Georgina Mills
Director, Business Retail Market
Ofwat
21 Bloomsbury Street,
London WC1B 3HF

22nd August 2020

Dear Georgina,

COVID-19: Bad Debt CFI

Please find attached Business Stream's response to Ofwat's Call for Inputs on the potential for an Excess Bad Debt recovery mechanism.

Our completed RFI is also enclosed along with a statement of methodology and assurance.

We are keen to be involved in the development of these proposals, and would be happy to discuss in more detail our responses to the questions posed in the CFI.

Please do not hesitate to contact me if I can be of further assistance.

Yours sincerely

[signature redacted]

Jim McDowall
Finance Director

Summary Position:

- As can be seen from our completed RFI, our debtor position has continued to deteriorate during 2020/21, but because Government support schemes have been extended, we're concerned that we haven't yet seen the full economic impact of COVID-19 on businesses and we are likely to see an increasing number of customers in difficulty in 2021/22;
- We are firmly of the view that bad debt levels associated with COVID-19 will be above the 2% threshold set by Ofwat. Rather than waiting for the evidence from audited accounts to confirm that this is the case, it would be useful for Ofwat to take an interim view based on the evidence submitted by retailers in the RFIs, so that we (and our lenders) have certainty on whether a support mechanism will be put in place and if so, what proportion of the bad liability will be recoverable;
- Timing of the recovery of excess bad debt is critical for retailers. If we wait until 2022 (as proposed in the CFI) we will have COVID-19 debt in excess of 2 years old for which we have already paid wholesale charges and are therefore having to finance;
- Wholesalers will start recovering their 2020/21 COVID costs from 1st April 2021 and we had hoped that to ensure parity, we would also be able to implement an excess bad debt recovery scheme from 1/4/21;
- From recent discussions with Ofwat, this does not now appear to be possible and hence in response to Q11 we have suggested how retailers could obtain some temporary support from wholesalers during 2021/22, until the regulatory support scheme for retailers commences in 2022 (we do not believe that a mid-year tariff change would be practical for reasons set out in our response to Q11 below);
- Whilst this timeframe is not ideal, it will give us more time to develop the details of the support mechanism. At this stage, our thoughts on how it would work are as follows:
    - *Defining 'excess' or COVID-19 bad debt*: in order to minimise the costs of implementation, we suggest relying on audited statutory accounts to the extent possible to define the debt that retailers are able to recover through the support mechanism. Retailers' initial claim from the mechanism would be based on their March 2021 provisioning position including any COVID-19 provisions already booked in retailers 2019/20 statutory accounts, and would be trued-up at March 2022 when it is reviewed and write-offs made. The process would repeat for each subsequent year of the scheme. The critical task will be to verify the movements in the annual provisions that are due to COVID-19 rather than BAU, but we believe that this might be done by asking auditors to provide additional assurance;
    - *Recovery of excess bad debt*: we believe that a mechanism involving an uplift in wholesale charges is more equitable than Ofwat's proposal for amending the REC and avoids potential disputes with contracted customers and the risk of cross subsidy. However, we have suggested an amendment to Ofwat's wholesale approach in order to ensure that it is proportionate for small and large customers alike;
    - *Mechanism for sharing the cost of excess bad debt*: we recognise that if all debt above a circa 2% threshold was recoverable from the support mechanism, there would be no incentive on retailers to continue pursuing debt collection once the threshold is reached, which is inefficient. Consequently we have suggested a sharing mechanism based on the cost of debt recovery, which would mean retailers only being able to recover 90% of the excess bad debt through the mechanism.

More detail on our position is set out in the following pages in the responses to each of the questions posed in Ofwat's CFI document.

Question 1 – Our initial view is that we consider it is relevant to measure customer bad debt costs that may arise for Retailers solely in terms of amounts due from customers that are appropriately provided for or written off. To what extent do you agree with our initial view here?

We agree that the debt that we are unable to recover from customers, and which has to be provided for or written off, will be the greatest cost to retailers associated with COVID bad debt.

However, there is also a significant cost to retailers of funding this debt. For every £100 unpaid by a customer, retailers still have to find £90-95 to pay the wholesaler, as well as meeting its own operating costs. [redacted]

[redacted]

If retailers are unable to recover any funds from the support mechanism until 2022, by this time some of the excess bad debt could be almost three years old. The cost of financing excess debt is not covered by retail margins and therefore retailers have no more capacity to meet this cost than the cost of the debt itself. Hence we would propose that financing costs are also recognised and recoverable through the regulatory mechanism.

