

Covid-19 and the business retail market – consultation on next steps

Response of Castle Water Limited

Notes: This response follows the order of the questions in the consultation document.

The answers to the questions in Appendix 1 to the consultation document are in a separate Appendix 1 to this document, and the associated spreadsheet. These are both **CONFIDENTIAL**.

Consultation question 1: Of the three options identified in relation to extending liquidity support, which option do you support and why? Please explain your answer and provide supporting evidence wherever appropriate. Which option is most compatible with furthering customers' interests and why?

The choice of options only affects Castle Water's competitors. Given the outcome will affect competitive conditions it would be inappropriate for Castle Water to support one or other option.

Consultation question 2: If we were to implement option 2, should we retain the existing capped amount of liquidity support (i.e. 40% of primary charges from March to July), or should this be reduced to a lower level (e.g. 30%, or 25%)? Please explain your answer and provide supporting evidence wherever appropriate.

See answer to Question 1 above.

Consultation question 3: If we were to implement option 2, should we continue to allow Retailers to opt into the scheme at any time up until October 2020? We also welcome stakeholder views on the most appropriate way a cap could be implemented into the current mechanism. Please explain your answer and provide supporting evidence wherever appropriate.

As opt-in at any time during the deferral period is the *status quo ante*, there seems no reason to exclude it in the event that Ofwat were to decide upon any further deferral arrangement.

Consultation question 4: Of the three options identified in relation to unwinding liquidity support, which option do you support and why? Please explain your answer and provide supporting evidence wherever appropriate. Which option is most compatible with furthering customers' interests and why?

See answer to Question 1 above.

Consultation question 5: Under option 3 do you agree that 33% of deferred wholesale charges should be repaid by end November 2020 and that 66% should be repaid by end January 2021? Please explain your answer and provide supporting evidence wherever appropriate.

See answer to Question 1 above.

Consultation question 6: Do you agree that the option for Retailers to use the temporary vacancy flag should be allowed to expire on 31 July 2020? Please explain your answer and provide supporting evidence wherever appropriate.

We have consistently advocated an approach to the transition out of the Covid-19 temporary vacancy arrangements that is pragmatic and capable of being flexed to deal with the inevitable high level of uncertainty over:

- The rate of transition, and the type and degree of ‘normality’ that returns - the current signs are that the transition will be gradual and the old normality will not return in full; and
- The continuously evolving analysis of the future course of the pandemic, the risk of national or local increases in infection, and the nature of the Government’s response(s), including how NHH customers are required to respond to local lockdowns.

Against that background it seems to us injudicious to remove, rather than suspend, the temporary vacancy arrangements, and to keep available no measures to deal with these very plausible developments.

In particular, although retailers have until end-September to regularise the temporary vacancy markings up to end-July, the assumption that customers as a whole will be able to pay bills effective from 1 August (as we understand may be the intention) is unrealistic:

- Many customers may well remain in, or return to, lockdown;
- Many no longer required to close are still deciding never to reopen.
- Evidence from the Scottish market, where requirements to pay remain in place for some customers, is that many customers simply refuse to pay water charges.

These customers’ premises cannot reasonably all be described as ‘Occupied with reduced consumption’ and many would object to our working on that assumption. Further:

- A great many remain on restricted trading, staffing and permitted customer numbers in order to observe Covid-safe conditions; and
- The economic and safety impact on personal movement and spending is unknown.

In addition, the approach to returning all premises to Occupied with a meter read or an ‘accurate’ YVE based on customer engagement on the timescale proposed is based on unrealistic assumptions about:

- The presence, availability and ability of customers to engage. During the initial period of the lockdown, we found it was not possible to contact c. 40% of our customers, despite using all normal contact channels. We are now receiving updates from customers, many of whom are confirming that they vacated their premises while informing us of their anticipated date of reopening. Nonetheless, the precise status of many other customers will for some time remain uncertain in terms of whether they are open for business; on reduced income, activity or consumption; insolvent; or otherwise permanently closed; and

- The capacity of the industry to carry out meter reading and customer contact operations with all customers in short order. It is simply unrealistic to assume that industry participants are resourced to carry out in two months the levels of activity normally required of them in a year, even were that possible given the constraint just mentioned.

Collaboration between retailers and wholesalers alone, however strong, will not compensate for these factors. It should also be borne in mind that, while Ofwat's and MOSL's monitoring activity assumes that retailers have had an incentive to apply temporary vacancy flags 'incorrectly' (in fact retailers have an incentive to return sites to Occupied, as absent being able to invoice customers retailers have no source of income), wholesalers also have an incentive to see premises returned to Occupied on flimsy or incorrect evidence. We have documented some of these in the context of the vacancy audit carried out by [REDACTED]

It is therefore wrong to assume that wholesaler evidence is invariably better than that of retailers, who i) benefit from direct contact with more customers, and ii) in our case have local teams visiting customers. This merely underlines, however, that collaboration will not obviate the need for cross-checks to mitigate the effects of using unsatisfactory evidence.

