
Wholesale Retail Code Change Proposal – Ref CPW101 part b

Modification proposal	Wholesale Retail Code Change Proposal – Addendum to CPW101: Change to Credit Support Requirements (as proposed in CPW101)
Decision	The Authority has decided to approve this Change Proposal
Publication date	4 August 2020
Implementation date	5 August 2020

Background

The Business Terms provide three payment terms options for the payment of Primary Charges from Retailers to Wholesalers:

- Pre-Payment;
- Post-Payment; and
- Alternative Payment Terms.

The Post-Payment option enables Retailers, with access to appropriate credit arrangements, to pay Primary Charges after the R1 Settlement Run. In order to access Post-Payment terms, the Retailer must provide one or more forms of Eligible Credit Support¹ and/or (with the agreement of the Wholesaler) Alternative Eligible Credit Support to meet the Credit Support Amount².

The value of credit support that a Retailer is required to provide to the Wholesaler(s) that it contracts with is normally calculated based on the value of each Settlement Report provided by the Market Operator. Settlement Reports are calculated based on the consumption, or estimated consumption, of Retailers' customers in each given Area.

¹ The various forms of Eligible Credit Support are set out in Schedules 2 and 3 of the Business Terms

² The Credit Support Amount is the amount expressed in pounds sterling to be provided by the Contracting Retailer calculated on a monthly basis in accordance with Section 9.11.3 of the Business Terms (representing the Credit Support Requirement less any applicable Unsecured Credit Allowance and any interest accrued on the cash deposited in the Cash Security Account for that Contracting Retailer)

With the ultimate aim of protecting business customers during the Covid-19 pandemic, Ofwat approved a series of urgent and temporary Change Proposals, initially:

- [CPW091](#) - Given the challenges associated with getting meter reads during lockdown businesses were likely to be billed on the basis of (higher) historic meter reads. To ensure charges more accurately reflect (reduced) levels of consumption, in March we approved CPW091 which enabled Retailers to temporarily apply the vacant flag in the Central Market Operating System (CMOS) where premises have closed down due to Covid-19³; and
- [CPW093](#) - Which enabled Retailers to temporarily defer up to 50% of Wholesale Charges in March 2020, and from Settlement in April and May 2020.

The combined effect of these changes increased the bad debt risk to Wholesalers as the Credit Support Requirements were based on Settlement Reports which would have been substantially lower due to increased vacant premises, while at the same time Retailers that chose to defer a proportion of their Wholesale Charges would owe Wholesalers more money.

To address an unintended consequence of CPW091, through [CPW095](#), Credit Support Requirements were maintained at pre-Covid (that is, March 2020) levels for Retailers that had not deferred Wholesale Charges. CPW095 was superseded by [CPW096](#), which extended the requirement to maintain Credit Support Requirements at the March 2020 level to all Retailers, regardless of whether or not they have deferred any Wholesale Charges. The rationale for this was to mitigate the increased risk to Wholesalers arising from a potential reduction in the level of credit support required through Retailers' applying the temporary vacant flag, and, for prudential reasons, to protect Retailers from encountering a cliff-face in the provision of credit support when vacant flags are switched off and consumption begins to rise. CPW096 also provided an extension to the period over which Wholesale Charges can be deferred, further details can be found in the [decision document](#).

At the same time as publishing our decision on CPW096, we also published our decision to cap the increased exposure that Wholesalers bear from the liquidity arrangements we have put in place, to the average monthly charge for the failed Retailer. Until the cap is reached, any increased bad debt costs not covered by the

³ CPW091 allowed Retailers to use a bespoke temporary vacancy flag where a premises: (a) is not open or available to workers, the public or visitors; or (b) usual activities at the premises had fallen by 95% (as a proxy for a similar reduction in consumption).

credit arrangements in the business retail market will be shared with customers through the totex sharing mechanism. Once the cap is reached, all bad debt costs from the failed Retailer resulting in the increased exposure are borne by customers.