Question 2 - To what extent do you consider that bad debt costs may have differed by geographic region and/or by customer type?

Geography: Although we have observed some differences in the level of debt arising between regions, they appear to be driven by differences in our customer portfolio rather than the geography per se. Whilst we recognise that given the high density of businesses, the Thames region may be an exception, we do not believe that there would be sufficiently robust means of measuring different levels of debt by region to justify applying the support mechanism on a regional basis.

Customer groups: We are seeing significant variation in debt associated with different customer groups. The impact on our SME customers (small and medium enterprises) has been much greater than on our larger 'Key Account' customers, to the extent that the growth in our aged debt is almost entirely driven by SMEs. Although we saw an initial slow-down in payment from Key customers, we believe that this was precautionary cashflow management on their part, and has largely recovered. However, we have lower exposure to the high street retail, leisure and hospitality sectors, so our experience may not be typical. [redacted]

The value of total debt amongst SME customers has grown, despite the cessation of billing for closed premises during the months of initial lockdown. As shown in the graph below, SMEs' aged debt in particular has grown steadily month on month since March 2020, reflecting that some of the SME customers who have been unable to pay during COVID-19, haven't paid their pre-COVID debt or the new bills raised during the restrictions [redacted]

[graph redacted]

Defining Bad Debt

Question 3 - What is your view on the best approach to measure bad debt costs arising, in ways that are objective, consistent and verifiable?
&
Question 4 – Do you agree that Ofwat should allow Retailers to determine the basis on which they report bad debt costs (provided that it complies with relevant accounting standards)? Alternatively, should Ofwat set out a more prescriptive and defined basis for the determination and reporting of bad debt costs? Please set out the basis for your view or conclusions.

We agree that customers must not be disadvantaged because of inconsistent approaches to defining bad debt costs, and that retailers seeking support for excess debt costs must be treated consistently. However, we are keen to avoid creating excessive complexity or significant additional cost, and to keep the verification of retailers' claims for excess bad debt support as simple and as transparent as possible.

Statutory accounting rules provide a common framework within which all retailers already operate. Whilst some discretion is allowed in provisioning and write-offs to reflect a company's attitude to risk and their view on the likelihood of debt recovery, provisioning policies and their application are subject to independent scrutiny by external auditors as part of the annual audit process. Rather than trying to establish a new set of criteria for defining bad debt (age of debt, attempts to collect etc) we believe that we should find a way of using the existing statutory accounting framework, and the expertise of auditors, to ensure that retailers' claims for excess debt are fair and consistent.

The critical task will be to verify how much of the movement in a retailer's annual provisions is due to COVID-19 rather than BAU provisioning, to ensure that there is no scope for retailers to over-estimate excess bad debt. Even under 'normal' circumstances, auditors require justification for any changes in a company's provisioning policy, and we know from our 2019/20 audit, that the auditors have wanted to understand and verify the increase in provisions for existing debt and unbilled accruals at risk from the impacts of COVID-19. Again, we believe that the external audit process would be the most efficient way of verifying a retailer's distinction between BAU and COVID-19 provisioning – companies could be required to provide a joint assurance statement from their auditors and Board for example.

Our current thinking is that a retailer's COVID-19 provisions at March 2021 would be the basis of their initial 'claim' from the support mechanism, which would be trued-up based on provisioning adjustments and write-offs at March 2022 – all as per audited accounts. If a retailer had over-provided in 2020/21, a repayment would effectively be made to the mechanism, and vice versa. The same process would be repeated for each subsequent financial year of the mechanism.

It is worth noting that if we use the statutory accounting framework on provisioning to define bad debt, there would be no explicit cut-off date for COVID-19 bad debt, as implied in the consultation paper. For example, our provisioning at March 2021 will recognise that we had debt outstanding at March 2020 from as far back as April 2019, which was already in the debt recovery process (DCA, legal etc.), but which had to stop as a result of COVID-19 and consequently, we have not yet been able to collect. A cut-off date would only be necessary if we used an approach to defining bad debt based on specified criteria rather than statutory accounting provisions.

