

Measures in support of the retail market in light of the current pandemic

April 2021

The ongoing coronavirus (COVID-19) outbreak is presenting unprecedented challenges to businesses and the wider economy in Scotland. Mindful of its statutory duties to promote the interests of customers, the Commission has set out measures to support non-household customers affected by the pandemic and transition the market back to its normal operations. This document also consults on additional measures to support the retail market.

Comments should be sent to competitionteam@watercommission.co.uk no later than 23 April 2021.

This document has been sent to:

- All licensed providers;
- Scottish Government;
- Scottish Water;
- Citizens Advice Scotland; and
- The Central Market Agency Limited.

1. Background

1.1 Measures in response to the pandemic

The Covid-19 pandemic has had, and is likely to continue to have, material impacts on customers, businesses and the wider economy. The Commission is committed, within its statutory duties, to ensure that business and other non-household customers, many of which are facing unprecedented financial and other difficulties during this challenging time, can, as far as possible, receive appropriate support.

In light of this, in March 2020 the Commission implemented [steps](#) to protect customers affected by the pandemic and to support licensed providers during these challenging times. Since March 2020, Scottish Water has also supported licensed providers by suspending the two-month wholesale prepayment requirement on licensed providers.

Since the outbreak of the pandemic, the Commission has also been pleased to see licensed providers and Scottish Water working together to ensure that affected customers could benefit from a partial deferral of their water charges and receive a refund of pre-paid monies. As we now consider how to phase out the current support measures, we are mindful of our statutory duties to ensure an orderly functioning of the market and that there is no detriment to the wholesale business of Scottish Water.

Most importantly, the pandemic has brought into focus the need to ensure that licensed providers are appropriately financially resilient and can withstand unexpected shocks. It is, therefore, important to ensure that market participants can demonstrate that they are and remain financially resilient. During this transition period, it is important to preserve the operation and integrity of the market and to provide certainty to businesses. The Commission, therefore, wants to ensure that the unwinding of the current support measures is done in a measured and proportionate manner.

1.2 Working jointly on transition arrangements

In November 2020 the Commission published a consultation [letter](#) on steps to transition the market back to its normal operations and to ensure that the recent experience of all stakeholders is used to improve the market framework. The Commission also invited licensed providers to work collaboratively on developing a set of proposals to address the issues identified.

In December 2020, licensed providers established a Working Group, chaired by Citizens Advice Scotland and have been working on proposals for the introduction of a new deferral scheme in support of businesses affected by the pandemic along with other measures to ensure that licensed providers are, and remain, financially resilient.

2. Implementing measures to transition the market back to its normal operations

2.1 More recent steps

The Commission reviewed the proposals submitted by the Working Group in February 2021 and published a [decision](#) to extend temporarily the existing support measures (including both the wholesale deferral scheme and the temporary relaxation of wholesale prepayment due to Scottish

Water). The Commission also set out some operational principles for the introduction of new measures in support of non-household customers affected by the pandemic and licensed providers.

In March 2021, the Working Group further engaged with the Commission and, thereafter, submitted to the Commission a set of revised [proposals](#) committing to the introduction of a new deferral support scheme in support of customers and the introduction of a new licence condition that would require licensed providers to satisfy the Commission and Scottish Water of their financial strength to withstand external shocks.

2.2 The views of the Commission

In line with the principles of Ethical Business Practice, the Commission encourages licensed providers to continue to work collaboratively with the Commission and take ownership for improving the market framework. To this end, the Commission is broadly supportive of the proposals prepared by the Working Group and has been pleased to see licensed providers working constructively together on a solution that is consistent with the Scottish Government's Principles of Charging for the water industry.

It is important, however, to remind stakeholders that all issues should be considered 'in the round' and that the proposed steps should not be viewed in isolation but rather as a package of measures aimed at improving the market framework.

The relaxation of wholesale prepayments and the introduction of a wholesale deferral scheme, for example, were aimed at supporting licensed providers to allow them to pass on the benefits from such measures to their customers affected by the pandemic. The Commission is, however, also mindful that the relaxation of wholesale prepayment has temporarily reduced Scottish Water's ability to manage licensed providers' risk of non-payment. In light of this, if licensed providers were not sharing the benefits with their affected customers in full, and were not making a clear commitment to demonstrating that they are and will remain financially resilient, it would appear consistent with our statutory duties to reintroduce the wholesale prepayments requirement on licensed providers as soon as practical.

