16 April 2020

Covid-19 and the business retail market: Proposals to address liquidity challenges and increases in bad debt – a consultation

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Foreword

The impacts of Covid-19 are being felt across the whole of the UK economy. Government and regulators have been acting together to support businesses through this period. In the water sector, Ofwat's actions have been guided by the central principle of protecting customers from the disruption that would be caused by being subject to debt recovery activities or failure of the business retail market. In order to protect customers, we need the retail market to work, and any consequent pressure on wholesalers to be acceptable.

With that aim, on 30 March, working closely with the market operator MOSL, we put in place urgent retail code modifications to resolve an immediate liquidity problem in the business retail market and align wholesale bills more accurately to the reduced consumption caused by temporary business closures. We very much appreciate wholesaler support in providing this liquidity and recognise the pressure it has placed on them.

We now need a set of arrangements to see us through the coming months. This is a national crisis and all parties need to share the burden in order to keep the market as a whole functioning, in the interests of customers. There are some key considerations that we have used to guide our thinking in this consultation and it's important all parties recognise:

- We expect retailers to fully explore and where possible access the Government's main Covid-19 financial support facilities. This should be the principle vehicle for managing the financial pressures they are facing. The availability of this support will be taken into account first in agreeing final regulatory arrangements to manage liquidity and bad debt impacts.
- We will support the business retail market during this time. But liquidity on offer is only for protecting retailers from Covid-19 impacts. It is not a way of managing other cash flow issues and retailers must pay back what they owe promptly. 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.
- The provision of additional liquidity to the business retail market should not come at the expense of the financial viability of the wholesalers. Bad debt concerns will be managed in the business retail market in line with existing market arrangements and wholesalers will only take on liability for a proportion of bad debt where a retailer becomes insolvent.
- Any customer bill impacts from the temporary interventions we put in place will be managed carefully over time to prevent any major shocks.

- Through this process and over the longer-term, Ofwat will work with MOSL and market participants to remove frictions and improve the way the market works and the benefits it provides to customers.
- And in some cases, there will be a longer-term need to strengthen the financial resilience of both retailers and wholesalers, and we will return to these issues as we come out of the Covid-19 crisis.

We hope that the package of proposals in this consultation balances the needs of different parties and will help the sector to cope with the impacts of Covid-19 and continue to provide a high quality service to customers.

Executive summary

This document explores a range of options for supporting the business retail market through the current Covid-19 pandemic and seeks stakeholder views on these options. Below we summarise our draft position for consultation, with points in [square brackets], where we are seeking views and further information to firm up our proposals.

Although government is providing substantial financial support to businesses economy wide, we consider there is merit in providing a period of **liquidity support** to retailers in the market. This would provide sector-specific protection against systemic retailer failure, in recognition that the market is new, many companies are not yet well capitalised and the arrangements to protect customers on supplier failure have not yet been well tested.

Our proposal for consultation is that retailers should receive liquidity support at least [to the end of July 2020], or longer if this period is extended following a review and further consultation by Ofwat early in the summer. Support will be provided by relieving retailers of the requirement to pay the full amount of wholesale bills due for this period. We are minded to require retailers to pay wholesalers each month a minimum of [70%] of the wholesale bills due or a proportion equivalent to the invoices they have received from their own customers, whichever is the higher. MOSL is designing formal arrangements to monitor retailer receipts from their customers for this purpose, bearing in mind the importance of accurate data to support this measure.

We consider it is appropriate that wholesalers charge interest on deferred payments [and seek views on what the appropriate rate of interest should be] in recognition of the cost of providing this liquidity and to incentivise retailers to use other sources of liquidity where they can. We propose that retailers will be required to start to repay deferred amounts from August, with all amounts repaid by the [end of 2020].

We have considered the arguments for providing retailers with **protection against the bad debt arising from customer default on bills.** In principle, the liquidity support explained above, gives retailers time to put in place the financing – including from government funds – they need to weather bad debt. However, as long as the Customer Protection Code of Practice places restrictions on the measures retailers can take to collect outstanding amounts from non-household customers affected by Covid-19, there is an argument for providing retailers with some protection against bad debt exposure. This could be done either through making an adjustment to the price cap put in place for most customers via the Retail Exit Code (REC), or by capping retailer bad debt exposure with some or all bad debt above this cap being recovered from non-household customers over time. We are minded to introduce a cap on bad debt exposure. We expect this cap to be **above** normal levels of bad debt and expect this to sit at around [2%] of retailer turnover. If, following consultation, we decide to implement such a cap, the mechanism to implement a cap would be developed with Trading Parties in due course.

A number of mechanisms in the PR19 price control protect wholesalers to an extent from **bad debt risk of a retailer exiting the market.** Wholesaler exposure to this risk will increase if we introduce the liquidity support measures noted above and will increase the more generous and long lasting this support is. While we expect water companies to be resilient to the shocks associated with an economic downturn, we do not consider it appropriate that liquidity measures to support the retail market should come at the expense of the financial resilience of the wholesalers.

Depending on the extent of liquidity support that is provided, there could be a case for providing wholesalers further protection (above that provided in the price control) from associated bad debt exposure. We are seeking further information on whether we need to place a cap on wholesaler exposure to bad debt arising from the liquidity arrangements. We seek further information to help us decide where, as a percentage of wholesalers' annual non-household turnover, the cap should sit, if it is required. If we decide to provide this extra protection to wholesalers we will work on the arrangements for recovering the bad debt amounts above the cap, including considering whether this should be recovered from the wholesaler's own customers or more widely across all non-household customers.

Contents

1. About this document

The UK economy has been significantly affected by the Covid-19 outbreak and the Government is making unprecedented levels of financial support available to businesses. We want to protect customers in these unprecedented times and ensure that the delivery of water and sewage services is as smooth as possible during the current crisis. As a result this consultation looks at what further steps may be necessary to protect non household customers from the impacts of Covid-19.

Covid-19 and the associated restrictions on the movement of people and the operation of businesses, has created some immediate challenges to the on-going operation of the business retail market. To protect and provide continuity for non-household customers at a time of considerable uncertainty, we worked closely with MOSL to implement a number of urgent changes to the industry codes. These changes focus on protecting end customers and avoiding systemic retailer failure (which would not be in customers' interests at this time) and include: restricting retailers from charging interest or late payment fees for late payments or requesting that customers be disconnected at this time; deferring payment of a proportion of wholesale charges to reflect late payment by non-household customers; and temporarily allowing retailers to use a vacant flag in the market database to reflect where businesses are closed and not consuming water.

The change we made on the temporary deferral of wholesale charges was an interim solution designed to address the immediate cash flow issues facing retailers and to create some time to develop a more enduring solution to the liquidity challenges facing the market until normal market arrangements can be restored. We are grateful to wholesalers for their support in providing these temporary liquidity support measures.