Finally, we have assumed that excess bad debt includes debt relating to all customer groups arising as a result of COVID-19. There are several places in the consultation where it might be implied that bad debt relating to contracted customers (as opposed to those on default tariffs) or customers over 50Ml would not be recoverable through the mechanism. We don't see any justification for any exclusions. Indeed if larger customers have gone into liquidation, the impact on their supplier could be significant. [redacted] We would appreciate clarification on this point.

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Question 5 – (a) What is your view on the period over which we should be measuring bad debt costs arising, (b) What in your view is the appropriate time interval following this for the measurement of bad debt costs?

(a) Time period to which COVID-19 bad debt relates.

Ofwat has suggested that the period over which we should be measuring bad debt costs arsing is primarily the financial year 2020/21, including invoices relating to the previous quarter, back to January 2020 at the earliest.

'Start' date: As we indicated in response to Q3&4 above, if we use statutory accounts as the basis for defining retailers' bad debt, the key prerequisite would be a robust distinction between BAU and COVID-19 provisioning, and not a cut-off date from which 'normal' debt became 'COVID-19' debt.

In practice, it would be very difficult to find a fair way of identifying a specific date before which debt was 'normal' and after which is was related to COVID-19 (which is a further reason for using statutory accounts rather than introducing new criteria to define bad debt).

Whilst we agree that the impact of COVID on business customers began to manifest from the end of March 2020, our analysis shows that the subsequent increase in debt does not just relate to bills issued immediately prior to and during the COVID period, but also to bills that were in the process of being recovered from up to 12 months prior to the restrictions being introduced. Aged debt and particularly debt over 360 days old has grown significantly more than total debt during the COVID period, indicating that a significant proportion of it belongs to customers who were already in debt at March 2020, and whose debt has continued to accumulate and grow since. This is debt originally billed in 2019 that was in the debt recovery process (including debt collection agencies and legal processes) at March 2020 and which we expected to be able to recover, but which, as a result of halting our debt recovery activities, and/or because the customers were hit by the restrictions, we have not yet been able to collect.

'End' date: The impact of COVID-19 on business customers will not be confined to 2020/21. There remains a huge degree of uncertainty about the course of the pandemic and the measures that will be required to try and contain it. We are concerned that the true economic impact of COVID-19 restrictions will only become apparent as furlough and other Government support schemes come to an end. At this point, we would expect an increase in the number of customers going into arrears, and an increase in new debt as COVID-19 support is withdrawn and businesses try to re-start their businesses.

Since the submission of our RFI in August, we have adjusted our debtors forecast, to reflect our growing understanding of the impact of the COVID-19 restrictions on our customer base. Whilst we believe the magnitude of bad debt will remain in line with our original forecast, because Government support has been extended to many businesses, we believe the true extent of the debt will take longer to materialise, manifesting in 2021/22 rather than 2020/21 as previously expected.

Whilst we cannot predict with any certainty what will happen as we move into 2021/22, we can be sure that bad debt levels will continue to be above 'normal' levels for some time. At this stage we believe that the mechanism will be required for several years – essentially for as long as bad debt levels remain above 2% - the level that Ofwat has defined as 'excessive'. The same process for defining and 'trueing-up' retailers' bad debt claims would apply for each year of the scheme.

A significant point to note and one which we would be keen to discuss further with Ofwat is the multi-year effect of bad debt remaining above 2%. Ofwat has suggested that retailers should absorb a 100% increase in bad debt costs – but, as is clear in the consultation paper, this was when excess bad debt was expected to be confined to 2020/21. If the implications of the ongoing lockdown restrictions are that bad debt levels remain at excessive levels for more than 1 year (which now seems inevitable), we would have to challenge the assumption that retailers could absorb this additional cost for more than one year.

(b) Time period for measurement of bad debt costs.

We have proposed above that for the first year of the recovery mechanism, a retailer's initial 'claim' for support from the bad debt recovery mechanism would be based on their (audited/verified) March 2021 provisioning, including any COVID-19 provisions already booked which would be trued-up in accordance with provisioning adjustments and write-offs in the following year to 31 March 2022. It seems likely that a further true-up may be required after that, as detailed above.

