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Water UK response to COVID-19 and the Business Retail Market: Proposals to address liquidity challenges and increases in bad debt – a consultation

Summary

Water UK is the representative body and policy organisation for water and wastewater service providers across the UK. This response is on behalf of all wholesalers in England and Wales; if there are any differences or additional points individual wholesalers wish to highlight, they may be responding separately.

The non-household retail market has faced, and continues to face, significant challenges due to impacts of COVID-19. Wholesalers have endeavoured to take a holistic approach to solutions to these challenges for the market as a whole. We have been guided by what is in the best interests of customers, both in the short-term in these exceptional circumstances, and in the longer term.

Wholesalers have engaged constructively with Ofwat and other stakeholders on this basis and appreciate both the open and constructive spirit with which Ofwat has engaged with stakeholders over the last few weeks, and the progress that has already been made towards seeking a resolution that is in the best interests of customers.

Wholesalers welcome Ofwat's recognition that the provision of additional liquidity to the business retail market must not come at the expense of the financial viability of wholesalers. While there is still more to do to set out the detail of how the provision of liquidity will be recovered, we also welcome the clarity that wholesalers should be compensated for the provision of additional "bridging" liquidity that was not foreseen under the previous market arrangements.

We also welcome Ofwat's recognition that issues of liquidity and of the recovery of that liquidity are intrinsically linked. We urge that in coming to a final decision on these matters, Ofwat should consider very carefully how best to avoid short-term emergency actions compromising long term perceptions of regulatory predictability and stability to the detriment of all customers, and also should be fully conscious that wholesalers are of necessity bearing a wide range of risks and impacts related to COVID-19 across all areas of their businesses.

Below, we provide responses to the specific questions in the consultation. We would be pleased to both expand on these responses and to redouble our productive and constructive engagement with Ofwat and other parties, with the aim of working at pace during the remainder of this month to ensure an outcome that is in the best interests of customers in both the short and the long term.

Consultation question 1:

Do you agree with these objectives as set out, which will guide our decisions about what are the preferred options?

We support the aims and objectives set out by Ofwat in both the Foreword and Chapter 3 of the consultation. We consider that these are well aligned to the principles of good regulation of transparency, predictability, targeting, accountability and proportionality.

Consultation question 2:

Excluding customers with temporary vacancy flags, what percentage of remaining wholesale charges are you currently able to recover from customers each month? Please explain why these customers, who are still open for business, are late paying (or not paying in full). Please also provide evidence to support your response.

Consultation question 3:

Please explain how you expect your response to question 2 to change over the next month or two. [NB these questions are aimed at retailers but we would welcome views and evidence from other stakeholders].

We would note that retailers will be better placed to provide full responses to questions 2 and 3 than wholesalers. Notwithstanding this, in the context of recent use of the vacant property flag we welcome and support Ofwat's statement on page 1 of the consultation that:

‘The use of vacant property flags must also be used in line with the intention of the recent code modifications. There will be penalties for misuse’

For the long-term health of the market, it is important that this principle is applied, and we will look to MOSL in particular to provide further clarity on the mechanism to monitor the application of this principle now and in the future. We are keen to see a narrowing of the guidance and approach of using the vacant property flag to focus this support on customers most in need. The use of the vacant flag is having a real impact on the water sector now, and we welcome early action by Ofwat to address any misuse as soon as possible.

Consultation question 4:

Which option for dealing with the remaining liquidity gap facing business retailers do you think would be in the best interests of customers, the market and best reflects the objectives we are trying to achieve? Please explain your view and provide supporting evidence.

We agree that the size of the remaining liquidity gap is a key factor that should inform regulatory decisions on this point, that retailers should be expected to demonstrate that they are taking reasonable steps to access existing or future Government support and that if the remaining liquidity gap is modest, then option 1 would be preferable. However, if the remaining liquidity gap is likely to be material then we would recommend exploring other options.