In those circumstances we consider that a further 'breathing space' is needed to bridge the period between end-July and the point at which we can establish more precisely the status of customers who at end-September appear to remain, or likely to remain, Covid-affected - albeit not necessarily vacant. This need do nothing to take away from the urgency with which all parties should co-operate to establish reliable data on occupancy and consumption.

Ofwat also proposes to publish 'league tables' of the proportion of temporary vacancies that are switched to vacant by each retailer. This is a superficial measure. Given the express statement that this is to be undertaken with a view to taking action where higher proportions are found, we suggest that deeper analysis of the reasons would be necessary to justify such action.

There are two further points that are germane to our future work on vacancy:

- First, if reliance is to be placed additionally or wholly on the pre-existing Code provisions on vacancy, we would require clarity on the application of the current Section 3.1.5 of CSD0104 which provides that "A property that is prohibited by law from being occupied, for example an unsafe property, is also considered to be a Vacant Premises."

We are of the view that this provision would apply where, for example, a pronouncement is made such as that of 16 March, where the Government ordered certain premises to close, underpinned by legislation. We have put this point to Ofwat previously. Clarity here would be useful in the event of further local or more widespread lockdowns.

- Second, if there is evidence that a premises is unoccupied, we take the view that under section 144 the Water Industry Act 1991 no charges (wholesale or retail) may be levied as only the occupier can be liable to pay them. The Codes cannot override the operation of primary legislation. Confirmation of this point would also be helpful.

Consultation question 7: Do you agree that in the event of (1): reduced consumption, and/or (2) any local lockdowns, Retailers should seek to obtain meter reads to reflect actual consumption in the market (or in the event a meter read cannot be obtained engage with customers to obtain an accurate estimate of consumption (YVE))? Please explain your answer and provide supporting evidence wherever appropriate. If you do not agree, please set out an alternative proposal.

We agree that in normal circumstances a meter read, whether by a trading party or customer, is the best available indicator of consumption. We also agree that, in the absence of a read, other forms of customer engagement are a reasonable substitute.

As above, in current circumstances it is, however, unrealistic to assume that it will always be possible to engage with a customer - especially a smaller one or sole trader - because they are indisposed, do not respond for financial reasons, or have simply gone away. Resources are better devoted in the early stages of transition to regularising the position of those who respond more readily (and are therefore more likely to be able to pay) than repeatedly chasing those who are unwilling or unable to respond.

We are not suggesting giving up on this last customer group but, given that we cannot definitively classify their premises as closed, open or on reduced consumption, we would propose a new temporary vacancy flag 'Uncontactable, presumed Covid-19 vacant'.

Consultation question 8: Do you agree that following the expiration of the temporary vacancy flag Retailers will have until the end of September to remove these flags from CMOS? Please explain your answer and provide supporting evidence wherever appropriate.

Large segments of the business customer base are under severe financial stress and are likely to remain so for some time.

It is clear that, following the sharpest fall in GDP for 300 years, where hard evidence of the true economic impact remains negligible and there is no comparator on which to base a judgment, it would be prudent to assume that business conditions will take many months – if not years – to return to anything like pre-existing conditions. See further the evidence for this in our answers to Appendix 1.

For the reasons given, we consider that for customers for whom no meter reading is possible in the time available, or at all, and with whom no engagement has proven possible, the alternative temporary vacancy flag suggested above should be adopted for a further two month period.

In current circumstances, however, it must remain for Government and regulators to decide, as a matter of public policy, how to balance the priorities they attach to funding the water industry by attempting an early return to normal billing and payment patterns and the further financial distress that this will inevitably cause for a considerable number of customers.

Consultation question 9: Do you agree that a new MPS should be introduced from 1 October that focusses on the timely removal of all temporary vacancy flags? If so, what are your views about how this standard should be designed? Please explain your answer and provide supporting evidence wherever appropriate.

Retailers have the strongest possible incentive to returning to more accurate consumption data and to invoice and bill customers accordingly. We have previously pointed out to Ofwat that the deferral

and interest arrangements, and excessive credit support requirements, make it penal for a retailer to seek to delay a return to that situation.

Since the institution of the temporary vacancy arrangements there has been an increasing emphasis on retailers using them 'correctly'. This seems predicated on retailers having an incentive to treat them as a free ride, and needing to be punished accordingly.

