

May 2020

## **Questions raised in response to Ofwat's final decision published on 30 April 2020**

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## 1. Capping wholesalers' exposure to bad debt in the event of a retailer failure

Wholesalers are concerned that their exposure has increased materially as a result of the mechanism set out by Ofwat, but are unclear on the degree of increased exposure. To avoid misunderstanding, can Ofwat clarify how the cap on Wholesaler liability for Retailer Bad Debt is calculated? Specifically, we would appreciate **a worked example of how this cap would work at each step of Figure 1 in the Ofwat Decision document, including an example of how existing BAU exposure is calculated, with reference to Retailer Default timeline.**

It would be helpful for this worked example to be based on a **retailer failing in September, one month after the period of deferrals set out in the Code Change ends.**

Our understanding is that the 'outstanding invoices / settlement charges' would include:

- the August invoice;
- **plus** all deferred amounts from April-July (up to a maximum of 40% x for 4 months invoices);
- **plus** deferred amounts from March (treated as a separate pool).

We note that securities and credit protections only cover a proportion of regular monthly invoices, and do not cover **any** deferred amounts.

Further, when calculating the average monthly charge for each retailer, can Ofwat clarify whether this should be the net position of all invoices issued in that month for each retailer i.e. R1, R2, R3, RF and any resettlements and whether this includes credits.

### **Answer:**

Please see our worked example below, which demonstrates that Wholesaler exposure is capped on a per retailer basis at the average of one month's revenue over the 2020/21 period.

**Figure 1: Illustrative example of wholesaler cap in event of bad debt crystallising through retailer failure**

- 1) The average wholesale charge is £10m per month
- 2) Retailer and Wholesaler have long-established contractual arrangements in place including: securities and credit protections of £2m; one month payment cycle
- 3) Retailer defers 40% of wholesale charges between March and July
- 4) Retailer defaults on 1 September 2020

Retail market information		Outstanding payment summary							
		Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Total	
Average monthly wholesale charges	10.0	Invoice value *	9.0	9.0	10.0	11.0	11.0	10.0	60.0
Security and credit protections	2.0	Payments and settlements	5.4	5.4	6.0	6.6	6.6		30.0
Wholesaler Totex sharing factor	50%	Amount deferred	3.6	3.6	4.0	4.4	4.4		20.0
		Invoices / charges outstanding in month	3.6	3.6	4.0	4.4	4.4	10.0	30.0

Wholesaler liability determined as follows:		£m
A	Identify invoices / settlement charges invoiced to Retailer that are outstanding per the Settlement Reconciliation Process	30.0
B	Identify value of securities and credit protections that Retailer has lodged with the wholesaler	2.0
C	Calculate outstanding amount after taking account of securities and credit protections = A - B	28.0
D	Identify actual amount Retailer has deferred under Covid-19 related liquidity arrangements	20.0
E	Calculate wholesaler liability that would apply absent the Covid-19 related liquidity arrangements = C-D	8.0
F	Calculate cap based on one month's total wholesale charge: = average monthly wholesaler charges invoiced to Retailer in 2020/21 ÷ Wholesaler Totex sharing factor	20.0
G	Calculate total wholesaler liability, pre Totex sharing = E + minimum {F,D}	28.0
H	Calculate total wholesaler liability, post Totex sharing = G x Wholesalers Totex sharing factor	14.0

\* For the sake of simplicity, the invoice for April 2020 is assumed to have been invoiced in full (100%). However, we understand that any deferral which was not invoiced in April, is to be invoiced in full by 20 May 2020 and so will not have any material impact on the calculations.

Figure 1 (above) sets out a stylised example of how the cap would work in the event of a retailer failing in September. Please note, the assumptions that we have used are for illustrative purposes.

For the purposes of calculating wholesaler exposure and the cap, we will use the total amount of invoices and credit notes charged in a particular month where liquidity support was granted. Invoice values would be based on the latest settlement runs at the time of the retailer failure. Where subsequent settlement runs for relevant months are made available, in line with Codes, we would expect wholesalers to invoice (or credit) the retailer(s) taking over the customer base of the exited retailer, in line with normal settlement arrangements.

In the worked example, the wholesaler's total exposure, before applying the totex sharing mechanism, will be £28million. The amount to be recovered through the totex sharing mechanism will be recovered in the next AMP in 2025-2030. The wholesaler's total liability (post Totex sharing) will be £14million of bad debt.

The wholesaler cap calculation will use information from the most recent invoices issued to the retailer before it fails to arrive at the values for (A) outstanding invoices and charges and (D) actual deferral amounts.