In July 2020, Ofwat [consulted](#) on next steps following the temporary response to Covid-19, including a proposal in relation to ongoing Credit Support Requirements. Our proposal was to require Retailers to maintain credit support requirements at March 2020 levels until they have removed all their temporary vacancy flags from CMOS in accordance with the Code. This formed part of our change proposal CPW101, on which we have published our decision on Thursday 30 July, which excluded our decision on credit support requirements. Reflecting both the evidence received in response to the public consultation and the recommendations of the Industry Codes Panel following its meetings on 28 and 30 July 2020, this document sets out and explains our decisions on the credit support requirement recommendations from change proposal CPW101.

In our consultation on next steps, we also sought views on behalf of The Panel on an alternative proposal in relation to Credit Support Requirements (CPW100), which seeks to reduce the Credit Support Requirements for Retailers who have not deferred any of their Wholesale Charges. Our decision on CPW100 is also published today and can be found [here](#).

The issue

The impacts of Covid-19 have been felt across the whole of the UK economy. Government and Regulators have been acting together to support businesses through this period, with Government providing substantial financial support to business, economy wide. Over the past few months, working closely with the market operator MOSL and the sector, we have taken a number of steps to further protect the interests of business customers in the water sector.

Recognising that a number of our measures were temporary in nature we published a [consultation on next steps](#) on 9 July. Recognising that the reduction in credit support requirements was an unintended consequence of allowing Retailers to mark premises as temporarily vacant, our consultation included a proposal to maintain the credit support requirement – for all Retailers who are making use of the temporary vacancy flag – at March 2020 levels until all its temporary vacancy flags are switched off. Beyond this date, we proposed that credit support requirements would then be calculated based on primary charges that are due.

In parallel to this the industry Codes Panel has considered an alternative code change proposal (CPW100), which seeks to reduce the credit support requirements for Retailers who have not deferred any of their wholesale charges.

The Change Proposal⁴

CPW101 was proposed by the authority to seek to unwind (in a measured way) the temporary measures put in place to mitigate the impact of Covid19 on the Non-Household Retail market. It included setting out how and when deferral of payments by Retailers will end as well as their repayment, restarting Market Performance Standard (MPS) and Operational Performance Standard (OPS) charges, removal of temporary Covid-19 related vacancies and when credit support levels may return to normal.

The proposal relating to credit support requirements in CPW101 was to maintain credit support requirements for all Retailers at March 2020 levels until all the temporary vacancy flags that Retailers have switched on within CMOS are switched off. Retailers will be required to provide Wholesalers with a minimum of the credit support requirement for March 2020 until the credit support requirement calculated in September 2020, i.e. for the October 2020 P1 Settlement Run. From that point, where a Retailer has evidenced all of its sites as no longer vacant in line with the requirements of the Code they can return to the normal rules for calculating credit support set out in Section 9.11 of the Business Terms.

Industry consultation and assessment

Ofwat consulted with industry stakeholders on credit support requirements as part of its Covid-19 and the business retail market - consultation on next steps. Our consultation set out 3 options relating to ongoing credit security requirements:

1. Allow credit support requirements to be calculated on the basis of primary charges in any given month;
2. Maintain credit support requirements at March 2020 levels until all the temporary vacancy flags are switched off; or
3. Maintain credit support requirements at March 2020 levels until further notice (essentially the 'do nothing' approach).

In the consultation, we were minded to implement option 2. This option should provide additional incentives for Retailers to remove the temporary vacancy flag and

⁴ The proposal and accompanying documentation is available on the MOSL website at <https://www.mosl.co.uk/market-codes/change#scroll-track-a-change>

get meter readings or accurate estimates into the market so that their credit support requirement is more closely aligned to actual consumption levels going forward.

Wholesalers, Water UK and CCW agreed with our position of being minded to support option 2 with some requests for clarification and one suggested addition. There was also one request for Ofwat to link the return to 'business as usual' credit arrangements with the removal of Covid-19 related YVE changes, particularly those that removed at least 95% of estimated charges.

