JANUARY 2021 COVID-19 CFI

SUMMARY

Thank you for the opportunity to respond and to help to identify solutions in the long-term interest of all customers and the market.

It is interesting to see how thinking on this subject has developed. There has been strong coordination and cooperation between Retailers, Wholesalers and Regulators for the good of customers. This needs to be taken forward beyond this epidemic to help secure an effective NHH market that serves all customers effectively and efficiently.

PWS supports this consultation and commends the creativity in the range of options explored to support Retailers in the future. Swift response and roll out remains essential to alleviate the short term cashflow liquidity pressures that are current and remain forefront of Retailers managements attentions.

This issue is of the utmost importance to us. In our 2020 financial statements the cost of COVID-19 bad debt is £5m in accounting provision plus a further £0.4m in additional costs or lost revenues. To put this in perspective our underlying operating profit was £1.0m: it will take us 5 years of normal business to recover from the effects of the first assessment alone.

In responding to the consultation, we have tried to identify the framework of solutions for OFWAT to consider and our key opinions on these proposals are:

- A 2% bad debt cap exceeds our own experience and we prefer a mechanism that fairly rewards a good retailer.
- A more expansive tariffs scheme should be introduced, which protects good customers and gives more flexibility to Retailers to charge bad payers. Immediate payment on switching is also required.
- A method of bad debt recovery must be consistently fair to customers and not too onerous whilst maintaining a level playing field for all Retailers.
- Timely conclusion to the consultation and interim measures to alleviate short term difficulties are vital.
- The REC recovery method combined with an enhanced by a “Poor Payer Tariff” will most swiftly help PWS recover from the challenges of COVID-19.
- The Wholesale recovery mechanism is attractive, however, we consider the wholesalers will be reluctant to support such an initiative and the mechanics too slow to implement to effectively aid the market.

We trust you will find our responses to the CFI interesting, constructive and positively challenging. At PWS we want to ensure that all customers are protected including those that pay their bills even in challenging times. Therefore, we promote protection for those willing to pay from unnecessary cross subsidization.

Consultation Question 1: Our initial view is that we consider it is relevant to measure customer bad debt costs that may arise for Retailers solely in terms of amounts due from customers that are appropriately provided for or written off. To what extent do you agree with our initial view here?

Noting three cost components considered in section 2.1 relating total bad debt cost we share the following feedback:

a) We agree that accounting provision capturing the expectation that payment may not be received to be the greatest cost in relation to bad debt and the simplest to comprehend.

b) The exclusion of additional working capital while awaiting cash receipt is an omission. The two subsequent issues arise:

- A very large proportion of water retail customers are already poor payers (note the AR days of the 2020 published accounts for Retailers who have already filed) and, whilst we have had some success in reducing overdue debt, this remains our biggest business problem. COVID-19 has amplified this effect, more so than causing good payers not to pay. The opportunity cost of delays in receiving cash leads, as a direct consequence, to delayed future investment in the business. This stifles innovation and impedes improvements to customer experience.
- The true cost of bad debt should also include the hidden cost of delayed payments. Relevant examples include, PWS was charged a higher year end audit fee by Ernst & Young relating to our statutory audits and the cost was directly attributed to the additional audit resource to review our ledger, risk assumptions and bad debt provisions. Further, the time and cost allocation of time of senior Finance and other managerial resource has increased, to ensure sufficient review of auditable information. The estimated additional cost is £0.05m.

c) The time spent pursuing outstanding accounts: there are two elements we believe the regulator is overlooking:

- There are inefficiencies in chasing the same account balances and duplicating effort. However, there is also the additional cost relating to insolvency and insolvency management. Over the course of 2020 PWS have invested in an insolvency team and credit analysis software. This is a new cost, £0.15m is excluded from our allowed cost to serve. We believe this investment is essential to minimise our losses.

- Our existing debt collection process includes a visit fee charging mechanism whereby we visit customers in person and charge the additional account management time. The financial benefits and effectiveness of this team have eroded during 2020 and therefore are an additional cost of debt collection linked with COVID-19. We estimate lost revenue of £0.2m this year.