In this context, we infer from the consultation that Ofwat has a preference for addressing any liquidity gap in an order along the lines of:

- first collecting payments from customers;
- then extending existing commercial financing arrangements or establishing new arrangements;

- then accessing Government support; and
- with wholesalers being strictly the liquidity provider of last resort.

It may be helpful for Ofwat to state more explicitly in its conclusions document its view of the order of preference for measures to address any liquidity gap.

We also agree that given that retailers can temporarily use the vacant flag in CMOS where a business has closed due to COVID-19 (and already have to a significant degree), it is entirely reasonable to expect that retailers should pay more than 50% of wholesale charges each month, as was the intent behind the recent code changes. It also follows that retailers should not face undue or extended constraints on their ability to use the full range of debt recovery tools available to them in normal circumstances.

The precise figure that retailers should be required to pay will need to be determined empirically based on the evidence, but we support Ofwat's expectation that at least 70% of wholesalers' charges should be paid each month and that this percentage could be increased over time. We also support Ofwat being absolutely clear that retailers should pass on to wholesalers at least the wholesaler charge proportion of all customer payments, regardless of whether this is over the 70% minimum threshold. The recent clarifications required on the related code changes demonstrate why it is crucial to be very clear on this point.

We also agree with Ofwat that issues of liquidity (delayed payment) and increased levels of bad debt (non-payment – i.e. default by non-household customers or retailers) are intrinsically linked; as a result, our response to this question is intrinsically linked to our response to question 11.

Consultation question 5:

How should we determine the financing costs associated with any liquidity provided by wholesalers? Please explain your view and provide supporting evidence.

Consultation question 6:

Do you agree that the financing costs associated with any liquidity provided by wholesalers should be borne by retailers? Please explain your view and provide supporting evidence.

As questions 5 and 6 are linked, we are responding to them together. We agree that retailers should bear the financing costs associated with the provision of any additional liquidity by wholesalers. We recognise that in setting the appropriate cost to be borne by retailers, there may be a degree of tension between cost reflectivity and maintaining appropriate incentives.

In particular, we agree with Ofwat that it is important to preserve incentives on retailers to search for other competitive forms of liquidity (including by accessing existing Government support). This is to ensure that wholesaler-provided liquidity will act as a backstop only for those retailers who cannot access more competitive forms of liquidity – and to preserve incentives on retailers to pay back wholesale charges as soon as they can. Wholesaler liquidity should be a last resort.

Ofwat should ensure that this principle is followed through strict audit and rules and/or making the use of wholesaler liquidity less commercially attractive than is available to retailers in the market.

On enforcement, recent experience on urgent clarifications on the related code changes demonstrates the absolute necessity for code changes to be clearly drafted and the need for accompanying guidance from Ofwat and/or MOSL that ensures that all parties interpret new requirements consistently and are

required to act in line with them. Our current view on the areas that would need to be fully captured in the code and guidance include:

- Retailers required to pay an absolute minimum of 70% of charges;
- All customer payments equivalent to at least the amount of wholesaler charges should be passed on to wholesalers, regardless of whether this is over the 70% minimum threshold;
- The use of vacant flags must be applied in line with recent guidance and retailers must proactively gather evidence for Ofwat and wholesaler review, and Ofwat to impose penalties for misuse;
- Retailers should demonstrate to Ofwat that they have sought alternative sources of liquidity, including for example accessing Government support measures; and
- Ongoing review and revision of code guidance documents with industry, to address any issues that arise and require further clarification

We request Ofwat work closely with both wholesaler and retailers over the next few days, to develop and refine the wording of code changes and associated guidance documents before they are submitted to the Panel.

In this context, our view is that the charge to retailers for financing costs should as a minimum be no less than the cost to wholesalers of providing any liquidity. We consider that sufficient incentive would likely be achieved by using the standard wholesale WACC in nominal terms, which represents Ofwat's assessment of the cost of financing wholesale businesses (we note that this is higher than the default interest rate set out in the Wholesale Retail Code of the Bank of England base rate + 4%). In relation to small companies, some degree of uplift would be appropriate, given that Ofwat recognises small companies cannot raise debt as efficiently as large companies.

