

April 2020

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

Executive summary

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 primary 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.

With that aim, we have decided to implement a further period of liquidity support to Retailers. Although government is providing substantial financial support to businesses economy wide, Retailers will need time to establish what support they can gain access to and how quickly. A further, time limited period of wholesale charge deferrals would be in the interests of business customers, protecting against the risks of systemic Retailer failure, in recognition that the market is relatively new, some companies are not financially resilient to Covid-19 impacts, and the arrangements to protect customers against Retailer failure have only been used in a small number of cases involving a very small number of customers. Supplier exit is a feature of any functioning market and, even with these measures, we may see some Retailer exit in due course. Whilst we are continuing to work with MOSL to ensure that the industry interim supply processes are able to cope efficiently with Retailer failure, we believe it is in customers' interests to mitigate the risks of systemic Retailer failure during the current crisis.

Our decisions reflect existing market arrangements and our objective is that liquidity measures to support the retail market should not come at the expense of the financial resilience of the Wholesalers. However, we do not 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

Reflecting evidence from the public consultation, we have decided that Retailers should receive liquidity support to the end of July 2020. We will review and consult on next steps early in the summer. One component of this review will consider the availability of wider government financial support or other liquidity provision 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 and that the payment mechanism developed by a sub-group of the Industry Panel includes an element of catch-up of wholesale charges deferred in March and April, Retailers who opt in to these arrangements will be required to pay the higher of either:

- 60% of primary charges due to the Wholesalers; or
- 94% of the cash they have collected from their customers.

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 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 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. If we find that Retailers who opt to defer payment of wholesale charges do not comply with the requirements of the scheme, then we reserve the right to rule out the option of extending provision of liquidity beyond July 2020 for all Retailers.

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 have decided that Wholesalers should be able to 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 maximum interest rate of 5.98% nominal. This is equal to the PR19

nominal wholesale allowed return on capital plus 1%. This is a ceiling 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 time¹. 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 in the period to the end of July.

¹ We will also consider whether there are other mechanisms to provide regulatory protection for retailers.

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 support provided from March onwards to the retail market should come at the expense of the financial resilience of the Wholesalers. As a result, we have set a cap on the additional exposure that each Wholesaler will face as a result of providing liquidity to each Retailer. On a Retailer failing, the bad debt the Wholesaler will carry, after the price control sharing factor has been applied, will be capped at the £m figure equivalent to the average monthly wholesaler charge for that Retailer. Consistent with our objective to protect customers, this cap covers part, but not all, of the additional risk Wholesalers face from Covid-19 liquidity measures. We will not alter this cap even if the liquidity measures are extended beyond July.

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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. This includes relieving 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.

Like many other sectors of the economy the business retail market has been affected by customers reducing their demand and being unable to pay their bills on time. Recognising that the market is relatively new, Retailers will need time to time to establish what support they can gain access to and how quickly and the arrangements to protect customers against Retailer failure have only been used in a small number of cases involving a very small number of customers, we worked closely with MOSL to introduce urgent code changes in late March and early April. These changes²: provided relief to business customers unable to pay their bills; introduced a mechanism to identify where businesses were closed and should not be liable for certain charges; and allowed Retailers to temporarily defer up to 50% of wholesale charges. Recognising that the deferral of up to 50% of wholesale charges was a short term interim measure, we committed to introduce a more enduring solution by the end of April, which would also set out how bad debt would be treated.

We worked closely with the sector to develop a set of [consultation proposals](#) and with a sub group of the Industry Panel to develop a payment mechanism and associated reporting requirements. Having assessed the [evidence received](#) in response to the consultation and considered the recommendations of the Panel sub group, we then proposed a code change (CPW096) to the Industry Panel aimed at addressing the liquidity challenges facing the market³. At the same time we published [a note](#) setting out our current thinking on both liquidity and bad debt.

The Industry Panel met on 28 April to discuss CPW096. Code change CPW096 is focussed on dealing with the liquidity challenges facing the market as a result of Covid-19. It does not include proposals for dealing with bad debt as these are Ofwat decisions, which do not require code changes and therefore do not fall within the remit of the Industry Panel. The Panel voted to recommend CPW096 for approval by Ofwat but set out some issues for us to consider further in making our final decision.

² See code changes CPW091, CPW093 and CP0006 on our website [here](#).

³ More information on CPW096 can be found on MOSL's website [here](#).

These issues are set out in the [Panel's Final Recommendation Report](#) to Ofwat and addressed in section 3.

Reflecting both the evidence received in response to the public consultation and the recommendation of the Industry Panel, this document sets out our final decisions on liquidity and bad debt and also includes our decision on code change CPW096. Appendix 1 sets out how our decision on CPW096 will facilitate the principles of the Wholesale Retail Code and also includes amendments to the legal drafting. CPW096 will be implemented on Friday 1 May at 8am.

Consequentially, we will revisit the Customer Protection Code of Practice (CPCoP) to ensure that it aligns with changes we have made via CPW096, where appropriate. We are particularly keen to ensure that it strikes the right balance in protecting customers seriously affected by Covid-19 while enabling Retailers to recover debt from customers who are operating normally and can pay.

This decision document is the culmination of a public consultation as well as numerous discussions and input from the entire sector. We would like to thank MOSL, the Industry Panel (and sub group), Wholesalers, Retailers and the Consumer Council for Water (CCW) for their support in developing the decisions set out in this document.

The remainder of this document is structured as follows:

- Section 2 sets out what we are trying to achieve through our decisions on liquidity and bad debt;
 - **Decisions:** We consider the objectives that we proposed in the consultation to guide our decision making to be appropriate. We will revisit the CPCoP to ensure that it protects customers seriously affected by Covid-19 while enabling Retailers to recover debt from those customers who are operating and able to pay.
- Section 3 sets out our decisions on addressing liquidity challenges;
 - **Decisions:** We have decided to provide a further, time limited, period of liquidity support to Retailers for the months May, June and July. Retailers who opt into these deferred wholesale arrangements will be required to pay the higher of either:
 - 60% of primary charges due to the Wholesalers; or
 - 94% of the cash they have collected from their customers.
 - We have decided that Wholesalers will be able to charge interest on deferred payments to incentivise Retailers to use other sources of liquidity (including government finance) where they can. We have

- decided to set a maximum interest rate of 5.98% nominal. This is equal to the PR19 nominal wholesale allowed return on capital plus 1%.
- Retailers should receive liquidity support to the end of July 2020 and all deferred wholesale charges should be paid back in full by the end of March 2021.
 - We will review and consult on next steps early in the summer.
 - Section 4 sets out our decisions about how bad debt should be treated;
 - **Decisions:** Retailers should be prepared to bear outturn bad debt costs to a level equivalent to 2% of their retail business market turnover.
 - 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. Retailers who have seen historic levels of bad debt in excess of 1% should expect to absorb - in full - such incremental bad debts costs up to an amount equal to an additional 1% of their annual turnover in addition to their historic, pre covid-19, levels of bad debt.
 - We have set a cap on the additional exposure that each Wholesaler will face as a result of providing liquidity to each Retailer. On a Retailer failing, the bad debt the Wholesaler will carry, after the price control sharing factor has been applied, will be capped at the £m figure equivalent to the average monthly wholesaler charge for that Retailer. Consistent with our objective to protect customers, this cap covers part, but not all, of the additional risk Wholesalers face from Covid-19 liquidity measures. We will not alter this cap even if the liquidity measures are extended beyond July.
 - Section 5 sets out next steps; and
 - Appendix 1 sets out how our decision on CPW096 will facilitate the principles of the Wholesale Retail Code and also includes amendments to the legal drafting for CPW096.