Given the challenges and uncertainties that attach to implementing Ofwat's latest proposals, we consider that it is premature to decide now that a new MPS standard is either necessary or desirable.

Alternatively, if an MPS were to be considered further, it should be matched by an equivalent penalty regime for wholesalers whose activities in relation to data accuracy and submission, meter reading bilateral requests are outside SLA parameters. This would make the imposition of an MPS on retailers fairer, more proportionate and less discriminatory.

Customers frequently complain and withhold payment if there is an outstanding bilateral relating to chargeable data in CMOS (for example, incorrectly recorded meter numbers). Bilaterals are covered by SLAs in the Codes, which are not always adhered to by Wholesalers. It would be helpful to have clear guidance on the status of the SLAs – as to whether they are an optional guide, or intended to be a contractual obligation.

Consultation question 10 : Do you agree that an additional MPS (or alternatively an API) should be introduced to monitor the use of YVEs in the market and incentivise the submission of more accurate consumption data? Please explain your answer and provide supporting evidence wherever appropriate.

See answer to Question 10 above.

We would aim to replace YVEs rapidly with accurate meter readings, and we are working with meter reading contractors as well as continuing to install AMR. However, there are some cases where it is not possible either i) to take a meter reading, or ii) to use the reading in CMOS (for example, if there is a broken meter, or if the customer has challenged the accuracy of the supply arrangements).

We believe it unreasonable to penalise a retailer where taking a meter reading is clearly not possible and the retailer has made appropriate attempts to obtain one. It would be fair and reasonable for penalties not to apply where either i) a retailer has requested a Wholesaler to take a meter reading through a contracted meter reading service and the Wholesaler has not done so; or ii) there is an outstanding bilateral relating to that supply (B,C or G bilateral).

Alternatively, penalties charged to a retailer under these circumstances should be permitted to be netted from the charges due to such Wholesaler under Section 9.7.2 of the Business Terms.

Consultation question 11 : If we were to introduce a financial incentive on YVEs, how could arbitrarily low YVEs entered into CMOS be identified in a proportionate way (for example via one or more simple rules)? If we were to introduce a reputational incentive on the use of YVEs, how could such a reputational incentive be strengthened?

The assumption that YVEs are being used to an extent 'arbitrarily' implies that retailers are deliberately misusing the YVE methodology. We would make the following points:

- These estimates are just that: as currently deployed, they rely for their relative accuracy on the judgments applied to them by retailers, backed where possible by customer engagement or other evidence. It would be iniquitous retrospectively to hold retailers to account financially for the accuracy of their estimates.
- The purpose of using of YVEs to reflect reduced consumption during the Covid-19 period is to protect customers, so far as possible, from the threat and worry of excessive bills. We believe that, even if it is found in hindsight that some YVEs not as accurate as they could be, they will resemble actual consumption more accurately than if they had been unamended.
- As with the unwinding of the temporary vacancy flags, it is premature to form judgments on whether and how to react to any 'arbitrary' use of YVEs. We also await the result of the [REDACTED] audit on this.

Consultation question 12 What are your views on how we can better (financially or reputationally) incentivise Wholesalers to work constructively with Retailers during the unwinding of the temporary vacancy flag and to improve the accuracy of data in CMOS?

We would propose that:

- MOSL and Ofwat should express their willingness to penalise wholesalers.
- Wholesaler evidence on reoccupation should be audited by the market auditor, to the same criteria and standard used for auditing retailers, as to the robustness and reliability of their processes for gathering, assessing and recording evidence.
- The results should be reported to the market, customers and more generally and to the same extent that the retailer audit receives such attention.
- If financial penalties were to be applied to retailers they should be applied equally to wholesalers to incentivise proper collaboration. Our experience is that in a number of instances 'evidence' has been used to apply pressure on us to accept re-occupancy when on analysis it has been proven to be flimsy, partial or misleading. This wastes time that could be better spent on proper assessments of customer circumstances.

Consultation question 13: Do you agree with the expectations set out above, which will guide trading parties through the unwinding of the temporary vacancy flag?

These expectations are reasonable, *provided* they are reasonably applied recognising the constraints as to timing and practicability rehearsed above.

Consultation question 14: Should Market Performance charges come back into effect from end September 2020 or end October 2020? Please explain your answer and provide supporting evidence wherever appropriate.

As we have made known on a number of occasions, we consider the MPF to be a deeply flawed framework for assessing relative retailer performance, both in itself and in relation to the (non-) enforcement of SLAs on wholesalers.

We have also expressed above our view that the transition out of Covid-19 will be much slower and more gradual than Ofwat appear to believe.

In the light of those views we favour turning MPF charges back on no earlier than October (though we consider this also to be too early). The early indications are that wholesalers are adopting a cautious approach to ramping meter reading activities back up and that it will be several months before they approach near normal levels.

