Covid-19 and the business retail market

Proposals to address liquidity challenges and increases in bad debt

We welcome Ofwat's publication on the business retail market, which puts forward several constructive proposals to address the unprecedented pressures being faced by retailers. As a wholesaler, we are willing to play our part in supporting the market and providing liquidity during this crisis period – but we are also under pressure due to the Covid-19 pandemic. As such, we welcome Ofwat's statement that support for the retail market must not come at the expense of wholesalers' financial viability. This will help to support investor confidence in the sector and the stability of the regulatory framework.

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

We support the objectives as set out. They are consistent with Ofwat's duty to protect the customer interest and with the principles of good regulation.

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.

Retailers will be better placed to answer these Q2 and Q3 as our information is second hand. We have only just invoiced for April and have asked the retailers about the proportion of the wholesale charge that they expected to pay. We were encouraged that several stated an intention to pay the full value, but we expect the overall value recovered to be closer to 55% of the regular invoice – this is in line with March where we received 56% of the invoived amount.

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.

The approach must take account of the size of the liquidity gap for retailers. They should look to existing or future Government support as their first option and if these are sufficient – coupled with use of vacancy flags and reduced Yearly Volume Estimates (YVEs) – then this would be preferable.

However, it is likely that the liquidity gap will be material. We believe Ofwat's expectation that at least 70% of wholesalers' charges should be paid each month is reasonable. While the value of wholesale charges due will already have been reduced through vacancy and lower YVEs, retailers still face the prospect of delayed payments from their own customers. Their ability to manage non-payment has been curtailed through the changes to the customer code of practice, so it is reasonable for wholesalers to be flexible.

We do not support the options that involve payment on receipt by retailers as these effectively transfer the risk of retailers' performance on revenue recovery to wholesalers and provide very poor incentives to manage debt collection properly.

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.

Our response deals with question 5 and 6 together. We think that retailers should retain the incentive to manage their liquidity using the means that are already available to them (including Government support), rather than looking immediately to wholesalers as the main source of finance. Wholesaler liquidity should be a backstop and there should be incentives for retailers to pay wholesale charges as soon as they can. For this reason, they should bear the financing costs associated with the liquidity that wholesalers provide.

When setting an appropriate rate, Ofwat should set this no lower than the cost to wholesalers but too high a rate could be damaging to the retail market; we would not see this as a potential source of profit. We think that Ofwat should take a judgement as to the appropriate level – at extreme the allowed wholesale cost for new debt could appear an attractive first resort for retailers.

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?

In principle, we think that liquidity support should be time-limited as the aim should be to return the market to the position which existed prior to the Covid-19 crisis. The emergency liquidity measures should start to be unwound as soon as is practicable. Ofwat is better placed to make judgements about the most appropriate length of time required because it possesses more information about the financial position of retailers.

Administering the changes in payment terms is quite complex, so continual change should be avoided. MOSL, retailers and wholesalers have automated systems which are designed to deal with large volume transactions and these are not well-suited to quick adaptation. For example, some retailer payments were already being processed by the time Ofwat made its announcement relating to March invoices.

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.

In principle retailers should bear bad debt costs from non-household customers because they are best placed to manage the cost of recovery. Retailers implicitly accept bad debt risk when they choose to participate.

The current circumstances are exceptional and retailers' ability to manage bad debt costs has been impaired. They cannot apply interest or charges for late payments and cannot disconnect customers. This was not part of the package that retailers expected when entering the market and therefore it would be reasonable for their risks to be limited, particularly when regulatory changes have occurred.

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?

In our view the propsed limits strike a fair balance the level of bad debt that retailers should have expected and provided for, and the unprecedented crisis we are currently experiencing (coupled with regulatory changes that constrain their tools for debt recovery, as described above).

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.

When determining the sharing rate above the threshold, we think there are two considerations:

- Firstly, retailers should continue to have an incentive to recover debt because they are best placed to manage the risk. The retail share should not be set to zero at any level of bad debt because this would effectively pass all risk to other customers and create a moral hazard.
- Secondly, the overall ability of retailers to absorb the additional costs given that they will already have suffered the first 2% (or existing rate +1%). If they absorb too much of the excess costs, there will be a serious risk to the recovery of the market.

Taking this into account, we do not think an even 50/50 split of the excess amount or an absolute ceiling on retailer exposure would be correct, and a tapering approach could be appropriate.

As outlined in the consultation, wholesalers should not have any direct exposure to customer debt – only to retailer debt, if they default. This means that the customer share would need to be recovered through retail, rather than wholesale charges. We support the view that this should be shared at an industry level to avoid an excessive impact on any one region's customers.

A potential mechanism could be for Ofwat or MOSL to charge a fee to all non-household retailers over a number of years – this would be part of the gross margin that they could charge on to their customer base. The fee income would represent a guaranteed revenue stream that could be used to secure finance for the pooled bad debt now. If the income stream is secure, it should be possible to obtain this at a reasoble rate without the need to raise the funds from wholesalers.

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?

We welcome Ofwat's recognition that the changes to market codes have exposed wholesalers to a greater level of risk than before 27 March. Wholesale costs include no provision for bad debt at present; if it was perceived that wholesalers had a significant exposure to retail failure then that would probably need to change. The overall level of risk within the system cannot be reduced, only transferred – improved credit terms for retailers mean more exposure for wholesalers and these costs will ultimately be passed on.

Given that the additional exposure arising from code changes was not part of the PR19 settlement, it would not seem appropriate to apply the regular totex sharing rates to all differences. In our view bad debt exposure should be capped at a percentage of non-household revenue. This could be set at a level that is consistent with the pre-March 27 credit exposure – this is the level implicitly included within determinations. Bad debt below the cap would be shared in line with companies' normal sharing ratios; costs above the cap would be passed on to customers in full.

If Ofwat considers it important that household customers do not pay for this, it could use charging rules to achieve this objective (there is existing Government guidance stating that households should not bear the costs of competition, so this would do no more than reinforce an existing requirement).