Conversations with both wholesalers and retailers (collectively referred to in this document as Trading Parties) have made it clear that a more enduring solution on liquidity (late payment) cannot be separated from decisions about how elevated levels of bad debt (non-payment) will be treated. As a result this consultation sets out options for dealing with liquidity issues facing the business retail market as a result of Covid-19. And it also sets out options for treating higher levels of bad debt resulting from both non-household customers defaulting; and a business retailer defaulting.

We intend to make decisions on liquidity and bad debt before the end of April. We intend to implement our decision on liquidity by recommending a code change to the Industry Panel at its meeting on 28 April. Implementation of this change is required by the end of April so it can be reflected in the settlement runs that take place in early May.

By the end of April and following responses to this consultation, we also expect to make a decision on how both types of bad debt should be treated. We will make it clear who is expected to manage these risks and incur the associated costs. And whether (and by how much) a given party's exposure to these costs are capped. The more detailed mechanism for implementing these arrangements will not be agreed by the end of April, but will be our priority thereafter.

The remainder of this document is structured as follows:

- Section 2 introduces the issues and provides relevant background information;
- Section 3 sets out the objectives that will guide our decision making and assessment of the options;
- Section 4 identifies and assesses options for addressing:
  - Temporary liquidity issues facing retailers from late customer payments;
  - Elevated levels of bad debt from customers defaulting; and
  - Elevated levels of bad debt from business retailers defaulting.
- Section 5 sets out next steps; and
- Appendix 1 summarises the consultation questions.

Responding to this consultation

We welcome stakeholder views on the questions detailed in Appendix 1 of this document by 5pm on Tuesday 21 April 2020.

Please submit email responses to covidbusinessretailmarket@ofwat.gov.uk, with the subject 'Liquidity and bad debt consultation'.

Due to the closure of the Ofwat offices we are currently unable to accept responses by post.

Responses to this consultation may be published on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the General Data Protection Regulation 2016, the Data Protection Act 2018, and the Environmental Information Regulations 2004. For further information on how we process personal data please see our Privacy Policy.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

In developing these consultation proposals we have used information and evidence collected so far, including from requests for information from trading parties and from discussions we have had with the UK Water Retail Council, Water UK and the Consumer Council for Water. We have welcomed the constructive discussions thus far and this consultation is an opportunity for stakeholders to provide further evidence to support their positions and views. It's important that stakeholders explain their views clearly and provide supporting evidence wherever possible. We will continue to work closely with MOSL in making final decisions and implementing the solutions.

In responding to this consultation we request that stakeholders view these consultation proposals as a package of measures and to be mindful of the interactions between the proposals and the interactions with other changes also recently made. It's important we avoid doubling counting risks but it's also important we hear views on any gaps or unintended consequences. We also request that in responding to this consultation stakeholders bear the current extreme circumstances in mind. We want to hear views in the context of what is in customers' best interests, bearing in mind these changes will be time limited and will subsequently be unwound.

Existing Government support

To manage the economic impacts of Covid-19 the Government has already made a range of financial support available to businesses. This includes the Covid Corporate Financing Facility (CCFF), Coronavirus Business Interruption Loan Scheme (CBILS) and the soon to be launched Coronavirus Large Business Interruption Loan Scheme (CLBILS). In managing the financial pressures Covid-19 has placed on them we expect trading parties to use these facilities (where they are eligible) as their principal support.

The regulatory support Ofwat is considering making available through this consultation should be seen as a backstop in case wider Government loans and facilities are not sufficient for the circumstances trading parties find themselves faced with. We will design our regulatory support mechanisms with this approach in mind and in setting wholesaler bill deferral rules, repayment terms and bad debt burden sharing arrangements we will take into account the availability of this wider economy support. If we believe that Government financial support is sufficient to allow trading parties to function effectively in the core delivery of services to customers we may decide that further regulatory support is not required. We're asking respondents to this consultation to provide us with views on this approach.

Terminology

Within this document, wholesalers are the companies responsible for owning and maintaining the physical assets associated with supplying water and wastewater services to customers. Retailers are those responsible for billing non-household customers for their consumption, and for providing other customer-related services. Non-household customers are businesses (e.g. corner shops, hotels, laundrettes etc.), charities and public sector organisations that are using and paying for water and wastewater services and who are eligible under industry rules to choose their retailer. The term trading parties is used to refer to wholesalers and retailers collectively in this document.

2. Background

The respective responsibilities and risks borne by retailers and wholesalers in the business retail market are set out in relevant legislation, regulations and market codes. Retailers' responsibilities include reading meters, billing end customers, managing bad debt and collecting revenues from customers and for paying charges to wholesalers. Wholesalers' key responsibilities include the delivery of safe and reliable water and wastewater services to end users, maintenance of the physical assets that they own and to manage interactions with retailers, including managing the bad debt associated with the failure of a Retailer counterparty, in line with regulations and provisions of the market codes.

Like many areas of the economy, the business retail market has been significantly impacted by the Covid-19 pandemic. Demand has significantly reduced, in particular because many businesses have been instructed to close. And many non-household customers may experience difficulty paying, or are unable to pay their bills. This creates a cash flow issue for business retailers because they are required to pay wholesalers for the water and wastewater services that their customers use and these charges are generally based on historic usage. While we expect the retailers to weather an economic downturn, the impact of the Covid-19 pandemic has been sudden and sharp. This presents risks to customers. We are seeking to mitigate the impact of these risks on customers.

While significant financial support has been made available by government to support businesses through Covid-19, in order to provide some immediate and interim relief to retailers and crucial stability and protections for end user customers, Ofwat, working closely with MOSL, has made a number of urgent temporary modifications to the market codes:

- We made a suite of temporary changes to the Customer Protection Code of Practice[1] in order to afford non-household customers added protections during this period of uncertainty. These changes i) **prohibit retailers from requesting the disconnection of non-household customers for non-payment** due to the outbreak of Covid-19; ii) ensures that retailers **do not seek to recover any default interest for non-payment of invoices** during a specified period which covers the outbreak of Covid-19; and iii) prohibit

[1] Ref CP0006 - https://www.ofwat.gov.uk/publication/customer-protection-code-of-practice-change-proposal-ref-cp0006/

retailers from **seeking to enforce the non-payment of invoices** against non-household customers until Ofwat permits this.

- To mirror the temporary prohibition on the disconnection of non-household customers, we made a similar change to the market codes[2] to ensure that **self-supply retailers, who are also customers themselves, cannot be disconnected** if they experience difficulty in paying their bill.

- **Temporary change to vacancy** – We allowed[3] retailers to temporarily apply the 'vacant' flag in the Central Market Operating System (CMOS) so that charges are not accrued for those premises that have closed due to the Covid-19 pandemic. The effect of this change is to more accurately reflect actual levels of consumption during the pandemic, which in turn reduces the liabilities on the part of retailers in terms of the wholesale charges they would be due to pay and the bills that non-household customers are required to pay retailers. If this change had not been made, consumption (and consequential charges) would have been based on historic usage or estimates, which would have resulted in retailers being liable for charges in excess of the revenue they would justifiably have been able to recover from their customers.

