
south east water

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

South East Water response

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1. Introduction

This document sets out our response to Ofwat's proposed changes to the treatment of un-invoiced revenue.

We agree with the proposed changes to the WRC, which have the effect of ensuring that the losses resulting from a retailer failure will fall, as much as possible, on the guarantors. This avoids such incidences falling on either water companies, or the generality of customers through the RFI.

We do not agree with the proposed changes to the RFI formula, as set out below. They have the effect, in our opinion, of shifting risk from the generality of customers (where it lies now) to the companies. The intention of the introduction of the retail non-household market was to bring benefits to the generality of customers. It is right that risks associated with that market should also be allocated (through the RFI) to the generality of customers. This allocation of risk is effectively part of the PR19 price review, and we don't see any justification for changing it mid-price review period, if at all.

Ofwat has always maintained that the PR19 price determination and its associated mechanism should be considered and accepted 'in the round'. We understand that Covid-19 has given rise to exceptional circumstances following the determination, particularly in the areas of residential customer behaviour and business demand, and that there are reasonable grounds for reviewing the mechanisms which relate to these particular areas. We do believe however that this current proposal places an increase in risk to wholesalers which is largely outside their control and is not compensated for as part of the PR19 overall package.

We understand from communications that we have had with Ofwat, that this transfer of risk was not the intention of this proposal, and that the proposal may be based on confusion, and different interpretations of how the RFI currently works.

2. Specific Consultation Questions

1. Does our proposed approach deliver the following policy aim in a way that is consistent with our statutory duties?

“in the event of a Retailer’s unplanned exit from the business retail market, a Wholesaler should be able to recover relevant un-invoiced revenues for services that the Wholesaler has provided to that Retailer - but were not due for invoicing or had not been invoiced - at the point of Retailer failure.”

We believe that the existing RFI mechanism already achieves this policy aim, and therefore the proposed approach is not required.

Our view is that if a retailer fails, the un-invoiced revenue would not be recognised in the regulatory accounts. This is based on our interpretation of RAG 1.09 and RAG 3.12. We note that this interpretation has not been tested in the real world because such a failure has not occurred.

In the case of such a failure, any accrual for un-invoiced revenue would simply be reversed, and that revenue not recognised, consistent with IFRS15. We believe this is consistent with RAG 1.09, which does not discuss the billing of retailers at all, but refers to the billing of ‘properties’. In the absence of any indication to the contrary, we presume that IFRS15 would apply to retailer revenue.

If ‘properties’ were construed to include those billed to retailers, then RAG 1.09 clearly stipulates that those amounts should be billed, not left un-invoiced. If there was a ruling that such revenue should be recognised, then both the revenue (whether invoiced or not) and the associated bad debt would need to be recognised in the regulatory accounts. We do not believe it is possible for the revenue to be recognised, but not the associated bad debt.

The current RFI mechanism is designed in a symmetric way such that shortfalls or over recovery in revenues are corrected 100% albeit with a two year lag. The proposed mechanism would reduce this recovery rate to 38% for South East Water which is inappropriate.

2. Do you agree that it is appropriate to apply company specific Totex cost sharing rates to amounts relating to un-invoiced revenue to be recovered via the RFI mechanism in the event of a Retailer failure?

We do not believe this is appropriate. Ofwat was clear, when setting up the non-household market that wholesalers should not have to bear bad debt costs if a retailer failed. Such costs are not funded in the periodic review and any such failures are completely beyond wholesale company management control. Therefore a wholesaler should not bear any of these costs. As outlined above, our understanding of the way that the RFI mechanism currently works, is that un-invoiced income is recovered at 100% and invoiced income is recovered at the company specific cost sharing rate (for SEW this is 38%). Any

change to this protection could be interpreted as a retroactive change to PR19, as it would expose companies to a new risk.

3. Do you have views that alternative approaches may be more effective or straightforward to implement?

As outlined above our view is that un-invoiced revenue not recovered would result in a shortfall in actual revenue recovered and would be 100% recovered via the RFI mechanism.

If Ofwat's intention is to provide appropriate protection to wholesalers from the financial consequences of retailer failures, then the best way to do this is to deal with invoiced income rather than un-invoiced income.

Invoiced revenue not recovered would currently result in a bad debt charge to wholesale opex which would then be recovered only in part through the totex cost sharing mechanism (38% for SEW). We believe there is a strong argument – particularly in the larger scale event of a retailer company failure that this invoiced revenue not recovered should also be recovered through regulatory mechanisms at 100%. A larger scale event, of this nature, is of much greater consequence than any single business customer failure that wholesale companies were exposed to before non-household competition was introduced.

If Ofwat added 'lost invoiced income' to the RFI formula, it would need to multiply the amount by (1-company specific cost sharing rate). This would have the effect of allowing companies to recover the amount that they could not recover through the totex sharing mechanism at the following periodic review.

This would allow companies to be adequately protected from the financial consequences of a significant retailer failure, as originally envisaged.

4. Do you agree with the proposed change to the WRC? Please explain your answer.

We are in agreement with the proposed change to the WRC.

The removal of the unintended restriction on credit support for a Wholesaler to draw down of the credit support should there be a Retailer failure will avoid the sums of money being recovered from the general customer base.

5. Do you agree with proposed amendments to the legal drafting? Please explain your answer.

We are in agreement with the proposed amendments to the legal drafting.

This will facilitate the amounts due that remain un-invoiced to be drawn down against the credit collateral.

6. Do you agree that the proposed change to the WRC furthers the objectives and principles set out in WRC Schedule 1, as described in section 4 above?

We agree that the proposal furthers the objectives of the wholesale retail code as set out in the consultation document

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