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

Ofwat

About this document

In our September 2021 consultation, we set out proposals to deal with un-invoiced Wholesale charges in the event of an unplanned Retailer exit. We noted that, in an event where a Retailer fails and exits the market, unrecovered charges that a Wholesaler has invoiced for are treated as bad debt. The price control arrangements allow a Wholesaler to recoup from customers a portion of such bad debt costs via the PR19 Totex cost sharing mechanism. We concluded, however, that there is not currently a similar provision for dealing with charges for usage that remain un-invoiced by Wholesalers when a Retailer fails.

Our consultation outlined the following policy aim:

"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 proposed that in the event of a Retailer failure during the 2020-25 period, we would allow Wholesalers, subject to supporting evidence, to make an adjustment through the PR19 reconciliation mechanism known as the Revenue Forecasting Incentive (RFI).

To meet this aim, we proposed to:

- Amend licence conditions to make updates to the RFI formula and include a new un-invoiced revenue (UIRt) definition.
- Permit the in-period recovery of un-invoiced revenue, subject to each company's specific cost sharing rate. This would reflect the existing cost sharing arrangement for the recovery of bad debt costs.
- Update the PR19 reconciliation rulebook to provide clarity and guidance to Wholesalers; and
- Modify the Wholesale Retail Code (WRC) to enable Wholesalers to draw down on credit collateral in relation to un-invoiced amounts for services that the Wholesaler has provided to the exiting Retailer.

The remainder of this document sets out our decision in relation to our September 2021 proposals and clarifies how Wholesalers will be able to recover un-invoiced revenue in the event of a Retailer failure during the remainder of the 2020-25 price control period.

Looking further ahead, we intend to introduce a mechanism during PR24 to allow for in-period adjustments relating to un-invoiced revenue, similar to the approach outlined in the September 2021 consultation. Condition B allows us to set a new RFI formula for the 2025-

2030 period by 31 December 2024. The precise nature of this will form part of our wider development of the RFI for 2025-30

In **section 2** of the decision we highlight, and respond to, some of the key themes that were raised in response to our consultation.

Contents

1. Our decision

1.1 Summary of responses to consultation and our decision

In total, 18 parties responded to the consultation. 13 Wholesalers, four Retailers and CCWater.

Most respondents were supportive of our proposals. Two Retailers considered that the proposals were unbalanced, with a focus on Wholesalers rather than the underlying causes of Retailer failure.

The small number of Wholesalers that challenged our proposals were primarily unhappy with the proposed updates to the RFI formula. Some Wholesalers considered that there is no need for change. In their view the RFI, in its current form, delivers our policy aim. We consider that this view is largely based upon a misunderstanding of how the current RAGs and revenue recognition guidance works.

Concern was also raised with the intention to apply a cost sharing rate in the proposed updated RFI mechanism for the recovery of un-invoiced revenue. Some concerns were also raised about the application of cost sharing rates for invoiced revenue. We consider that applying cost sharing rates to un-invoiced revenue is the correct approach. If usage is invoiced for at the time of Retailer failure, then it is reconciled as bad debt and is subject to a company's individual cost sharing rate. We proposed that un-invoiced revenue is recovered using the same cost sharing rate, to remove any incentive for Wholesalers to delay the invoicing of Retailer usage.

In **section 2**. of this document we set out, and respond to, some of the key themes that we identified from consultation responses.

In summary:

- We remain of the view that, in the event of a Retailer failure, a process does not exist to permit Wholesalers to make an in- period adjustment to recover un-invoiced revenue.
- We will not be consulting upon amending the licence conditions to enable in period changes for un-invoiced revenue for the last two years of this price control period.
- Instead, should a Retailer failure occur in time for it to be considered as part of PR24, Wholesalers will benefit from an adjustment in relation to un-invoiced revenue through the RFI at the end of period reconciliation for PR19.

1.2 The change to our proposed approach

In our consultation we proposed to modify each Wholesaler's licence to amend the RFI formula that we notified to each company for the purposes of Condition B of their licence in an annex to our PR19 final determination of price controls. The proposed licence modification was specifically intended to update the RFI to allow for in period adjustments during the 2020-25 price control period.