- **Interim deferral of wholesale charges** – We allowed[4] for a deferral of up to 50% of the charges due from retailers to wholesalers. The change covers amounts invoiced and due in March, and from settlement in April and (subject to the proposals in this consultation) May[5]. This modification was an interim measure to reduce the burden on Retailers in the immediate term.

- Finally, we temporarily **suspended the collection of Market Performance Charges**[6] to reflect the impact that the introduction of widespread social distancing to combat the spread of the Covid-19 pandemic has had on wholesalers and retailers. Trading Parties are much less able, for reasons outside their control, to meet the requirements of the market performance framework – for example, many 'Business As Usual' activities, such as meter reading, have been significantly affected and our changes ensure that Trading

[2] Ref CPW094 - https://www.ofwat.gov.uk/wp-content/uploads/2020/04/CPW094-Decision-Document.pdf
[3] Ref CPW091 - https://www.ofwat.gov.uk/wp-content/uploads/2020/03/CPW091-decision-document.pdf
[4] Ref CPW093 - https://www.ofwat.gov.uk/wp-content/uploads/2020/03/CPW093-decision-document.pdf
[5] The deferral would also apply for the May settlement as a backstop only and if a more enduring solution has not been established by end April.
[6] Ref CPM023 and CPW090 - https://www.ofwat.gov.uk/wp-content/uploads/2020/03/CPM023-and-CPW090-decision-document.pdf

Parties are not unfairly penalised for failing to meet market performance standards due to factors outside of their direct control.

Taken together, the package of urgent modifications outlined above has ensured that the business retail market has continued to operate, protecting and providing continuity for non-household customers at a time of considerable uncertainty. When we introduced the interim deferral of wholesale charges, we made it very clear that this was a stop gap solution, designed to provide time to develop a more enduring solution to the liquidity challenges facing the market. We also agree with Trading Parties that, as we look longer term, the 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. This consultation sets out options for dealing with both issues.

The remainder of this section introduces and provides relevant background information on the liquidity challenges facing the market and bad debt, which can arise from non-household customers defaulting or from business retailers defaulting.

Liquidity challenges

In the normal course of business, the terms of payment between retailers and wholesalers are established in the market codes, and this provides for retailers to pay wholesalers for the services that they and their customers use. The market codes allow retailers to choose to pay their charges in advance or in arrears. Where they choose to pay in arrears, they are required to provide credit collateral to the wholesaler to mitigate the impact of retailer default. Retailers would then recover this money from customers, again either through customers paying in advance for their usage, or in arrears.

Covid-19 has led to many customers being unable to pay their bills on time. Retailers are forecasting[7] a steep fall in payment from non-household customers, reflecting the impact of Covid-19 with many businesses in lockdown, and we are aware of increases in cancellations of direct debits. This can create a 'liquidity gap', largely arising from the difference between what the retailer owes the wholesaler in wholesale charges and the wholesale charges that the retailer is able to recover from end customers in a given month. Of course, Retailers will also face other costs that will likely contribute to this liquidity gap.

[7] Responses to a Call for Inputs issued by Ofwat in March 2020

At present, non-household customers should fall into one of the following three broad categories:

1. Businesses such as restaurants and hotels that have closed due to Government's instructions. The 'temporary change to vacancy' code modification should ensure that such businesses are identified and marked as 'vacant' and will not face water charges (or at least do not face most water charges[8]). This group of customers should not have a material ongoing impact on the 'liquidity gap' due to the code change already in place. However, there is a variant of this category insofar as some businesses closed quickly and before a vacant flag was able to be imposed. This means that there are charges due but retailers are unable to collect revenue from these customers who as a result do impact on the 'liquidity gap'.
2. Businesses that remain open and experience increased levels of activity – e.g. food manufacturing, delivery services, supermarkets, etc. These companies should generally be able to pay in full and on time, recognising there may be cash flow issues facing these businesses too (for example, where they have provided goods on credit to other businesses).
3. Businesses that remain open or continue to use water / wastewater services[9], for example holiday parks, but for whom their usual business activity is lower, or who have cash flow problems of their own and are more likely to experience problems paying their water bills on time. These are the customers most likely to contribute to the 'liquidity gap' facing business retailers.

Retailers have a different mix of customers and there could be a large variation in the degree to which they are exposed to the third category of customers.

The implementation of CPW091 has seen a significant increase in properties being flagged as vacant. Based on MOSL data, the period from 16 March 2020 to 6 April 2020 saw vacant premises increasing by around 40% (100,000). Prior to 15 March, premises were being flagged as vacant at a rate of around 150 per day, in the period from March 16th this has risen to c.4500. Implementation of CPW093 has effectively seen Wholesalers inject liquidity into the market, as up to 50% of the charges they

[8] This is dependent on the approach adopted by the relevant wholesaler – some wholesalers apply fixed charges for vacant properties

[9] The temporary vacancy flag can be used where a customer is using 95% less water than it would ordinarily. So if a business has only reduced its usage by 80% for example, a retailer could not use the vacancy flag.

would otherwise be due are temporarily deferred. Anecdotally, we have been told that some retailers have paid the minimum 50% of wholesale charges due.

Our proposal to provide a more enduring solution to the liquidity challenges in the market is discussed in section 4.

Increased levels of bad debt

Many non-household customers are experiencing or will experience difficulty paying their bills. Where businesses are closed, retailers can temporarily make use of the vacant flag in CMOS, which will significantly reduce or even waive wholesale charges owed whilst the business is closed. The government has also made unprecedented levels of financial support available for businesses who are being affected by Covid-19, and as explained above, we made a suite of temporary changes to the Customer Protection Code of Practice to provide added protections for non-household customers where they are struggling to pay their bills during this time – including a prohibition on disconnecting non-household customers.

Despite these measures, it is possible that some non-household customers may struggle to continue operating and default on payment of their water bill. When this debt is owed but becomes unrecoverable using normal debt collection methods or the relevant business has become insolvent, it becomes ‘bad debt’. This in turn puts pressure on the cash flow of retailers, who may themselves face difficulty in paying their wholesale bills and potentially be forced to exit the market.

A level of bad debt cost is generally accounted for in business as usual and, as explained further below, there are already allowances for bad debt costs in Retailers’ price restraints through the Retail Exit code (REC). However, it is possible – although not at this stage known – that levels of bad debt materialising as a result of Covid-19 could materially exceed levels anticipated by the current market arrangements and which may not be possible for Trading Parties to bear without threatening their financial resilience and risking financial failure, to the detriment of end user customers.