Consultation responses

In response to our consultation, we received submissions from CCW, thirteen Wholesalers, ten Retailers, WaterUK, one Investor Association, one NAV, one Self Supplier and a joint submission from the Self Supply community. Many Wholesalers supported the submission from WaterUK, sent on behalf of all wholesale water companies in England and Wales. The responses have been redacted and published on our website.

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. Our objectives

What we said in the consultation

Our [consultation](#)⁴ set out seven objectives that we proposed should guide our decision making on the temporary provision of liquidity and treatment of excessive, Covid-19 related, bad debt. We asked stakeholders if they agreed with these objectives.

Consultation responses

CCW supported the objectives and highlighted that they expect customer protection to be a guiding principle in terms of bad debt.

Water UK provided a response on behalf of all Wholesalers in England and Wales. It supported the aims and objectives set out and considered these to be well aligned to the principles of good regulation of transparency, predictability, targeting, accountability and proportionality. In several individual responses Wholesalers expressed support for the Water UK submission or broadly agreed with the objectives.

Most Retailers disagreed with at least one of the objectives and flagged what they saw as some unfairness, with some Retailers saying more risk should sit with customers.

Most Retailers raised concerns with respect to objective 2 whereby Retailers should continue to be prohibited from charging customers' interest, imposing late payment fees or requesting disconnection. Some thought that this objective pulled against objective 3, in that Retailers should continue to collect charges and to use these to fund the payment of wholesale charges.

Most Retailers flagged that they are still expected to pay interest on deferred charges to Wholesalers whilst being unable to charge interest or late repayment fees to customers. A number of Retailers thought this was unfair and unworkable. Many stated that there should be clarity over the restrictions enforced regarding debt collection and suggested they should be able to 'chase' debt that existed prior to

⁴ See page 20

Covid-19. Many Retailers requested clarity over the obligation to pass payments through to Wholesalers and whether this should include the retail margin.

Objective 4 is for Retailers to be incentivised to explore and access alternative forms of liquidity (e.g. Government support) before considering whether to defer payment of wholesale charges. Some Retailers stated that borrowing from government is potentially very difficult. Some weren't sure that they would be able to take advantage of government finance and therefore placing interest rates on financing costs from Wholesalers fails to act as an incentive to seek other forms of finance.

Objective 6 expects Retailers themselves to manage risks associated with non-household customers defaulting, but many Retailers argued that the pandemic should not be considered as a normal part of the business cycle and suggested that it was impossible to prepare for this event and subsequent high levels of bad debt.

One Retailer highlighted that the onus on customer protection is disproportionately high. It was argued that in competitive markets with no price caps, the risk profile would be reflected in higher prices for customers. Another Retailer echoed this view, noting that customers in other markets ultimately bear more risk, and argued that water should be no different. Some Retailers highlighted that existing market arrangements need to be amended to deal with the impacts of Covid-19. It was suggested that market resilience and the sustainability of the Retailers needs to be improved and the current situation provides an opportunity to do so. It was also proposed that we should more closely align the English retail market with the Scottish retail market.

Our decision

We consider the objectives proposed in the consultation appropriately reflect our statutory duties and overall policy aims to protect customers (including from systemic Retailer failure), whilst ensuring that the provision of liquidity to the business retail market does not come at the expense of the financial viability of the Wholesalers. Some of the points raised by stakeholders on the objectives relate to more detailed points of policy and are discussed further in sections 2 and 3 below.

Whilst we are engaging with the Water Industry Commission for Scotland (WICS) to understand how the Scottish market is responding to Covid-19, we note material

differences between the Scottish and English markets⁵. We acknowledge Retailers' concerns about objective two and their ability to collect payments effectively. As set out above, we will revisit the Customer Protection Code of Practice (CPCoP) to ensure that it strikes the right balance in protecting customers seriously affected by Covid-19 while enabling Retailers to recover debt from customers who are operating normally and can pay. 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.

⁵ There are structural differences between the two markets – for example in Scotland there is only one Wholesaler. There are also procedural differences – for example until recently all Retailers in Scotland paid wholesale charges 2 months in advance.

3. Addressing liquidity challenges – Change Proposal CPW096

Collectively, code changes CPW091 and CPW093 have assisted Retailers in addressing the immediate liquidity challenges that have arisen as a result of Covid-19. Recognising that CPW093 was an interim solution, a longer-term solution which addresses the liquidity challenge in the market, with a mechanism to ‘unwind’ the deferral of wholesale charges, is required. This is the basis of Change Proposal CPW096, which seeks to place provisions in the Wholesale-Retail Code to enable a further period of liquidity support to Retailers in the form of deferral of settlement charges.

Implementation of CPW091 did create unintended consequences in relation to the amount of credit support that Retailers are required to provide. In summary, it reduced the amount of credit support required from Retailers as this is linked to the settlement values which were significantly reduced as a result of Retailers applying the vacant flag. As a result, Wholesalers’ exposure in the event of a Retailer default was consequentially increased. We implemented an Urgent Code Change⁶ to correct this unintended consequence, and we confirm here that the intent is for credit support to be maintained at pre-Covid levels. We also think that for prudential reasons this requirement should apply to all Retailers. We have clarified this in the legal drafting.

More detail on the Change Proposal is included in the Panel’s [Final Recommendation Report](#).

3.1 Deferring payment of wholesale charges

What we said in the consultation

We noted 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 whose operations are currently suspended. We identified

⁶ Ref CPW095 – Maintaining the Credit Support Requirement: <https://www.ofwat.gov.uk/wp-content/uploads/2020/04/CPW095-Temporary-Maintenance-of-March-2020-CSN-collateral-requirements.pdf>

three options for dealing with the remaining liquidity gap in the business retail market, which could work in combination:

- i. Retailers resolve their cash flow issues independently, 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 to the extent that they themselves are recovering charges 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 Wholesalers a minimum of 90%). This option could involve both Retailers and Wholesalers providing some additional liquidity.