For the avoidance of doubt, we expect wholesalers to have used all reasonable endeavours to exhaust the securities and credit protections (in B) relating to the failed retailer, and use these to offset any outstanding balance, before wholesaler exposure and protections are calculated. Therefore we expect all wholesalers to provide details of the security they hold with which retailers, including amounts and terms of security. We have also excluded any charges which are unbilled at the point of retailer failure from the wholesaler liability calculation as we have made clear that these would be reconciled under the RFI mechanism and would therefore not be reconciled through the totex sharing mechanisms. More information is provided in response to question 7 below.

Where payments to wholesalers have been deferred we recognise that, if a retailer were to fail, these amounts would not be repaid and so would increase the bad debt charge. This charge will impact the 2020-21 reporting period and so we confirm that the PR19 cost sharing rates would be applied. Only bad debt accounted for in 2019-20 can be calculated using the PR14 cost sharing rates. This is consistent with accounting conventions and our previous approach to the bad debt notified item.

### **Question:**

A further point that we seek clarification on is the impact of Ofwat maintaining differential cost sharing rates between wholesalers. To assist, we have set out below our high-level understanding of how this would operate based on Ofwat's document. Can Ofwat confirm whether this is correct?

Wholesalers continue to be exposed to totex costs (and totex sharing) for retailer failure on the same basis as before the March 27 code change (i.e. amounts invoiced but not paid **or** deferred at the time of retailer failure) PLUS an additional amount for amounts deferred related to COVID-19, determined in line with the process below.

Two scenarios are provided to show the impact of different totex sharing rates.

### **Scenario 1: A Wholesaler has £10m monthly wholesale charges to a Retailer. Cost sharing rate is 50%.**

Cap on additional wholesaler exposure is £10m. The cap is effected as follows:

- Up to £20m of costs are borne by the wholesaler through totex
- A 50% cost sharing rate is then applied
- The net **maximum** additional exposure to the wholesaler is £10m

**Scenario 2: A Wholesaler has £10m monthly wholesale charges to a Retailer. Cost sharing rate is 70%.**

Cap on wholesaler exposure is £10m. The cap is effected as follows:

- Up to £14.3m of costs are borne by the wholesaler through Totex
- A 70% cost sharing rate is then applied
- The net **maximum** additional exposure to the wholesaler is £10m

The impact of the above mechanism is that the maximum additional exposure to the wholesaler (in this example) is capped at £10m regardless of cost sharing rates, but a company with a lower cost sharing rate feels less intense “pain” over a longer tranche of debt and the company with the higher cost sharing rate feels more intense “pain” over a shorter tranche of debt.

Furthermore, if the COVID-19 related deferrals are less than the cap, can Ofwat confirm that as set out below wholesalers will have different exposures to COVID-19 related deferrals depending on their totex sharing factors?

Illustrative comparison of additional wholesaler exposure due to COVID-19 deferrals	Scenario 1	Scenario 2	Delta (1-2)
Monthly revenue (illustrative data)	10	10	–
Totex sharing factor	50%	70%	(20)%
Bad debt cap (= monthly revenue / totex sharing factor)	20	14.3	5.7
Cumulative deferrals at Termination Date (purely illustrative data)	10	10	–
Post-totex sharing impact of deferrals (= Cumulative deferrals x totex sharing factor)	5	7	-2

**Answer:**

The numbers in the illustrative examples you have provided are correct. Where the cap is not reached, there will be no change in the wholesaler’s current sharing arrangements. However, once the cap is reached, customers take on an increased share and the wholesaler’s overall share will reduce as the total liability rises. Please also see answer to Question 2 on the sharing mechanism.

## 2. Use of differential totex cost sharing rates

On page 36, Ofwat state that 'We are not adjusting the PR19 cost sharing rates for any Wholesalers.' No rationale for this is given. Can Ofwat clarify, in light of the differential impacts set out above, and consultation responses that noted that Ofwat would need to demonstrate that this would be appropriate based on the behaviours of wholesalers on this issue and on their ability to control this specific risk, its rationale for this position?

For the avoidance of doubt, we restate that all wholesalers have engaged fully and proactively on this unprecedented industry wide issue, and we strongly believe that there is no justification for a differential approach, particularly at the wholesaler level. There would appear to be no valid rationale for companies with worse sharing rates, based on Ofwat's view of their PR19 business plans, picking up more pain from a risk that was nothing to do with those plans and was unforeseen at the time either of plans being produced or at the time of Final Determinations.

### **Answer:**

While we consulted on the possibility of adopting uniform 50:50 sharing rates to apply, doing so would involve departing from our prevailing approach. PR19 totex sharing rates are designed to incentivise efficient cost revelation within business plans, by holding companies to account for their submissions during a price control period. They are a key tool in addressing the information asymmetry between companies and regulators in assessing efficient costs, and any encroachment on them risks undermining or distorting their incentive properties. Sharing factors are applied on a totex basis in recognition of the interrelationships between different expenditure choices, and to give companies flexibility so they can respond efficiently to challenges which emerge after final determinations.