In summary we estimate that our true bad debt cost excluded from the Regulators allowed total bad debt assumption is c £400k over the accounting provisions booked to date.

Consultation Question 2: - To what extent do you consider that bad debt costs may have differed by geographic region and/or by customer type?

a) We look at Ageing profile, business type and payment experience routinely, prioritising 'Previous Occupier' debt (businesses that have left the premises). We take the most prudent approach on these customers because recovery rates are much lower. PWS has a provision coverage of 94% in this sector across all overdue aged debt. A similar approach is applied to the 'Market Moved' sector, with an 88% provision coverage. This data is reflected on the 'Debtor Provisions Supplement' tab of the RFI. Our experience is that the hospitality industry has highest proportion of past due invoices with 35% of Year end debt is still unpaid.

[redacted]

c) Additionally, with the regulatory controls in place through the CPCoP, we have also experienced an increase in late payment from industries that have experienced a lesser impact of COVID-19. Industries such as Agriculture historically pay on final demand and on disconnection threat. With the revised codes these are also acting as an impediment to successful cash collections.

Consultation Question 3: What is your view on the best approach to measure bad debt costs arising, in ways that are objective, consistent and verifiable?

a) The calculation of statutory or non-statutory bad debt costs is not particularly onerous, so we do not have an initial strong view. However, in reviewing the CFI in detail combined with some of the settlement mechanisms and particularly the wholesaler settlement we could support a non-statutory account basis in conjunction with the wholesaler settlement method should be explored by the Regulator as a recovery mechanism.

b) PWS would be happy to prepare periodic analysis of either bad debt measurement method. The Regulator should understand that the statutory basis would be on an expected credit loss basis to mirror our management accounts and audited statutory accounts (subject to continuation of current IFRS bad debt rules). Noting that the IFRS policy requires us to recognise some of the potential bad debt provision in advance. However, PWS would not support a Regulator proposal where PWS booked a regular bad debt charge based on the non-statutory accounting basis because of the potential for fluctuating profits.

c) For the Non-Statutory accounts method and given the extended timetable proposed in 3.3 – focus on invoices > 12 months (rather than 6 months) might avoid fluctuations and reduce the need for the true-up mechanism. This also reflects our view of the longer-term impact COVID-19 is having on the market.

d) Invoice timing – we note the working assumption that COVID-19 consumption risk commenced in January 2020. With our invoicing cycles mixed between unmeasured in advance and measured bills invoice frequency ranging between 1 months and 6 months in arrears – to develop reporting we need to review a partial element of the annual billing in April 2019, and then subsequent bill starting in February 2020 for monthly customers. The last bill in arrears relating to January 2020 would have be billed in July 2020.

In summary both statutory and non-statutory accounts bad debt are objective, consistent and verifiable for individual Retailers. We are uncertain about the consistency of comparing trends between Retailers, assuming the January 2020 COVID-19 because of different billing frequencies and approaches to collection.

Consultation Question 4: Do you agree that OFWAT should allow Retailers to determine the basis on which they report bad debt costs (provided that it complies with relevant accounting standards)? Alternatively, should OFWAT set out a more prescriptive and defined basis for the determination and reporting of bad debt costs? Please set out the basis for your view or conclusions.

We believe that OFWAT should allow Retailers to determine the bad debt costs calculation. Our preference is to maintain control of our policies, we are mindful of the additional administrative burden covering reporting and management review and cost if a prescriptive policy was introduced something that has not been recognised in our cost to serve. Bad debt costs in managements account which are subsequently audited will mean a broadly similar framework is applied. For an incumbent Retailer, we operate multiple billing frequencies – it is possible the prescriptive basis could entail fairly substantial billing system investment in terms of time to implement and cost, preventing a swift implementation of any prescribed changes.

a) We believe that OFWAT should allow Retailers to determine the bad debt costs. It is a legal requirement for Directors to sign off on Statutory Accounts it would be extremely damaging for our market and our financial independence if we lose control of our own accounting policies.