We suggested that an amendment to the calculation of the adjusted allowed revenue would achieve our objective. To allow for recovery of un-invoiced revenue we proposed to introduce a new term 'UIR' into the RFI formula calculation of adjusted allowed revenue for the Network Plus Water, Network Plus Wastewater and Water Resource price controls.

The proposed new UIR definition is set out as follows

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 (or, if the Licensee is an individual, has died) 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.

The proposed UIR definition meant that at least one full year (and up to two years) would elapse before the RFI would allow additional revenue to be recovered, subject to each company's specific cost sharing rate. Part of the reasoning for this was to provide Wholesalers with sufficient time to fully exhaust securities and credit protections available to them, and use these to offset any outstanding balances due from Retailers, concerning the extent to which amounts arise in respect of un-invoiced revenue.

Given where we stand in the current price control period, we are aware that there is a limited window remaining during which our September 2021 proposals would have an effect. If we were to proceed with consulting on amending the licence conditions to allow for an in-period adjustment, these changes would only capture Retailer failures that occur up to the end of this financial year (March 2023). From 1 April 2023, any un-invoiced costs associated with a Retailer failure would be considered as part of the end of period reconciliation for PR19.

Because of the above, we consider that it would not be an efficient use of Ofwat or company resources to proceed with modifying licence conditions at this time. Should a Retailer failure occur in time for it to be considered as part of PR24, Wholesalers benefit from an adjustment in relation to un-invoiced revenue through the RFI at the end of period reconciliation for PR19. This would not prevent us, if it was appropriate, from making a licence modification in time to allow Wholesalers to take un-invoiced revenue into account when setting charges for 2024-25 if a retailer failure occurred before the end of the current (2022-23) charging year.

In that eventuality we would carry out a further consultation before making any licence modification.

1.3 End of period reconciliation

In line with the approach outlined in our September 2021 consultation, we consider that the following process should apply if Wholesalers seek to recover un-invoiced revenue through the RFI at the end of period reconciliation for PR19.

Schedule 1, Part 2: Business Terms under the Wholesale Retail Code ("WRC") sets out the credit provisions between Retailers and Wholesalers in the business retail market. Retailers must lodge credit in advance where they opt to post pay their Wholesale Charges. In the event of a Retailer failure, before proposing adjustments through the RFI, we expect Wholesalers to demonstrate that they have first used all reasonable endeavours to exhaust these credit provisions and to offset them against unpaid charges, including in respect of amounts relating to un-invoiced usage.

Where a Wholesaler then seeks to pass through the RFI mechanism amounts in respect of un-invoiced revenue, we expect the Wholesaler 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 annual performance report (APR) table 2M.

Any amounts of un-invoiced revenue in relation to network plus and water resources activities that remain outstanding after a Retailer failure will be subject to each company specific underperformance cost sharing rate before any amounts are recovered via an adjustment through the RFI.

In line with our September 2021 proposals, we intend to amend the PR19 Reconciliation Rulebook to provide clarity and guidance to Wholesalers with regard to the relevant end of period reconciliation process[1].

1.4 The Wholesale Retail Change proposal

At present, where a Wholesaler holds credit protections, such as securities or deposits in respect of a Retailer on post payment terms, these can be offset against the Retailer debt in the event of Retailer failure – provided that the usage relating to the debt has been invoiced.

As noted in our September 2021 consultation, we intend to proceed with our plan to amend the WRC to allow for credit protections to also be accessed where charges for services that the Wholesaler has provided to the exiting Retailer remain un-invoiced.

[1] The end of period reconciliation process outlined will also apply to the Price Control for the Thames Tideway Tunnel Project

In our consultation, we proposed to amend paragraph 9.14.2. of the Business Terms in the following way.