Under normal circumstances, if a case requires court proceedings (and is justified financially), the full debt recovery process would take up to 12 months or more. However, following COVID-19, we anticipate that debt recovery will be more complex and is therefore likely to take longer, including as courts clear backlogs. Where we know that customers have gone into administration it will be relatively quick to identify and to write off debt, but where customers just disappear (e.g. don't re-open after lockdown) and cease to engage, it will take much longer to establish that the debt is not recoverable. There are also likely to be cases where, as businesses reopen, they may be in a position to pay new bills as they are incurred, but struggle to pay debt accumulated over the COVID-19 period. Again, this will take time to assess. The discipline of regular payment has, for many customers, been interrupted by COVID-19 and it will take time to re-establish payment behaviours and routines. We will continue to reassess our bad debt provisions for 2020/21 into 2022/23 in accordance with best practice accounting, so if the recovery mechanism is required for say two financial years before bad debt levels return to normal, it may take 3 or 4 years to complete the true-up of retailers' bad debt claims.

Assessing the Magnitude of Bad Debt

Question 6 – What is your view on the change in and/or scale of bad debt costs likely to arise since March 2020? Please provide evidence to support your views, for example concerning metrics on changes in the number of customers with payment difficulties or payments in arrears.

(i) Increase in debt and aged debt arising since March 2020

The 'debtors' data in the RFI shows that during the July to December period, as expected, the growth in debt has accelerated as we started to bill again following the end of the initial lockdown period [redacted]

However, total debt still reflects the lag effect of the initial lockdown and the temporary suspension of billing for vacant premises, and a more accurate indicator of the deteriorating position is aged debt (debt more than 30 days overdue). The RFI shows the breakdown of the debtor book at the end of September and end of December. [redacted] As explained in response to Q5, a significant proportion of this aged debt is associated with SME customers who had debt already outstanding at March 2020, on bills originally issued before the initial lockdown, where the debt has continued to age with the suspension of all debt recovery activity.

Interestingly, the increase in the number of accounts in arrears has been relatively modest compared to the increase in the value of total and aged debt, indicating that to date, the impact of COVID-19 has largely been on customers who were already in debt at March 2020 and that the Government support schemes have enabled many customers to continue paying their water bills. Our concern is that this pattern will change as the Government support is withdrawn – see below.

(ii) Bad debt forecast

Since the submission of our RFI in August, we have adjusted our debtors forecast, to reflect these indicators and our growing understanding of the impact of the restrictions on our customer base. As we indicated in response to Q5 above, the impact of COVID-19 on business customers will not be confined to 2020/21. We are concerned that the true economic impact of COVID-19 restrictions will only become apparent as furlough and other Government support schemes come to an end. At this point, we are anticipating an increase in the number of customers going into arrears, and an increase in the growth of new debt as COVID-19 support is withdrawn. Whilst we believe the broad magnitude of bad debt will remain in line with our original forecast, because Government support has been extended to many businesses until the end of 2020/21, we believe the debt will take longer to materialise, manifesting in 2021/22 and possibly even into 2022/23 rather than in 2020/21.

Looking further ahead, we have already seen some big high street names going into administration, and it seems inevitable that many more smaller businesses will be unable to survive. Where we know that businesses have become insolvent, the bad debt will be almost immediately apparent, but for those that simply cease trading, the debt will take longer to crystallise – even under normal circumstances it can take up to a year to exhaust all debt recovery options before we are in a position to write it off. We anticipate that the economic scarring as a result of COVID-19 will be felt by our customers for a number of years to come.

[redacted]

Whilst there remain many uncertainties in terms of the financial impact that COVID19 will have on our customers and their payment behaviours, our projections have been closely reviewed by our lender's financial advisors as well as by our Board and are considered to be plausible.

Based on these metrics, there is no doubt that bad debt levels across the industry will exceed the 2% hurdle rate that Ofwat has set as a result of COVID-19. Rather than waiting for the evidence from audited accounts to confirm that this is the case, it would be useful for Ofwat to take an interim view based on the evidence submitted by retailers in the RFIs, so that we (and our lenders) know for sure whether a support mechanism will be put in place and if so, what the scale and timing of relief will look like. This assurance and clarity will be essential for retailers in order to satisfy the 'going concern' test at financial year end, which is a key part of the audit sign off process. It will also be a pre-requisite for providing the annual Certificate of Adequacy to Ofwat.

Regulatory Protections

Question 7 - Do you agree that these are the right objectives for considering whether and how to amend regulatory protections in relation to bad debt costs?