Our minded to position was to require Retailers to pay Wholesalers each month a minimum of 70% of the wholesale bills due or a proportion equivalent to the amount they were paid that month by their own customers, whichever is the higher. We asked the following questions to understand the extent of the remaining liquidity gap.

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.

Consultation responses

Responses from Retailers suggested that they expected to recover between 50% and 85% of wholesale charges in April. Two Retailers thought it could be possible for them to pay all of their wholesale invoices in April in full. The self-supply community also did not anticipate issues with providing full and timely payments for wholesale charges in April and over the next 2 months.

Retailers expected a downside risk to their ability to collect payments over the next few months, but most of them could not provide an estimate of their expected liquidity gap due to the lack of similar historic precedents and the significant level of economic uncertainty. Others provided a range to reflect uncertainty going forward. Three Retailers estimated they could recover somewhere between 40% and 68% of wholesale charges over the next two months and one Retailer expected to be able to pay their charges in full over that period.

Most Retailers suggested that the recent updates to the CPCoP are restricting their ability to recover customer payments during this period – including for customers who can pay. Several Retailers noted flagging premises as vacant is a continuous process. While it helps to reduce settlement charges, it takes time to verify which businesses have temporarily closed and some Retailers noted an increase in direct debit cancellations and difficulties reaching customers.

Wholesalers noted they were not well placed to respond to questions 2 and 3 and mainly focussed on the use of vacant flags. They support MOSL monitoring the use of these flags effectively and would like to see the guidance tightened up, and for Ofwat to take action where misuse is identified.

Even though these questions are primarily for Retailers to answer, CCW recognised that recovery of wholesale charges will be impacted due to many business customers struggling to pay their water bills during this time. But that not all business customers will be adversely affected, so the impact on Retailers will largely be determined by their specific customer base. CCW also considered that payment options, including payment breaks, should form part of the support being offered by Retailers.

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 responses

CCW preferred options 2 and 3 set out in the consultation. It considered that this would enable Retailers to pay the Wholesalers with some of the revenue from business customers' bills and fill the gap where a minimum set proportion of the wholesale charges is not met.

Wholesalers were generally supportive of the Water UK response, which highlights a preference for a sequence of liquidity options:

- Existing Retailer facilities;
- Additional commercial facilities;
- Additional Covid-19 relief, such as government support;
- Extension of Wholesalers liquidity (lenders of “last resort”).

Several Wholesalers noted they did not support the options that involved a ‘pay when paid’ approach by Retailers, as this effectively transfers the risk of Retailers’ performance on revenue recovery to Wholesalers and provides weak incentives on Retailers to manage debt collection properly. The majority of Wholesalers indicated that they would welcome clarity on the mechanism and reporting requirements that would be put in place to monitor Retailers’ ability to pay.

The majority of Retailers agreed that they should utilise the government schemes available – though some Retailers did not think that they would be eligible for existing government schemes. One Retailer noted that it did not need liquidity support as it has put in place trade credit insurance for its main customers to ensure it can pay what is owed to Wholesalers.

Most Retailers were supportive of a ‘Pay when Paid’ approach, as this option is least likely to result in a Retailer failure and allows more flexibility for Retailers given the current level of uncertainty. Some Retailers were concerned that in the face of current uncertainties setting a % deferral rate that is based on current information may prove inflexible and inappropriate as the situation changes. One Retailer suggested building in a 10% buffer to the 70% minimum to prevent potential Retailer default. Some Retailers also highlighted the need to ensure that their operating costs, some of which are fixed, are covered before paying the wholesale charges.

Views from the Industry Panel

Proposals to address the liquidity challenges in the market were discussed via an Authority Timetabled Code Change (CPW096). This change was considered at the 28 April 2020 Panel Meeting. In considering CPW096, and in addition to a number of clarifications and corrections to the legal text, Panel Members identified a range of matters which they considered could be amended in the solution.

The Panel requested that Ofwat take the following into account when making its final decision:

- 1) **Parameterising ‘X’ and ‘Y’ factors⁷:** While the Panel offered no view on the ‘X’ and ‘Y’ factors, many members felt these should be kept under review by Ofwat and that they may need to be amended based on market conditions. Parameterising these would enable Ofwat to determine and amend these values without reference to a further code change. The Panel also recognised the importance of providing regulatory certainty and some Panel Members suggested that these factors (or any change to the prevailing factors) should be set out by Ofwat well in advance of their application.
- 2) **Application to amounts deferred from March 2020 invoices:** The Panel noted that CPW096 excluded amounts relating to March 2020 invoices that had been deferred. Panel Members acknowledged that some Retailers may have paid these invoices in full and others had not. However, under current code rules, deferred amounts relating to March 2020 invoices would become due at the end of May 2020. Panel Members queried the extent to which this had been taken into account by Ofwat and requested that Ofwat consider including these deferred amounts in the CPW096 solution.
- 3) **Application to Alternative Payment Terms:** The Panel noted that the proposed solution did not apply to Alternative Payment Terms (APTs) that may have been agreed bilaterally between Wholesalers and Retailers. The Panel confirmed there were currently four APTs arrangements between Wholesalers and Retailers (as published on the MOSL website). Some Panel Members observed that APTs may not be compatible with the deferral scheme since they were, by definition, bespoke in nature. In these cases, it should be for the relevant Wholesaler and Retailer to agree how to accommodate deferral under the specific APT they had agreed. However, on balance, the Panel felt that an accommodation for APTs could be made and should be carefully considered. The Panel requested that Ofwat consider updating the solution to make it clear that APTs were accommodated under the deferral mechanism.
- 4) **Opt-In provisions:** Panel Members noted that the solution set out a single point of time by which a Retailer must effectively ‘opt in’ to the deferral mechanism. However, it was noted that some Retailers may wish to opt in at a later date. The Panel agreed that Ofwat should consider updating the solution to enable Retailers to join the deferral mechanism while it was still in operation, rather than as a once-only option.

⁷ The Y factor is the minimum % of wholesale charges payable each month. The X factor is the % of cash collected by retailers that must be passed on to Wholesalers (=100% - % (to reflect Retailer operation costs)).

It was also requested that Ofwat ensure that the Customer Protection Code of Practice be amended to reflect features being introduced via CPW096, including the 'X' and 'Y' factors and deferral interest. We agree with this and discuss this further in next steps at the end of this document.

The Panel voted to approve CPW096, for recommendation to Ofwat for implementation (10 votes for, 1 vote against and 1 abstention) on the understanding that the small number of clarifications and corrections to the legal text should be made and consideration given to the issues outlined above.

Our decision

Reflecting stakeholders' views in the consultation responses, we have decided to provide for a further period of liquidity support to Retailers. Although government is providing substantial financial support to businesses economy wide, Retailers will need time to establish what support they can gain access to and how quickly. We think that a further, time limited, period of wholesale charge deferrals would be in the interests of business customers, protecting against the risks of systemic Retailer failure.

