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By email to: covidbusinessretailmarket@ofwat.gov.uk

21 April 2020

Dear Ofwat,

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

Thank you for giving Water Plus the opportunity to respond to the consultation on Covid-19 and the business retail market: Proposals to address liquidity challenges and increases in bad debt.

Our responses to the eleven questions are set out below. We agree with the well-intended principles of the consultation, but have expressed concerns about:

- the timing of repayment of deferred wholesale charges; and
- that the non-household retail prices which have effectively been capped by the Retail Exit Code (following on from PR14 and PR16), never allowed for the significant levels of bad debt that may arise as a result of the Covid-19 lockdown and subsequent period of economic decline. In our opinion, levels of bad debt above a threshold (absolute maximum of 2% of revenue) should be borne wholly by customers. The mechanism to achieve this needs to be determined to ensure: i) there is suitable rigour around the additional costs ultimately recovered from customers; and ii) retailers recover all legitimate costs above the threshold.

We would be more than happy to discuss these points in more detail, so please do not hesitate to contact me or someone from the Legal and Regulation team (contact details below or simply regulation@water-plus.co.uk).

Yours sincerely,

[redacted]

Lewis Gross
Chief Financial Officer
[redacted]

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 first and overarching objective to protect the interests of customers. The continued and effective functioning of the NHHR retail market is imperative to achieving this aim.

We support the principle that retailers should show flexibility with customers unable to pay their bills due to Covid-19, however the restrictions in the Customer Protection Code of Practice ("**CPCoP**") go significantly further than this and prohibit retailers form carrying out any enforcement activity – including ongoing enforcement activity in relation to aged debt not caused by Covid-19, and enforcement activity against customers whose ability to pay may not be adversely affected by Covid-19. There is an inconsistency between objective 2 and 3 in that retailers are expected to continue to collect payments from customers where they are able to pay, but with no enforcement options available as an incentive for these customers to continue to pay. This is likely to undermine retailers' ability to pay the minimum amount of wholesale charges required.

Objective 2 states that retailers should "continue to be prohibited" form carrying out enforcement activity where customers cannot pay on time for reasons related to Covid-19. In the expected event of a recession following the pandemic, customers are likely to be in financial difficulties for a long period following the pandemic, impacting the revenues received by retailers. Objective 4 states that retailers should be incentivised to pay back deferred wholesale charges as soon as possible. It is important that retailers are not required to have to repay deferred wholesale charges until a reasonable time after the restrictions on enforcement activity, which will enable them to collect customer debt, are lifted.

Objectives 5 and 6 refer to retailers managing risks associated with customer defaults and being able to withstand changes in business cycle. Whilst retailers manage bad debt risk associated with customer default in a normal economic environment, the allowed bad debt cost is wholly inadequate to enable retailers to manage risks associated with customer defaults in this unprecedented pandemic situation, and the anticipated recession that will follow. The existing market arrangements therefore need to be amended to deal with the impacts of Covid-19, and risk allocation in the market needs to be carefully reviewed in the longer term.

We agree with the principle that all trading parties (retailers and wholesalers) should act in the best interests of the market and customers, and that bill impacts should be managed so as to avoid shocks where possible. However, it is important to note that retailers simply do not have the resources to be able to fund any additional bad debt arising out of the Covid-19 pandemic, or a resultant recession, under the current cost allowances and market arrangements.

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 have not yet updated the market with temporary vacancy flags as we need to implement a change to our IT systems to be able to do this at scale. We expect this change to be available next month.

Our levels of cash collection have reduced by about 25% since lockdown, suggesting that we should be able to pay up to 75% of wholesale charge amounts, assuming collection levels do not worsen from currently observed levels. Expectations are that the longer lockdown continues, the less we will be able to recover from customers, Latest Office of National Statistics figures show 25% of businesses having closed and a 37% of the remainder reporting themselves as being in significant distress.