"9.14.2. The Contracting Wholesaler shall not be entitled to draw on any Eligible Credit Support or Alternative Eligible Credit Support in excess of sums **owed** ~~**and due**~~ to the Contracting Wholesaler at that time (amounts subject to disputes or question pursuant to Section 9.7.2 shall not be considered **owed** ~~**or due**~~). Should the Contracting Wholesaler draw on any Eligible Credit Support or Alternative Eligible Credit Support in excess of sums **owed** ~~**and due**~~ (contrary to this section 9.1.4.2), the amount of Eligible Credit Support or Alternative Eligible Credit Support that the Contracting Retailer is required to provide pursuant to Section 9 shall be reduced by the amount that the Contracting Wholesaler drew upon in excess until such time as that excess amount is reimbursed to the Contracting Retailer by the Contracting Wholesaler."

One Retailer raised a concern that the proposed WRC drafting changes could potentially enable Wholesalers to draw down upon credit support in wider circumstances, not just in the event of a Retailers unplanned exit. We will consider this feedback when finalising our Authority timetabled change proposal.

1.5 Our approach for PR24

As noted earlier in this decision, we intend to introduce a mechanism during PR24 to allow for in-period adjustments relating to un-invoiced revenue, similar to the approach outlined in the September 2021 consultation. Condition B allows us to set a new RFI formula for the 2025-2030 period by 31 December 2024. The precise nature of this will form part of our wider development of the RFI for 2025-30.

2. Key themes noted from consultation

2.1 Proposed changes to the RFI formula

In our consultation we proposed to modify each Wholesaler's licence to amend the RFI formula to allow for the in period recovery of un-invoiced revenue, subject to each company's specific cost sharing rate. We proposed to introduce a new term 'UIRt' into the RFI formula calculation of adjusted allowed revenue for the Network Plus Water, Network Plus Wastewater and Water Resource price controls.

The proposed new formula is set out below:

ARt = Rt + BYAt + RFIt + (UIRt x [company specific cost sharing rate – underperformance])

- **ARt** is the adjusted allowed revenue stated in £ millions in charging year t
- **Rt** is Revenue stated in £ millions allowed to the Appointed Business in a Charging Year by a Price Control in respect of the activities concerned
- **BYAt** is the blind-year adjustment, stated in £ millions, to the allowed revenue of the relevant network plus or water resources control in each year over the charging years 2021/22 to 2024/25, inclusive
- **RFIt** is an in-period reconciliation that takes the form of a revenue adjustment.

We proposed to define a new term "UIRt" in respect of un-invoiced revenues as follows:

- **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 (or, if the Licensee is an individual, has died) in relation to the period following the end of

A small number of Wholesalers considered that there is **no need for change**. One Wholesaler considered that the RFI mechanism, in its existing form, allows un-invoiced revenue to be recovered at 100% and invoiced revenue to be recovered at the company specific cost sharing rate.

We consider that this view is largely based upon a misunderstanding of how the current RAGs and revenue recognition guidance works. The revenue recognition guidance in RAG1 requires Wholesalers to currently report all usage that has occurred as revenue, regardless of whether the usage has been invoiced or not. As a consequence, un-invoiced revenue is not classed as revenue under-recovery and reconciled through the RFI. In addition, usage that remains un-invoiced is not accounted as bad debt and therefore cannot be reconciled via cost sharing

mechanisms. There is, therefore, a need for Ofwat to take action to provide a mechanism to allow Wholesalers to recover an appropriate proportion of un-invoiced revenue in the event of an unplanned Retailer exit from the business retail market.

Two Wholesalers suggested **drafting updates to the formula**.

- It was noted the "-" in the right-hand section of the formula is intended as a hyphen but could be read as a minus sign.

- Another Wholesaler identified a possible error in the proposed formula. It suggested that the multiplication of UIRt by the company specific cost sharing rate would result in companies recovering the element that they should be forgoing. They suggested the new term in the formula should therefore read "UIRt x (1 – [company specific cost sharing rate])".

When developing our original proposal, it was our intention to replace "[company specific cost sharing rate]" with the correct numerical cost sharing rate for each specific company. For example, "UIRt x 0.75". We consider that presenting the formula in this format should address the above concerns.

2.2 Applying cost sharing rates

Several Wholesalers **raised concern about our intention to apply company specific cost sharing rates** to the recovery of un-invoiced and invoiced revenue. In general, these Wholesalers considered that they should not have to bear any costs where a Retailer fails, as they considered that such an event will be largely outside of the control of the Wholesaler.