Retailers who opt into these deferred wholesale arrangements will be required to pay, as a minimum, the higher of either:

- i. 60% of primary charges due to the Wholesalers; or
- ii. 94% of the cash they have collected from their customers.

We agree with respondents who were concerned that a simple pay when paid approach, without a minimum percentage payment requirement, reduced Retailers incentives to actively manage customer credit (within the permitted bounds of the CPCoP).

We have decided to reduce the minimum proportion of wholesale bills due each month from 70% to 60% in light of consultation evidence and also to reflect that the payment mechanism developed by a sub-group of the Industry Panel includes an element of catch-up of wholesale charges deferred in March and April (see below for more on this). Several Retailers raised concerns about the ability to pay 70% of wholesale charges given uncertainty around how long it will take for businesses to return to 'normal operation'. Wholesalers did not provide evidence to suggest that deferring up to 30% of wholesale charges for the next three months would materially affect their financial resilience, assuming the deferred charges are repaid, although a

number of Wholesalers suggested that deferred charges should be repaid in full by 31 March 2021. The 60% minimum proportion of wholesale bills due will be fixed for the settlement runs in May, June and July. Some Retailers argued for an approach that kept this minimum level flexible. However, we believe that providing a fixed figure for the duration of the deferral period provides certainty to Trading Parties on the minimum amount of charges that are payable.

Reflecting potential inconsistencies between settlement charges and customer receipts in a given month and the difficulty faced by Retailers in netting off retail margins from the cash they have collected from customers in a given month⁸, we have deducted 6% from the cash collected by Retailers in (ii) to reflect Retailer operating costs. Data previously supplied by Retailers broadly suggests that average gross margins are around 5.5%.

A sub-group of the Industry Panel has developed a mechanism for calculating the minimum wholesale charges that need to be paid to avoid a Retailer being put into default. This is described in Appendix A of the Industry Panel's [Final Recommendation Report on CPW096](#).

In direct response to the four points raised by the Panel:

- 1) Parameterising the 'X' and 'Y' Factors:** We understand the Panel's view that it did not have access to the full range of information on which we have arrived at the % figures that have formed the minimum payment requirements. We also acknowledge that not including specific values for the X and Y factors allows for these to be amended based on market conditions at any one time. However, recognising that there is an element of discretion and judgement in the setting of these factors, we have decided to include the values in the Code to provide certainty of the minimum amounts payable until the end of July, which we consider on balance to provide more stability to the market than continual fine-tuning of factors over a relatively short timeframe.
- 2) Application to amounts deferred from March 2020 invoices:** The mechanism developed by the sub group requires Retailers to pay at least 60% of wholesale charges on a rolling average basis between April and July, or 94%

⁸ For customers consuming less than 0.5MI per year, the Retail Exit Code (REC) sets out allowed costs and allowed net margins, which differ according to tariff and company. For companies consuming more than 0.5MI but less than 50MI, the REC specifies gross margins for water (8%) and wastewater (10%). For customers using more than 50MI, there is no default tariff.

of cash collected in a given month if this is higher. One implication of this approach (i.e. the exclusion of any wholesale charges deferred in March) is that if a Retailer deferred payment of wholesale charges in March, then these charges would need to be repaid in full by the end of May. We agree with the Industry Panel that this may not be possible. We have decided that where Retailers deferred payment of wholesale charges in March, they will have until June to ensure that at least 60% of March charges are paid.⁹ For clarity, March payments will not count towards the cumulative total payments made between April and July¹⁰.

- 3) Application to Alternative Payment Terms:** We agree with the Panel that those Retailers who have agreed Alternative Payment Terms (APTs), should have access to equivalent liquidity measures to those in the standard deferral scheme, and should also be able to access the standard deferral scheme for any of their wholesale contracts which do not have Alternative Payment Terms. We do not have visibility on the payment terms that Retailers have with their customers and on which APTs may be based. Therefore, we have revised the legal text to provide a framework for APTs to be accommodated within the deferral scheme, and we have included an obligation on Wholesalers to offer, in the round, equivalent terms, to those in deferral scheme to Retailers with whom they have agreed APTs, taking account of the particular features, context and supporting rationale for the APTs.
- 4) Opt-in provisions:** We agree with the Panel that the ability to opt-in to this scheme should be flexible and not subject to a one-off point in time. We have amended the legal text to give this effect.

There is one further element to this that we wanted to provide clarity on concerning Self-Supply Retailers. The overwhelming response to our consultation from Self-Supply Retailers was that they did not intend to utilise the deferral scheme. Many Self-Supply Retailers are continuing to operate across some or all of their sites. We have considered this, and taking into account that Self-Supply Retailers, unlike other end customers, are in direct control on the use the vacant flag and are able to enter

⁹ March payments will be included in a separate pool and the following key steps will be applied: 1) Calculate the minimum amount due (60% of wholesale charges) to each wholesaler; 2) Establish the amount paid to date for March charges to each wholesaler; 3) Where an “overpayment” was made to a wholesaler compared to the minimum due, no clawback is applied for the “excess” payments to offset against charges pertaining to April onwards – this is a result of having a separate pool; 4) Where there is an “underpayment” compared to the minimum amount due, the retailer has to make a payment up to the minimum threshold. Interest can be applied to the residual deferred amount.

¹⁰ This is to avoid the March payments (which generally reflect February consumption) reducing the need for Retailers to pay at least 60% during the period April – July in cases where Retailers had previously paid more than 60% of the amount owed under March invoices.

meter readings for those sites which are closed and/or are using reduced volumes of water, we have decided that Self-Supply Retailers should not be able to opt-in to the deferral scheme. We will revisit this in future if evidence suggests that it is appropriate to allow Self-Supply Retailers to opt-in to the deferral scheme.

The sub-group has also developed a standardised set of reporting requirements for Retailers who choose to defer a proportion of their wholesale charges, which includes provisions for assurance and audit of the information provided. Only Retailers that opt-in to these deferral arrangements will be required to provide the reporting information to Ofwat and MOSL.

MOSL will work with the sector to implement the payment mechanism and reporting requirements in early May.

3.2 Cost of providing liquidity

What we said in the consultation

In the consultation we said that where Wholesalers provide additional liquidity to the business retail market through Retailers deferring payment of wholesale charges, the provision of this liquidity will come at a cost. We noted a number of ways of estimating these costs including (but not limited to):

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

In relation to this, we asked the following questions:

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 responses

All Wholesalers agreed that Retailers should exhaust other sources of funding first before accessing liquidity from Wholesalers. To ensure this is the case, Wholesalers suggested that whatever rate Ofwat determines is appropriate, it should be complemented with a range of other measures to ensure wholesale liquidity support is only used as a last resort.