Retailers responded both in support of option 1 (3 responses) and option 2 (4 responses). Where responses set out support for option 1, some of the reasons that were cited included:

- As the number of temporary vacant flags are reduced the risk to Wholesalers reduces and the fairest option is Option 1. It does not seem right that a Retailer should provide credit support for figures that are not due.
- Following a 20% reduction in GDP, artificially mandating a level of credit support for a volume of wholesale charges which is not reflective of current consumption effectively ignores the consumption lost due to Covid-19 and thus fails to recognise changes in the market. There needs to be some consistency between the level of credit security and ongoing consumption levels.

There was a suggested alternative option where credit support requirements would be based on the P1 for all non-Covid sites and for Covid sites to use the April P1.

One Retailer also suggested that Ofwat should wait before adjusting credit support requirements and reassess its position in September. The rationale stated was that it would be unlikely that consumption levels will return to March 2020 levels for some time, and it would not be reasonable to expect Retailers to maintain credit support at pre-Covid levels (Option 3) indefinitely. It would be prudent to wait until a 'new normal' is established before adjusting credit support requirements. It was suggested that this should be in September when more data was likely to be available.

One Retailer's response to this question included the view that there is a strong case for progressing [CPW061](#) (proposal to provide a new unsecured credit allowance to Retailers based on payment history) at this time to incentivise retailers to repay their deferred charges, and to improve liquidity for unassociated retailers.

We have considered all of the responses to this consultation when developing the recommendation for CPW101.

Panel recommendation

At its meeting on 28 July 2020, the Panel considered change proposal CPW101 and recommended CPW101, by unanimous decision, for approval by Ofwat in its entirety, inclusive of our proposals on credit support requirements for implementation on 1 August 2020. Panel Members agreed that adjusting the credit support requirement in relation to the October P1 Settlement Run (in early September) would set an appropriate expectation and incentive regarding the removal of temporary vacant supply points for periods from 1 August 2020 onwards.

At the same meeting, the Panel also considered change proposal CPW100, raised separately by Castle Water. This change seeks to reduce the credit support requirements for Retailers who have not deferred any of their wholesale charges. The Panel discussed CPW100 and voted to recommend this change proposal for rejection by Ofwat. However, whilst we acknowledge the discussion and subsequent Panel vote on that Change Proposal, we were concerned that the Panel was not entirely clear on the nature of the proposal and the interdependencies with CPW101. For example, we note that some Panel Members voted on the basis that the two changes could be implemented in parallel, which is not the case and was not the intent of either change.

We therefore asked the Panel to reconvene on Thursday 30 July to reconsider CPW100. As a result, we delayed our decision on the credit element of CPW101 until after the Panel meeting. Our decision on CPW100 is also published today and can be found [here](#).

Our decision

We have considered the issues raised by the Change Proposal and the supporting documentation provided in the Panel's Final Report and have decided to approve the credit element of CPW101. We have concluded that the implementation of this element of CPW101 will better facilitate the principles of the Wholesale Retail Code detailed in Schedule 1 Part 1 Objectives, Principles and Definitions, Principles and Definitions, and is consistent with our statutory duties. The legal drafting to give effect to this decision is included in Appendix 1.

We think that this change furthers the principle of Efficiency as it provides an approach to unwinding the temporary arrangements related to credit and is a step towards helping the market return to normal operation (acknowledging that 'normal operation' may reflect lower levels of consumption than prior to March 2020). The solution seeks to enable all Retailers who are on Post-Payment terms to return to standard Credit Support Requirements in a timely and measured way and so is proportional across these Retailers.

Reasons for our decision

Through Code Change CPW096, credit support requirements were maintained at pre-Covid-19 (that is, March 2020) levels for all Retailers. The primary rationale for this was to mitigate the increased risk to Wholesalers arising from a potential reduction in the level of credit support required through Retailers' applying the vacant flag, and, for prudential reasons, to protect Retailers from encountering a cliff-face in the provision of credit support when vacant flags are switched off and consumption begins to rise.

Reflecting the potential impacts that use of the temporary vacancy flag is having on settlement values, we think it is prudent to ensure that the level of credit support is maintained at the March 2020 level until each Retailer has removed all of its temporary vacancy flags from CMOS. If Credit Support Requirements were to be set based on current Settlement Reports, there is a risk that Retailers might not be posting the appropriate amount of credit, for example if there are lags in removing the temporary vacancy flags from CMOS. This has the potential to increase Wholesaler risk and also the potential to negatively affect customers in the event of an unplanned Retailer exit.