Several Wholesalers suggested alternative approaches, such as applying no cost sharing rates or applying a standard cost sharing rate across all Wholesalers. One Wholesaler suggested adding 'lost invoiced income' to the RFI formula, as they considered 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.

As noted in our September 2021 consultation, the current price control arrangements allow revenue that has been invoiced by the Wholesaler at the point of Retailer failure, but not paid, to be treated as a bad debt cost and reconciled through the Totex cost sharing mechanism. Any amounts recovered by companies via this mechanism are subject to the company specific cost sharing rate set out in the company's PR19 final determination. This ensures that customers and companies share the burden of additional cost overrun that exceeds the company's allowed cost set out in its final determination.

We cannot see any good reason why un-invoiced revenue outstanding in the event of a Retailer failure should be subject to different cost sharing arrangements from unpaid

invoiced revenue. In fact, we consider that it is important that un-invoiced revenue is recovered using the same cost sharing rate as invoiced revenue to remove any incentive for Wholesalers to delay the invoicing of Retailer usage. Our view remains that cost sharing arrangements should be equivalent for usage that is un-invoiced at the point of Retailer failure, and usage that is invoiced but unpaid at the point of Retailer failure.

2.3 The UIRt definition

As noted above, we proposed to include a new RFI term "UIRt" in respect of un-invoiced revenues.

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 (or, if the Licensee is an individual, has died) 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.

Two Wholesalers raised concerns that our UIRt definition did **not appropriately consider the settlement timetable**. They considered that the reference to a singular period in the proposed definition did not reflect the actual operation of the market and that the invoicing timetable in the market is not at the discretion of Wholesalers.

One Wholesaler stated that, due to the timing of the market billing cycle and the availability of meter readings, un-invoiced revenues may not be fully crystallised until the last RF settlement is issued. As a result, any adjustments to the RFI for an unplanned Retailer exit may impact the RFI calculations for several financial years.

The settlement timetable was considered when developing our proposals. Our understanding is that balances from future settlement runs that occur after a Retailer failure will be invoiced to the Retailer that takes on the failed Retailer book after an interim supply event. We consider that this process should limit the extent to which Wholesalers are exposed to un-invoiced revenue in the event of a Retailer failure. It is also worth noting that trading parties can request unplanned settlement runs to enable the recalculation of primary charges for an invoice period outside of the planned schedule of reconciliations. For example, this can be carried out when an incorrect data item has affected the calculation of primary charges reported in a planned settlement run.

A Wholesaler suggested that amendments to the UIRt definition should be made to ensure that it covers circumstances where Retailers have **ceased trading as a "going concern"**. It was suggested that the wording in the proposed definition, "ceased to be a legal entity", did not cover all situations where a retailer is no longer able to pay the Wholesaler. The

Wholesaler suggested that the current drafting will only include debt owed by Retailers who no longer exist in law. The Wholesaler contended that "going concern" has a well-known meaning in insolvency law and is recognised by HMRC.

The same Wholesaler also considered that there is **no need for a two-year lag** in the adjusted allowed revenue, when in some cases it will be possible to collect this in the following year.

We do not intend to adopt the proposed alternative of "a going concern" in the UIR definition. We consider that this term can be open to interpretation and is not as clear to determine as "ceased to be a legal entity". Whether or not a legal entity has ceased to exist (or has died) can be clearly established. Confirming that a business is a going concern would require more of a judgement.

As noted earlier, the proposed UIR definition meant that at least one full year (and up to two years) would elapse before the RFI would result in a higher revenue allowance. This should ensure that there was sufficient time for Wholesalers to draw down upon credit and securities before making a claim through the RFI. In theory, it could be possible for a company to fully take account of the costs associated with a Retailer failure in the current year. We'd be concerned, however, if a shorter period reduced the incentive for companies to fully recover what they can before accessing the RFI route.

2.4 Reporting revenues in the APR

The consultation responses highlighted some queries regarding accounting treatment, annual performance report submissions (APR) and the application of regulatory accounting guidelines (RAGs).