There were different views between Wholesalers and Retailers regarding who pays financing costs. Broadly speaking, all Wholesalers agreed that Retailers should bear financing costs and want the financing costs to be a true and accurate reflection of what it is costing them to fund any gap. None of the Retailers supported paying for liquidity provided to them by Wholesalers if they could not pass this cost through to their own customers. Reasons included unfairness, lack of internal consistency in our policy or slim margins, some adding that this was because this kind of unusual shock event was not factored into business plans or the design of the business retail market and as such Covid-19-related financing and bad debt costs are likely to exceed profit margins. CCW noted that protections in the CPCoP should remain to prevent Retailers placing increased financial demands on business customers in order to minimise the need to access Wholesaler provided liquidity.

Most Wholesalers and CCW favour financing costs being based on nominal wholesale Weighted Average Cost of Capital (WACC) with smaller Wholesalers in favour of a small company uplift to reflect their higher cost of drawing on more expensive, short-term debt facilities. Use of the WACC was justified as a more appropriate parameter for calculating financing costs than a 'cost of debt' only measure or the default interest rate set out in the Wholesale Retail Code (Bank of England base rate plus 4%) on the basis that liquidity extended to Retailers comes from a combination of drawing on debt facilities and delaying or cancelling dividend payments (equity retention). There were two alternative views from Wholesalers: one suggested that allowed wholesale cost for new debt appeared to be an attractive first resort for Retailers, and another suggested that the default interest rate may be appropriate.

Four of the ten Retailers that responded to the consultation supported at least one of the three proposed methods for charging for liquidity (WACC, cost of debt at PR19 or default interest) if the extra cost could be passed through to customers, the others did not state a preference except one Retailer who suggested that wholesale liquidity should be charged at no more than the 1% available on the Government's Large Corporate Finance Facility. Self-suppliers responding collectively were in support of wholesale liquidity being provided at the default interest rate as they consider this to

be a commercial arms-length rate. However, most self-suppliers do not expect to access Wholesalers liquidity.

In terms of how Retailers should pay for the financing costs of wholesale liquidity, one Retailer suggested recovery through an adjustment to wholesale costs in the following financial year and another Retailer suggested recovery through additional allowances in pricing determinations so that costs are borne proportionately across the entire market and not just by Retailers.

Our decision

We have decided that Wholesalers should be able to charge interest on deferred payments to incentivise Retailers to use other sources of liquidity (including government finance) where they can. This is expected to 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, whilst ensuring Wholesalers do not earn excessive returns from providing liquidity.

Therefore, we have decided to set a maximum interest rate of 5.98% nominal. This is equal to the PR19 nominal wholesale allowed return on capital plus 1%. This is a ceiling, so individual Wholesalers can provide liquidity at lower rates than this. In deciding what interest rate to charge its Retailers, we suggest Wholesalers consider their own costs of providing liquidity and the risk associated with lending to Retailers more generally and then apply this rate consistently to any of their Retailers who opt to defer payment of wholesale charges.

We have decided not to attach any further measures or conditions in addition to the application of an interest rate. We do not believe that this is necessary given the incentive properties attached to the rate of interest we have chosen. Also, we acknowledge that Retailers will need time to establish what support they can gain access to and how quickly, meaning that they may not be in a position to access other forms of liquidity in the time available.

3.3 Timing

What we said in the consultation

Our consultation proposal was that Retailers should receive liquidity support at least until 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 also set out our preference that unwinding of additional liquidity provided by Wholesalers should commence as soon as is practicable and possible. We proposed that Retailers should be required to start to repay deferred amounts from August (unless the period is extended following consultation in the summer) and that all additional liquidity provided by Wholesalers should be repaid by the end of December 2020.

In relation to this, we asked the following question:

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 responses

CCW expressed some concern about the proposed July and December deadlines. They noted that liquidity support for Retailers, and the associated benefits for customers, should continue for as long as the restrictions on business customers remain in place.

Wholesalers broadly supported the principle that liquidity support should be time-limited and subject to regulatory review. They suggested that the repayment of additional liquidity provided by Wholesalers should commence as soon as practicable to avoid any financial resilience impacts on Wholesalers. One Wholesaler was not comfortable with extending the existing deferment beyond the two months originally envisaged without a cap or a gateway approach. Some argued that deferred payments should begin to be paid from August, rather than back loaded to December.

Several Wholesalers suggested that December 2020 might be too ambitious to unwind liquidity arrangements and suggested a longer initial period. One Wholesaler noted that the impacts of Covid-19 would likely have a material impact through the

next 12 months and may hinder Retailers being able to access finance as new sources of liquidity. Several Wholesalers noted the importance of the liquidity being repaid within the 2020/21 financial year, recognising limited financial headroom and that they were keen to ensure that their covenant reporting is not affected.

Retailers generally expressed uncertainty on how long market liquidity might be required. Several Retailers broadly agreed with the July deadline, as long as this was subject to review and extension, if deemed necessary. One Retailer suggested that the liquidity arrangements should be in place either until the end of July or two months after lock-down winds down, whichever is the later date.

A significant number of Retailers did not support the July deadline. One Retailer argued that this deadline was not supported by sufficient reasoning, noting that timing of the end of restrictions is still unknown. They suggested that Ofwat should not act in isolation and follow the economic conditions and other regulators in determining such a date. Another Retailer suggested that a rolling approach should be implemented to account for the evolving situation. One Retailer expressed concerns that it might not be able to access Government support, especially given the requirement to evidence an ability to raise finance pre Covid-19. It noted the possibility that the liquidity gap could get worse by end of the year as a result of recession.

With regard to the December deadline for repaying deferred payments, Retailers were generally split in opinion. Several of the Retailers who agreed were cautious about this date but agreed with it on the basis that a deadline needed to be set, while also noting the need for it to be reviewed. One Retailer did not support the proposed December deadline noting that the end point for restrictions remains unknown. Some of the Retailers who disagreed with the December deadline suggested alternative approaches. Two Retailers indicated that there should be a six-month period after normal billing resumes before Retailers are required to pay back deferred wholesale charges. One Retailer thought an 18-month period might be more appropriate. Another Retailer suggested that while a deadline of December seemed appropriate, an extension to March 2021 could be considered.

Our decision

Reflecting evidence from the public consultation, we have concluded that Retailers should receive liquidity support to the end of July 2020. We will review and consult on next steps early in the summer. One 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. If we find that Retailers who opt to defer payment of wholesale charges do not comply with the requirements of the scheme, then we reserve the right to rule out the option of extending provision of liquidity beyond July 2020 for all Retailers. We may also decide to rule out the option of an extension if we find material evidence that Retailers are making inappropriate use of the temporary vacancy flag.

We acknowledge the concerns raised by a number of Retailers and Wholesalers with respect to the December 2020 deadline proposed in the consultation. Reflecting consultation responses, we have concluded that all deferred wholesale charges should be paid back in full by the end of March 2021.

