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

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

We have the following comments on the proposed objectives:

- Objective 2 – We understand and support the current principle to not chase customers who face Covid-19 related difficulties. However, as we highlighted in our consultation response previously, in ceasing all debt escalation, Retailers are faced with increased irrecoverability of pre- March debt, in addition to debt associated with invoices issued from March onwards. This needs to be recognised and included in consideration of the Covid-19 associated debt risk.

- Objective 5 & 6 – We agree this is the aspiration for the market, both in terms of resilience and responsibility to manage risk. However, it needs to be recognised that we are facing unprecedented times with a potentially very deep economic fall-out such that even established retailers would struggle to establish a buffer to this degree. By contrast, our market is immature, with all the key risks sitting with the Retailers, and low commensurate reward. Consequently, due to low Retailer Net Margin there has been no scope for Retailers to build up any buffer or balance sheet strength to support the desired 'resilience' or to manage the downside risks when they crystallise.

We propose that there are additional objectives which should also guide decisions as follows:

- National customers are not finding it easy to understand why there are different regulatory approaches between England/Wales and Scotland, for example, premises can be made temporarily vacant in England but not in Scotland. Different approaches will also be difficult for data reporting by Retailers because Retailer systems do not easily split customers in this way. Therefore, we would like to see that there should be an objective to align approaches between England/Wales and Scotland wherever possible and that the respective regulators and market operators will work together to achieve this.

- We believe that most Retailers may not have the financial capacity to support the unplanned exit of another Retailer at this time through the Supplier of Last Resort (SOLR) mechanism. If a Retailer with a mandatory responsibility to be a SOLR in a wholesale area exits in an unplanned way, it is likely that every other Retailer will opt out of the process and the customers will be left without a Retailer. Furthermore, it is very likely that any customer credit balances would be lost and this element would cause added complexity to the process. This would be a disruptive and costly outcome for customers at a time when they are least able to deal with it. Therefore, it is critical to ensure that all Retailers are in a sustainable position. Otherwise, we will create a knock-on effect whereby the impact of the first Retailer to exit causes the failure of others. Wave has opted out of the SOLR mechanism wherever it can because we are focused on supporting our current customer base and managing the current financing challenges. [redacted]

- For the non-household market to operate effectively, Retailers need to be able to operate with cost-reflective deemed pricing. We currently have a situation where Retailer's deemed prices are capped (which apply to most customers), cash collection activities are severely restricted and potentially there is a restriction on the pass-through of additional bad debt costs. In a truly commercial market, Retailers would be able to recover additional costs through higher prices to customers. In a regulated monopoly, additional costs would be recovered from customers through price controls. We have a hybrid regulated competitive market, but this also requires a solution where the additional costs are borne by customers. We have set out our thinking on how to recover the risk already crystallised in our response to question 10, but we believe that Covid-19 has exposed the fragility in the market and therefore as soon as possible we need an amendment to the price caps in respect of Group 1 and Group 2 customers (as set out in the Retail Exit Code (REC)) to enable the competitive market to operate sustainably. The non-household retail market needs to be resilient enough to deal with managing risk more generally, the current arrangements have not enabled any resilience to be achieved. This will ultimately be in the best interests of non-household customers.

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 current data (which is limited to only 4 weeks), we think that Wave can potentially recover approximately [redacted]% of April's wholesale charges, taking into account the impact of temporary vacant flags. However, we expect this to worsen – see our response to question 3 below. This does not factor in our operating costs of approximately £[redacted] per month (including financing costs) which we need to retain in order to continue running the business and is not available to pay Wholesalers. Furthermore, we are yet to see the full impact of suspending debt escalation activity on our revenue collection. Even if Wave was successful in applying and receiving Government support (see our response to question 4 below), we believe that there remains a liquidity gap that needs to be addressed.

The chart below highlights a [redacted]% reduction in average cash levels, since mid-March.

Note that these figures include Scotland rather than just England, and we will also expect an additional reduction in customer receipts from May onwards [redacted]. No impact from temporary vacants would be expected in the time period outlined above due to the lag in billing. Therefore, the reduction represents a like for like reduction in cash collected.

