulting from this consultation should take place on a monthly basis.

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.

Option 2 is the preferred option for dealing with the remaining liquidity gap facing business Retailers in order to provide temporary relief to the market. We believe that it is fundamental that cash flow is maximised in the market for mutual benefits to customers, Retailers and Wholesalers.

In our opinion following consideration of the mechanisms put forward we believe a paid when paid or DSO model as proposed by UKWRC members enables consistency and clarity across the market of mechanism to deal with the liquidity gap.

We believe that this also takes into account that variation of the customer demographics between Retailers which could see variation in the threshold limits each is able to meet. By utilisation of a paid when paid, combined with Retailers incurring interest the mechanism provides a fair and balanced approach of maximising cash flow.

We believe that option 1 is the least desirable option and combined with current Retailer on Retailer restrictions of debt collection has the highest probability of Retailer failure. This is particularly undesirable with the fragility of process to deal with Retailer failure.

5: How should we determine the financing costs associated with any liquidity provided by Wholesalers?

We believe that the cost of financing should be covered but for no financial gain to the Wholesalers. In relation to this for parity in the market between Wholesalers, Retailers and customer we believe that there is a requirement for Ofwat to review the. Restrictions imposed on Retailers preventing interest charges for liquidity they are forced to take through customer non-payment with no ability for recovery.

The requirement for finance due to late payment originates from the customers and is being funded currently through Wholesaler payment deferral. The proposal that Wholesalers are not burdened with the cost is appropriate however unbalanced when the expectation is then for the Retailer to be burdened with the cost and no current mechanism available for recourse to the customers who have defaulted and are the root cause of the requirement for additional liquidity requirement as a result of wider market implications of Covid-19.

In light of the slim margins within the market there is minimal ability for Retailers to absorb increased levels of bad debt in particular if recovery of provisioning the working capital and investment to do so recovery is prohibited through regulation.

In that respect the weighted average cost of capital WACC seems the most appropriate form of charge mechanism, however on if this is transposable by Retailers to customers as described above a principle outlined in communications by both Water UK and UKWRC on behalf of their members to Ofwat, MOSL and Defra.

6: Do you agree that the financing costs associated with any liquidity provided by Wholesalers should be borne by Retailers?

No – we do not believe that this reflects a competitive market environment. There is a disparity in expectation of Wholesalers providing liquidity with ability to recover costs from Retailers whilst Retailers are prohibited through the change in the Customer Code of Protection of chasing debt and controlling debt through disconnection.

Retailers operate in a price capped market that prevents reaction to changing risk exposure. In an un-capped market, Retailers would be able to react to emerging circumstances and apply price changes proportional to the emerging risk or issue experienced in the market all be it typically with a contractual notice period for the change. In doing so customers would pay the additional cost borne through increased costs to maintain supply of goods and/or services. Retailers are prevented from this 'normal' commercial practice because of the capped market.

Operating in a price capped market combined with mandated changes through the customer code of practice vastly increases the exposure of Retailers to customer debt whilst proposed code changes protect the Wholesaler against Retailer debt leaving the Retailer in a position of mandated loss whilst there is no recourse with customers currently for customers who had pre-Covid or Covid-19 related debt.

7: Do you agree that Retailers should receive liquidity support at least to the end of July 2020? And do you agree additional liquidity provided by Wholesalers should be repaid by the end of December 2020?

7.1 Should Retailers receive liquidity support. Until the end of July 2020?

It is our opinion liquidity support should be available until at least the end of July 2020 applied within the proposed code changes on 28th April. Further with the uncertainty of the cessation of lockdown we believe this date should be reviewed and that the period of liquidity support be either the end of July or a minimum of two months following the relaxation of lockdown, whichever is the later.

Our proposal is based on the inference from Government that lockdown when it commences is liable to be phased and will mean that some market sectors return to business operations sooner than others e.g. it is likely that a reverse phasing will be undertaken which would see schools return to operations prior to pubs and restaurants as has also been evidenced in other countries such as Spain and Austria existing similar lockdowns.

This would enable Customers, Retailers and Wholesaler to reintroduce "normal" billing and collection processes along with the recommencement of supporting services such as meter reading and leak detection. This will allow Retailers who are on pre-payment terms with Wholesalers to bill and collect payment within timescales needed to ensure payment by Wholesalers due date.

7.2 Do you agree additional liquidity provided by Wholesalers should be repaid by the end of December 2020?

It is our opinion Retailers are given adequate time to repay any liquidity provided by Wholesalers - given Retailers, through market regulation, have existing low margins, price caps, and the removal of any recourse for Retailers to address bad debt with customers through the modification to the Customer Protection Code of Practice.

The proposed liquidity charges provide incentive to pay and will focus Retailers on repayment within practicable timescale to avoid financial penalties.