Sections (i) and (ii) below distinguish between two different types of bad debt and explain how these are dealt with under the current market arrangements. Section 4 then sets out our proposal for dealing with elevated levels of both types of bad debt resulting from Covid-19.

i) Bad debt that emerges as a result of non-payment by customers

Under the current market arrangements, retailers bear the risk of bad debt from end customers not paying their bills, mainly because they own the relationship with the customer and are therefore best placed to manage this risk. Retail price restraints applying to retailers under the Retail Exit Code (REC) include an allowance for a range of bad debt costs, set with reference to those current at the time of market opening. This also provided an incentive for retailers to manage bad debt costs, as those who did so would be at a competitive advantage.

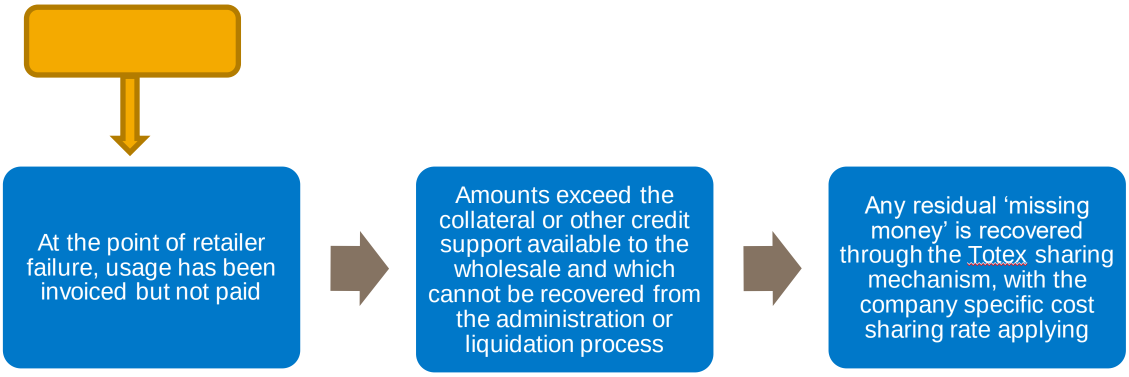
Further, and as explained above, we have made changes to the Customer Protection Code of Practice that temporarily prohibits retailers from enforcing their contractual rights with customers, including a prohibition on charging interest, late payment fees and requesting disconnection for non-payment. In effect, these changes reduce the tools available to retailers to manage and reduce levels of bad debt. This, combined with a higher likelihood of non-household customers going out of business, could lead to levels of bad debt experienced by retailers being higher than they otherwise would be.

ii) Bad debt that emerges as a result of retailer default

The primary risk facing wholesalers is the risk that their counterparty, the retailer, goes into default. Wholesalers have the ability to manage this risk to some extent – wholesalers either receive payment in advance from retailers, or where the retailer chooses to pay in arrears, the wholesaler is able to call on credit arrangements (including, for example a Guarantee or Letter of Credit). While the wholesaler is unable to choose which retailer it enters into a contract with, compared to the pre-2017 framework, wholesalers have less exposure to customer bad debt risk (as this is now transferred to retailers) but some exposure to retailer failure. We recognise that the Covid-19 pandemic will have affected the likelihood of retailer default and the temporary liquidity arrangements we have put in place has increased the wholesalers' level of exposure were a retailer to go into administration.

Where the retailer does fail and goes into default, and it owes the wholesaler money, there are three alternative scenarios that could then play out. In each scenario, the price control arrangements afford an element of protection to the wholesaler – this is explained further below and in Figures 1, 2 and 3.

Figure 1 Water has been used, has been invoiced but has not been paid



For revenue invoiced (or due for the purposes of regulatory accounting) but not paid, a proportion of this revenue would be recovered by the wholesaler through the price review totex cost sharing mechanism[10] with the company specific cost sharing rate established through the PR19 price control applying, as set out in the table below. This ranges between 25% and 50% recovery for wholesalers. We are talking here about revenues that exceed the collateral or other guarantees available to the wholesaler and which cannot be recovered from the administration or liquidation process.

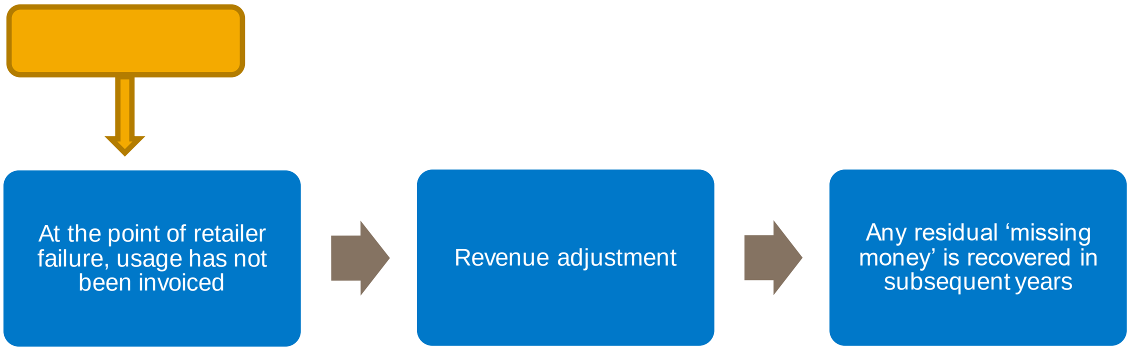
[10] The cost sharing reconciliation model calculates any adjustment for underperformance or outperformance against forecast total expenditure (totex) at the PR19 final determinations.

Company	Water resources and water network plus		Wastewater network plus	
	Out-performance	Under-performance	Out-performance	Under-performance
Anglian Water	31.89	68.11	34.96	65.04
Dŵr Cymru	42.66	57.34	41.51	58.49
Hafren Dyfrdwy	53.96	50.00	59.11	50.00
Northumbrian Water	46.19	53.81	34.40	65.60
Severn Trent Water*	50.00	50.00	50.00	50.00
South West Water*	50.00	50.00	50.00	50.00
Southern Water	36.45	63.55	36.08	63.92
Thames Water**	32.27	75.00	44.22	75.00
United Utilities*	50.00	50.00	50.00	50.00
Wessex Water	43.86	56.14	41.33	58.67
Yorkshire Water	38.06	61.94	33.21	66.79
Affinity Water	46.51	53.49		
Bristol Water	39.76	60.24		
Portsmouth Water	60.08	50.00		
South East Water	38.09	61.91		
South Staffs Water	45.06	54.94		
SES Water	44.63	55.37		

* For fast track companies we apply cost sharing rates of 50% as they accepted our view of costs at the initial assessment of plans.