Furthermore, whilst the Commission has been pleased to see the Working Group refining its proposals taking into account the comments made by the Commission in its consultation [response](#), we also believe that it is important that all licensed providers make formal commitments to implement the measures against clear timescales.

This document, therefore, sets out milestones and timescales for the implementation of these measures. The document is also consulting on a set of new measures that will apply in the event that licensed providers do not make clear commitments to support their customers. We, therefore, welcome stakeholders' feedback on these new measures.

The Commission finally notes that the Working Group has sought further clarifications on the following issues:

- Whether customers who are in debt but have not been enrolled in the existing Wholesale Deferral Scheme would be eligible to the new deferral scheme.
- Whether customers who are in debt but have not yet engaged with their licensed provider are eligible to the new deferral scheme, and whether it would be appropriate for them to access a full deferral of charges.

- Current disconnection arrangements recently implemented by Scottish Water.
- Whether an industry-wide senior stakeholder group could be established in order to discuss strategic issues of the retail market.

The Commission has addressed each question in the following sections of this document.

3. Measures to transition the market back to its normal operations

3.1 A new deferral scheme

In its [response](#) to the consultation on Covid-19 measures, the Commission set out some guiding principles to support the implementation of the new measures. In light of the questions raised by the Working Group and following discussions with Scottish Water and the Central Market Agency, the Commission has updated these principles:

Eligibility to the scheme

- Support measures should be targeted at small and medium-sized businesses which are likely to be the most affected customers. The new wholesale deferral scheme should allow licensed providers to apply to Scottish Water for a deferral of future wholesale charges for any non-household premises with a meter size of 25mm or smaller, any unmeasured premises and those premises with surface drainage only.
- The arrangements for the new scheme should allow licensed providers to defer a portion (or all) of the primary wholesale charges for a given customer, depending on the specific support offered at a retail level by each licensed provider to that customer. This scheme should allow licensed providers to provide a like-for-like support to their customers and pass on the benefits from the deferral of wholesale charges to their customers.

Ensuring there is no detriment to Scottish Water

- The scheme should only allow for a deferral of charges due from the opening date of the new deferral scheme (which should be the end of May 2021 at the latest) or at a later date depending on the specific circumstances of the customer. Deferrals of charge, however, should not pre-date the start of the new deferral scheme. This will ensure that the scheme is fully auditable and that Scottish Water is not exposed to an unquantified risk.
- Deferrals of charges should be managed by the central market systems to ensure transparency and certainty of settlement. To ensure transparency and clarity of the arrangements, Scottish Water will publish its guidance around the new wholesale deferral scheme in April 2021.
- Customers should not be worse off as a result of the new scheme. Licensed providers should not levy any fees or penalties on any customers in relation to the implementation, exit from and/or operation of the new scheme.

- No detriment to the core business of Scottish Water is made. Scottish Water will charge an annual interest of 3.5% on any deferred charges and may cap the amount that each licensed provider is allowed to defer based on the licensed providers' financial position. Scottish Water will publish its guidance around the new wholesale deferral scheme in April 2021.

Encouraging transparency and open and honest behaviours

- It is important that all customers can receive the support made available. Licensed providers should, therefore, evidence that they have taken all reasonable and appropriate steps to inform customers pro-actively of the support made available. Notwithstanding the tailored support that each licensed provider will offer its customers, a full deferral of charges should be made available on request by the customer.
- In the event that a licensed provider does not commit to support their customers affected by the pandemic and demonstrate their financial resilience, the Commission plans to take appropriate steps to protect customers and the core business of Scottish Water. The Commission is consulting on these steps in the following section of this document.
- To ensure transparency and consistency of approach, Scottish Water will set out its approach to assessing licensed providers' creditworthiness. Credit terms negotiated between Scottish Water and licensed providers will be a function of the financial resilience that can be evidenced (on an on-going basis) by a licensed provider.
- The new measures should be transparent and auditable. The Market Health Check (MHC) will be used to audit the operation of the new scheme and licensed providers' financial strength in line with the new arrangements. The Commission plans to work with stakeholders and finalise the arrangements for the MHC process by October 2021.

3.2 Financial resilience

Any licensed provider that seeks to operate in the Scottish market and is appropriately capitalised can, on average, earn a retail gross margin including a fair return on a portfolio of customers. The default tariffs were set by the Commission after a detailed scrutiny of the costs to serve different classes of customers, reflecting the maintenance of an appropriate level of working capital, the incidence of bad debt, an allowed for cost of capital and the remuneration of a resilient capital structure of a standalone retail business. If a licensed provider can be more efficient then it is open for a licensed provider to either earn a higher return or reflect this in the prices that it offers to its customers and earn the same return.

Licensed providers are, therefore, remunerated for costs incurred in managing bad debt and for this reason they are fully responsible for their customers' non-payment. Scottish Water, on the other hand, does not receive any allowance for bad debt originating from non-household customers or for late payment by licensed providers. Whilst the requirement to pre-pay two months of wholesale charges reduces Scottish Water's exposure to the risk of a retailer's failure, it does not remove the systematic market risks for which all retailers are remunerated through an appropriate allowed for rate of return in the gross margin.

The pandemic has, therefore, highlighted the importance of ensuring that licensed providers are robustly capitalised and can withstand systematic risks without causing a detriment to the core

business of Scottish Water. In the absence of any evidence of retailers' financial resilience, some of the measures taken in response to the pandemic to protect the integrity and effectiveness of the market (such as the relaxation of the two-month prepayment requirement and the introduction of a deferral wholesale scheme) increase the risk exposure to Scottish Water. It is, therefore, important that licensed providers take responsibility to ensure (and evidence that) they are robustly capitalised and will continue to operate in a financially sustainable manner.

In this regard, the Commission has also closely reviewed market evidence from other re-financing arrangements put in place by retailers in response to the pandemic and has observed that four months of wholesale prepayments appears to be an appropriate level of liquidity that would allow a retailer to withstand shocks of similar scale to the current pandemic.

Given the exceptional nature of the Covid-19 pandemic, the Commission believes that three months of wholesale prepayments is a reasonable level of liquidity that should be required by any retailer, in the absence of any evidence or clear commitments to demonstrating its financial resilience.

4. Additional measures in support of the retail market

4.1 From development to implementation

In line with the principles of Ethical Business Practice (EBP), the Commission expects licensed providers to take responsibility for high standards of conduct and pro-actively support their customers, especially during this pandemic. It will be critical for customer confidence that there is clear and demonstrable evidence that licensed providers have supported them through this unprecedented crisis. It is also important that the lessons learnt from the pandemic are embedded in the market framework and that licensed providers can demonstrate that they are and will remain financially resilient.

EBP places firmly the onus on licensed providers to seek trust and demonstrate pro-actively why such trust is justified. The Commission, therefore, expects all licensed providers to sign up to new licence requirements that will require licensed providers to:

- a) Provide support to their customers on a like-for-like basis through the new deferral scheme; and
- b) Satisfy Scottish Water and the Commission of its financial strength to withstand external shocks.

As mentioned above, the Commission believes that it is important that licensed providers make clear commitments against these requirements and is, therefore, proposing that licensed providers communicate to the Commission and Scottish Water in writing their intentions in May 2021.

In the spirit of the principles of Ethical Business Regulation, the Commission is also inviting the Working Group to take ownership for the implementation of the measures and work alongside other licensed providers who are not members of the Working Group on a draft licence condition for the Commission and Scottish Water to review in the following weeks.

The Commission is also consulting on additional steps that would apply in the absence of any formal commitment by licensed providers on the above-mentioned measures to protect customers and Scottish Water. These steps include revising credit term arrangements between Scottish Water and

licensed providers, additional restrictions around customer prepayments taken by licensed providers and improved public information of licensed providers' performance through the use of the MHC.

The following sections set out the detailed steps that we propose to take under the different scenarios that may arise to encourage open and honest behaviour and that there are proportionate customer protections in the absence of such evidence.

4.2 A licensed provider commits to financial resilience and customer support measures

The Commission believes that, were licensed providers to provide formal commitments by signing up to the additional licence requirements on both financial resilience and customer support measures it may be appropriate to consider relaxing some regulatory requirements and allow such licensed providers to benefit from a more gradual unwinding of the support provided.