4. Treatment of bad debt

Our decisions on bad debt set out in this section do not form part of our decision on code change CPW096. However the deferral of wholesale charges has implications for bad debt, which is why we are publishing these decisions at the same time to provide companies and their investors with greater certainty about how this will be treated.

The consultation document distinguished between two different types of bad debt that could materialise as a result of Covid-19 and the arrangements we have put in place to temporarily defer payment of wholesale charges: bad debt that can emerge as a result of non-payment by customers; and bad debt that can emerge as a result of a retailer defaulting and exiting the market. This section deals with each type of bad debt in turn.

4.1 Elevated levels of bad debt from non-household customers defaulting

What we said in the consultation

In our consultation we said Retailers retain the primary commercial relationship with customers and that it is their responsibility – and in their commercial interests – to bear and manage bad debt costs that may arise. We made an allowance for bad debt costs in setting default price terms in the Retail Exit Code. However we also acknowledged that as a result of Covid-19, and despite a number of support measures introduced by government, many business customers may struggle to pay sums owed. As a result, levels of bad debt faced by Retailers may increase. We also highlighted that changes we made to the CPCoP reduced the tools available to Retailers to effectively manage and reduce levels of bad debt.

We noted that as a consequence of the above, it is possible that levels of bad debt faced by Retailers – arising from non-household customers defaulting – could materially exceed levels anticipated by the current market arrangements. Our consultation set out two options 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 arising as a result of Covid-19 effects exceed a pre-determined threshold, these costs are shared. We set out three options here for determining the threshold for excessive levels of Covid-19 related bad debt:
- (a) REC price control benchmark – i.e. 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 – i.e. 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 – i.e. 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.

We said that we saw merit in 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. On the basis of the scale of bad debt costs incurred following the financial crisis of 2008, we set out our minded to position that we considered 2% of turnover represents a reasonable approximation of the potential likely maximum bad debt costs Retailers should have anticipated.

We also sought views on (1) whether the threshold should be set at a higher level for companies whose bad debts costs already exceed 2% to 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, and (2) how costs should be shared between customers and Retailers once levels of bad debt exceed this threshold.

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 responses

i) On the question of a threshold (Q8)

CCW agreed that some bad debt costs should be recoverable beyond the threshold, but would not agree with any adjustments to the price caps currently in place in the Retail Exit Code. It stated that if costs are expected to be shared between Retailers and business customers, appropriate protections must be in place for business customers.

The majority of Retailers agreed in principle that they should expect to manage all bad debt costs up to a certain threshold. Increases in bad debt cost beyond this level should be recoverable from customers in some manner. Of those Retailers who agreed in principle, some Retailers argued that the current price caps do not include a sufficient allowance for bad debt to cover the impact of Covid-19. It is therefore important they are allowed to recover some costs from customers. A number of Retailers also noted the introduction of changes to the CPCoP had limited Retailers' ability to manage the risks associated with non-household bad debt.

All self-suppliers and one Retailer argue that Retailers should incur all bad debt costs arising from Covid-19 and that liquidity measures in place should provide a sufficient measure to negate the need for further steps in relation to bad debt.

ii) On the level of the threshold (Q9)

Retailers that responded to our consultation had mixed views on the proposed thresholds above which bad debt costs could be recovered from customers. A number of Retailers supported or stated they did not oppose the 2% industry-wide level. One Retailer felt this option would be simpler to implement than the option to set a threshold on an individual Retailer basis. One Retailer agreed with this level but noted that this was three times higher than the market leading bad debt performance. One Retailer proposed an alternative method to estimating the burden

of excess bad debt that a Retailer could bear. The proposal adopts a methodology seen in financial restructurings.

Some Retailers argued that setting a threshold in relation to an individual Retailer's position better reflects the price protections at PR16¹¹ and individual company positions on bad debt. In addition, one Retailer argued that a blanket protection for all Retailers does not require equity holders to bear debt cost in proportion to how they have handled historic bad debt risk. One Retailer disagreed with the 1% incremental threshold on the basis this would unfairly penalise companies with low bad debt levels. It noted however that a threshold at 0.5% would be appropriate. One Retailer noted the merit of this proposal, but stated this would only be viable for bad debt experienced before changes were made to the CPCoP.

Some Retailers noted that both thresholds would unfairly penalise companies who have managed bad debt well in the past. One Retailer argues that Retailers should only be liable for the bad debt costs accounted for in the cost to serve allowance. In addition, one Retailer states that all bad debt costs should be capped at historic levels.

iii) Sharing factors above the threshold (Q10)

The majority of Retailers argue that if Ofwat implement a pre-determined threshold, then the bad debt costs incurred above this level should be born solely by customers. Of those Retailers that did not agree with this:

- One Retailer felt that customers should not share any of the costs associated with Retailer bad debt;
- Two Retailers felt that customers should bear some proportion of the bad debt costs and the remaining proportion should be shared between Retailers and Wholesalers.
- Several Retailers suggest that it is currently difficult to assess what portion of costs Retailers or customers should bear without having better data on the full impact of Covid-19. They note that this will not be available for some time.
- One Retailer suggests that there is no immediate requirement to determine the cost sharing above the threshold and it could be put off until better data is available.

¹¹ PR14 set business retail price controls for a two-year period, allowing for a review of these arrangements prior to market opening. This review was known as PR16.

Some Wholesalers and Retailers commented on the mechanism to recover costs from customers. A number of Retailers argued that the bad debt costs should be recovered from the wholesale charge. One Retailer argued that recovering from the retail charge would make some Retailers uncompetitive and present new entrants and existing Retailers with an opportunity to under-price regionally. It noted applying the levy via Wholesalers could be designed so that it is treated as a separate charge so that Wholesalers do not pick up additional liquidity liabilities. One Wholesaler disagreed that the bad debt costs should be recovered through the wholesale charge as Wholesalers should not have any exposure to the cost of bad debt in the market. Two Retailers provided precedents of cost sharing as a result of an economic shock, including the recovery of increased bad debt costs through wholesale water charges after the 2008 financial crisis and the energy retail market.

WaterUK supported the sharing of some of the Retailer bad debt liabilities with non-household customers. It also states that it supports the thresholds set out in the consultation. Some Wholesalers raised additional points stating that setting thresholds based on Retailer historic performance may lead to a disincentive to manage bad debt effectively and could reward past mismanagement of debt. Wholesalers argue that whatever the option adopted by Ofwat to deal with the bad debt costs it needs to preserve an incentive on Retailers to collect bad debt efficiently.

Our decision

The measures put in place by government to address the effects of Covid-19 are still recent (commencing from 16 March) and there is considerable uncertainty regarding the full effects of Covid-19. So whilst there is considerable scope for the Covid-19 pandemic to increase the frequency and size of delayed and defaulted payments and for this to crystallise as bad debt for Retailers, it is too early to gauge the overall scale and effect of these.