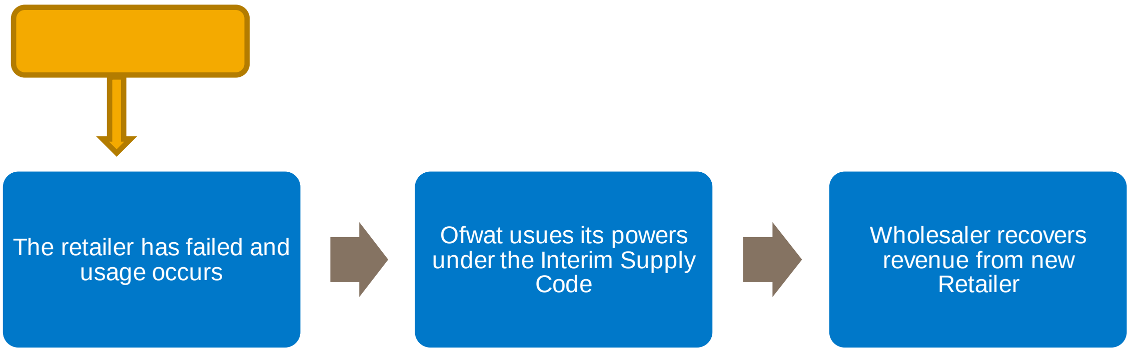
** Thames Water's cost sharing rate for underperformance is based on a reduced rate of 75%, due to its business plan classified as significant scrutiny and lack of appropriate engagement after the Initial Assessment of Plans. Further detail in 'Significant scrutiny companies – Application of lower cost sharing rates and outcome delivery incentive cap'.

Figure 2 Water has been used, but has not been invoiced



Under scenario 2, any water that has been used but not invoiced (or due for the purposes of regulatory accounting) at the point of retailer failure and that therefore is not recovered, would form part of the Revenue Forecasting Incentive Mechanism (RFI) established through the 2019 Price Review (PR19). The RFI is a revenue adjustment, applied in-period to reconcile any revenue under or over-recovery in an earlier year. Where differences between actual and allowed revenues (as set out in the PR19 price determination) are greater than 2%, the RFI applies a financial penalty which would be recovered in-period[11].

Figure 3 Water has been used after the retailer has failed



Under scenario 3, upon retailer failure, Ofwat would step in and use its powers under the Interim Supply Code to allocate affected customers to a new retailer[12]. It is important to recognise that under this scenario, any usage that occurs after the date of failure is applied to the new retailer(s) regardless of the time period between the previous retailer failing and the new retailer(s) assuming supply. The Market Operator (MOSL) is able to backdate the new retailer(s)' appointment to the day after

[11] Any imbalances are recovered with a 2-year lag – e.g. a shortfall in 2020/21 would be recovered in 2022/23
[12] Depending on the process Ofwat decides to use to allocate customers, customers may be allocated to more than one retailer.

the failure of the previous retailer, so for the purposes of wholesaler exposure, there is in effect always a retailer in place.

3. Objectives

This section sets out the objectives that we think should guide our decision making on the temporary provision of liquidity and treatment of excessive, Covid-19 related, bad debt.

For clarity we are of the view that these objectives are consistent with the Principles of the Wholesale Retail Code and in particular further the principles of Efficiency, Proportionality, Transparency and [reduction of] Barriers to Entry.

1. We want to protect the interests of all end user customers. We see the effective functioning of the business retail market in both the short and longer term should help achieve this aim.

2. Where customers cannot pay on time for reasons relating to Covid-19, retailers should continue to be prohibited from charging customers' interest, imposing late payment fees or requesting disconnection.

3. Where customers are able to pay on time we expect retailers to continue to collect charges and to use these to fund the payment of wholesale charges. Retailers must not hold onto money collected from customers where this can be used to fund wholesale charges.

4. Retailers should be incentivised to explore and access alternative forms of liquidity (e.g. Government support) before considering whether to defer payment of wholesale charges. And they should be incentivised to pay deferred wholesale charges back as soon as possible.

5. Both wholesalers and retailers should be capable of withstanding the changes in business cycle. The provision of additional liquidity to the business retail market should not come at the expense of the financial viability of the wholesalers.

6. Consistent with existing market arrangements we generally expect retailers to manage risks associated with non-household customers defaulting and we expect wholesalers to manage risks associated with business retailers defaulting.

7. The Covid-19 pandemic and the arrangements put in place to provide liquidity to the market may see levels of bad debt materially exceed those envisaged by the current market arrangements. In such cases it may be appropriate for

retailers to recover some of these incremental costs from non-household customers. But consistent with principle (1) we do not expect customers to bear all the additional risks and we want to maintain incentives on companies to act in the bests interests of the market and customers. Where companies can recover additional costs from non-household customers, bill impacts will be managed carefully over time to prevent any major shocks.

Consultation question 1: Do you agree with these objectives as set out, which will guide our decisions about what are the preferred options?

4. Options

This section identifies and assesses options to deal with the three separate - but related – issues that are the focus on this consultation:

i. Temporary liquidity issues facing retailers from late customer payments caused by Covid-19 pandemic which are over and above expected levels of late payments;
ii. Elevated levels of bad debt from customers defaulting caused by Covid-19 pandemic which are over and above expected levels of late and defaulted payments; and
iii. Elevated levels of bad debt from business retailers defaulting caused by Covid-19 pandemic which are over and above expected levels of late and defaulted payments.

Temporary liquidity issues facing retailers from late customer payments

Section 2 above introduces the concept of a 'liquidity gap', which largely arises from the difference between what the retailer owes the wholesaler in wholesale charges and the wholesale charges that the retailer is able to recover from end customers in a given month, also noting that retailers will face other costs that are likely to contribute to the liquidity gap. Section 2 also highlights that the temporary change to vacancy code modification (CPW091) is expected to go at least some way to addressing the liquidity challenges arising from non-household customers who are currently closed. And for non-household customers that remain open and experience normal levels of activity - e.g. food manufacturing, delivery services, supermarkets, etc. - we would expect these customers to generally be able to pay in full and on time.

We would like to understand the size of the 'remaining liquidity gap', i.e. the liquidity gap that remains once we have deducted the effect of the use of the temporary vacancy flag due to Covid-19.

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].

Options identification

In general there are three types of option for dealing with the remaining liquidity gap facing business retailers:

i) Retailers resolve their cash flow issues, through loans or other sources of finance and pay all wholesale charges that are due even where they have not recovered these from end customers (this is essentially the 'do nothing' option before the recent code changes were made);
ii) Retailers adopt a 'pay when paid' approach, which means they pay wholesale charges only where they have been able to recover these from end customers. This option involves wholesalers providing additional liquidity to the market; or
iii) Retailers required to pay a minimum proportion of wholesale charges, which could be greater than the proportion of wholesale charges they have been able to recover from customers. (E.g. a retailer recovers 80% of total wholesale charges owed from customers but is required to pay the wholesaler a minimum of 90%). This option could involve both retailers and wholesalers providing some additional liquidity.