Two Wholesalers made reference to **IFRS15** (Revenue from contracts with customers: Application guidance) and suggested that this guidance conflicts with RAG 1.09.

One Wholesaler considered that IFRS15 indicates that revenue should not be recognised unless it is probable that the consideration will be collected. They concluded that where a Retailer has failed this would suggest that any unbilled revenue would not be recognised as revenue.

The Wholesaler noted that Ofwat's section 4 of RAG 1.09 states that:

> 4.3 Our requirement is 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. For clarity, this ensures that properties only fall into one of the following two categories for regulatory accounting statement purposes:

- billed and recorded in turnover; or
- void properties.

4.4 Therefore companies should assume that for regulatory reporting purposes where an amount is billed it is probable that cash will be collected. For instance, in IAS18 (or IFRS15 if adopting early), the requirement is that 'Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity'. So Ofwat requires a deviation from that requirement in that there is no judgement applied to the probability of collection, it should all be considered collectable.

The Wholesaler stated that section 4.4 of RAG 1.09 disapplies part of IFRS 15 to avoid it conflicting with the RFI. The Wholesaler, however, suggested that the following statement from our consultation (page 7) is inconsistent with RAG 1.09.

"If a Retailer fails under current regulatory arrangements, 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"

They suggested that **Ofwat could amend RAG 1.09 to allow any revenue due from a failed retailer to be de-recognised** in accordance with IFRS15. They considered that this would align to the PR19 cost assessment process as Wholesalers are not funded for the risk of Retailers failing. The option of redefining revenue was previously considered but discounted due to the potential negative implications on household customers. We do not propose to apply different definitions of revenue as we have concerns that such an approach could result in unwanted outcomes, such as disincentivising the collection of household bad debt.

Another Wholesaler considered that **RAG 1.09 doesn't apply to the billing of Retailers**. Instead, it refers to the billing of properties. They presume that IFRS15 should apply to Retailer revenue.

The Wholesaler considered that 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. The Wholesaler did not consider it possible for the revenue to be recognised, but not the associated bad debt.

We have never set out any expectation that the accounting treatment for wholesale sales should be different to that for retail sales. If different treatment were adopted, then the reporting at the whole company level would be unnecessarily complicated. We have consulted on the RAGs several times in previous years, and this has not been raised as an issue. If companies have strong views about this then they should include this in their response to the next RAG consultation.

One Wholesaler argued that the RAGs are clear that, in the regulatory accounts, companies are **obliged to bill any legitimate consumption**, even if they do not expect to recover any of it. They indicated that, even in the event of retailer failure they would expect to invoice the administrators. They therefore expect all revenue would naturally flow through revenues and bad debt and see no need for this additional adjustment.

In our May 2020 publication we noted that if a retailer went into administration, we recognise that there will be amounts that wholesalers will be unable to bill (up to approximately 45 days' worth of consumption should a retailer fail). Normal accounting convention would mean that if a company is unable to raise an invoice, then the amount could not be recognised as bad debt. We recognise that the RAGs do not directly address this scenario – they operate on the premise that invoices are eventually raised for all services provided to customers.

Several Wholesalers suggested that there was a need to **update our annual performance report tables** or to update APR guidance to facilitate the policy outcome.

One party suggested an additional disclosure in Table 2I ("Revenue analysis for 12 months…") to distinguish between invoiced and un-invoiced revenues would support the commentary and then flow through to Table 2M ("Revenue reconciliation for 12 months…") and the RFI calculation, allowing full visibility of amounts claimed through cost sharing.

A Wholesaler considered that the proposed approach could lead to a discrepancy in the accounts, because un-invoiced revenue could be recognised as income but not be considered as bad debt if a retailer fails. They asked that Ofwat give extra guidance on the way that this should be reported in the APR given that it could lead to a further difference with the statutory accounts.

Another Wholesaler noted that our proposed update to the reconciliation rulebook creates a requirement for Wholesalers to provide commentary setting out the value of un-invoiced amounts due to a Retailer failure as part of the RAG3 disclosure requirement (linked to APR table 2M). At the time of responding, the Wholesaler considered that Ofwat would need to update its APR reporting guidance for 2021/22 onwards, to include this reporting requirement.

