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Peter Trafford



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## Un-invoiced Wholesaler charges consultation

Dear Georgina,

Thank you for the opportunity to respond to the consultation on proposals regarding how un-invoiced Wholesaler charges will be dealt with in the event of an unplanned Retailer exit, which was published in September 2021.

We appreciate the acknowledgment from Ofwat that there is a gap in the regulatory mechanisms to protect Wholesalers from the risk associated with un-invoiced wholesale charges and welcome the proactive steps now being taken to address this.

We have considered the potential impact of the proposed changes on the allowed wholesale revenues of incumbent companies. As per the views set out in various consultation responses submitted by Water UK and Wholesalers alike in the weeks and months after the Covid-19 pandemic began, we strongly urge Ofwat to reconsider the use of company-specific cost sharing rates in the revised allowed revenue formula as we fundamentally disagree with this proposed approach. We have also identified an error in the proposed formula relating to the application of the cost sharing rate.

We note that any changes that are made to our licence and to the PR19 Reconciliation Rulebook will also need to be applied to our Thames Tideway Tunnel price control. At present, only the water resources and network plus price controls are mentioned in the consultation document.

We are supportive of the proposed changes to the Wholesale Retail Code ("WRC") to avoid unintended consequences of implementing CPW079.

More detail on the points raised above and our answers to the questions included in the consultation document can be seen in the appendix accompanying this letter.

Should you have any questions or comments on our response, please do not hesitate to contact either me or my team.

Yours sincerely,



Peter Trafford  
Head of Regulatory & Market Economics

## Appendix – response to consultation questions

Our answers to the six questions raised in the consultation document can be found in the sections below.

### Proposed changes to the price control arrangements and the reconciliation rulebook

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

In general, we feel that the proposed approach does deliver the policy aim set out in the consultation document in a way that is consistent with Ofwat's statutory duties, however we note that there is a slight discrepancy between the wording of the policy aim and the amendment being proposed to the allowed revenue formula.

The policy aim states that Wholesalers "should be able to recover relevant un-invoiced revenues for services... provided... at the point of Retailer failure", however the proposed approach only permits the Wholesaler to recover a proportion of the relevant un-invoiced revenues due to the application of the cost sharing rate.

If the policy aim is to be delivered exactly as it is currently written, it would seem that no cost sharing rates should be used in the amended allowed revenue formula.

#### **Question 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 agree with the use of company-specific underperformance cost sharing rates when adjusting allowed revenues for un-invoiced wholesale charges, however we can see why Ofwat are suggesting the proposed change as it aligns to the default treatment that would be applied to unpaid amounts that have been invoiced to failed Retailers (through the existing Totex cost sharing mechanism that includes bad debt).

We appreciate that amending the existing Totex cost sharing mechanism to treat differently the specific impact that Retailer failure has on bad debt is outside the scope of this consultation<sup>1</sup>. However, as the treatment of un-invoiced wholesale charges has no precedent and can start from first principles, we do not necessarily need to align the treatment to that used for invoiced amounts. Instead, we have the opportunity to apply such adjustments more uniformly and in a manner that reflects the degree of influence (or lack thereof) that Wholesalers had on the circumstances that led to the need for such adjustments i.e. the failure of the Retailer.

In addition, use of company-specific rates adopts the assumption that either under-performance or out-performance applies. For that to be a valid line of thought, there would need to be an allowance in the relevant price controls for such a cost, as there is within the retail residential price control. However, there is no non-household or Retailer bad debt cost allowance provided.

As pointed out by Water UK in their response to the April 2020 consultation on proposals to address liquidity challenges and increases in bad debt, a higher cost sharing Wholesaler is no more responsible than a lower cost sharing Wholesaler when it comes to their involvement in the Retailer failure. As such, it does not make sense to penalise some Wholesalers more than others. We therefore maintain the view adopted by Water UK that there is no justification for a differential approach amongst Wholesalers to the issue of un-invoiced wholesale charges.

Ofwat stated that "sharing factors are applied on a totex basis in recognition of the interrelationships between different expenditure choices"<sup>2</sup> but the loss of un-invoiced revenue and/or bad debt that results

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<sup>1</sup> For example, treating Retailer bad debt in the same way as abstraction charges and business rates, which have a different cost sharing rate applied uniformly across all companies.

<sup>2</sup> "Questions raised in response to Ofwat's final decision published on 30 April 2020", Ofwat, May 2020, page 6, section 2

from a Retailer failure is not an “expenditure choice” on the part of the Wholesaler as the adverse impact is imposed on them by way of the Retailer’s failure.

We therefore disagree that adopting the same cost sharing rate amongst Wholesalers for the un-invoiced revenue adjustment will risk undermining or distorting the incentives for companies to spend efficiently, nor will it make companies less accountable for delivering their business plans.

For the above reasons, we do not believe that there is any rationale for the cost sharing rate to be such that companies bear more than 50% of the un-invoiced wholesale charges. We note the equitable approach of sharing costs 50:50 is as per that implied by Water UK. However, fairness is not the only consideration, in our view.

We would suggest that appropriate cost sharing rates to apply to the un-invoiced charges adjustment are those used for business rates and abstraction licenses in the PR19 Final Determinations.<sup>3</sup> These rates are to be applied uniformly across the industry as a whole and acknowledge that companies have little to no control over these cost items due to the external factors at play. The same is true for the un-invoiced charges that result from Retailer failure. As such, this would result in companies funding 25% of the un-invoiced wholesale charges with customers funding the remaining 75%.

If, as referenced in previous Ofwat documents, a sharing exposure cap was also to be applied then this too would be welcome, however we do not believe that this justifies a differential approach amongst Wholesalers to the cost sharing mechanism for the impact incurred up to the cap.

Aside from the debate detailed above regarding the most appropriate cost sharing rate, we have noted an error in the proposed formula. The multiplication of  $UIR_i$  by the company specific cost sharing rate would result in companies recovering the element that they should be forgoing. The new term in the formula should therefore read “ $UIR_i \times (1 - [\text{company specific cost sharing rate}])$ ”.

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

We believe that adjusting the allowed wholesale revenue formula within the wider remit of the RFI mechanism is the most appropriate and straight-forward way of addressing the issue of un-invoiced wholesale charges in the event of Retailer failure.

We do however wish to query the wording of the proposed addition to section 3.8.6 of the PR19 Reconciliation Rulebook. Ofwat propose the following text, as set out on page 10 of the consultation document:

*“... we expect that where relevant, companies would fully exhaust securities and credit protections available to them using all reasonable endeavours...”*

We would ask that Ofwat clarify what “**all** reasonable endeavours” means in practical terms. Inclusion of the word “all” can lead to insurmountable requirements being imposed often at the expense of other competing interests, including cost. We therefore feel that consideration should be given to removing the word “all” from the proposed addition i.e. “using reasonable endeavours”. We would also be grateful for guidance on when Wholesalers would be considered to have satisfied this requirement in practice.

### Proposed changes to the WRC

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

We agree with the proposed changes to the WRC. They remove ambiguity in relation to the use of collateral, enabling a more efficient market.

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

We agree with the simplicity of the proposed drafting.

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<sup>3</sup> “PR19 final determinations: Thames Water final determination”, Ofwat, December 2019, page 81, section 4.4.4

**Question 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 proposed changes support the objectives and principles of the WRC, primarily those of an effective and efficient market. Should a Retailer default, clarity is required to ensure the event runs smoothly and that the end-user customer is protected.