Several companies agreed with the proposition of adopting a uniform 50:50 sharing rate but none provided a compelling rationale for departing from the existing cost sharing rates in addition to providing an overall cap on sharing exposure, which itself provides definitive protection. In our judgement, the cap is a proportionate response to the risks associated with Covid-19-related retailer liquidity measures and retailer failure, whilst also recognising the importance of maintaining appropriate cost efficiency incentives to the benefit of consumers.

### **3. Multiple retailer failures**

On page 36, Ofwat state that: 'We have set a cap on the additional exposure that each Wholesaler will face as a result of providing liquidity to each Retailer ... we will cap Wholesalers' additional exposure at the £m figure equivalent to the monthly wholesale charge for the relevant retailer. On a Retailer failing, the bad debt the Wholesaler will carry, after the price control sharing factor has been applied, will be capped at the £m figure equivalent to the average monthly wholesaler charge for that Retailer.'

As the cap is for each Wholesaler's exposure to each Retailer, can Ofwat confirm that in the event of more than one Retailer failing, separate and independent caps would apply for each Wholesaler in relation to each Retailer that failed?

#### **Answer:**

Yes we can confirm that there is a separate and independent cap for each retailer.

## 4. Revenue forecasting incentive penalties

Several consultation responses noted that given the exceptional and unforeseeable nature of current circumstances, it would not be appropriate to apply standard penalties associated with the Revenue Forecasting Incentive (RFI) in relation to revenue shortfalls due to the impact of COVID-19. The decision document does not appear to cover this point. For the avoidance of doubt, could Ofwat confirm that in a situation which Ofwat recognises is unprecedented, it will not apply RFI penalties to revenue shortfalls due to the impact of COVID-19?

### **Answer:**

Consistent with Rachel's letter to CEOs on 19 March, we will consider whether any ex post adjustments, including exceptions to RFI penalties, are appropriate in light of the impact of Covid-19 within our normal reconciliation processes. This will require that companies can demonstrate how their operations have been impacted by COVID-19 and how they made their decisions.

## 5. Vacancy flags and payment deferrals

We note that the Next Steps section (page 39) makes explicit reference to monitoring the use of vacancy flags and the retailer collection and payment performance. Can Ofwat clarify:

- How they intend to share this information with Wholesalers, so that they can have confidence that the rules are being followed (noting that Retailers do not need to share their reporting with Wholesalers)?

### **Answer:**

MOSL's guidance on the use of vacancy flags states that it will investigate instances where reads submitted for SPIDS show levels of consumption that may not align with vacant periods. MOSL are also tracking the levels of changes being made to vacancy flags, seeking assurance from retailers of their compliance with code obligations and requesting insight to retailer approaches to gathering evidence on occupancy status. In addition to this work, MOSL are seeking to gain views from wholesalers on their confidence levels in the changes they are seeing.

MOSL is also establishing a MPC sub-group to identify inconsistencies in how these flags are being applied and work towards establishing a common approach across retailers. Where there appear to be issues that warrant further investigation on the use of the vacancy flag, we or MOSL will engage with relevant Trading Parties.

We do not propose to share the information that retailers provide to us and MOSL on collection and payment performance as part of the deferral arrangements with wholesalers as this is commercially confidential. Retailers' Standard Licence Conditions require them to provide Ofwat with accurate information. If we have concerns that retailers are not complying with the requirements of their Licence and the Code, we would investigate that and take enforcement action as appropriate, in line with our published enforcement guidelines.

### **Question:**

What steps Ofwat would take if any infringements were identified, and when these steps would be taken?

### **Answer:**

Consistent with our general approach to enforcement, we would take a targeted and proportionate approach where infringements were identified and evidenced. As we said in our decision document we will take account of any evidence that schemes are being misused or that supporting retailer data is unreliable in deciding whether it is appropriate to extend the liquidity scheme beyond July 2020.

## 6. Applying interest rate for wholesalers providing liquidity support

Can Ofwat clarify when wholesalers should publish their deferral interest rate, as the legal text appears to be contradictory, or impossible to comply with for the initial period?

Section 29.5.2 of the Business Terms states ‘...The Contracting Wholesaler shall notify the Contracting Retailers of the relevant Deferral Interest Rate no later than the 30th Day of the Month preceding the introduction of the new Deferral Interest Rate which then shall apply from that date.’

As the Code change was implemented on 1 May, the 30th day of the preceding month has already passed, making it impossible for Wholesalers to meet this requirement for the initial period.