We do not propose to update the APR tables to distinguish between invoiced and un-invoiced revenue. As noted earlier in this decision, in the event of a Retailer failure, we expect Wholesalers to provide a commentary setting out the value of un-invoiced amounts as part of the RAG3 disclosure requirement linked to APR table 2M.

2.5 The Reconciliation Rulebook

To support our policy objective, we proposed to amend the PR19 Reconciliation Rulebook and insert the following additional paragraph in section 3.8.6:

Guidance concerning un-invoiced business retail market revenue

Concerning the failure of a business Retailer and the extent to which amounts arise in respect of any un-invoiced revenue and hence submission of any non-zero value for the term UIRt, we expect that where relevant, companies would fully exhaust securities and credit protections available to them using all reasonable endeavours, and use these to offset any outstanding balances due from Retailers, concerning the extent to which amounts arise in respect of un-invoiced revenue.

In relation to our expectation that companies should exhaust all available securities and credit protections, two respondents queried **how Ofwat would expect companies to evidence how they have met this expectation**.

One respondent suggested that the phrase "...using all reasonable endeavours" could lead to insurmountable requirements being imposed at the expense of other competing interests, including cost. They suggested that the word "all" be removed and **replaced with "using reasonable endeavours"**.

In our consultation we noted that:

"...in the event that a Retailer fails and a Wholesaler seeks to pass through the RFI mechanism amounts in respect of un-invoiced revenue, that the Wholesaler will 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 APR table 2M. Such commentary should be consistent with our guidance to be inserted into the PR19 Reconciliation Rulebook – reconciliation model guidance...".

The above statement confirms that an assessment of Wholesaler commentary will be undertaken when we review APR submissions. We will be looking to Wholesalers to provide details relating to the credit protection and securities that Retailers are obliged to have in place to secure a wholesale contract. We'd also expect Wholesalers to show that they had engaged with the insolvency process as a creditor. It is also worth reminding companies that APR table 2 is subject to an independent audit.

On the point concerning "all reasonable endeavours", we are not minded to update the proposed text. If companies have not fully exhausted securities and credit protections available to them, we would expect them to be able to provide sufficient and convincing evidence to demonstrate that they have used all reasonable endeavours to do so, before applying to claim back funds through the RFI. In the event of a Retailer failure, we should be able to compare how different companies have approached recovering un-invoiced revenue and we reserve the right to challenge companies if we are not satisfied with aspects of their RFI claims.

2.6 Market Credit arrangements

Two Wholesalers considered that, in the light of our proposals, there was a case for reviewing the **balance of risk in the market credit arrangements** (defined under Schedules 2 and 3 of the WRC Business Terms).

One Wholesaler was concerned that the proposed adjustment shifts the balance of risk that a Wholesaler bears in the event of a NHH retailer failure. They considered that when the market was set up credit arrangements provided protection for a portion of the invoiced revenue. Including the un-invoiced revenue shifts this balance to a level lower than at the market's inception. They suggested that, in order to maintain this level, a change also needs to be made to the credit arrangements.

Another Wholesaler suggested that company forecasts at pre-market opening were based on historic values and unrealistically forecast zero retailer bad debt cost. They noted that a certain level of credit is required by the market rules. Wholesalers have been encouraged to use Schedule 3 (alternative credit terms) to increase market competition, but they considered that this tends to increase the credit on offer rather than reduce it. The Wholesaler suggested that the more credit that is offered, the potential for greater inefficiency increases.

The first point was raised by a Wholesaler who didn't consider that there is a case for change and incorrectly concluded that they could already fully recover un-invoiced revenue through the existing RFI mechanism. On this basis, they considered that the September 2021 proposal would move them to a position where they can only recover a portion of this revenue. As such, their argument is that the current credit arrangements are based on an assessment of less risk, which isn't the case.

Regarding the second point, the Wholesaler raised some notable observations around the information available at market opening not providing an accurate representation of potential Retailer risk and bad debt. However, we aren't intending to revise anything relating to the Credit Arrangements in conjunction with this proposal. If we consider that changes are required to Schedules 2 and 3 of the WRC Business Terms, this would be undertaken as a separate piece of work.