Retailers would be under no obligation to pay this level of financing costs if less expensive financing was available elsewhere (such as through Government support). However, if retailers do wish to use the wholesaler liquidity "bridge" then application of the WACC would ensure that there is appropriate recognition of the costs that wholesalers must bear in order to finance this activity.

The timing of the reimbursement of the cost of financing will also be important; cash flow and accounting recognition delay could have adverse impacts on key financing metrics, which could be material in some cases.

Consultation question 7:

Do you agree that retailers should receive liquidity support at least to the end of July 2020? And that all additional liquidity provided by wholesalers should be repaid by the end of December 2020?

We agree with the principle that liquidity support should be time-limited and subject to regulatory review. We also agree that unwinding of additional liquidity provided by wholesalers should commence as soon as is practicable and possible.

We agree with Ofwat's judgement in the consultation, informed by evidence from its recent Requests for Information (RFIs) to retailers, that retailers should be required to commence repayment in August and complete repayment by the end of December 2020.

Clearly, earlier repayment would be beneficial, so we would encourage repayment when possible rather than waiting until a backstop regulatory requirement. We support the application of interest on the liquidity used as an appropriate incentive to retailers.

Consultation question 8:

Should retailers incur all bad debt costs from non-household customers defaulting or should some of these costs be recoverable beyond a pre-determined threshold? Please explain your response and provide supporting evidence.

Consultation question 9:

If bad debt costs from non-household customers defaulting should be recoverable beyond a pre-determined threshold, then do you agree that retailers should expect to manage all bad debt costs up to 2% of their turnover, or the level of bad debt from their most recently audited level +1%, whichever is the greater?

Consultation question 10:

Where bad debt costs from non-household customers defaulting exceed a predetermined threshold, should these costs be shared between retailers and non-household customers, and in what proportion, or should they be born wholly by customers? What relevant precedents are there (including in other sectors)? Please explain your response and provide supporting evidence.

We are responding to questions 8-10 together. In normal circumstances we would agree with the principle that wherever possible, retailers should bear bad debt costs from non-household customers, as retailers are best placed to manage these costs and retailers accepted these bad debt risks when they entered the market. However, like Ofwat we recognise that COVID-19 has caused unprecedented economic conditions, and that these conditions are beyond reasonable expectations of what any prudent retailer could have predicted or allowed for. We note that these observations apply equally to wholesalers. We also recognise that in the current exceptional circumstances, retailers' ability to effectively manage bad debt costs has been constrained by regulatory requirements.

Given this situation, it would be reasonable for retailers' liability for bad costs arising from customer non-payment of bills to be limited, and for some or all of the liability above this limit to be borne by non-household customers.

The appropriate limit, and the proportion above this limit to be borne by customers should be based on Ofwat's assessment of the evidence it has obtained from engagement with retailers including relevant RFI responses. We would tend to concur with Ofwat's view that retailers might reasonably be expected to have the financial resilience to deal with some level of bad debt above 'average', either through their own facilities or accessing other forms of liquidity such as the Government's COVID-19 financial support.

The thresholds outlined in the consultation appear to be a reasonable attempt to balance the extraordinary impact of the COVID 19 pandemic – which retailers could not reasonably have anticipated – with the need for retailers to anticipate more general economic pressures that are likely to emerge from time to time in any business environment.

Consultation question 11:

Do you do you agree there is a case for protecting wholesalers from the bad debt exposure associated with the liquidity measures? To what extent do you think the wholesale price control mechanism

provide sufficient protection to wholesalers for Covid-19 related bad debt? Do you think we should amend the totex sharing factors or introduce a cap –for example, a proportion of wholesaler business market turnover?

Before turning to the specifics, we agree with Ofwat that issues of liquidity (delayed payment) and increased levels of bad debt (non-payment – i.e. default by non-household customers or retailers) are intrinsically linked; as a result, our response to this question is intrinsically linked to our response to question 4.

A further consequence of this intrinsic linkage is that all parties – retailers, wholesalers and customers – need full clarity at the earliest possible opportunity (and no later than the end of this month) simultaneously on both issues related to liquidity and issues related to bad debt. One cannot be resolved without the other, and we reconfirm our willingness to redouble our productive and constructive engagement with Ofwat and other parties, working at pace during the remainder of this month to ensure an outcome that is in the best interests of customers in both the short and the long term.

We would also note that full clarity being provided simultaneously on both issues relating to liquidity and issues related to bad debt is essential to ensure that any subsequent decisions by either retailers or wholesalers on whether to appeal to the CMA in relation to any proposed code changes on liquidity are fully informed by clear regulatory decisions on the treatment of bad debt.

While wholesalers have provided ‘bridging’ liquidity to provide short-term relief to the non-household market, and are willing within limits to continue to do so (as above), we agree that it would not be reasonable for the liquidity arrangements that are being proposed to support the business market to compromise wholesaler financial resilience.

Maintaining the pre-27 March risk exposures would be consistent with the principles of good regulation, such as transparency and predictability, and consistent with holding all parties accountable for the risks they are allocated in the regulatory regime. Departing from this position could call into question external perceptions of the stability and predictability of the regulatory regime at a crucial time for investor confidence. Ofwat’s consideration of the use of the PR19 FD WACC for interest payments implies that Ofwat believes that the regulatory framework can continue to maintain the levels of risk faced by wholesalers at the level they were at before this crisis. Any increase in levels of risk borne by wholesalers would necessitate an increased WACC.

The importance of these features of the regulatory environment in supporting investor confidence and the creditworthiness of the sector are clearly articulated and well understood. Moody’s ratings agency – for example – ascribes a 15% weighting to stability and predictability and in its 22 May 2018 description of its ratings methodology for utilities makes the following observations:

“Issuers operating under regulatory regimes that have a very long track record of clearly defined risk allocation principles, which have been consistently applied and transparently disclosed to the public receive the highest scores under this sub-factor. Issuers operating in a jurisdiction that has not implemented a defined regulatory framework and/or is extremely unpredictable or politically driven receive the lowest scores under this sub-factor. For instance, the regulator or government may have a track record of making unilateral changes to the terms and conditions of concessions in water (or

similar infrastructure sectors that are relevant precedents) to the detriment of the concession-holder without providing compensation. Concerns about the independence of the regulatory authorities and the risk of politically-motivated intervention in the regulatory process generally also result in a lower score."

It is important that the collective actions of the sector – by wholesalers, retailers and regulator – are seen to be addressing the issues arising from the COVID-19 event in a stable, effective and predictable manner, thereby reinforcing the strong levels of confidence in the sector. We suggest that before finalising its approach, it would be beneficial for Ofwat to seek views from ratings agencies to avoid unintended consequences.

Wholesalers recognise they have always had a degree of exposure to risk if a retailer failed, and in relation to this exposure there is a clear logic to treating all companies equitably rather than applying the totex sharing outcomes of a price review process where circumstances such as the ones the sector is now facing were not contemplated by either companies or the regulator. The use of sharing factors implies that different wholesalers should be relatively rewarded or penalised on their exposure to business retailer risk related to COVID-19. Ofwat would need to demonstrate that this would be appropriate based on the behaviours of wholesalers on this issue and on their ability to control this specific risk. To date, all wholesalers have engaged fully and proactively on this unprecedented industry wide issue. We strongly believe that there is no justification for a differential approach to this issue, particularly at the wholesaler level.