Some form of combination of options (ii) and (iii) are also possible, for example a requirement on the retailer to pay the minimum percentage of the wholesale charges, or based on the proportion of their receipts, whichever is the higher.

It is important to note that different retailers will be in different positions – both with respect to their exposure to customers who are unable to pay (and who have not been temporarily flagged as vacant) and with respect to their ability to withstand shocks and their access to liquidity at competitive rates. Wholesalers may also be in different positions in terms of their ability to withstand shocks and provide liquidity. The provision of additional liquidity to the business retail market should not come at the expense of the financial viability of the wholesalers.

It is also important to note that the Government has made unprecedented levels of financial support available to businesses as a result of Covid-19. We want to ensure that any interventions we make will maintain incentives on retailers to access this support where appropriate.

Options appraisal

The business retail market was introduced on the expectation that it would be self-standing and capable of withstanding the changes in business cycle. We required Retailers to make minimum liquidity provisions and to manage bad debt. The business retail market, like any other, will also, from time to time, see the exit of less healthy companies. Option i recognises this original intention and a long term aspiration we have for the market. **If use of the temporary vacancy flag has significantly reduced the size of the 'remaining liquidity gap' then option i is likely to be the preferred option.** This option is most closely aligned to the existing market arrangements and reflects the fact that Government has made unprecedented levels of financial support available to businesses during the Covid-19 outbreak.

On the other hand a combination of unprecedented economic conditions caused by Covid-19 and the temporary restrictions on Retailers' ability to charge interest, issue late payment charges and threaten disconnection (see section 2 above) could lead to higher levels of late payments than they might have reasonably expected. If the 'remaining liquidity gap' is material, and business retailers are not able to access existing Government support or other forms of financial support so that they can pay all wholesale charges, then this might lead to a systemic failure of retailers and disrupt service to customers.

Option ii would remove Retailers' exposure to the current economic conditions completely, asking instead Wholesalers to provide the missing liquidity. This could create a potential liquidity issue for Wholesalers and affect their financial viability. Changes we have made to the Customer Protection Code of Practice (CPCoP) stop retailers from applying default interest or enforcing their rights to recover overdue charges, for instance threatening to stop supply, threatening civil proceedings, threatening disconnection. They don't prevent non-threatening reminder letters or discussions with customers about rescheduling payments if that would help the customer.

A combination of options ii and iii could involve something similar to the existing interim code change (CPW093). The intention of which is that Retailers pay all of the charges that they have been able to collect from customers, and – where that falls below 50% of wholesale charges – make up the difference to at least 50% of wholesale charges.

Anecdotal evidence implies there has been some misunderstanding of the intention behind this code change, which some trading parties have interpreted as retailers only having to pay 50% of wholesale charges. As a result we and MOSL published a joint letter to clarify the intention of the code change.[13] This letter also emphasises the importance of using the temporary vacant correctly, in line with published guidance, and that retailers could face penalties if the flag is used illegitimately.

In the absence of information on the revenues collected from customers by individual retailers in different wholesale regions, it has also been difficult to enforce the intention behind this interim code change, which is that retailers should be paying more than 50% of wholesale charges if they can. For this reason MOSL has commissioned a sub group of the Industry Panel to consider what additional reporting requirements are necessary for us to understand and monitor the value of the liquidity gap for each retailer in each wholesale region. (See section 5 for more information on this).

If the 'remaining liquidity gap' appears to be material and there are risks that business retailers may be unable to access existing Government support, then a combination of options ii and iii would be our preferred option. That is, our preference would be that retailers each month pay the greater of either; a minimum proportion of charges due to wholesalers, or what they have recovered from customers.

We believe this recognises the liquidity pressure on both Retailers and Wholesalers and preserves incentives on Retailers to collect and pay. This should also help retailers and end customers' in the longer term by reducing the amounts that are owed when these arrangements are unwound. We also think it aligns with the

[13] See: Ofwat and MOSL joint letter concerning CPW091 and CPW093

objectives we are trying to achieve of resilient trading parties capable of withstanding changes in business cycle.

If a combination of options ii and iii is pursued we would expect the evidence provided in response this consultation to inform our decision on the minimum proportion of wholesale charges that must be paid by retailers. Given that retailers can temporarily use the vacant flag in CMOS where a business has closed due to Covid-19, we think it likely that retailers should pay more than 50% of wholesale charges each month. We expect retailers should pay a minimum of at least 70% and will review this in light of evidence received.

It's important to note that while wholesalers should have sufficient headroom to be able to weather some of the costs associated with Covid-19 and the associated economic downturn, we do not think it is reasonable for the additional liquidity arrangements being introduced to support the business retailers to expose wholesalers to an inappropriate level of risk. We want to ensure we understand the impacts on wholesalers.

Cost of providing liquidity

Where wholesalers are providing additional liquidity to the business retail market by deferring payment of wholesale charges, the provision of this liquidity comes at a cost. There are a number of approaches to estimating the financing costs of liquidity provided by wholesalers, which include (but are not limited to):

- Weighted average cost of capital (WACC) set at PR19;
- Cost of debt set at PR19[14];
- Default interest rate set out in the Wholesale Retail Code (Bank of England base rate plus 4%).

We are seeking views as part of this consultation on what is the most appropriate financing cost to use where wholesalers provide additional liquidity to the business retail market.

We believe that retailers should bear the financing costs associated with the provision of any additional liquidity by wholesalers. This will preserve incentives on

[14] These are set out in the PR19 final determination Allowed return on capital technical appendix here. And are also subject to the outcome of any reference to the Competition and Markets Authority (CMA).

them to search for other competitive forms of liquidity (including by accessing existing Government support) which means that wholesaler-provided liquidity will act as a backstop only for those retailers who cannot access more competitive forms of liquidity. This will also preserve incentives on retailers to pay back wholesale charges as soon as they can.

Timing

It is not clear how long the current pandemic, or the associated restrictions on the movement of people or operation of business, will last. Our current view is that retailers should receive liquidity support at least to the end of July 2020, or longer if this period is extended following a review and further consultation by Ofwat early in the summer. We are conscious that extending the scheme beyond a certain point could come at the expense of wholesaler financial viability. However this does depend on the maximum proportion of wholesale charges deferred each month. For example a wholesaler could provide liquidity for longer if 10% of wholesale charges are deferred each month, compared to a scenario where 30% of charges are deferred.

Our current view is that unwinding of additional liquidity provided by Wholesalers should commences as soon as is practicable and possible. We propose that retailers will be required to start to repay deferred amounts from August (unless the period is extended following consultation in the summer). So this means that at least some, if not all, of the payments deferred in March would be payable by the end of August. But this is a backstop and if retailers can repay deferred charges sooner than this, then they must do so.

Our current view is that all additional liquidity provided by wholesalers should be repaid by the end of December 2020. Any amounts outstanding from non-household customers at that point should be managed by retailers through their own bad debt processes.