We also think it is important to incentivise a measured removal of temporary vacancy flags and the submission of more accurate consumption data as some business adapt to a 'new normal' level of consumption. . We therefore disagree that a return to March 2020 credit arrangements should also be conditional on the Retailer having no outstanding deferred amounts under the deferral scheme as this would dampen the incentive to transition out of Covid vacancy arrangements for those Retailers who have opted into the deferral scheme. Whilst we agree that the deferral of wholesale charges also increases Wholesaler risk, we have already capped the increased exposure that Wholesalers bear from the liquidity arrangements we have put in place, to the average monthly charge for the failed Retailer.

Where it was suggested that the return to March 2020 credit arrangements should also be linked with the removal of Covid-related YVE changes, we do not think that this is practical to monitor and note that MOSL is already actively monitoring the use of YVEs. To be clear, we do not expect Retailers to enter arbitrarily low YVEs simply as a means to accessing lower credit support requirements. We will work with MOSL to monitor this and will take appropriate action if this is found to be the case. As stated in our decision document on CPW101, we will work closely with MOSL to update guidance and provide clarity on the evidential requirements for using YVEs. We are also minded to introduce an incentive this autumn to monitor inappropriate use of YVEs to encourage more accurate consumption data in the market.

Concerning the views that Ofwat should wait before adjusting credit support requirements and reassess its position in September, we think that this could unfairly penalise Retailers who have taken proactive and measured steps to remove temporary vacancy flags from CMOS. Similarly, many businesses will be adapting to a 'new normal', which could involve lower levels of consumption. We therefore do not think that, when the vacant flags have been removed, it is right to require Retailers to provide credit support on the basis of March levels as this may not accurately reflect actual levels of consumption.

On the suggestion that CPW061 should be progressed, the Panel recommended CPW061 to us prior to knowing the extent to which temporary vacancy flag would be used and also without understanding the level of uptake of the deferral scheme that there could be. We acknowledge this suggestion and we will consider and progress to a decision on CPW061 in due course. Where necessary (dependent on the timing of our decision) we will consider the implications of use of the temporary vacancy flag and deferral of primary charges alongside CPW061.

Respondents requested clarification around the definition of 'until all temporary vacancy flags are switched off'. We confirm that this applies equally to individual Retailers and that credit support requirements for an individual Retailer will be maintained at March 2020 levels until all temporary vacant flags for that specific Retailer have been removed from CMOS, rather than all of temporary vacancy flags across the market being removed, and that in removing their temporary vacancy flags Retailers have complied with the requirements in Section 3.2.5 of CSD104.

Decision notice

In accordance with paragraph 6.3.7 of the Market Arrangements Code, the Authority approves this Change Proposal.

Georgina Mills
Director, Business Retail Market

Appendix 1 Legal drafting for credit element of CPW101

9.12.3 – insert the following:

(d) Commencing from the October 2020 P1 Settlement Report, the requirement in Section 9.12.3 (c) shall no longer apply to a Contracting Retailer who, for all their SPIDs, has no Eligible Premises set as Vacant Premises in accordance with Section 3.16 of CSD104 (Maintain SPID Data) outside of the Covid-19 Vacancy Period (as defined in that CSD) and has complied with Section 3.2.5 of CSD104 (Maintain SPID Data). Where a Contracting Retailer complies with Section 3.2.5 of CSD104 (Maintain SPID Data) only after 30 September 2020, the requirement in Section 9.1.2 (c) shall be deemed to no longer apply from the next P1 Settlement Report.

(e) Where the provisions of Section 9.12.3 (c) have ceased to apply to a Contracting Retailer pursuant to Section 9.12.3 (d) they shall not subsequently reapply to that Retailer if it transpires that one or more of their SPIDs has wrongly been marked as an 'evidenced' Vacant Premises, provided that the Contracting Retailer is able to provide contemporaneous evidence which supports that marking.