With respect to the timescale outlined we acknowledge this however we believe that in any proposed code change a mechanism for a review, initially on a monthly basis, should be included, so that measures are flexed around Government direction provided for the unwinding of lock down, which could be accelerated or deferred for further yet undetermined timescale based upon the control of the spread and treatment of Covid-19 in the UK as a whole. We believe with current public domain information that there is insufficient hard evidence upon which to fix firm dates however recognise the importance of target dates and support these with an appropriate review period and review criteria being implemented in tandem.

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?

We believe Retailers should not incur bad debt costs from non-household customers defaulting and these costs should be recoverable.

Given the extremely low/negligible profit margins Retailers are currently operating under whilst the market matures, we believe it unfair and unrealistic to expect Retailers to shoulder bad debt costs without ability of recovery. It is also difficult to establish which bad debt is due solely to Covid-19 as opposed to pre-existing debt which has been exasperated by Covid-19.

Furthermore, where there are bad debt costs, these should be fully recoverable. At present the ability to recover both bad debt and bad debt costs has been removed from Retailers, leaving them in the position where they will be penalised by interest charges on deferred payment to Wholesalers, but with no facility to recoup these costs from the customers which have caused the need for deferral.

Whilst there is Government support being made available to Retailers, not all qualify, and even where they do, the lack of any incentive to pay available to Retailers means this support will be superficial at best, a stop gap which when removed will result in potentially an even larger problem.

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?

If it is determined bad debt costs from non-household customers defaulting is to be incurred by Retailers, and is deemed recoverable beyond a pre-determined threshold, Smarta Water do not agree with either option tabled.

Both options would unfairly penalise Smarta Water and potentially other Retailers on their business model where, through market segmentation and credit check processes, bad debt realisation has been minimised.

We believe the application of either option presented would create what we believe to be a breach of the level playing field policy and penalise those Retailers who actively manage bad debt beneath a ceiling of 1%.

Where we have chosen to enter into contracts with specific customers based on a number of key points, one of which being credit worthiness, this has enabled us to be price competitive with the larger incumbent Retailers who can afford higher levels of bad debt.

It also means our level of bad debt is low, to force us to accept either 2% or +1% whichever is the greater would put us at a disadvantage. Other Retailers who carry a high level of bad debt would be greatly advantaged by having an additional cost of 1% above bad debt levels whereas with a level of bad debt far less than 1% a Retailer such as we would attract an increase of almost 2% removing competitive advantage gained through good business practice.

We believe the fairest option would be to simply apply the most recently audited level +0.5%, giving the same level playing field to all Retailers, large or small, well established or new to the market, high level of debt or negligible debt.

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?

Given the extremely low/negligible profit margins Retailers are currently operating under whilst the market matures; we believe it unfair and unrealistic to expect Retailers to absorb bad debt beyond a pre-determined threshold level.

While we believe that if the outcome of consultation is for a mechanism sharing debt between Retailers and Customers further data is essential in order to determine any percentage split and determination of a percentage split of debt at this time would be entirely inappropriate.

We refer to our response to question eight of this consultation. We believe Retailers should not incur bad debt costs from non-household customers defaulting and these costs should be recoverable from customers or from review of the market to implement greater market efficiencies enabling reduction in Retailer market operating costs.

We believe a hybrid of these two options is the most realistic to attain through full market collaboration.

As stated in response 1.6 and 1.7 of this document we believe that the Covid-19 situation prompts for a wider review of the market arrangements. The current crisis has illustrated the NHH market's lack of resilience. and that Retailers are particularly vulnerable to cashflow disruption and abnormal levels of customer default.

Hence, we believe that in seeking a solution for bad debt we should not necessarily be constrained by the existing market set-up. We now have an opportunity to review the market arrangements and to consider what needs to change to ensure that it is more robust in the future. This might include measures
to:

- reduce market overheads and the costs of operating in the market;
- address market inefficiencies and reduce the complexities;
- more appropriately align the balance of risk and reward between parties – Wholesaler, Retailer and
- customer – including treatment of and exposure to customer bad debt;
- improve the cashflow, financing and payment term model;
- align and improve performance incentives; and
- improve meter reading arrangements – cost, quality and capacity.

If we can strengthen the market and the balance of risk within it, the options for recovery of bad debt may be greater.

11: Do you do you agree there is a case for protecting Wholesalers from the bad debt exposure associated with the liquidity measures?

We believe that there is merit in providing a level of protection for Wholesalers from bad debt associated with liquidity measures. As it currently stands, we do not believe that the wholesale price control mechanism provides sufficient protection to Wholesalers for Covid-19 related bad debt. As stated in previous responses to this consultation we believe that Covid-19 is an extraordinary circumstance and neither Retailers or Wholesalers levels of debt protection prior to the pandemic are realistic and that increased protection should be in place for both parties.

In reviewing the proposals put forward in the consultation we believe that option 2 is the most appropriate. Whilst providing additional protection which we believe is merited it also maintains an incentive to manage and minimise exposure to the risk of bad debt. Further this does not fully expose the bad debt to customers.

Further consideration needs to be undertaken to the detail of the mechanism however this appears to be the basis of a mechanism that can be applied to the market with greatest consistency which we believe has borne considerable weight in our consideration.