We are also seeing a significant jump in Direct Debit cancellations, a significant increase in reminder letters being triggered due to non-payment and continued higher contact levels from customers expressing difficulty, we expect cash collection to worsen before reaching any stability. The collection of this arrears will be an exposure regardless of any reduction in ongoing billing.

Regarding the vacancy flags in the system, it should be noted:

- This will prevent any further billing for ongoing consumption for these customers, therefore prevent any further build up in irrecoverable debt. It should however be noted that Wave's billed and unbilled position equates to c.[redacted] days of billing, therefore on average a customer who closes will have [redacted] of charges outstanding.

- We are also working closely with Wholesalers to ensure we are correctly using the Vacant flag, pooling knowledge of customers where appropriate.

Whilst we have applied the principles in CPW091 to make those properties that we believe to have closed temporarily vacant, we suspect that the volume of sites identified so far is still significantly lower than the actual number of business closures This is based on articles suggesting that almost 40% of small businesses will close. https://smallbusiness.co.uk/two-in-five-small-businesses-face-closure-because-of-coronavirus-2550068/ This would indicate that we have not been able to evidence a significant number of business closures, and we will continue to face financial exposure on these sites. We are continuing to contact our customers and make it as easy as possible for them to advise us of their circumstances. We received [redacted] new temporary vacant web form notifications during the last 7 days.

From the calls/responses we have, customers still open for business are typically late paying (or not paying in full) due to:

- Although being open for business, business revenue will be low and therefore businesses are unable to pay their bills.
- De-prioritisation of water/sewerage bills because of the suspension of debt escalation as required by Ofwat's Customer Protection Code of Practice which is on all Retailer websites.
- Practical inability to pay e.g. accounts payable staff not working, systems unavailable outside of the office.
- Actually being closed, but we have not been made aware, despite pro-actively seeking to contact customers and putting information, forms etc on our website.

Our analysis indicates that Wave has seen a [redacted]% increase in the volume of customers in payment arrears since the end of February ([redacted]) and an associated £[redacted] (and rising) increase in the value of debt. Of the accounts that have been updated to temporarily vacant due to Covid-19, [redacted] are in debt with a gross debt of approximately £[redacted].

Furthermore, in the light of current meter reading suspension, this is likely to impact on bill inaccuracy leading to increased levels of customer queries and bill disputes leading to further payment delays.

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

Given the unprecedented circumstances and very limited data, we (nor anyone else) can predict with any certainty how circumstances will change over the coming months. We have no clarity now on how the current lockdown may be released, whether it might be geographical or by sector. Furthermore, not all customers have gone through a bill cycle yet since the crisis began.

Therefore, our best guess is that cash recovery will get worse in May as the current lockdown continues for a longer period along with the suspension of debt escalation activities. Once the lockdown begins to lift and debt escalation activity can begin again, based on our experience we expect a potential lag of 3-6 months before all our debt escalation activities are back up to full efficiency. In addition, our customers' reaction to our debt activity is unlikely to be instantaneous as customers are expected to have little available cash and low business confidence, and we would expect to see many opting for payment plans to pay down any arrears (rather than simply reverting to payment on time), further protracting the recovery for Retailers. There is a significant likelihood that a recession will be triggered as a consequence of Covid-19 which will lead to an increased expectation of insolvencies. Therefore, we expect the situation to get worse before it gets better. There is a significant risk that the levels identified in responses to question 2 are too high if the lockdown continues and/or recession follows.

Wave is prepared to share data with Ofwat to demonstrate the impact on our cash recovery as events progress. We suggest that in order to provide transparency on the level of payments that can be paid each month, Retailers should be willing to report to Ofwat each month providing total customer payments less operating costs and total wholesale charges.