This exposure that wholesalers have always had is commensurate with the credit terms that were in place prior to the March 27 code changes, and we note that the existing wholesale price control mechanisms were predicated on the codes as they were before March 27 and therefore do not provide protection for the impacts of these changes. Given the unprecedented nature of these circumstances, it would be inappropriate to apply any revenue forecasting penalty under the Wholesale Revenue Forecasting Incentive Mechanism/Revenue Forecasting Incentive (WRFIM/RFI), and it would also not be appropriate to for companies to face any adverse consequences under Ofwat's gearing outperformance sharing mechanism.

We also note that wholesalers, outwith the NHH market risks, are currently exposed to significant additional risks specifically as a result of COVID-19, such that wholesalers are already feeling 'pain', as we recognise are many individuals and sectors of the economy.

The COVID 19 pandemic has exposed wholesalers to a large number of additional risks, many of which are already crystallising. Many household customers are struggling to pay bills due to the difficult circumstances they find themselves in, developer activity has sharply reduced and along with it developer revenue, the industry's supply chain is need of support and companies are facing operational disruption and additional costs as they do whatever it takes to maintain core services in these unprecedented circumstances.

Any concept that wholesalers are exempt from pain or are seeking to be exempt from pain is simply not the case, and we would refute any argument that some extraordinary regulatory manoeuvre might be justified on this basis.

Specifically in the non-household market, wholesalers note that they are exposed to the material volume reductions in the market, with consumption sharply reduced and many properties now marked as being vacant. At the very least this represents a significant impact on the timing of revenue recovery which will be later than expected in the pre-pandemic period.

Wholesalers are also clearly exposed to a heightened risk of retailer failure, compared to the expectations in the pre-pandemic period. As a point of principle, whilst (as would be expected under the established regulatory framework) wholesalers are inevitably more exposed to the event of retail failure as the failure of a retailer is now more likely as a result of COVID 19, wholesalers should not be exposed to any greater quantum of failure from any individual retailer than those which they would have been exposed to prior to the recent code change.

In terms of the options Ofwat has put forward, this means that as a matter of principle and good regulatory practice option i) is clearly inappropriate. The exposure wholesalers face should be capped, and the cap should be set at the level of exposure that existed **before the 27 March code change**.

This would be consistent with ensuring that the allocation of risks was not redistributed at a time when the risk has already begun to crystallise. Not to do so would be changing the rules of the game after it has already started – akin to doubling the size of one goal in a game of football at half time.

We also note that both the March 27 code change and any further extension of liquidity provide a strong incentive for wholesalers to take immediate action to mitigate any further liability if any retailer payments are missed in full or in part. This incentive is strengthened by the existing remedies for wholesalers in the event of a retail default operating with a significant time lag (such as revenue recovery through WRFIM/RFI not being recouped for over 2 years, and the amounts recovered through totex sharing not being recovered until the next AMP), which will put wholesalers under additional pressure in terms of cash flow, ratings assessments and banking covenants. We would note that if a retailer is unable to fulfil its obligations, swift and decisive action may be also be required by Ofwat.

Given this, we suggest that it is crucial that all parties understand the steps that would be necessary in this situation to mitigate the impacts of a retailer failure, protect the customer experience and avoid disruption so far as possible.

We would welcome further discussion in the near future with Ofwat on the practical arrangements that would be needed (for example how interim supply arrangements would work if there were a limited number of, or even no, retailers able to accept additional customers), particularly in view of the potential need to move at pace in a considered and co-ordinated manner to protect both these customers and the broader customer base.

We also strongly urge Ofwat to continue to work with the wholesalers and retailers as the decision and code proposals are finalised over the coming days. The tight timescale and urgency of this issue has already led to some unintended consequences through misinterpretation and lack of clarity, which have required urgent clarification and guidance from Ofwat. We want to ensure that all parties follow both the letter and spirit of any new requirements. We would ask Ofwat to continue to work openly with the industry to minimise the risk of unintended consequences in the next few critical weeks.