We agree with the three objectives set out in the Ofwat CFI.

Although it may be implicit under the objective of 'protecting customer interests', we consider that it would be worth articulating a fourth objective – 'ensuring the resilience of the NHH market'. The level of debt that we are seeing as a result of COVID-19 could not have been foreseen: it wasn't built into the retail margins, nor would it have been efficient (or allowed under accounting standards to provide in advance for future losses) for retailers to provide for this level of debt on an ongoing basis. It would be useful therefore to acknowledge that this support mechanism is seeking to address an extraordinary situation, of potential threat to the resilience of the NHH market, and which will remain a threat until debt levels return to normal.

Question 8 - Do you have views about the merits of enabling the recoupment of (some portion of) excess bad debt costs via amendment to the REC? Do you have any comments or views about the practical implementation of such an approach?

As currently proposed, we would be opposed to the use of the REC to recover excess bad debt costs, for the following reasons:

- *Smaller customers would bear a proportionately greater cost:* The recovery of an average bad debt cost *per customer*, would mean that small customers' contributions would be proportionately far greater than larger customers. It would not seem equitable, or consistent with 'protecting the interests of customers', if customer A, Jo Bloggs corner shop, faced the same £10 (for example) increase as customer B, a large supermarket chain, especially as we have shown that it is SME customers who have been most affected by COVID-19 and that larger customers appear to be in a better position to contribute. In order to be equitable, recovery would need to be on the basis of a cost per unit, or a percentage of bill.

An average cost per customer would also be problematic from an administrative perspective as the market works on the basis of SPIDs not unique customers. Furthermore, one customer with several sites could be supplied by multiple retailers – which one of them would recover the charge increase?

- *A uniform margin increase creates winners and losers*: Following clarification at the Ofwat Q&A session on 11th January, we understand that the proposal is to apply a uniform price adjustment across the whole market, and that each retailer would retain the additional revenue recovered from their own customers to meet their excess bad debt costs. However, if this is the case, the amount of uplift recovered by each retailer is driven by the number of his customers and bears no relation to the amount of excess bad debt actually incurred. It would be impossible to ensure that each retailer bore the appropriate proportion of excess bad debt (as proposed in Ofwat's Figure 2, p13). Given the dynamic nature of the market, and the different size and shape of each Retailer's customer portfolio, a uniform margin increase would lead to inequitable treatment of both customers and Retailers.

  For example, each Retailer will inevitably have a different COVID-19 bad debt exposure because of the composition of their customer base. At the Q&A session, Ofwat suggested that this would be due to a retailer's debt recovery performance. Whilst performance may be a contributory factor, under COVID-19 conditions, it is much more likely to be driven by the composition of their customer portfolio and the extent to which those customers have been affected by the Government restrictions. A Retailer with a portfolio of larger customers unaffected by COVID-19 would have a much lower bad debt exposure than a Retailer with a large SME customer portfolio. Similarly, Retailers whose customers pay in advance or by direct debit are likely to have less bad debt exposure than those 'exited' Retailers (constrained by the terms of the REC), where the majority of SME customers pay quarterly in arears. A uniform margin increase would create winners and losers, unless it was set at the level of the retailer with highest exposure, but this would over-compensate less exposed Retailers and penalise their customers.

  A margin increase tailored to each Retailer's specific bad debt exposure would address the problem above, but it would risk over/under recovery as the Retailer's customer portfolio composition changed over time. More significantly, it would also mean that customers of a badly hit retailer would be asked to pay proportionately more than the customers of a less impacted retailer, which again seems the wrong way around.

- *Costs targeted at default tariff customers:* Although it is not entirely clear from the proposal, it appears that the calculation of the total excess bad debt includes the bad debt associated with all customers (i.e. those on default tariffs plus those on contract) other than those above 50Ml, yet the resulting 'cost per customer' is only recovered from customers on default tariffs. If this is the intent it would again put the greater burden on small customers.

  If excess bad debt is recovered through an amendment to the REC, the extent to which retailers can recover any costs from contracted customers will depend on the terms and conditions (T&Cs) of their contracts. It would not be equitable that some customers would be able to avoid meeting a share of the cost in this way.