In reaching our decision we have been guided by the following factors:

- The principle that Retailers are, in the first instance, responsible for managing bad debt risks and costs in the business retail market and that a prudent Retailer will take these risks into account, including their reasonable variation due to economic cycles and shocks;
- Our recognition that:
 - the Covid-19 pandemic may well result in outturn bad debt costs in excess of those that a prudent Retailer could reasonably have expected or planned for; and

- Ofwat's amendments to the CPCoP has diminished Retailer's abilities to collect payments due from customers and manage bad debt effectively;
- Our recognition that there is a case for Retailers to recoup a proportion of bad debt costs that arise over and above those levels that might reasonably be expected, i.e. concerning *incremental* bad debt costs that are seen to arise as a result of the effects of the Covid-19 pandemic.
- Balancing desires to:
 - provide a degree of certainty to Retailers in terms of the bad debt costs they should expect to bear; but
 - avoid committing customers to bearing an undue share of bad debt costs above a certain threshold, when it is as yet unknown to what degree these costs will exceed the threshold, and how and on whom bad debt costs may crystallise.

We have decided therefore that Retailers should be prepared to bear outturn bad debt costs to a level equivalent to 2% of their retail business market turnover. This is on the basis that industry doubtful debt costs in 2009/10, i.e. immediately following the financial crisis, were around 1.5%. We further note that, on average and on the basis of data provided to us by Retailers, outturn bad debt costs in the most recently audited financial year, were around 1% of turnover.

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, for example through wholesale charges¹².

For the avoidance of doubt, Retailers who have seen historic levels of bad debt in excess of 1% should not assume that outturn bad debt costs also in excess of 2% will necessarily be recoverable through some form of sharing arrangement. In such cases 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 in addition to their historic, pre covid-19, levels of bad debt. Please see Appendix 2 for examples.

¹² We will also consider whether there are other mechanisms to provide regulatory protection for retailers.

Before applying any protections, we would 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. We would also need to ensure Retailers are using common definitions and that these had been appropriately assured and if necessary, audited.

We have not set out the mechanism, sharing parameters or time scale for the recovery of bad debt costs in excess of the 2% threshold (or where relevant, historic bad debt + 1% threshold) set out here. We recognise that there are pros and cons in seeking to recover any share of such costs from customers either through revisions to the default price terms in the Retail Exit Code, or through some form of pass through in wholesale charges¹³. On balance we think that providing certainty on the existence and level of the threshold will provide assurance to Retailers that they will not carry all of the bad debt above this threshold. It should also avoid committing customers to bearing an undue share of bad debt costs above this threshold, when it is as yet unknown to what degree these costs will exceed the threshold, and how and on whom bad debt costs may crystallise.

4.2 Elevated levels of bad debt from business Retailers defaulting

What we said in the consultation

Our consultation noted that Wholesalers faced a risk that their counterparty, the Retailer, goes into default. 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 originally introduced in March to support the retail market should come at the expense of the financial resilience of the Wholesalers.

¹³ For clarity if recovery was via the wholesale charge, this would apply to business (non-household) customers only.

In our consultation we identified three options to address the elevated risk resulting from Retailer default that Wholesalers are exposed to:

- i. Do nothing – Wholesalers continue to receive the price control protections associated with a business Retailer defaulting, as explained in section 2 of the consultation;
- ii. Cap Wholesalers' 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 Wholesalers' exposure to bad debt costs as a £m figure or as a proportion of annual wholesale charges to business Retailers.

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?

Consultation responses

CCW and a number of Retailers believe that Wholesalers are better placed to carry a higher proportion of the risk due to their monopoly position, size, ownership and access to lower cost of financing. They are also concerned that the debate about debt has been viewed as a zero sum game between retail and wholesale. It would be normal for an entire supply chain to co-operate to support each other. CCW also suggested that any consideration of protection of Wholesalers should start with an assessment of the level of protection already afforded in Wholesalers' price controls.

Water UK and the Wholesalers emphasised that, consistent with the principles of good regulation, such as transparency and predictability, and with holding all parties accountable for the risks they are allocated in the regulatory regime, it is important that the risks Wholesalers are exposed to should remain at levels that existed before the 27 March code changes.

A related concern cited by Water UK was how those code changes may impact confidence in the market, and therefore the credit ratings assigned by ratings agencies. Wholesalers are concerned that exposing companies to the additional level of risk at the time when the risk appears to be greatest could be seen as a decision based on expediency, and could negatively impact their ratings.

Water UK also suggested that both the 27 March code change and any further extension of liquidity support would 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. Water UK suggested that it is crucial that all parties understand the steps that would be necessary to mitigate the impacts of a Retailer failure, protect the customer experience and avoid disruption so far as possible, were this situation to arise.

Water UK and the Wholesalers argued that the existing wholesale price control mechanisms were predicated on the codes as they were before 27 March 2020, and therefore do not provide protection that accounts for the impacts of those changes or the changes that might result following this consultation. Wholesalers are concerned, absent any changes to the regulatory arrangements applying to Wholesalers, about the increased exposure to risk as a result of these code changes.

These concerns included that, as noted by Water UK, existing mechanisms and sharing factors included within current Wholesalers' price controls would not be sufficient to provide protections against new risks and exposures provided for under the code changes. One Wholesaler argued that, given the additional exposure arising from the code changes was not part of the PR19 settlement, it would not seem appropriate to apply the regular totex sharing rates.

Water UK and almost all Wholesaler respondents stressed that, in terms of the options Ofwat has put forward, maintenance of the status quo (option i) is clearly inappropriate. Wholesalers believe that they should not be exposed to any greater quantum of failure from any individual Retailer than that which they would have been exposed to prior to the recent code change.

For the reasons set out above, Wholesalers showed preference for option (iii), stating that the exposure Wholesalers face should be capped. Wholesalers argued that the cap should be set at the level of exposure that existed before the 27 March code change. A few Wholesalers explicitly set out their preference for option (iii) and a cap as a percentage of non-household wholesale revenue.

Retailers generally believed there is merit in providing a level of protection for Wholesalers from bad debt associated with provision of the liquidity measures. It would seem unfair that Wholesalers should pick up further risk for assisting the industry by financing the liquidity gap. Views varied as to whether option (ii) or (iii) would be more appropriate to provide the protection.

One Retailer suggested that the current financing structures of a number of Wholesalers are unviable in light of a systemic reduction in consumption of water,

under current price controls. However, measures to maintain these structures, which inevitably result in the failure of Retailers, will ultimately cause greater damage to Wholesalers and customers, as it will not be possible in a finite timescale to replicate invoicing and collection activity.

WaterScan, whose response is supported by a number of self-suppliers, stated that the commitment by the industry to be carbon neutral by 2030 is arguably more important than the current, short term crisis. All measures should be considered to ensure the obligations to reduce the impact on the environment, improve performance and service to customer are not affected.