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 that Retailers should take advantage of Government support where this is available. The two forms of support potentially available to Wave as a large business are as follows:

- Covid Corporate Finance Facility (CCFF) – [redacted]
- Coronavirus Large Business Interruption Loan Scheme (CLBILS) – [redacted] We are in discussion with our lenders to ascertain our ability to secure funding via this route, although with the scheme only being launched on 20 April, the details, practicalities and any potential timeline to secure funding are unclear at the point. Unhelpfully, the cost of borrowing under CBILS is more expensive than under the CCFF. [redacted]

The challenge is that the current circumstances are extremely uncertain and therefore a mechanism is needed with maximum flexibility. Pay when Paid mechanisms offer this flexibility. To enable this approach, Retailers should be willing to provide Ofwat with data to evidence their cash receipts and their operating costs along with their wholesale charges. Retailers should be willing to pay their cash receipts less their operating costs to Wholesalers. This provides a transparent approach and will enable the highest possible payments to be made to Wholesalers each month. If Retailers are required to pay all customer receipts available as above, then a minimum requirement is not needed. This will be in the overall best interests of customers because the market will be able to continue.

The problem with having a fixed floor is that it is too inflexible for the conditions we find ourselves in. We assume that the proposed 70% is based on current evidence, as provided by Retailers. But the reality is that no-one knows how this scenario is going to play out and, as set out in our responses to questions 2 and 3, we think that the situation is likely to deteriorate further, before it gets better. If that proves to be true, say because of extended lockdown or the restrictions on cash collection activities, then what happens if a Retailer cannot make the necessary payment? We understand that a Retailer would automatically be in default and the normal default processes would operate. The knock-on of this would be a retailer failure which would likely result in the SOLR mechanism. However, as noted above, the outcome we want to avoid is causing a collapse of the market through additional financial stress being forced onto other Retailers affecting their long term solvency.

We suggest a buffer of 10% is incorporated before a Retailer defaults. This should provide the additional flexibility needed. Continual calibration of Retailer cash receipts through reporting can monitor the levels in line with the percentage set.

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.

We do not agree that wholesalers should be able to charge interest on financing costs for reasons set out in our response to question 6 below. If interest is charged, then Retailers must be able to passthrough the additional costs to customers.

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.

No, whilst we recognise the pressure wholesalers are under and we appreciate that charging interest on financing costs means that Retailers are incentivised to seek financing elsewhere before Wholesalers, charging interest is inconsistent with:

- The inability for Retailers to impose interest on customers, as restricted by the Customer Protection Code of Practice, and
- The Government Coronavirus Business Loans which are interest-free for 12 months.

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 that Retailers should receive liquidity support until at least the end of July 2020. We think there needs to be some flexibility in the approach in order to be able to adapt accordingly. For example, there is not yet any clarity on whether the restrictions on debt recovery and disconnection may be extended beyond 31 May 2020. Politically, we would expect the water industry to want to be seen as supporting the recovery of businesses, and therefore, retailers chasing down debt via disconnection may remain an unacceptable option. If this is the case, recovery of unpaid bills will be slower than the consultation envisages. It should be noted that the disconnection journey from initial communication through to wholesaler disconnection can take in excess of 3 months. We would support a further review in July based on Retailer data reported to Ofwat. This would then help determine whether further liquidity support is needed.

We think that it's highly unlikely that all additional liquidity provided by wholesalers will be able to be repaid by the end of December 2020 and therefore we would like to see some flexibility in the timescale. Its not clear what rationale has been used to identify December 2020 which seems extremely optimistic. Based on our experience of implementing debt processes following the creation of Wave, our evidence indicates that there is a lag between turning debt processes on and seeing the benefit of the cash recovery, and all parties acknowledge that some of the uncollected cash will be 'uncollectable' due to insolvency risk. Although no-one can fully predict the impact, we expect customer confidence to be hit hard, customers to re-prioritise their water bills in the light of the debt collection suspension and cash to be short for some while. Given this level of uncertainty and based on current information and our own experience of cash recovery, we think it is more likely to be at least 12 months (end April 2021) before Wave's cash collection will have stabilised, and even then will be faced with a shortfall due to insolvency. This timescale is supported by the Government business loans which are offering 12 months interest free credit, which suggest that businesses will need support for at least 12 months.

If the evidence demonstrated that Retailers could repay sooner, as supported by the reporting to Ofwat, then Retailers would be expected to do so.

The proposal would benefit from greater clarity on how and when the deferred payments will be paid. We now understand that March and April deferrals will be extended until August 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.

Our view is that some costs should be recoverable beyond a pre-determined threshold for the following reasons:

- Solvency & financial resilience - Permitting all debt cost to remain with Retailers creates a financial distortion in the viability of the sector, as Retailers are not permitted any route to recover any excess debt costs above those allowed in the REC, and the expected costs will significantly exceed those levels. There needs to be a mechanism to recover charges from the end customers. Without this, Retailers will be faced with insolvent balance sheets if they cannot secure any further equity (a potentially commercially unacceptable situation given the low returns in the market). It should also be noted that with any significant portion of debt risk remaining with the Retailers, the balance sheet strength will be diminished even if they remain solvent, leaving them less resilient to any future shocks (in contradiction of the ambition of Objective 5).

- Control & ability to manage the debt risk – with the introduction of the amended Customer Protection Code of Practice, which severely limits the ability of any Retailer to manage their own debt risk, Retailers have been put in a position where they are not able to 'manage risks associated with non-household customers defaulting', as set out in Objective 6. It seems unreasonable and unfair for Retailers to therefore bear all the cost of the expected increase in customer default.

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 agree that the bad debt costs need to be capped for Retailer and we understand the need for consistency and simplicity. However, it seems unreasonable to give all Retailers a blanket protection, as this will increase the value of what needs to be recovered in the future, rather than require the equity holders to bear debt cost in proportion to how each Retailer has historically managed the risk, where some will have been more prudent than others. Any quantification of debt risk must be based on a consistent approach as per normal accounting rules, i.e. the P&L provision for expected losses rather than simply looking at what has 'crystallised' as an insolvent debt. All Retailers will be required to assess their expected losses, and that is the P&L risk that needs to be mitigated.

We propose that the bad debt costs are capped at the most recently audited level +1%.

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 a normal commercial market, Retailers would be able to recover additional costs through higher prices to customers. In a regulated monopoly, additional costs would be recovered from customers through price controls. We have a hybrid regulated competitive market, but this also requires a solution where the additional costs are borne by customers.

We agree that the amount below the recently audited level +1% (or 2% if a blanket approach is used) should be borne by Retailers. Above this level should be considered 'Covid-related'.

We believe the 'Covid-related' excess should be recovered from non-household customers via increased wholesale charges representing a 'Covid-related levy' which are passed through to customers. This approach is consistent for all Retailers and guarantees recovery. If recovery was through increased retail prices following a relaxation of the retail price controls, it would make some Retailers uncompetitive and present new entrants and existing Retailers with an opportunity to under-price regionally, preventing Retailer recovery of the debt. The mechanism of applying the levy via Wholesalers would be designed so that it is treated as a separate charge so that Wholesalers do not pick up additional liquidity liabilities. This levy would also need to cover Retailer's financing costs, especially if it is recovered over a number of years.

The 'Covid-related levy' received by Wholesalers via wholesale charges can then be routed back to the Retailer via a central rebate process governed by Ofwat. We believe this mechanism is simple and fair.

It's not currently clear to us what the potential timescale is for recovery. Whilst we note the need to avoid bill shocks it may not be ideal to wait until April 2021 because the Retailer P&L will have to hold the bad debt exposure until prices can rise to recover. If a mechanism can be agreed and formalised then it may be possible to hold an offsetting asset. Alternatively, a mechanism could be devised so that prices could be allowed to rise sooner.

We would expect any consideration of excess debt for recovery to run from 1 March 2020 for accounting reasons, ensuring support for the increased accounting provision that will be necessary in accounts dated 31 March.

Consideration also needs to be given to the timescales over which any recovery of excess debt can be agreed and secured for Retailers. The full exposure for ‘Covid-related’ bad debt (and the associated required provisions) are unlikely to be known in the accounts to 31 March 2020, therefore may not be finalised until the next set of audited accounts are signed off after this period of uncertainty has ended (potentially September 2021 for Wave). In the interim, Retailers will be carrying significantly higher funding costs, representing a further margin erosion.

Consultation question 11: 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?

As this is primarily relevant to Wholesalers we haven’t responded to this question.