

**RD12/01**

**TO THE REGULATORY DIRECTORS OF ALL  
WATER AND SEWERAGE COMPANIES AND  
ALL WATER ONLY COMPANIES**

**15 August 2001**

Dear Regulatory Director

**NOTIFIED ITEM FOR BAD DEBT**

In RD16/00 we outlined our general approach to applications for an interim determination relating to the notified item for bad debt. MD169 set out the timetable and overall process for handling any applications made this year and indicated that a further letter on the bad debt notified item would follow.

We now have data on levels of debt and recovery costs for the years 1998-99, 1999-2000 and 2000-01. This data shows a general trend towards rising levels of outstanding revenue and increasing numbers of customers in debt. The picture varies from company to company with some showing an improved position, some a significantly worse position. Annex A summarises the changes seen to date, not all of which will be directly attributable to the ban on disconnection of households for non-payment.

In the light of our analysis of companies' annual returns we are now able to specify what information companies should include in interim determination applications which involve the bad debt notified item (see Annex B). The focus must be on the changes in company costs and outstanding revenue between the base year 1998-99 and 2000-01 that are due to the loss of the ability to disconnect domestic customers.

A proforma table and summary of supporting information, which you should use to structure any submission on this notified item, together with general guidance to reporters and auditors, is attached at Annex C.

If you have any queries or wish to discuss in more detail the content of any application please contact Lynne Currie on 0121 625 1302.

Yours sincerely,

**Sue Cox**  
**Head of Service and Performance**

## **ANNEX A**

### **INDUSTRY LEVEL CHANGES IN DEBT AND RECOVERY COSTS SINCE 1998-99**

Ofwat collects each year, on a confidential basis, information about the impact on companies of the ban on disconnecting households for non-payment of water bills. This paper summarises industry changes in the level of revenue outstanding and the cost to water and sewerage companies of collecting that revenue<sup>1</sup>.

Outstanding revenue and expenditure on debt collection have both risen since 1998-99, the last full year in which disconnection was permitted. The number of customers in debt<sup>2</sup> has increased, but their average debt has fallen. However, the variation between companies is greater than the changes since 1998-99.

#### **Outstanding revenue**

- Outstanding and written off revenue is up 7% overall since 1998-99, standing at £688m for the industry.
- The Water Only Companies (WoCs) together currently account for a small proportion of revenue outstanding across the industry but report a higher proportionate increase (11%) than the Water and Sewerage Companies (WaSCs). The reported figures differ substantially between companies, ranging from a 50% reduction to a 99% increase in outstanding revenue.

#### **Revenue Collection Operating Expenditure**

- Revenue collection operating expenditure has increased by just under 10% to £51m.
- Eight companies have recorded reductions in operating expenditure. Other companies show significant increases.
- The cost of collecting outstanding revenue varies significantly between companies but is generally around £1- £3 per household billed.

#### **Households in debt**

- The number of households in debt has increased 10% to over 4.4 million, or 19% of households served.
- This increase is proportionately larger than the increase in outstanding revenue, and the average amount customers owe has decreased to £154.

#### **Charitable Trusts**

- Donations to charitable trusts have reduced by nearly 20% since 1998-99. In total the Industry contributed £3.7m towards charitable trusts and money advice organisations in 2000-01.

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<sup>1</sup> The data quoted may change in the light of continuing correspondence with companies.

<sup>2</sup> A customer is defined as being in debt if he has received a bill for an amount which is due, but not paid by the end of the billing year in which it is issued.

## **ANNEX B**

### **PROCESS FOR INTERIM DETERMINATIONS UNDER THE NOTIFIED ITEM FOR BAD DEBT**

The principles which would be used in the event of an interim determination under the notified item for bad debt were set out in RD16/00.

RD16/00 set out a two stage approach, which we now confirm. Firstly any company making an application must show that there has been a material change between the base year 1998-99 and the reporting year in one or more of the following:

1. Loss of revenue due to increased non-payment;
2. Financing costs of changing debt profiles;
3. Operating costs of collecting outstanding revenue;
4. Annualised capital costs directly attributable to loss of the power to disconnect.

As set out in MD169, unless the combined Net Present Value (NPV) over 15 years of the relevant items exceeds 1% of revenue for 2000-01, the change will be regarded as trivial.

The company will also have to provide evidence that this increase was directly due to the ban on household disconnections.

These two stages are combined in the approach set out below, which indicates the areas in which companies are expected to submit.

#### **Loss of revenue**

##### Consistency with bad debt charge

Price limits included allowance for bad debt charges. This will include an element related to unrecoverable household revenue. For the purposes of the notified item we will therefore consider changes in the level of unrecoverable household revenue. We would expect changes in the revenue outstanding and bad debt written off to be consistent with movements in the bad debt charge since 1998-99. Where this is not the case the company should provide clear justification for any disparities.

##### Non-recoverable revenue

RD16/00 advised that in order to take account of variations in companies' write-off policies, we would look to apply standardised assumptions on the proportion of outstanding revenue in each time band (<12 months, 12-24 months, 24-48 months) that is likely never to be collected. Our review of companies' policies has shown that companies generally apply a similar approach. In most cases debt from household customers is written off only when the householder moves from the company area or becomes otherwise untraceable. Despite this broad consistency of approach there is significant variability in the company data on revenue outstanding, which makes it difficult to derive a standard assumption. Any company making an application should therefore indicate the amount of revenue in each time band which is not collectable and set out clearly with supporting evidence how it has come to its conclusions. Where a company writes off debt because it believes it would be uneconomic to

pursue it, its application should set out clearly the criteria and financial thresholds applied.

We will compare the amount of revenue outstanding as a proportion of household revenue across all companies. Where this proportion significantly exceeds that in the rest of the industry, or where it has increased markedly, we will need to assess whether the company has maintained realistic debt recovery operations. We will seek the views of the CSC on this matter.

In order to show that the ban of disconnections has directly affected the ability to collect revenue, the company should provide evidence of changes in customers' payment patterns based on an analysis of debt cases.

Any research into changes in customers' attitudes or behaviour should also be presented. Anecdotal evidence will not be accorded significant weight unless supported by rigorous analysis of company data.

#### Debt over 48 months old

Some companies have reported that there may be a significant amount of revenue outstanding for longer than 48 months, which has not been written off but which may not be collectable. We will consider any changes in revenue outstanding for more than 48 months in the same way as changes in revenue outstanding for shorter periods. Companies should make a case for any such amounts, including quantification of how the ban on disconnections has affected the level of debt collected.

#### **Financing cost of changing debt profiles**

As indicated in RD16/00, if a company considers that increases in late payment have caused a material cash flow effect, it should set out its detailed calculations and justification. Calculations should be based on actual revenue rebased by RPI.

#### **Operating costs of revenue collection**

The abolition of disconnection may have made revenue collection less effective, so that this component of operating costs had to increase to achieve the right balance. We will need to consider the change in costs between the base year and the year of the application.

Changes in costs may have arisen through changes in policy or procedure. The company should set out each change of policy or procedure which it considers to have contributed to the increase in costs. The company should show that the new policies have been introduced to combat the impact of the disconnection ban, and present evidence that these overall policies are more expensive than those previously employed. This will involve a comparison of current debt recovery activities, the timing of their introduction, and the resulting costs with those in place in 1998-99. Information should be broken down into staff costs, other operating costs, costs of contracted out activities and IT costs.

We will challenge companies' submissions based on our knowledge of industry practice and specific company policies. Where we do not consider that costs arise from changes which are clearly related to the ban on disconnection we may make a downward adjustment.

We will carry out a comparative assessment of companies' unit costs of debt recovery (i.e. the amount spent per household customer). Where a company's costs are significantly above industry norms we would need to consider whether this is due to obvious differences in practice or other reasons.

### **Comparative assessment of overall impact**

There is likely to be some interaction between the level of unrecovered debt and the expenditure incurred in recovering debt. We will therefore look at the combined effect of levels of revenue outstanding together with debt recovery costs and compare across the industry. Where a company shows an impact significantly higher than industry norms, we will consider whether there is strong evidence of particular socio-economic characteristics or other external factors outside of management control in its area which could justify higher costs. The company should be able to point to robust external comparative data or evidence to back up any claim of this type.

### **Increased Capital Expenditure**

We do not anticipate that companies will generally have incurred major capital expenditure as a result of the ban on disconnection. However, where the company can provide evidence that such costs are directly attributable to the change in legislation, Ofwat will consider them. The company should set out the costs and expected life of the asset, and explain how the investment results from the ban on disconnections.

### **Calculation of NPV and allowable amount**

The NPV will be calculated taking account of changes actually demonstrated between 1998-99 and 2000-01. Where any allowance was made for this issue in the existing price limits we will take account of that when assessing changes. Given the proximity of the next Price Review and the level of uncertainty around subsequent changes in costs and recovery rates, we will assume that in future these continue at 2000-01 levels when calculating the allowable amount for this notified item.

## ANNEX C: SUMMARY DATA FOR BAD DEBT NOTIFIED ITEM

All in 2000-01 prices

		1998-99	1999-00	2000-01
		£m	£m	£m
	<b>Changes in unrecoverable debt</b>			
1	Unrecoverable debt written off			
2	Change from 1998-99	-	X <sup>1</sup>	X <sup>2</sup>
	<b><u>Financing cost of outstanding revenue</u></b>			
3	Outstanding revenue <48 months (excluding debt written off as above)			
4	Outstanding revenue >48 months if applicable (excl. debt written off)			
5	Total outstanding revenue (excluding debt written off)			
6	Change from 1998-99	-		
7	Financing cost *	-	Y <sup>1</sup>	Y <sup>2</sup>
	<b><u>Changes in debt recovery costs</u></b>			
8	Operating costs			
9	Change from 1998-99	-	Z <sup>1</sup>	Z <sup>2</sup>
10	<b>Total Opex Impact</b>	-	X <sup>1</sup> + Y <sup>1</sup> + Z <sup>1</sup>	X <sup>2</sup> + Y <sup>2</sup> + Z <sup>2</sup>
11	<b>Capex due to loss of disconnection</b>			

\* Rate of return assumed in line 7

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## ANNEX C

### COMPANY SUBMISSIONS & REPORTERS' GUIDANCE

Set out below is a brief summary of the information which should be submitted by a company requesting an Interim Determination under the Notified Item for Bad Debt.

Companies should submit only the data relevant to their own claim (e.g. some companies may not wish to include debt over 48 months as part of their claim), but where data is submitted it should be accompanied by the relevant commentary. Where an element of commentary is mentioned twice, the company may cross reference as necessary.

This table should be used as a guide and read in conjunction with Annex B which sets out how Ofwat will treat the information submitted. It also indicates the issues which Reporters should address in their reports. Some input from Auditors may also be necessary and should be agreed with the Reporters.

Non recoverable revenue		
Data	Commentary	Reporter's Commentary
<p>Change in the amount of outstanding household debt between 1998/99 and 2000-01 attributable to the loss of ability to disconnect:</p> <ul style="list-style-type: none"> <li>In total</li> <li>Broken down into 3 age bands: <ul style="list-style-type: none"> <li>&lt;12 months,</li> <li>12-24 months</li> <li>24-48 months</li> </ul> </li> </ul>	<p>Company explanation of what is driving the change. Evidence of changes in customer payment patterns. Justification for any differences with the Industry.</p> <p>Other evidence backing up the company's conclusion (e.g. market research).</p> <p>Description of debt collection policies 1998-99 and 2000-01. Explanation of any changes in policy or procedures and their effect on debt collection.</p>	<p>Comment on the robustness of evidence presented. In particular confirm that data is correctly extracted from company systems.</p> <p>Confirm or otherwise that numbers are consistent with the June Returns for relevant years. If not, ensure that reasons for the difference are exposed and comment on their robustness.</p>
<p>Increase in household debts written off between 1998-99 and 2000-01 attributable to the loss of ability to disconnect.</p>	<p>Current write off policy including any criteria used for judging when recovery action is uneconomic. Changes in debt write off policies between 1998-99 and 2000-01.</p> <p>Explanation of why changes are attributable to the loss of ability to disconnect.</p> <p>Demonstrate correlation between doubtful debts provision and amounts written off or explain any lack of correlation.</p>	<p>Confirm or otherwise that write off policy and key assumptions are accurately reported and that policy has been followed.</p> <p>Ensure key assumptions underlying the company's attributions are exposed.</p> <p>Confirm that the correlation is demonstrated correctly, or comment on the company's explanation of any difference.</p>

<b>Debt over 48 months old</b>		
<b>Data</b>	<b>Commentary</b>	<b>Reporter's Commentary</b>
<p>Change in the amount of debt outstanding over 48 months.</p> <p>Proportion of this amount due to the ban on disconnection.</p>	<p>Explain why the amount has changed and how it is due to the ban on household disconnection.</p>	<p>Confirm that data on debt over 48 months old is robust and properly sourced from company systems.</p>

<b>Financing Costs of Changing Debt Profile</b>		
<b>Data</b>	<b>Commentary</b>	<b>Reporter's Commentary</b>
<p>Financing cost of increases in late payment.</p> <p>Note: set out workings as well as conclusions.</p>	<p>Explain key assumptions used to calculate financing cost.</p>	<p>Ensure that key assumptions are exposed and check that the cash flow effect been worked out according to Ofwat's guidance.</p>

<b>Operating costs &amp; policy</b>		
<b>Data</b>	<b>Commentary</b>	<b>Reporter's Commentary</b>
<p>Changes in revenue collection costs between 1998-99 and 2000-01.</p> <p>Breakdown of changes in collection costs:</p> <p style="padding-left: 100px;">Staffing</p> <p style="padding-left: 100px;">Other operating costs</p> <p style="padding-left: 100px;">Contracted out activities</p> <p style="padding-left: 100px;">IT</p>	<p>If costs reported are not consistent with June Return 2001, explain where changes arise and why.</p> <p>Description of debt collection policies 1998-99 and 2000-01.</p> <p>Explanation of significant changes in policy or practice and their effect on costs.</p> <p>Where costs are not directly identifiable, their derivation should be explained.</p>	<p>Confirm either that costs reported are consistent with June Return or that the company explanation of differences is satisfactory and reasonable.</p> <p>Confirm that changes in costs can reasonably be attributed to causes quoted by the company.</p> <p>Confirm that costs have been robustly derived and that the company has followed the procedure it has described.</p>

**Unit Costs**

<b>Data</b>	<b>Commentary</b>	<b>Reporter's Commentary</b>
Amount spent on debt recovery per household customer.	Evidence explaining where necessary company level of unit costs compared with the rest of the industry. Evidence of any special socio-economic or demographic characteristics of the region.	Confirm sourcing of any evidence quoted by the company. Reporters are not required to comment on the robustness of evidence provided, but may highlight any concerns in this area if they wish.

**Capital Expenditure**

<b>Data</b>	<b>Commentary</b>	<b>Reporter's Commentary</b>
Capital costs related to collection of outstanding revenue.	Explain nature of the investment and how it relates to the ban on disconnections.  Expected life span of the asset.	Comment on the company's estimation of the capital costs related to revenue collection. Comment on robustness of any evidence from the company that investment was in response to the ban on disconnections.  Comment on the company's assumed asset life.