b) Prescriptive methods potentially create a conflict for the Retailer to be compliant with group accounting policies, other regulators and Financial Reporting requirements, whether IFRS or UK GAAP; they add complexity and thus costs to ensure compliance with that more complex framework. OFWAT could request Retailers to instruct their auditors to review the bad debt reporting requirements and issue a suitable assurance statement. Alternatively, Retailers could issue an assurance statement that is included in the Statutory Audit.

c) In reviewing the Auditing and Accuracy on page 16 of the Call-for input, we note the Regulators concern regarding Retailers over provisioning in 2020/21. We are sensitive to the concern and in the interest of transparency in accordance with IFRS 9, we included a £5 million in our year end statutory financial reporting ending March 2020, covering accounting period 2019/20. This provision was agreed with our auditors and included extensive analysis capturing our normalised provision process, cash collection rates and specific reviews of outstanding debt by industry classification. [redacted]

[redacted] We bring this point so that you may consider the appreciate the following issues:

- Our priority is to maintain liquidity which is achieved by cash recovery. We are chasing every debt we can with daily, weekly and monthly senior management monitoring to ensure we make our wholesale payments on time.
- PWS prides itself and making valid and sound accounting judgements.
- The working assumption of the Regulator should not be that Management has spare time to carefully manage booking excess provision.
- We are striving to break even and achieve our budget financials and booking additional bad debt provision does not help achieve that objective.

Consultation Question 5: (a) What is your view on the period over which we should be measuring bad debt costs arising, (b) What in your view is the appropriate time interval following this for the measurement of bad debt costs?

a) To give context to this response, when COVID-19 firstly materialised in March 2020, we initially assumed that the largest impacts would be felt within the first 6 months; we now anticipate that 2021/22 is a year of recovery.

b) The government funded financial support given to UK businesses has provided short term relief mechanisms during 2020. However, it is possible that the true financial consequences in terms of businesses that are no longer viable has been delayed due to the length of government initiatives. It is also worth noting that a complex insolvency of Lehman Brothers in 2008/09 is still not fully resolved. Therefore, the bad debt costs could run into 2026 /27, assuming a backlog of insolvencies of smaller companies have been reviewed and the tidy up process complete.

c) Our initial view is that an overarching annual review is an appropriate interval. We state this because we understand the seasonal variations of our customers, for example, our legacy customer base is dependent on a strong summer season. That said, we believe an interim 6 monthly review to capture market risks is also an appropriate requirement, the possibility that a customer will become insolvent can be used to plan resources in a timely manner.

d) We note the intention in the Time Intervals section on page 15 and respond to question 5 (b) as follows:

- PWS normalised provision process with ‘in excess of 100k’ customers is slower to write of debts than the process proposed, unless in liquidation or market move occurs. We would not assume a 100% provision when a customer is 6 months past due.

- Invoice timing – we note the working assumption that COVID-19 consumption risk commenced in January 2020. With our invoicing cycles mixed between unmeasured in advanced and measured bills invoice frequency ranging between 1 months and 6 months in arrears – to develop reporting we need to review a partial element of the annual billing in April 2019, and then subsequent billing starting in February 2020 for monthly customers. The last bill in arrears relating to January 2020 would have be billed in July 2020.

- Expectation to wait for audited 20/21 statutory financial reporting – we do not expect this to be an issue. Having searched Companies House for our competitors' submissions to review 2019/20 performance we note that 5 out of 8 have not filed accounts at this time including 3 out of 4 of the largest market participants. If this trend repeats the proposed timetable in section 3.3 looks doubtful.

Consultation Question 6: What is your view on the change in and/or scale of bad debt costs likely to arise since March 2020? Please provide evidence to support your views, for example concerning metrics on changes in the number of customers with payment difficulties or payments in arrears.

We use a number of metrics in determining our view of bad debt risk and note the following trends:

a) **Cash Trends** Our collection rates against billing show a slight positive trend over the last year as a result of the investments we have made in our collections team. However, they show large monthly fluctuations, closely matched with customer closure periods, causing significant uncertainty in our financial planning.

b) **Absolute Value**. Total debtors have increased £1.7m since year end (against a year-on-year revenue decline - so we would have anticipated debtors to decrease, however, they have not).

[redacted]

[redacted]

[redacted]

d) **Provisions recognised relating to COVID-19.** In our March 2020 year end accounts we recognised a provision of £5m, which was agreed by our auditors and was maintained during our half year financials in September 2020. PWS will closely monitor payment trends in January (particularly with the impact of the latest lockdown) and make an assessment of our provisioning for financial year 2020/21 between February and April 2021.

Consultation Question 7: Do you agree that these are the right objectives for considering whether and how to amend regulatory protections in relation to bad debt costs?

Having given careful consideration to the objectives of:
1. Protect customers interests
2. Promote efficiency
3. Provide clarity and minimise implementation costs

We can understand, from the perspective of the regulator, why these objectives have been given the greatest consideration.

a) The objective in protecting the customers interest is not purely about price and service; sustainability and single point of contact will give the market credibility. With regards specifically to the latter point, capturing and preventing the systemic risk of retailer failure is critical. The impact on the customer if retailer does fail is significant: the potential financial loss of deposit, the loss of strategic relationships and loss of trust in the market and cannot be ignored when drawing conclusions on solutions.

b) We share the concern that application of REC based pricing mechanisms could remove the level playing field however our overarching view is this is irrelevant because there will be fewer participants in the market.

c) The intention to audit and verify our actions is a further cost to the market not captured in the allowed cost to serve. A recovery mechanism should be included in future tariffs this could be based on the statutory accounts' provisions of market participants.

d) We think a prerequisite of efficiency is innovation. It is our view that comes from people who need to change and have the capacity to innovate. There is a risk that the COVID-19 affected environment will restrict Retailers only to be able to address the immediate issues of paying the monthly wholesale bill and not develop themselves into a sustainable business.

e) The third objective to provide clarity and to minimise implementation costs we understand the sentiment. Having participated in the recent CFI regulator/retailer meetings it is quite clear that this objective should also include a swift and timely response to support the very challenged Retailer for the good of their customers and the market. Continued regulatory burden distracts management from delivering on strategic market objectives, whether it is good market data, reducing water consumption and driving market efficiency. We can only re-emphasise the long-term consequences of the pandemic and ask the regulator to consider recovery of all aspects of bad debt costs.

Consultation Question 8: Do you have views about the merits of enabling the recoupment of (some portion of) excess bad debt costs via amendment to the REC? Do you have any comments or views about the practical implementation of such an approach?

a) This methodology of adding price to the REC is attractive because of its simplicity. Clearly it means the benefits flow to the retailer without the need for settlement credits. The application of the REC allows the burden of bad debt to be shared by many customers, through tariffs – changes IT systems is expected to be straight forward.

b) The issue is, of course, that the customer can switch between Retailers therefore the benefits might not be felt by the market or the retailer: there will simply be competitive pressure to reduce prices back to the original.

Consultation Question 9: Do you have views about the merits of enabling the recoupment of (some portion of) excess bad debt costs through wholesale charges?

a) The benefit of covering the bad debt costs or equivalent through the wholesale charge is that it provides a level playing field to ensure that all customers contribute and ensures a fair distribution of cost and recovery. This, in turn, engenders continued competition in the market.

b) This mechanism adds complexity in terms of administration, the return of cash and crucially, the timeliness that the retailer receives the compensation. There will of course be some double claims as customers move Retailers which might result from the less than 90-day rule. This methodology should be acceptable in terms of system implementation providing it is added through a variable or fixed charge line with current careful consideration to an allocation between water and waste services in order to facilitate the correct VAT treatment.

c) Experience suggests this will be a bureaucratic process, which will result in slow financial settlement for the Retailer placing pressure on our liquidity position and overall strategy. Further, the receipt of the cash relief will be significantly later than the wholesale payment relating to the unpaid debt.

d) This will introduce additional costs to the market: additional costs to the Retailer to apply for relief and for the Wholesaler to review and agree these. The implementation costs, which are suggested to be borne by the Retailer, may also be sizable and unsustainable unless funded by the customer.

e) Recoupment through a levy, equivalent to that applied as an insurance levy might be a more appropriate mechanism: Wholesalers charge could collect a bad debt surcharge, which Retailer can claim against if their customer goes out of business.