In particular, in the event that a licensed provider signs up to both licence requirements, the Commission is proposing to:

1. Reintroduce one-month prepayment of wholesale charges due to Scottish Water in July 2021.
2. Reintroduce two-month prepayment of wholesale charges due to Scottish Water in December 2021.
3. Lift the cap on customer prepayments that the Commission recently introduced as an additional customer protection measure. As part of the market review, the Commission has reviewed and identified the risks associated with customers prepaying a licensed provider who then subsequently enters insolvency. Given that customers may risk losing prepaid monies under such circumstances, the Commission has consulted on the introduction of [measures](#) to cap the amount of prepayments that licensed providers can take from their customers. The Commission believes that it could be appropriate to consider relaxing such restrictions on prepayments in the event that a licensed provider can demonstrate its financial resilience.
4. Licensed providers take part in the MHC process. Pending the outcome of the MHC, the Commission could provide a quality kitemark of the performance of the licensed provider. The kitemark could be based on a three-tier level and could be incorporated in an annual commentary published by the Commission on Scotland on Tap and on its website. Licensed providers who commit to these licence requirements and can successfully complete a MHC would likely be in the top tier.
5. Offer licensed providers the flexibility to agree with Scottish Water tailored credit term arrangements that are consistent with the financial resilience requirements.

In the event that a licensed provider signs up to the new licence requirements but fails to satisfy the financial resilience test, the Commission would expect that licensed provider to set out a remedial plan. In the absence of such a plan or of any substantive progress against that plan, the Commission will consider taking appropriate and proportionate actions including enforcement notices and other formal sanctions, having regard of the specific circumstances and on a case-by-case basis.

The Commission will also require any new licence applicant to adhere to the new licence condition in relation to the financial resilience.

4.3 A licensed provider provides commitments only to the financial resilience measures

In the event that a licensed provider only signs up to the licence requirement on financial resilience (but does not commit to support its customers affected by the pandemic through the new deferral scheme) the Commission proposes to implement the following steps:

1. Reintroduce one-month prepayment of wholesale charges due to Scottish Water in July 2021.
2. Reintroduce two-month prepayment of wholesale charges due to Scottish Water in October 2021.
3. Licensed providers take part in the Market Health Check. Pending the outcome of the Market Health Check, the Commission would kitemark the performance of that licensed provider. The Commission plans to take into account in its commentary whether that licensed provider has taken reasonable steps to support its customers affected by the pandemic.
4. Licensed providers would only be allowed to collect up a maximum of three month of charges in advance from their customers. This is in line with the policy [decision](#) published in April 2020.
5. Licensed providers would also highlight on their website and write to all potentially affected customers in plain and simple terms explaining why it is not providing any Covid-19 support to its affected customers. The licensed provider would also facilitate any customer to switch to an alternative licensed provider without any penalty or cost to the customer, irrespective of the contract that is in place or of any outstanding debt.

4.4 A licensed provider does not provide commitments on financial resilience and customer support measures

In the event that a licensed provider does not sign up to either the financial resilience or customer support measures the Commission believes that it is appropriate to take steps to reintroduce the pre-covid payment terms and take further steps to ensure that retailers retain a minimum level of liquidity to manage external future shocks.

As explained in the previous sections of the consultation, in light of the market evidence observed from other re-financing arrangements in response to pandemic and having regard of the exceptional nature of the pandemic, the Commission believes that three months of wholesale prepayments is a reasonable level of liquidity that should be required by any retailer, in the absence of any evidence or clear commitments to demonstrating its financial resilience. This is in line with the Commission's assessment of the systematic risk of the non-household retail market.

In light of this, if a licensed provider does not take appropriate steps to provide support to its customers affected by the pandemic and to demonstrate financial resilience, the Commission is proposing to take the following steps:

1. Reintroduce a one-month prepayment of wholesale charges due to Scottish Water in July 2021 and a two-month prepayment in September 2021.

2. Increase, thereafter, the prepayment requirement to three-months of wholesale charges due to Scottish Water in January 2022. Scottish Water would continue to pay an interest on the balance of any prepayment held.
3. Given the risks associated with customer prepayments and in the absence of robust evidence of a licensed providers financial resilience, the Commission is proposing to impose a complete ban on customer prepayments. Licensed providers would, therefore, not be allowed to take any payments in advance from their customers for any new contract agreed from 1 June 2021 onwards.
4. The licensed provider would not access the Market Health Check process and, as a result of this, would fall in the lowest of the three-tier level. The Commission would therefore kitemark the retailer as a ‘high risk provider’ and would incorporate this commentary on Scotland on Tap and on its website.
5. Licensed providers would also highlight on their website and write to all potentially affected customers in plain and simple terms explaining why it is not providing any Covid-19 support to its affected customers. The licensed provider would also facilitate any customer to switch to an alternative licensed provider without any penalty or cost to the customer, irrespective of the contract that is in place or of the outstanding debt.

4.5 Timescales for implementation

The Commission plans to carefully review all responses to this consultation and publish a final decision on the proposals set out in this consultation document, including any revised licence condition, by the end of April 2021.

The table below sets out indicative timescales for consultation.

Date	Milestone
23 April 2021	Draft licence condition submitted to WICS by the Working Group
23 April 2021	Consultation closes
End of April 2021	Final decision published by the Commission
May 2021	Scottish Water publishes its approach to assessing licensed providers’ creditworthiness
May 2021	Licensed providers decide whether to sign up to the new licence requirements
May 2021	New Deferral Scheme
June 2021	Scope for Market Health Check finalised
June 2021	Approach to assessing licensed providers’ financial strength is published
July 2021	Procurement for appointment of Market Health Checker
October 2021	Market Health Checker appointed
November 2021	First Market Health Check
April 2022	Interim review of progress on financial resilience arrangements

November 2022	Second Market Health Check
31 March 2023	All deferred wholesale charges are repaid
April 2023	New financial resilience measures are live

4.6 Increased transparency of licensed providers' activities

In its open [consultation](#) in November 2020, the Commission also sought stakeholders views on how to ensure that customers are not unfairly disadvantaged nor exposed to any detriment by the activities of licensed providers operating in both the English and Scottish market. The Commission consulted on introducing some form of regulatory accounting separation between retail activities undertaken in Scotland and those undertaken in England.

The Commission notes that the Working Group [proposed](#) in its submission to the Commission in February 2021 that, instead of introducing a new regulatory requirement on accounting separation between Scottish and English operations, the licence requirement is enhanced to improve the transparency of licensed providers' operations across the two markets. In particular, the Working Group proposed to expand the current Standard Licence Condition A9 by requiring licensed providers' Board to provide annual assurances to the Commission that the licensed provider:

- Is conducting its affairs in way that Scottish customers are not unduly disadvantaged by its activities in the English water retail market and that the English activities are not being subsidised by Scottish customers.
- Is committed to ensure that charges in both markets reflect the underlying costs of operating in each market.
- Accepts an ex-post verification of the above written assurances through the use of the MHC.

The Commission is supportive of the proposals and would invite the Working Group to work on a draft of the revised licence condition and submit this to the Commission for review.

4.7 Further considerations

The Commission notes that the temporary removal of disconnections for non-payment by Scottish Water has the potential to increase licensed providers' bad debt costs. The Commission understands that further work is still required to review the potential options available and will, therefore, continue to monitor this and review whether any charging adjustments should be considered.

In light of the positive contribution of the Working Group to developing the transition measures in response to the pandemic, the Commission would also like to encourage the group to take full ownership for the implementation of the measures in the next weeks and engage with the wider group of licensed providers. The Commission also believes that the current Working Group could, thereafter, consider renewing its membership and invite other licensed providers to take part in the group.

This could form the basis for a wider senior stakeholder group that could work collaboratively with the other key industry stakeholders and take ownership for other strategic issues of the retail market. The Commission has, for example, set out the potential role for the Market Health Check in this document and in previous [consultation](#) documents highlighting that it represents a critical step for embedding the principles of ethical business practice within the retail market. To this end, a newly established stakeholder group could work constructively with the Commission and Scottish Water on the development of the scope and governance arrangements underpinning the Market Health Check.

5. Next Steps

The Commission welcomes comments on the proposals set out in this document which should be sent to the competitionteam@watercommission.co.uk by 23 April 2021. The Commission plans to review the proposal submitted by the Working Group alongside other responses to this public consultation and issue a final decision by the end of April.

The Commission will continue to work closely with Scottish Water, the CMA and all licensed providers to help ensure that the proposals can be implemented effectively and in line with our statutory duties and the guiding principles set out in this document.

To ensure sufficient progress is made and to allow a smooth implementation of the new measures in response to the pandemic, the Commission is also inviting the Working Group to submit a draft of the new licence requirements for review by 23 April 2021.