2.7 The WRC change proposal

Nearly all respondents were supportive of our proposal to amend the WRC. However, one Retailer considered that our proposed updates to paragraph 9.14.2. of the Business Terms would **allow a Wholesaler to draw on credit security in respect of un-invoiced sums in all circumstances**, not just in the event of a Retailers' unplanned exit. They suggested that the existing WRC drafting should be left unchanged, and the following text be added to paragraph 9.14.2:

'The references in [this] Section 9.14.2 to amounts due shall be disregarded in respect of a Contracting Retailer where the Authority has issued a Notice of Cessation of Supply in respect of that Contracting Retailer pursuant to the Interim Supply Code as defined in the document of that name issued by the Authority as amended from time to time.'

As mentioned earlier in this decision, we have noted the concerns raised by the respondent and intend to consider this feedback ahead of proceeding with our Authority timetabled change proposal.

2.8 Other notable queries

On page five of our September 2021 consultation, we made the following statement

> "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 2I. 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"

A Wholesaler enquired what the 'RFI adjustment' is 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)?

They specifically asked if Ofwat expects the actual revenue in the RFI calculation to include or exclude un-invoiced revenue? They considered the interaction between the revenue control licence amendment and the RFI adjustment is critical in interpreting whether the licence amendment works as intended.

In the event of an unplanned Retailer exit, un-invoiced revenue should be included in actual revenue for the purpose of the RFI formula. The proposed change to the RFI formula would then allow an increase in allowed revenue in year t to reflect the extent to which un-invoiced revenue had not actually been recovered (in cash terms) in year t-2.

Regarding point 3, concerning "allowed revenue" (Rt). Rt is "Revenue stated in £ millions allowed to the Appointed Business in a Charging Year by a Price Control in respect of the activities concerned". It would be difficult, therefore, to establish if Rt should include un-invoiced revenue because parties will not know in advance if there will be an unplanned Retailer exit.

A Wholesaler noted that in previous documents Ofwat referred to **a sharing exposure cap** which could be applied. The Wholesaler expressed support for this, though they did not consider that this justifies a differential approach amongst Wholesalers to the cost sharing mechanism for the impact incurred up to the cap.

We consider that the reference to a cost sharing cap relates to a position that we set out in April 2020[2], when we discussed the impact of Covid-19 on the market and outlined our proposals to address liquidity challenges and increases in bad debt. In our decision we stated that:

> "We have set a cap on the additional exposure that each Wholesaler will face as a result of providing liquidity to each Retailer. We are not adjusting the PR19 cost sharing rates for any Wholesalers. But we will cap Wholesalers' additional exposure at the £m figure equivalent to the monthly wholesale charge for the relevant retailer. On a Retailer failing, the bad debt the Wholesaler will carry, after the price control sharing factor has been applied, will be capped at the £m figure equivalent to the average monthly Wholesaler charge for that Retailer. We expect all companies to be able to manage exposure up to this level"

We do not intend to re-introduce a similar exposure cap in the context of un-invoiced revenue. We consider that the context has changed since publishing our April 2020 decision. We are no longer asking Wholesalers to provide liquidity support to Retailers and the Covid-19 legal restrictions have largely been removed.

Thames Water noted that any changes that are made to its licence and to the PR19 Reconciliation Rulebook would **also need to be applied to the Thames Tideway Tunnel price control**. Thames Water noted that only the water resources and network plus price controls are mentioned in the consultation document.

While we are no longer intending to pursue a licence modification to change the in-period effect of the RFI mechanism for the remainder of this price control period, Thames Water is correct that the RFI formula covers its company-specific price control in relation to its interfacing activities for the Thames Tideway Tunnel. It would be consistent therefore to include that control in the scope of our September 2021 proposals (as well as the Network Plus and Water Resources controls).

[2] Covid-19 and the business retail market: Proposals to address liquidity challenges and increases in bad debt

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA
Phone: 0121 644 7500

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Any enquiries regarding this publication should be sent to mailbox@ofwat.gov.uk.

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