To summarise our proposals for consultation on the provision of liquidity:

- If there is a retailer liquidity gap that is material then our proposal is that retailers should receive liquidity support from wholesalers and should pay the financing costs associated with this. In this case we are minded to introduce a requirement on the retailer to pay a minimum percentage [70%] of wholesale charges, or based on the proportion of their receipts, whichever is the higher. The provision of any additional liquidity to the business retail market however should not come at the expense of the financial viability of the wholesalers.

- Our current view is 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.

> **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.
>
> **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.
>
> **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?

Elevated levels of bad debt from non-household customers defaulting

Section 2 explains that under the current market arrangements, Retailers bear the risk of bad debt from end customers not paying their bills and that retail price restraints applying to Retailers under the Retail Exit Code (REC) included an allowance for bad debt costs current at the time of market opening.

Section 2 also notes that temporary changes we have made to the Customer Protection Code of Practice (CPCoP), which restrict retailers from charging interest, late payment fees and requesting disconnections, effectively reduce the tools currently available to Retailers to manage bad debt effectively.

The Government has made unprecedented levels of financial support available for businesses who are being affected by Covid-19. Despite this, it is possible that levels of bad debt - arising from non-household defaulting - could materially exceed levels anticipated by the current market arrangements.

Options identification

In general there are two types of option for dealing with excessive levels of Covid-19 related bad debt resulting from non-household customers defaulting:

i) Retailers incur all bad debt costs associated with non-household customers defaulting (this is essentially the ‘do nothing’ option);
ii) Once levels of bad debt exceed a pre-determined threshold, these costs are shared.

Options appraisal

Option i most closely aligns with the current market arrangements and preserves incentives for Retailers to manage bad debt. Temporary changes we have made to the Customer Protection Code of Practice (CPCoP) have removed many of the tools Retailers have to manage bad debt. However, the Government is making unprecedented levels of financial support available to businesses and we are considering the provision of additional liquidity by wholesalers as part of this consultation.

If levels of bad debt from customers defaulting turn out to materially exceed levels that even a prudent and financially resilient Retailer could withstand, this could have a material impact on the effective functioning of the business retail market. If this is the case despite the provision of Government support and the additional liquidity measures set out in this consultation, then it may be more consistent with the objectives in section 3 to pursue option ii. We are seeking views on the merits of options i and ii through this consultation. Under option i we could review the allowances provided for in the Retailer Exit Code once we better understand what levels of bad debt have materialised from Covid-19 and the extent to which retailers have endeavoured to contain these.

If option ii was pursued as the preferred option, there is a question of how to determine the threshold for excessive levels of Covid-19 related bad debt. We have identified 3 options for determining this threshold (options a, b and c, below).

Options for determining the threshold of excessive levels of Covid-19 related bad debt include:

a) REC price control benchmark: At market opening, retail price caps were set that included an allowance in respect of bad and doubtful debt costs that may arise for Retailers. This option would gauge excessive levels of Covid-19 related bad debt as the extent to which outturn bad debt exceeded the range allowed for when setting the REC price controls.
b) Economic cycle: A prudent Retailer would look to earn gross margins that were robust to the likely cycle of bad debt costs over several economic cycles, including the likely maximum level of these. This option would gauge excessive levels of Covid-19 related bad debt as the extent to which outturn bad debt exceeded the likely maximum level of bad debt a prudent Retailer would have allowed for over the economic cycle.
c) Economic shocks: Companies and investors in general are expected to weather changes in economic circumstances, including where these have effects beyond the more usual economic cycle, for example as experienced as a result of the 2008-10 financial crisis. This option would gauge excessive levels of Covid-19 related bad debt as the extent to which outturn bad debt exceeded the levels of bad debt that might arise as a result of such shocks, for example, those levels seen just after the 2008-10 financial crisis.

While the impact of Covid-19 on bad debt may transpire to be greater than Retailers had anticipated in their original decision to enter the market, and which was allowed for under the REC price control, we do not consider that it would be right to intervene in such a way that uses customers' money to return retailers to an 'average' bad debt position. Such an intervention would over-insulate retailers from any bad debt above an 'average' economic situation by loading the full cost onto their own customers who are also bearing the impact of the current situation. We believe retailers should 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. For these reasons we do not favour option (a) as a method of gauging excessive Covid-19 bad debt costs.

We see 'in-principle' merit in both options (b) and (c), in that a prudent Retailer should have undertaken due diligence of the potential greatest scale of bad debt costs and factored that into its business model, not simply relied on average bad debt costs. There is no definitive means of determining the level of reasonable likely maximum bad debt costs, and so it is difficult to definitively gauge this as determined by potential maximum variations in the economic cycle (option (b)) or resulting from more intermittent economic shocks (option (c)).

We have examined evidence of the scale of bad debt costs following the financial crises of 2008. Our initial analysis implies that non-household doubtful debt costs across the industry were about 1.5% of turnover in 2009/10, remaining at around

1.5% of turnover on average across the sector to 2011/12 before falling slightly. However there appeared to be considerable variation across wholesalers, for example between 0.1% and 4.0% in 2009/10.

Furthermore, we note that levels of bad and doubtful debt have, broadly speaking, in the last two years (2018/19 and 2019/20) on average turned out at around 1% of turnover.[15] There are considerable variations among individual retailers; for some the ratio has approached 5%, while other retailers have reported no bad and doubtful debt i.e. the ratio is 0%.

On this basis we currently consider that 2% of turnover represents a reasonable approximation of the potential likely maximum bad debt costs retailers should have anticipated. We should note that this is an early view, which is subject to further analysis of evidence, including in response to this consultation. The level at which this threshold is set could influence our decision about how much of the increased bad debt cost should be borne by customers; the higher the threshold, the more appropriate it may be for customers to bear more of the incremental costs. Hence this figure could change.

Given the variance in retailer's outturn bad debt positions, we think it may be reasonable to set a threshold for a retailer either:

- at a common level, most likely reflecting our view above and so set at 2% as explained above; or
- at 2% of turnover, or the level of the most recently audited bad debt cost as % of net turnover + 1%, whichever is the greater. This approach is intended to

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?

[15] On the basis of retailer information

avoid recompensing retailers for levels of bad debt which they have in any case incurred, prior to and irrespective of the impact of the Covid-19 pandemic.

Once bad debt costs exceed the pre-determined threshold, the question becomes who should bear these costs. We are seeking views as part of this consultation about whether these costs should be shared between retailers and non-household customers, and in what proportion, or should they be born wholly by customers.

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.

Initial thoughts on the recovery mechanism

We still need to consider more detailed questions of implementation and the recovery mechanism that will be used - including whether costs are recoverable via the wholesale or retail charge and over what time period. There is also a question about which non-household customers should incur these costs. For example costs could be recovered from non-household customers within the same company area, or the costs could be recovered from non-household customers across England. Our current view is that costs should be recovered from non-household customers across England as this should avoid individual customers being disproportionately affected for something that is outside of their control. We will explore whether these costs could be recovered from non-household customers who are more likely to be active in and benefit from the market.

