United Utilities response to Ofwat consultation

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

We welcome this opportunity to respond to the potential options Ofwat has set out to address challenges stemming from the impact of Covid-19 on the business retail market. We offer the following observations as supplementary to the response provided by Water UK. Consistent with the approach we have taken throughout this process, our response seeks to identify the best outcome in the long term interests of all stakeholders and a more rounded view than what might be the case if UUW were pursuing narrow or short term interests of itself in isolation.

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

We broadly agree with the objectives set out by Ofwat in its consultation.

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].

<u>Market impacts</u>
It is not yet clear what the true level of Covid-19 related vacancy is as retailers continue to work through the validation of their customer base. This, coupled with the lack of meter read data means that it is not possible to determine at present the following with certainty either a) the number of premises genuinely vacant and thus for which no wholesale charges apply or b) the number of premises which remain open but with reduced consumption.

At present we are seeing an increase in vacancy rates of c30% and consumption reductions of a similar magnitude, but it is not possible to say with certainty that these trends are correctly matched or to assume that the majority of customers whose operations are materially impacted have been marked vacant and thus not be incurring wholesale charges. Of the remaining customers – ie: those who remain in operation and in charge – it is not possible for us to determine what proportion of these may have difficulty in paying their bills.

From a wholesale revenue perspective, for United Utilities, a 30% increase in vacancy between March and August would result in a revenue reduction of c£70m. This doesn't take into account any ongoing revenue impact associated with those businesses that do not re-open after Covid-19. Given that United Utilities accounts for 16% of the non-household SPIDs in the market, the overall market revenue impact could be in excess of £400m.

<u>Use of vacancy flags</u>
The use of the vacancy flag is a potential mechanism for the retailer to avoid both potential liquidity and bad debt issues. It is important the outcome of this consultation provides a transparent and predictable solution which is fair and balanced for retailers to incentivise the appropriate behaviours to maintain the integrity of the market. Absent such a solution Ofwat's actions may inadvertently promote the wrong behaviours and undermine the integrity of the market.

In common with some others, UUW is a company which has adopted the best practice guidance of operating a site area based approach for Surface Water and Highway Drainage charges. As a result, this means that incorrect use of the vacancy flag has a more material impact on revenue recovery patterns because of the scale of the non-volumetric charges which are being waived.

We believe that there has been considerable inconsistency in how the vacancy flag has been applied by different retailers. Given the degree of geographic alignment of retailers, this may lead to distorted outcomes by region as well as highly differentiated outcomes at a customer level. We are particularly concerned that there is the potential for very significant degrees of confusion and misunderstanding on the part of customers which could lead to significant issues when charging recommences, as we expect it eventually will. This – alongside other known difficulties with returning properties marked vacant to charge – poses longer term risks for the long term future efficient functioning of the market.

On this basis, we consider that there is more and urgent work to do in ensuring that the guidance associated with application of the vacancy flag is sufficient and capable of being enforced and also to develop a pragmatic and practicable mechanism to identify and fully correct any errors. We have already made submissions and representations to Ofwat in this regard and given its importance for customers and the market more generally we continue to consider it is important that it is not overlooked.

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 support the position outlined by Water UK in this regard; that is, that retailers should be incentivised to collect and pay as much of the wholesale charge as possible, then look to commercial or government funding to make up any shortfalls and only then rely on short term wholesaler liquidity.

The availability of commercial funding to retailers will be influenced to no small degree by the clarity that is available about the extent to which extraordinary bad debt will be recoverable through – for example – the mechanisms considered in questions 7, 8, 9 and 10. The sooner these mechanisms are established, and the more clearly they are defined, the greater the access that retailers are likely to have to commercial funding.

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.

If Ofwat wishes to incentivise retailers to seek commercial or other sources of liquidity – and to use wholesale liquidity only sparingly – then it should ensure that financing costs are not set at a level which tend to encourage the use of wholesale liquidity as the first option.

We also consider that there is the potential for the need for liquidity in this market to extend well beyond the suggested deadline of December 2020. In such circumstances the default interest rate may be appropriate (BOE +4%) even though this is lower than the nominal wholesale WACC or, perhaps, a stepped approach towards such a rate over time.

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 support the principle that retailers should not benefit from free liquidity provided by wholesalers. If this were to be the case, then as Ofwat notes there would be no incentive for retailers to seek independent sources of funding.

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 fully with the view that liquidity should be provided by wholesalers to retailers only to the extent necessary and for no longer than necessary. That said, we speculate that the timescales set out within the consultation for credit arrangements to return to normal may be overly ambitious.