Reasons for open businesses late/not paying include they have insufficient cash flow to make payment because of reduced trade, and possibly because of prioritising payments to other suppliers/employees as they are aware their water/wastewater services will not be disconnected and they will not be penalised for late payment, under the changes to the Customer Protection Code of Practice.

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

There is significant uncertainty to any forecasting of likely events in the next two months. We have no clear historical evidence to refer to, to state with high levels of confidence if the existing levels of customer cash payments will continue or decline further, and if (as expected) the latter – at what rate.

If lockdown continues beyond the three-week extension period, we believe we will see an increase in the level of customers not paying. If a partial and gradual release in lockdown occurs, without further problems, then our cash position should start to recover, but we expect decreased levels of customer payments for at least the rest of the year as a recession takes hold.

We will also be in a weaker position as we look to get back to a normal level of customer collections. For example, we have seen a 4000% increase in the number of direct debit cancellations in the three weeks since lockdown versus the average for the previous year. It will take significant time and effort to get these customers to sign new mandates and resume their payments.

As stated already, when we are able to update the market with legitimate temporary vacant flags we will do so.

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 **if** use of the temporary vacancy flag significantly reduced the size of our 'remaining liquidity gap' then option (i) could be preferable, assuming occupied businesses continued to pay on a timely basis, and we were able to obtain Government support (CLBILS). **However**, being able to apply temporary vacant status flags to thousands of properties at the same time was never envisaged by the market, and not a license requirement, and as such we cannot **currently** do this.

Therefore, our preference would be some form of combination of options (ii) and (iii) whereby there is a requirement on retailers to pay the higher of 50% of the wholesale charges (setting a floor), and 90% of their receipts (leaving 10% to finance retailers' operating costs). While the 50% floor is less than Ofawt's 70% minimum expectation, the 70% value assumed retailers can temporarily use the vacant flag in CMOS. The 50% floor percentage could subsequently be revised upwards, when there is more evidence of what percentage of customers continue to pay, but to start off with a higher level now increases the potential risk, within a short timeframe, of retailers either defaulting or having to seek a reduction in the floor percentage.

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.

As wholesalers should not be looking to make a return for shareholders on the liquidity financing, just covering their costs, and with limited credit risk* , the cost of debt set at PR19 would appear to be an appropriate value to determine the financing costs.

*the gap liquidity funding is there to minimise the chance of retailers failing, and also see the protection for wholesalers response to question 11.

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 understand the principle that wholesalers should not be expected to provide additional liquidity to the non-household retail market free of charge. However under the current circumstances, where retailers are unable to charge any interest on customer late payments, or apply late payment fees, which would assist retailers in being able to fund these financing costs, we do not believe that it is appropriate, or affordable, for retailers to fund these financing costs. Very few retailers are operating profitably under the current market arrangements, and with the current restrictions, are not in a position to be able to finance any additional liquidity in the market.

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 at least to the end of July 2020, or longer if this period is extended following a review early in the summer. In relation to the timeline for repayment of this liquidity support, it is important that retailers are given a reasonable amount of time (no less than six months) following the lifting of the current restrictions on debt collection activity in the CPCoP in order to recover as much revenue as possible, before they are obliged to repay all additional liquidity provided by wholesalers

The length of time that the pandemic situation will go on for is uncertain, but the economic impact of the pandemic on non-household customers is likely to go on for a much longer period, which again is unknown at this point in time. This will continue to impact customers' ability to pay bills, and therefore retailers' ability to repay any additional liquidity from wholesalers.

We expect that many non-household customers will become insolvent as a result of the impacts of Covid-19, many of those businesses which are temporarily closed will not re-open and the peak of insolvencies may not be apparent until next year. In addition, retailers' ability to collect charges will also be severely impacted while the restrictions on debt enforcement activity in the CPCoP are in effect. Assuming that Ofwat lift the restrictions in the CPCoP when it believes customers no longer need this protection, It is essential that retailers are given a reasonable amount of time (no less than six months) following the lifting of these restrictions, in order to recover as much revenue as possible, before they are obliged to repay additional liquidity provided by wholesalers.

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.

Retailers should not be expected to incur all bad debt costs from non-household customers defaulting, and all of these costs should be recoverable beyond a pre-determined threshold. Please refer to our answers to questions 9 and 10 below for further detail and explanation.

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?

Whilst we agree in principle that up to a certain threshold, retailers should be expected to manage all bad debt costs, we do not agree that 2% represents an appropriate figure for this cut off. We believe that a figure of 1.5% would be more appropriate, as this is more reflective of the bad debt cost assessed at previous price reviews.

In the consultation document Ofwat implies that retailers should have reasonably anticipated a higher level of bad debt than this 2% figure, however as a result of the pricing restrictions in the Retail Exit Code, retailers had no recourse to act on any such anticipation. Charging and therefore the level of cost and risk passed on to customers has been, and will continue to be, unless direct action is taken, capped at a level that we believe is about 1.5% of turnover.

Expecting retailers to manage all bad debt costs to a point over and above that accounted for in the cost allowance represents a clear and significant margin reduction for retailers, further skewing the risk / reward ratio of the marketplace. There is a very real possibility that the added exposure to bad debt costs, without any mechanism to pass through these costs, could lead to retailer failure.

Whilst we acknowledge that retailers will be required to take some of the burden of Covid-19, as discussed later in question 10 we believe that up to 2% is only an acceptable 'threshold' if it is considered as the retailer's share of the burden in its entirety.

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.

If a threshold is set at 2%, any additional risk or associated cost should be borne wholly by customers. This is because up to this level (anything above 1.5% as discussed in question 9) will already be additional retailers' risk that was not funded within the PR14 and PR16 allowances – and so retailers would have already taken their share of the burden of these unprecedented levels of cost.

As price controls were aimed to set a 2.5% retail net margin amongst the default tariff base, the impact of such a 0.5% increase above allowance would therefore immediately wipe out 20% of the theoretical maximum annual net margin. In reality, the impact of a 0.5% change on retailers is significantly higher than this 20% of margin. Market frictions, costs unaccounted for at PR14 and PR16, and reduced margins due to competition mean that many if not all retailers actually achieve a net margin significantly lower than this 2.5% figure. Any additional bad debt costs would result in most if not all potential 'profits' being wiped out. Whilst we do acknowledge the role retailers will have to play in sharing the burden, we believe that 0.5% (up to 2%) is the absolute maximum, and anything beyond will have to be borne wholly by customers.

Due to the unique nature of the non-household water retail market, or more specifically the regulatory framework for default charging, it is difficult to draw an exact parallel with other industries. That said, it is possible to review how other markets, without certain specific restrictions on Retailers, would react to such a shock. Using Energy as key example, whilst there are price restrictions, these controls are much more flexible than in the water market. As such, there would be more freedom for retailers to put prices up to mitigate bad debt exposure.

We believe that it will also be worth considering how such a shock would have been handled in a pre-market opening scenario, given the mechanisms and precedents that exist for wholesalers who under recover revenues in any particular year, to be able to re-balance in subsequent years and for additionally incurred costs to be shared with customers via the totex arrangements.

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? Whether we agree with the principles.

There is a case for protecting wholesalers from the bad debt exposure associated with the liquidity measures. Current market arrangements already expose wholesalers to retailer default risks. It would seem unfair that wholesalers should pick up further risk, for assisting the industry by financing the liquidity gap. A form of option (iii) should be used to cap wholesaler exposure to that which was in existence for each wholesale/retail relationship under normal market arrangements that existed at the end of February (before Covid-19). Any exposure beyond this level that materialises should be passed onto non-household customers.

This approach should mean that the wholesale price control mechanism provides sufficient protection to wholesalers as there will no incremental Covid-19 related bad debt monetary amount risk (albeit the risk of retailer default may be higher).