Section 29.5.2 of the Business Terms goes on to state ‘...Each Contracting Wholesaler must notify all relevant Contracting Retailers of the initial Deferral Interest Rate that they will be charging, at the point when, pursuant to Section 9.2.1, the Contracting Retailer selects to utilise the provisions of Section 29 (“Payment Deferral – Medium Term Measures”). This initial Deferral Interest Rate shall then be applied to all Deferral Interest Amounts from the commencement of the Payment Deferral Period.’

Could Ofwat please clarify that this means that the initial requirement is that Wholesalers should inform each Retailer of the initial Deferral Interest Rate only at the point the Retailer first selects to use the deferral facility, without a requirement on the Wholesaler to publish this rate, and the requirement to publish a Deferral Interest Rate by the 30th day of the month only applies to any changes to that initial Deferral Interest Rate.

### **Answer:**

As stated in section 29.5.2, Wholesalers must notify their initial Deferral Interest Rate to Retailers at the point that the Retailer chooses to opt into the scheme. If Wholesalers decide to change that Deferral Interest Rate, they must notify the Retailer no later than 30th of the month. While it may be prudent for Wholesalers to notify Retailers of this on an ongoing basis, there is no requirement under the Code for them to do so.

## 7. Use of revenue forecasting incentive

On page 34 Ofwat state that 'Water that has been used but not invoiced for at the point of Retailer failure would still be reconciled as part of the revenue forecasting incentive (RFI) charges'.

The implication of this is that Ofwat seem to be suggesting that water used but not invoiced is not treated as revenue in the regulatory accounts. This would not be consistent with the revenue recognition guidance as set out in RAG3. Our understanding is that for this to work Ofwat would need to adjust RAG3 to allow the IFRS treatment of revenue to be used in these circumstances.

Can Ofwat clarify whether this is also Ofwat's understanding, and if so, that the RAGs will be amended?

### **Answer:**

We do not intend to make changes to RAG3. However we recognise that there will be amounts that wholesalers will be unable to bill (up to approximately 45 days' worth of consumption should a retailer fail). Normal accounting convention would mean that if a company is unable to raise an invoice then the amount could not be recognised as bad debt. We recognise that the RAGs do not directly address this scenario – they operate on the premise that invoices are eventually raised for all services provided to customers.

We would expect companies to provide a commentary on setting out the value of un-invoiced amounts due to a retailer failure as part of the RAG3 disclosure requirement linked to APR table 2I. We would then allow companies, subject to supporting evidence, to make an adjustment relating to this amount within the RFI model as part of the reconciliation process. This would require an amendment to the Reconciliation Rule Book on which we would need to consult.

Note that, for the avoidance of doubt, we expect wholesalers to invoice retailers in a timely manner and in accordance with the standard settlement timetable and that where relevant, wholesalers would fully exhaust securities and credit protections (as set out under item 'B' in answer to question 1) using all reasonable endeavours, and used to offset any outstanding balances due from retailers, before wholesaler exposure and protections are calculated, and any monies recouped via the RFI mechanism.

For the avoidance of doubt, for 2020-25, bio-resources wholesale charges will be reconciled through the bio-resources reconciliation model. Therefore, in the event of a retailer default, any bio-resources wholesale charges that the wholesaler has not billed the retailer for will be reconciled via the bio-resources reconciliation model using the same principles as outlined in the general RFI policy.

## **8. Repayment of liquidity**

We note that on page 25, Ofwat state that 'We will review and consult on next steps early in the summer' in relation to liquidity support provided by Wholesalers to Retailers. On page 26, Ofwat state that 'we have concluded that all deferred wholesale charges should be paid back in full by the end of March 2021'.

Could Ofwat confirm that the date of March 2021 is firm, and would not be amended by the review early in the summer or subsequently?

### **Answer:**

As set out in our decision document, liquidity provided to the business retail market to the end of July 2020 should be paid back in full by end March 2021.

Our review in the summer will not seek to amend this date for liquidity provided up to the end of July.

## 9. Retailer bad debt

If a Retailer bad debt rises above 2%, does it recover the extra just from its own NHH customers, or from all customers in the market?

### **Answer:**

We have not set out the mechanism, sharing parameters or time scale for the recovery of bad debt costs in excess of the 2% threshold (or where relevant, historic bad debt + up to 1% threshold) set out in our Decision document.

We have in mind two broad options for such recovery; either via revisions to the Retail Exit Code (REC) price caps, or through revision to wholesale charges, with some form of pass through to retailers. Note we have not ruled out consideration of other options. Concerning any revision to wholesale charges, we are clear that this should apply to business (non-household) customers only. We have not yet reached any further decisions on the base of non-household customers over which any recovery might be appropriate.

We would look to set out and explore the relative merits of options in the context of the prevailing circumstances and evidence available to us over the summer.

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is a non-ministerial government department.  
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