Our decisionOur starting point is the expectation that– in line with existing market arrangements - Wholesalers need to manage and bear some risks of Retailer default and the accompanying exposure, including in times of economic downturn where the risk of Retailers exiting the market might be higher. However, we do not think that the liquidity arrangements that are being introduced to support the business market should come at the expense of Wholesaler financial resilience.

We consider that Wholesalers should shoulder some of the costs of the additional exposure associated with the additional liquidity they provided to Retailers should a Retailer fail. This is because in all other circumstances, Wholesalers would have an incentive to take action themselves to prevent or contain any Retailer failure to maximise wholesale charges that are paid and therefore revenue from customers collected. Whether in a competitive market without regulation or a regulated market without our intervention to support the retail market, Wholesalers would have had to provide additional support. In choosing the cap we bore in mind this counterfactual as well as the need to not compromise the Wholesaler's financial resilience.

We have set a cap on the additional exposure that each Wholesaler will face as a result of providing liquidity to each Retailer. We are not adjusting the PR19 cost sharing rates for any Wholesalers. But we will cap Wholesalers' additional exposure at the £m figure equivalent to the monthly wholesale charge^[1] for the relevant retailer. On a Retailer failing, the bad debt the Wholesaler will carry, after the price

^[1] Exposure to bad debts is shared with customers through the totex sharing mechanism at the end of the AMP, so in calculating the cap, we will gross-up the figure to ensure that Wholesalers remain responsible for the full amount of the cap.

control sharing factor has been applied, will be capped at the £m figure equivalent to the average monthly wholesaler charge for that Retailer. We expect all companies to be able to manage exposure up to this level. We will design a mechanism to enable Wholesalers to recover the costs above the cap^[2] from customers. The mechanism will protect household customers from any material bill impacts and will, wherever possible, recover the costs only from business customers. We will maintain this cap even if the liquidity mechanism is extended after our review in July. Figure 1 overleaf illustrates how the cap will apply.

^[2] Wholesalers will need to record separately the revenue and cost impacts associated with the NHH market.

Figure 1 Illustrative schematic of application of wholesaler cap in event of bad debt crystallising as a result of retailer failure

Retailer defaults

Wholesaler liability determined as follows:

A. Identify invoices / settlement charges invoiced to Retailer that are outstanding

B. Identify value of securities and credit protections that Retailer has lodged with wholesaler

C. **Calculate** outstanding amount after taking account of securities and credit protections
= A - B

D. Identify actual amount Retailer has deferred under Covid-19 related liquidity arrangements,

E. **Calculate** wholesaler liability that would apply absent the Covid-19 related liquidity arrangements:
= C - D

F. **Calculate** cap based on one month's total wholesale charge:
= $\frac{\text{average monthly wholesaler charges invoiced to Retailer in 2020/21}}{\text{Wholesaler's Totex sharing factor}}$

G. **Calculate** Total wholesaler liability, pre Totex sharing
= E + minimum {F,D}

H. **Calculate** Total wholesaler liability, post Totex sharing
= G x Wholesaler's Totex sharing factor

5. Next steps

The full effects of Covid-19 are unlikely to crystallise for some time. There remains a high degree of uncertainty as to how long social distancing restrictions will remain in place and to what extent, and it is not yet known when business' operations may return to normal.

While the decisions set out in this document provide much needed certainty and clarity to the sector on the issues of liquidity and bad debt in the medium-term, we are conscious of the need to continually review how Covid-19 is impacting the water sector and those operating within it, to ensure any interventions we make are timely, proportionate and fit for purpose.

Therefore, following implementation of the decisions in this document, we will pursue further work in the following areas:

- i) **We will revisit the temporary provisions we placed into the Customer Protection Code of Practice (CPCoP)** that afforded all non-household customers added protections during this period of uncertainty. We want to ensure that protections remain in place for those customers who are seriously impacted by Covid-19, but that it strikes the right balance in protecting customers seriously affected by Covid-19 while enabling Retailers to recover debt from customers who are operating normally and able to pay their water bill.
- ii) While the minimum payment levels set out in this decision are fixed for the months of May, June and July, **we will monitor the information provided by Retailers on the amounts that they have been able to pay to Wholesalers.** We will review and consult on next steps early in the summer. One component of this review will consider the availability of government support to Retailers. The expectation is that Retailers should take advantage of this support, in addition to exhausting all means to finance additional liquidity needs themselves, with the need for sector-specific support falling away over time.
- iii) Also in early summer, **we will confirm how the arrangements will be unwound to ensure deferred wholesale charges are paid back, in full, by the end of March 2021.** This will include consideration of how the restrictions that remain in place in the CPCoP will be lifted.

- iv) Working with MOSL, **we will continuously monitor Retailers' use of the vacancy flag**. We will be particularly keen to review the use of this flag if there is any relaxation of Covid-19 restrictions that allows businesses to reopen. As we set out in our decision on CPW091, we will consider how Retailers have applied the vacancy flag and the evidence they have taken into account in doing so.
- v) **We will monitor the level of additional Covid-19 related bad debt emerging in the business retail market**. 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.
- vi) We will be continuing work with MOSL **to ensure that the industry interim supply processes are able to cope efficiently with Retailer failure**.

Appendix 1 CPW096 and the principles of the Wholesale Retail code

We have concluded that the implementation of CPW096 will better facilitate the principles of the Wholesale Retail Code as detailed in Schedule 1 Part 1 Objectives, Principles and Definitions and is consistent with our statutory duties.

We think that the implementation of CPW096 furthers the principle of Transparency as it provides a clear and accessible mechanism for Retailers to be able to pay wholesale charges due and for Wholesalers to clearly understand the amount of charges it is owed that have been deferred.

The solution seeks to apply payments by Retailers to Wholesalers in equal proportions. This will be dependent on the number of Wholesalers who the Retailers have entered into a contract with, and so for this reason we think that the solution furthers the Proportionality principle.

Finally, we think that the modification furthers the principle of Simplicity, Cost-effectiveness and Security as it clearly reflects the payments made and amounts deferred by Retailers based on a simple calculation.

The changes to the legal drafting are published separately.

Appendix 2 Bad debt from non-household customers: Examples

Historical bad debt as % turnover	Outturn bad debt as % turnover	Change in bad debt as % turnover	Retailer expected to absorb bad debt up to level
0.5%	2.0%	+1.5%	2.0%
0.5%	3.0%	+2.5%	2.0%
1.0%	2.0%	+1.0%	2.0%
1.6%	2.4%	+0.8%	2.4%
1.6%	2.8%	+1.2%	2.6%
2.0%	3.0%	+1.0%	3.0%
2.0%	4.0%	+2.0%	3.0%
3.0%	3.5%	+0.5%	3.5%
3.0%	5.0%	+2.0%	4.0%

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April 2020

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