  Equally, we don't believe it would be right to recover excess bad debt costs associated with default tariff customers only from default tariff customers and bad debt associated with contract customers from other contract customers. There would not seem to be any justification for ring fencing pots of debt in this way.

  We believe that the only way of avoiding the pitfalls of contracted customer T&Cs would be to administer the recovery of excess bad debt through wholesale charges – see Q9 below.

- *No certainty:* A final concern, which has also been raised by our lenders, is that an increase in the retail margin to pay for excess bad debt could be 'competed away' by Retailers who are unencumbered, or less encumbered, with excess bad debt, and hence those Retailers with higher exposures would be unable to recover their costs. In order to secure immediate financing to fund the increase in customer debt, Retailers and their lenders need certainty that the costs incurred will be recoverable.

We believe that a more equitable way to make the REC amendment work, would be if all retailers were able to increase their charges, whether regulated or not, in a uniform way (e.g. a percentage uplift) so as to recover the total excess bad debt across the whole market. Retailers would pay the amount they collect into a central fund, which is then redistributed to compensate individual retailers for their actual excess bad debt costs (in same way as the wholesale recovery proposal). Whilst this addresses the most serious concerns raised above, it is still dependent on retailers being able to pass through a share of the cost to contracted customers. For this reason we believe that the use of an increment on wholesale charges represents a more practical and fairer approach.

Question 9 - Do you have views about the merits of enabling the recoupment of (some portion of) excess bad debt costs through wholesale charges?

The recovery of excess bad debt costs through an uplift to wholesale charges has the potential to address all of the concerns expressed above regarding Ofwat's REC amendment proposal. As currently proposed, the key benefits of the wholesale mechanism are that:

(a) it would compensate retailers in the right proportion, for the appropriate share of actual excess bad debt costs incurred; and

(b) it would be able to be passed through to all customers, whether on default tariffs or contract.

However, in order to ensure that customers are treated proportionately under this mechanism, and that smaller customers are not disadvantaged, the uplift to wholesale charges would need to be applied on the basis of consumption or a percentage of bill, rather than on a 'cost per customer' basis as proposed in the CFI (the problems with which are outlined in the context of a REC recovery mechanism at question 8 above). If the same % uplift was applied in the same way by all wholesalers, it would ensure that the aggregate amount of excess bad debt would be recovered proportionately from all customers.

Disbursement options to retailers: In principle, either of the proposed options for disbursement of funds to retailers would be acceptable, providing that both options are designed to reimburse retailers for the actual excess bad debt incurred rather than an industry average amount (it's not clear whether option (b) would recompense retailers only for the proportion of uplift billed to them – which would not bear any relation to the cost incurred and which we wouldn't support).

From a cashflow perspective, option (b) would be preferable if it meant recovering a proportion of cost each month rather than waiting until the end of the financial year to make a claim from a central fund. However, option (a) would appear to be less of an administrative burden on wholesalers, and payments could potentially be made each month under this option as well.

Question 10 – Concerning the option of recoupment of (some portion of) excess bad debt costs through wholesale charges, do you have comments or views about the costs for trading parties of implementing such an approach? Do you have comments or views about the practical implementation of such an approach? Do you have any comments about a possible application process and the data and audit requirements to accompany this?

All of the options for an excess debt support mechanism will need:

(i) an assessment of the aggregate value of excess bad debt that needs to be recovered from customers;

(ii) some form of verification of the amount each retailer should be allowed to recover; and

(iii) some form of disbursement mechanism.

In accordance with the stated objectives, we believe that we should keep the mechanisms as simple as possible, whilst ensuring they are robust and accurate. We don't believe that the verification and application processes need to be overly complex.

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In response to Q3&4 above we have suggested that the value of the excess bad debt to be recovered by each retailer in any year could be based on their COVID-19 specific bad debt provisioning, as reflected in their statutory accounts. The aggregate value to be collected from customers could be calculated in the same way. Both aggregate and individual retailer positions would be trued-up at the end of each subsequent year as the true bad debt position is reflected in revised provisioning and write-offs – again as evidenced in retailers' statutory accounts.

There will then be a role for Ofwat (or a third-party agent – we suggest an accounting firm) to ensure that retailers' claims are consistent with their audited statutory accounts and for the disbursement of funds to retailers on that basis. In practice this process would be simpler if each retailer made a single claim from a central fund, rather than being paid through refunds to multiple wholesale bills, which would be an unnecessary additional layer of complexity. However, as we have indicated in response to Q9 above, it will be important for retailers that funds are distributed regularly throughout the year, rather than waiting until the end of the financial year once all monies have been collected.