On this basis we consider that stability and certainty would be enhanced if there were a longer initial period set with the caveat that this could be shortened in future if it were manifestly too long.

An overly ambitious initial deadline of December 2020 could lead to a series of rolling extensions to avoid a series of crises or "crunch points" in future when deadlines approach. We consider that it would be better if all parties had a longer time horizon to plan and execute in a more stable market environment. Reduced uncertainty and anxiety amongst market participants would provide a better environment for market normalisation in due course. In our view, these benefits outweigh any perceived short term prize that might be realised by setting deadlines for the market to return to normality which do not (and at this stage cannot) anticipate the full scale of future events.

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.

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?

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 support the approach that Ofwat sets out in relation to the issues covered by questions 8-10. In particular, we fully support the view that the extent of the impacts of COVID 19 could not have reasonably been foreseen by retailers in their planning scenarios and that extraordinary levels of bad debt should be recovered through a mechanism which shares bad debt between retailers and customers.

Ofwat has access to more information than wholesalers on how retailer liability should be capped, but in our view the justification for a 2% cap – as outlined in the consultation – appear sound. We consider that above this level it would be appropriate for all additional bad debt to be rebalanced across the customer base and believe it is unlikely that a 2% cap is overly generous for the reasons set out below.

We note that setting a cap at 2% is already 1% higher than the reasonable expectation of bad debt in a normal year (ie: twice the typical level of bad debt in 2018/19 and 2019/20) and 0.5% higher than the figures identified by Ofwat for the financial crisis of 2008 (ie: 33% higher than the last major recession.) We speculate that even at this level some retailers may struggle for solvency and therefore fail and on this basis we consider it unlikely that Ofwat could be judged as providing for excessive support.

We also refer back to the point made in our response to Q4. If retailers are going to be able to access commercial lending, they need as a priority a transparent and predictable solution which clearly caps their degree of risk. Otherwise, we consider that commercial lenders are unlikely to extend credit.

We also consider that providing a robust solution to the bad debt issues facing retailers holds the ultimate key to ensuring that – in line with Ofwat aims – the extent of wholesaler liquidity requirements can be reduced promptly.

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 recognise that the wholesale price control mechanism provides protection to wholesalers in the event of retailer failure. This protection has never been more important to wholesalers given that the risks of retailer default have now materially increased due to COVID 19. UUW fully recognises that it is right both in principle and as a matter of the regulatory framework that it should be exposed to retailer failures in a way that is consistent with the market arrangements that were in place before the COVID 19 outbreak. We have never sought to avoid or challenge this responsibility, even though the likelihood of retailer failure now appears materially higher than it was before the COVID 19 pandemic.

We do, however, challenge the suggestion that it could be appropriate for UUW to be exposed to the impact of ex-post changes to the market codes which as a result of a regulatory decision extended - on a compulsory basis – the level of exposure wholesalers had to the crystallisation of a risk at precisely the point at which the risk appeared to be crystallising.

The impact of the code changes introduced on 27 March were to increase – by a factor of approximately 2.5x – the quantum of exposure wholesalers had to retailer failure. It did this at precisely the time that the likelihood of retailer failure was seen to be increasing. We are concerned that as a consequence, investors and observers may conclude that exposing wholesalers to this additional level of risk at precisely the time when the risk appears to be greatest could be characterised as a decision based on expediency rather than being grounded in consistency and transparency. To date, we have not been able to provide a rationale as to why exposing wholesalers to an expanded scope of risk at this particular juncture (when the likelihood of consequential losses is greatest) is well aligned either to the established regulatory framework or the better regulation principles of consistency or transparency.

The fact that the degree of liquidity being provided to retailers as of now is unusual and different to the liquidity previously provided to retailers before the code change is implicitly recognised in Ofwat's approach in relation to Q6 which advocates that retailers should be charged a fee for the provision of such incremental liquidity.

UUW wishes to avoid the situation where there is a significant issue of retailer failures. This is why we are so supportive of the measures that Ofwat is proposing – with wholesaler support – to ensure that the market is stabilised and suitably supported during this unprecedented time. However, in the event that there are retailer failures, we consider that the maximum exposure of wholesalers should be capped at the level that would have consistently and transparently been the case before code changes which have been or will be made to ameliorate the impact of the crisis on other market participants.

As noted above, the impact of code changes to date has been to increase exposure by around 2.5x the previous level. This would indicate that an appropriate cap would be approximately 40% of the current maximum exposure and – for UUW – this has always been and should remain subject to a 50% sharing rate through the totex mechanism.