Elevated levels of bad debt from business retailers defaulting

Section 2 above explains the risks that Wholesalers bear from a business Retailer defaulting under the existing market arrangements. It notes that the provision of additional liquidity to the market has increased Wholesaler exposure to this risk. It is important to note that the risk of a business Retailer defaulting varies significantly. Some Retailers may be more exposed to customer bad debt depending on the make-up of their customer base. And Retailers will also differ significantly in their access to support – e.g. from parent holding companies or the debt markets.

Options identification

We have identified three types of option for dealing with potentially elevated levels to wholesalers of bad debt risk resulting from a business retailer defaulting:

i) Do nothing – Wholesalers continue to receive the price control protections associated with a business Retailer defaulting, as explained in section 2;
ii) Cap wholesaler exposure to bad debt costs at 50% regardless of the sharing factor agreed for the company in PR19 (note that this applies to usage that has been invoiced or is due, but not been paid. Water that has been used but not invoiced for at the point of retailer failure would still be reconciled as part of the revenue forecasting incentive (RFI) charges); or
iii) Cap wholesaler exposure to bad debt costs as a £m figure[16] or as a proportion of annual wholesale charges to business retailers.

Note options ii and iii could be combined. For example, we could cap wholesaler exposure at 50% of bad debt costs or as a proportion of their annual wholesale charges – whichever is lowest.

Options appraisal

Our starting point is that we have an expectation that – in line with the establishment of the retail business market - Wholesalers are expected to manage and bear some risks of retailer default and the accompanying exposure, including in times of economic downturn where the risk of retailer exiting the market might be higher. We nevertheless recognise that the liquidity arrangements we are considering will increase the Wholesalers' level of exposure were a Retailer to go into administration. We do not think it is reasonable for the liquidity arrangements that are being introduced to support the business market to compromise wholesaler financial resilience.

Option i is the status quo under present price control arrangements applying to Wholesalers. We are keen to test our understanding of the financial impact on

[16] Given the disparity in size between wholesalers a cap expressed in £m would vary significantly for different wholesalers.

wholesalers of simply relying on the current price control protections to manage their exposure to the bad debt risk arising from the liquidity arrangements. We would like to assess if it is necessary to provide additional protections to shield wholesalers from the risk associated with these arrangements.

Option ii enables all Wholesalers to recoup 50% of bad debt costs arising from the liquidity measures. This option provides greater consistency between wholesalers for a risk that they may have limited control over and which has been introduced by a change to the market rules to address Covid-19. However, this option also in principle still exposes Wholesalers to an uncertain level of bad debt costs which may put wholesaler financial resilience under strain.

Option iii would provide further protection to wholesalers by capping their exposure to bad debt costs at a predetermined level (a percentage of wholesaler turnover from sales to the business market) and passing the exposure beyond this level to non-household customers. In doing so, the option has the drawback that incentives on Wholesalers to manage and minimise their exposure to the risk and extent of bad debt is reduced, and customers will bear a greater risk. The option has the merit of explicitly recognising that the liquidity measures we have proposed, and which wholesalers would be providing, may result in wholesalers' exposure increasing, above and beyond the exposure that would arise under normal market arrangements.

Normally under option ii wholesalers would recoup bad debt costs through the totex sharing mechanism which would increase their revenue cap which applies to all customers. We expect these costs to be recovered from non-household customers. Wholesalers may be able to record and only apply these costs to non-household tariffs. A benefit of option iii would be that we could design a mechanism to isolate the recovery of those costs to non-household tariffs.

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?

Initial thoughts on the recovery mechanism

Again we still need to consider more detailed questions of implementation and the recovery mechanism that would be used to recover costs from customers. We will explore whether these costs could be recovered from non-household customers rather than customers more generally (including household customers).

5. Next steps

We intend to implement our decision on liquidity by recommending a code change to the Industry Panel at its meeting on 28 April. Implementation of this change is required by the end of April so it can be reflected in the settlement runs that take place in early May.

Given the speed with which we need to implement our decision on the provision of liquidity, we have commissioned a sub group of the Industry Panel to develop a recommendation on what additional reporting requirements retailers should be subject to in order for Ofwat and MOSL to have greater regulatory oversight of the amount of customer revenue that retailers are able to recover each month. This work, which is described in the text box below, is being developed in parallel to this consultation.

We are aiming to make final decisions on how bad debt should be treated by the end of April. Our intention is for our decisions on bad debt to make it clear who is expected to manage these risks and incur the associated costs. And whether (and by how much) a given party's exposure to these costs are capped. The implementation mechanism itself will not be fully designed or agreed by the end of April, but will be our priority thereafter.

Box 1: Retailer reporting requirements being developed by a Panel sub group

Our current interim arrangements for deferral of wholesale charges to retailers and our thinking about a more enduring solution to liquidity issues requires greater transparency and regulatory oversight of the charges collected by individual retailers from f customers in a given wholesale region. This information will help Ofwat and MOSL to understand and monitor over time the extent of the ‘liquidity gap’.

Proposals about who should provide liquidity to fill this gap and how, will be set out in the Ofwat consultation on 16 April.

However, to aid greater transparency and regulatory oversight of the charges that retailers are able to collect from non-household customers, we would like the sub-group to develop a standardised process and set of reporting requirements on the revenue retailers receive from customers to help us monitor and, if necessary, determine the level of wholesale charges that should be payable (by an individual retailer in a given wholesale region) each month.

We expect these reporting requirements to be in place for the duration (and potentially during the unwinding) of Covid-19 trading restrictions.

Things we would like the group to consider when developing this proposal.

- Retailers should be incentivised to collect charges from non-household customers who are able to pay, within the provisions of the Customer Protection Code of Practice.
- The proposal should support customers and the effective functioning of the market, including by keeping customer payments flowing through the market from retailers to wholesalers. Retailers should not hold onto revenue recovered from customers where this can be used to fund wholesale charges.
- The proposal should reflect and complement other measures already in place (e.g. CPW091), and should consider the unwinding of CPW093, in particular where retailers may be holding customer monies as a result.
- The approach should be mandatory and enforceable. It should be clearly set out and can be followed/adopted consistently by all trading parties.
- The proposal should reflect that some non-household customers pay in advance whilst others pay in arrears.
- It will include provision for regular updates to ensure visibility of all retailers’ liquidity positions.
- It will include a standard calculation for establishing the monthly payment each retailer should pay and the times at which these payments should be made.

Appendix 1: Full list of consultation questions

Consultation question 1: Do you agree with these objectives as set out, which will guide our decisions about what are the preferred options?

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].

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.

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.

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?

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.

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?

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