Cost of administration: We don't believe that the costs of administering the scheme and providing validation of claims as described above would be particularly excessive. There are a number of mechanisms in the energy sector that collect centrally and then redistribute funds to market participants which might provide useful insights and lessons. Our understanding is that the cost of administering these energy sector mechanisms is rolled into the amount recovered, given that it is integral to its effective implementation. We would envisage the costs of administering the excess bad debt mechanism to be treated in the same way.

Question 11 – Aside from amending the REC or recovery through the wholesale charges, do you have any views on whether other mechanisms or approaches to amending regulatory protections may be appropriate? If yes please describe your preferred approach and your view of why it may be warranted.

As outlined in response to Q8, we consider there to be problems with the REC amendment proposal that could create inequity between customers or between retailers or both. For these reasons our strong preference would be for recovery through wholesale charges, amended as suggested above to ensure customer equity. We don't believe that the wholesale recovery option need be any slower to implement than a REC amendment, given that we now appear to have until 2022 before it is implemented.

As we have indicated throughout, the timing of recovery is critical for retailers. In recent meetings, Ofwat has recognised this urgency for which we are grateful, but has indicated that even if the consultation process was accelerated, there is no prospect of being able to commence recovery in the first half of 2021/22 without compromising due process - which we understand. Ofwat has also indicated during these meetings that the potential for a mid-year price change could be explored, in order to bring forward recovery to October 2021.

A mid-year change is an attractive option from a cashflow perspective, but in practice it creates significant problems for both customers and retailers. As we recently outlined to David Black in response to the option to allow the four CMA wholesalers to amend their charges mid-2021/22:

- it makes financial planning difficult for business customers, and could be especially problematic for small businesses as they transition out of the COVID situation;
- customers who are billed annually would have to be re-billed, which creates additional cost, will be confusing for customers and increases the likelihood of delayed payment and further bad debt;
- for Retailers, a mid-year charging change would add further complications to an already highly complex charging landscape. The MOSL CMOS system contains more than 8k wholesale charging elements for the current year and we expect 2021/22 to be similar. A mid-year wholesale tariff change would effectively double the number of charging elements in the system. Building twice as many wholesale and retail tariffs into our billing system would be a major logistical challenge – we believe that others would have the same problem. If billing systems are unable to cope with the additional complexity, it will inevitably impact bill accuracy

for customers. If we had to make changes to our billing system it would not be consistent with the stated objective of minimising implementation costs.

Consequently, we have an alternative proposal, that would give retailers some bad debt relief during 2021/22 without the need for a mid-year wholesale tariff change. Given that wholesalers have already increased their 2021/22 charges to reflect the actual and expected impact on them of COVID-19, and that more than 90% of the bad debt relates to wholesale charges, it is suggested that they temporarily share the responsibility for excess customer bad debt during 2021/22, ahead of the recovery mechanism commencing for retailers in 2022.

We recognise Ofwat's position that the relief provided by wholesalers in the summer of 2020 was only designed to give retailers a breathing space to arrange alternative sources of working capital to fund what we believed at the time would be customers' temporary inability to pay their bills during the initial lockdown period. However, things have moved on and conditions have changed:

- The impact of COVID-19 on business customers has been (and continues to be) more severe than originally anticipated. Ofwat has recognised that as a result, there is likely to be a significant increase in the level of bad debt experienced by retailers, considerably above the levels allowed in the retail margins, and acknowledged that Retailers need to be able to recover a proportion of this COVID-19 excess debt in order to avoid systemic retailer failure and to maintain the resilience of the market;
- Designing and implementing a robust excess debt recovery mechanism will inevitably take time, but if recovery doesn't start until 2022, retailers will have to fund debt for much longer than anticipated and hence their working capital requirement will be greater than originally envisaged;
- As wholesalers have published their charges for 2021/22 it's become apparent that they will be recovering their 2020 COVID losses as well as the losses they anticipate from next year (reduced volumes) during 2021/22. Given that Retailers are continuing to pay 100% of their wholesale charges, despite customer non-payment, it means wholesalers have almost no exposure to COVID by comparison.
- