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

This document summarises Ofwat's current position in light of responses to our consultation. We will continue to analyse evidence from the consultation and consider the recommendation of the Industry Panel before making and publishing final decisions after markets close on Thursday 30 April.

Our focus is to protect the interests of customers. We want to relieve business customers of the pressure of having to pay water bills on time if they are seriously affected by Covid-19, while ensuring all customers have access to reliable water and associated retail services now and into the future.

We recommend a further period of liquidity support to Retailers. Although government is providing substantial financial support to businesses economy wide, it is not yet clear what proportion of Retailers will gain access to this support or how quickly. A further time limited period of wholesale charge deferrals would be in the interests of business customers, protecting against systemic Retailer failure, in recognition that the market is new, many companies are not yet well capitalised and the arrangements to protect customers against Retailer failure have not yet been well tested. Supplier exit is a feature of any functioning market and, even with these measures, we may see some Retailer exit in due course. However it is in customers interests to avoid systemic Retailer failure during the current crisis.

Our proposals reflect existing market arrangements and our objective that liquidity measures to support the retail market should not come at the expense of the financial resilience of the Wholesalers. However we don't think that all of the additional costs resulting from Covid-19 should be passed onto business customers. Both Wholesalers and Retailers should also be prepared to bear some of these additional costs, consistent with other sectors across the UK economy.

Liquidity

The recommendations in this section are consistent with the change proposal[1] that we have put to the Industry Panel.

Reflecting evidence from the public consultation we recommend that Retailers should receive liquidity support to the end of July 2020. This period may be extended following a review and further consultation by Ofwat early in the summer. One

[1] See CPW096 on MOSL's website here.

component of this review will consider the availability of government support to Retailers. The expectation is that Retailers should take advantage of this support with the need for sector specific support falling away over time.

Support to the end of July will be provided by relieving Retailers of the requirement to pay the full amount of wholesale bills due for this period. Reflecting consultation responses, Retailers will be required to pay Wholesalers each month a minimum of 60% of the wholesale bills due or a proportion equivalent to the proportion of invoiced amounts recovered from their own customers, whichever is the higher. The 60% minimum proportion of wholesale bills due will be fixed for the settlement runs in May, June and July.

In order to qualify for these deferred wholesale arrangements, Retailers will need to provide information about the proportion of invoiced amounts they are receiving from their customers. A sub group of the Industry Panel has developed a standardised set of reporting requirements for Retailers who are taking advantage of the wholesale charge deferrals, which includes provisions for assurance and audit of the information provided. Wholesalers will continue to invoice Retailers for 100% of the wholesale charges due each month and the sub group has developed a mechanism for calculating the wholesale charges that need to be paid to avoid a Retailer being put into default. More detail is included in the documentation that has been submitted to the Industry Panel and published today (27 April)[2]. If we find that Retailers who opt to defer payment of wholesale charges do not comply with the requirements of the scheme, then we will rule out the option of extending provision of liquidity beyond July 2020.

We will revisit the Customer Protection Code of Practice (CPCoP) to ensure customers seriously affected by Covid-19 continue to be protected. Customers who are operating normally and can pay should be subject to normal debt recovery processes. We expect Retailers to take the necessary steps to differentiate between those customers who genuinely need support and those who should be expected to pay.

Reflecting consultation responses we think that any deferred wholesale charges should be paid back in full by end March 2021.

We recommend that Wholesalers should charge interest on deferred payments to incentivise Retailers to use other sources of liquidity (including government finance) where they can. This will also allow some remuneration of the risk facing Wholesalers from providing extra liquidity to the business retail market and maintain incentives on Retailers to search for cheaper forms of credit. We propose to set a

[2] See CPW096 on MOSL's website here.

maximum interest rate of 5.98% nominal. This is equal to the PR19 nominal wholesale allowed return on capital plus 1%. This is a celling so individual Wholesalers can provide liquidity at lower rates than this.

Bad debt

There is a considerable degree of uncertainty about how much bad debt will emerge as a result of business customers defaulting in the coming months due to Covid-19. It is too soon to tell what the impact will be.

Bad debt levels across the market normally sit at around 1% of annual turnover. Where bad debt levels increase owing to the Covid-19 pandemic, we believe that Retailers should expect to absorb - in full - such incremental bad debts costs up to an amount equal to an additional 1% of their annual turnover. That means a Retailer already carrying industry average bad debt of 1% should expect to fully absorb outturn bad debt costs up to 2% of annual turnover. However, we do not think it is appropriate for a Retailer to carry all of the bad debt above this threshold especially as changes we have made to the CPCoP prevent Retailers from using many of the tools they have to manage bad debt effectively.

We will monitor the level of additional Covid-19 related bad debt emerging in the business retail market and if it looks like bad debt across the market is likely to exceed the 2% threshold, we will provide regulatory protections for a portion of this 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. Before applying any protections, we will expect Retailers to provide evidence to demonstrate that they had taken proactive and adequate steps to minimise bad debt arising from Covid-19, including that they had not written off bad debt prematurely.

A number of mechanisms in the PR19 price control protect Wholesalers to an extent from bad debt risk of a Retailer exiting the market. Despite this Wholesalers still face some additional bad debt exposure as a result of the decision to defer payment of wholesale charges on 30 March and this will increase further as a result of Wholesalers providing additional liquidity to the market over the coming months.

While we expect water companies to be resilient to the shocks associated with an economic downturn, including the higher risk of Retailer exit, we do not consider it appropriate that liquidity measures introduced in March to support the retail market should come at the expense of the financial resilience of the Wholesalers. As a result we propose to cap Wholesalers’ exposure to bad debt. This cap will be set at a level that is appropriate to ensure Wholesalers' financial resilience isn't materially impacted but is consistent with our objective to protect customers and will cover a proportion, but not all, of the additional risk they face from Covid-19 liquidity measures. The level of the cap will be included in our decision document, published on Thursday.