We would therefore endorse OPS charges being turned back on before MPS, and non-meter reading focused standards being turned on first.

Consultation question 15: Should OPS charges be introduced before MPS charges? Please explain your answer and provide supporting evidence wherever appropriate.

Yes. See answer to Question 14 above.

Consultation question 16: Should non meter reading MPF charges come into effect before meter reading MPF charges? Please explain your answer and provide supporting evidence wherever appropriate.

Yes. See answer to Question 14 above.

Consultation question 17: Note – responses to this question will be shared with MOSL. Of the 3 options identified in relation to credit security requirements, which option do you support and why? Please explain your answer and provide supporting evidence wherever appropriate. Which option is most compatible with furthering customers interests and why?

Castle Water strongly supports Option 1, i.e. an early return to calculating credit support requirements (CSRs) on the basis of primary charges in any given month as provided for in the Codes prior to the adoption of CPW095. Ofwat states that it approved this Code change:

“to mitigate risk to Wholesalers arising from a potential reduction in the level of credit support through Retailers’ applying the vacant flag, and to protect Retailers from encountering a cliff face in the provision of credit support when vacant flags are switched off and consumption begins to rise.”

Ofwat has ruled out this option, notwithstanding its recognition that;

“economic recovery could take some time. This could lead to capital being tied up in the market unnecessarily if credit support levels remain at pre-Covid levels.”

This contradicts both the statement cited immediately before, and the rationale for asserting that it is prudent that the level of credit support is maintained at the March 2020 level to avoid retailers being:

“required to find additional credit support at incredibly short notice to reflect increased consumption as temporary vacant flags are switch off.” [Emphasis added]

As set out above, and in answer to the MOSL consultation questions in Appendix 1, we agree that economic recovery will take a considerable time and will not achieve pre-Covid levels for years rather than months, if at all. For this reason the balance of risk does not lie in having to find significant additional credit support at *“incredibly short notice”*.

We have explained to Ofwat and MOSL on several occasions why the maintenance of March 2020 CSRs is unwarranted and counter-productive to the health of the market. This is explained in more detail in answer to MOSL's questions in Appendix 1. To recap briefly, they:

- Require retailers to commit more cash to pay wholesale charges in full than deferring.
- Perpetuate charges based on an assumption of pre-Covid levels of business activity.
- Materially increase the risk of a systemic failure of the NHH market.

Following a 20% reduction in GDP, artificially mandating a level of credit support for a volume of wholesale charges which is not reflective of current consumption effectively ignores the consumption lost due to COVID-19 and thus fails to recognise changes in the market. There needs to be some consistency between the level of credit security and ongoing consumption levels.

- Failure to acknowledge that a fall in GDP and a reduction in economic activity will result in a reduction in NHH water consumption flies in the face of reason. Failing to reflect changed economic circumstances by imposing costs above those relevant to current economic circumstances goes against the principles of efficiency and cost-effectiveness.
- There has been a displacement of economic activity from NHH premises to households, as a result of a massive increase in homeworking.¹ Indicators of broad economic activity (such as GDP) therefore currently understate the level of economic activity currently undertaken at NHH premises.
- For independent retailers, given they have an overall limit on facilities, credit security is equivalent to cash that could be used elsewhere to the benefit of customers as well as for payments to wholesalers.
- It is implausible to assume that the only feasible follow-up to temporary closure will be reopening, because by no means all businesses will be able to open promptly or, in many cases, at all. A gradual transition is overwhelmingly more likely than a step change.
- It is against the consumer interest to maintain excessive CSRs, as systemically increased costs of working capital for retailers increase costs to customers.
- As small retailers have lower systemic costs of provision of credit security, maintaining high levels of credit security results in differential costs for retailers in different wholesale areas. This will distort competition, contrary to Section 1.5.6 of the Objectives, Principles and Definitions.

¹ Wholesalers have reported a significant rise in household consumption. A sidelight on the prospects for revenue collection from the bank analysis referred to in the answer to Appendix Question A2 is that some £50bn of incremental consumer deposits have been recorded over the period since lockdown i.e. some households have saved more in lockdown.

Consultation question 18: Do you agree that the CPCoP does not require amendment in light of the proposals set out in this document? Please explain your answer and provide supporting evidence wherever appropriate.

If temporary vacancy flags are to expire at end-July and, as a result, charges are to apply in full to customers from 1 August irrespective of when the flag is removed and / or in the absence of clear evidence on the status of the customer's premises and consumption, it is incumbent on Ofwat to explain this fully to customers and reflect it expressly in the CPCoP.

**Castle Water Limited
16 July 2020**