

Business Retail Market: Proposals to deal with un-invoiced Wholesaler charges in the event of an unplanned Retailer exit

The proposals consulted on seek to equalise the treatment of invoiced and un-invoiced revenue in the event of an unplanned retailer exit and we agree with that as a principle. We do not believe that the licence amendment as written delivers this however, so we suggest an amendment per below.

Our two other observations are over the references to accounting for uninvoiced revenue and any interaction of the licence amendment and the RFI model. It may be that both issues are compatible with the licence amendment as proposed, but it would be helpful if Ofwat could address them in the final consultation.

1 Equalising the treatment of invoiced and uninvoiced revenue not recovered requires a licence amendment to the allowed revenue that treats both the same

The licence amendment is a welcome recognition that, should the wholesale business face bad debt due to a retailer failure, the totex sharing mechanism only allows for a proportion of that to be recovered. The licence amendment as proposed allows for the remaining costs to be recovered for uninvoiced revenue.

As we see it, to treat unrecovered invoiced and non invoiced revenue the same would require an RFI formula adjustment that would treat both in the same way, and so we suggest the definition of UIRt in the allowed revenue formula should be changed to:

UIRt The total amount in £ millions owed to the Appointed Business for activities in charging year t-2 to which the relevant network plus or water resources price control applies by one or more Licensees that have ceased to be a legal entity.

~~in relation to the period following the end of the period that was covered by the last invoice issued to the Licensee by the Appointee for those activities.~~

If both invoiced and non invoiced revenue have been treated as revenue in the regulatory accounts, then both will generate a bad debt cost should they not be recovered. To only apply an allowed revenue adjustment to uninvoiced revenue risks a perverse incentive for companies not to invoice retailers that are in financial difficulty, which we are sure is not Ofwat's intention.

2 Observation: Accounting for Unbilled Revenue

Whilst this point does not challenge the licence amendment as proposed, we felt it was worthwhile to revisit the revenue recognition principles for clarity as it seems that companies may be taking different approaches.

We recognise revenue for wholesale water and wastewater services as the services are provided to retailer customers. Therefore we would typically recognise revenue for the period up until the retailer failed, **whether or not it has been invoiced**.

Under IFRS 15 'Revenue from Contracts with Customers', revenue should not be recognised unless it is probable that the consideration will be collected. In circumstances where a retailer has failed this would suggest that any unbilled revenue would not be recognised as revenue.

However, Ofwat's RAG 1.09 states that "companies should bill all properties where a service is being received unless confirmed as void, and should fully recognise the billed amounts in the reported turnover figures in the regulatory accounting statements." and that "Therefore companies should

assume that for regulatory reporting purposes where an amount is billed it is probable that cash will be collected.” Effectively, Ofwat disapplies part of IFRS 15 in order to avoid it conflicting with the RFI. RAG 1.09 doesn’t address the retailer failure situation.

In regulatory accounting, this means that we would recognise all of the revenue, some of it as a billed debtor and some as accrued revenue. Once the retailer has failed then we would invoice the outstanding balance in order to register our claim against the company’s assets. The full amount would be written off as bad debt and a share would be recoverable through the totex sharing mechanism. The licence amendment as proposed would allow recovery of the remaining share.

We don’t believe that Ofwat’s statement that “in line with normal accounting convention, amounts in respect of usage that were not due to be invoiced by the Wholesaler at the point of Retailer failure would not be recognised as bad debt” is consistent with RAG 1.09.

One alternative option would be for Ofwat to amend RAG 1.09 to allow any revenue due from a failed retailer to be derecognised in accordance with IFRS 15. This would align to the PR19 cost assessment process as wholesalers are not funded for the risk of retailers failing.

The current proposals should mean that any unbilled revenue to a failed retailer should be recognised as revenue and written off as bad debt, which means that it would be treated the same way as any billed revenue and addressed through the totex sharing mechanism and licence amendment to allowed revenue.

3 Request for clarification: Interaction between RFI and Licence Amendment

We have an area where some clarification would help:

In response, we stated that we would not make changes to regulatory accounting guidelines (RAG3) and that we would expect companies to provide a commentary setting out the value of un-invoiced amounts due to a Retailer failure as part of the RAG3 disclosure requirement linked to the Annual Performance Report (APR) table 21. 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.

It would be very helpful for Ofwat to set out what this ambiguous ‘RFI adjustment’ should be for and when it would apply, specifically;

- 1 To include in actual revenue any un-invoiced revenue due to retailer failure?
or
- 2 To deduct from actual revenue any un-invoiced revenue due to retailer failure?
or
- 3 To amend allowed revenue in any way (upwards or downwards?)

Essentially, do Ofwat expect the Actual Revenue in the RFI calculation to include or exclude un-invoiced revenue? The interaction between the revenue control licence amendment and the RFI adjustment is critical in interpreting whether the licence amendment works as intended.

4 Proposed Changes to WRC para 9.1.4.2.

We agree that changing the business terms of para 9.1.4.2 from ‘owed and due’ to simply ‘owed’ allows Wholesalers to draw down on credit collateral in relation to un-invoiced amounts. This helps

reduce potential burdens on customers in the case of an unplanned Retailer exit from the market and we support it.

Conclusion

Before we can accept the proposed licence amendment, we would like to see the allowed revenue adjustment apply equally to both invoiced and non invoiced revenue. We also suggest that the associated changes to the PR19 Reconciliation Rulebook need further explanation, with specific references to revenue recognition of non invoiced revenue and where and how adjustments to the RFI model inputs should be made. Only when we are confident of how these adjustments interact can we be confident of them working correctly and accept the licence change.

Northumbrian Water
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