Consultation Question 10: Concerning the option of recoupment of (some portion of) excess bad debt costs through wholesale charges, do you have comments or views about the costs for trading parties of implementing such an approach? Do you have comments or views about the practical implementation of such an approach? Do you have any comments about a possible application process and the data and audit requirements to accompany this?

We think the following issues should be considered:

a) A consultation with the wholesalers to review such a process is practical.

b) Our initial thought is that changes are simply charged on fixed prices to the existing wholesaler tariff codes. The tariff codes capture the varying consumption bands, so the charges can be proportioned, increasing incremental fix charges so that the cost is spread fairly based on consumption, with the largest users paying the higher fees.
c) A uniform fixed fee could be applied across England and Wales, applications can be raised based on the number of customers, and total debtor value each retailer has with debtors more than 6 months past due.
d) The 90-day debt rule for market switches should be removed. Of the £1.0m of Market Moved debt in the PWS accounts at 31 March 2020, more than 60% remains unpaid.

Consultation Question 11: Aside from amending the REC or recovery through the wholesale charges, do you have any views on whether other mechanisms or approaches to amending regulatory protections may be appropriate? If yes please describe your preferred approach and your view of why it may be warranted.

a) Currently the regulatory protection prevents Retailers objecting to a switch if a customer has invoices past due. This practice should cease and the customer must have settled all monies owed for a switch to take place.

b) A naughty customer tariff could be introduced – ie for a Group 1 customer the REC v5.0 caps are removed and a tariff penalty is introduced to those customers who are persistent late payers. This allows the retailer charge more immediately, in advance of more sophisticated market initiatives options. This incentivises enables Retailers to put prices up and proactively chase these customers and reducing the effect of cross subsidisation on the paying customer. This gives Retailers a self-help option currently not available.

Consultation Question 12: What is your view of the appropriate timing for the measurement and recovery of (a portion of) any excess bad debt costs?

a) The timetable proposed is slow and confirms that the financial pressure on Retailers will remain for a considerable time. We understand that introducing a new REC and amendment to a wholesaler charges will take time. We would suggest that further liquidity support measures are introduced to support the market in the interim.

b) We are concerned about Retailer failure and that the financing is not available to execute a Retailer of Last Resort scenario. In the context of the three objectives discussed in question 7, the Regulator will fail to protect customers and will be exposing wholesalers as well. An accelerated timetable or interim measures must be considered by the Regulator.

c) Our understanding following a review with the UK WRC is that the timetable is under review and remediation actions in the second half of 2021/22 are being considered.

Consultation Question 13: Do you agree that it makes sense to 'pool' recovery of (some portion of) excess bad debt costs across customer groups and/or regions?

a) We can understand the application of pooling customer groups specifically if linked with the consumption group and margin caps currently applied in REC v5.0.

b) If a regional approach is applied, we have concerns because the allowed cost to serve vary dramatically between regions. This is driven by the practices of the incumbent retailer/wholesaler. The result could make pockets of unattractive customer geographies due to regulatory management and therefore make the protection of customer interests worse. We maintain our concern about a regional approach.

Consultation Question 14: Where excess bad debt costs exceed 2% of turnover on an industry wide basis in your view, how should such excess bad debt costs be shared between Retailers and customers?

a) As discussed in our previous our RFI correspondence, our historic bad debts have been less than 1% of turnover prior to COVID-19 and the selection of 2% as starting point is arbitrary. As a retailer who prides itself as a good market participant, we are in effect being asked to finance other participants.

b) Fundamentally, the allowed cost to serve does not capture our experience of debt management in the market since its inception. Tariff models need to be expanded beyond consumption bandings so that the bad payers truly face punitive rates and the good payers' protection is maintained.

c) We wholeheartedly believe that a customer who has historically paid on time but is COVID-19 impacted and requires short term support, who then settles outstanding debt, should not bare an excessive proportion of the cost. That said, we still need a mechanism to recover the cost if we are to have a sustainable business. This excess cost in the market should be applied to those who abuse the regulatory framework that the regulator supports unintentionally and not as intended: the persistent late payers.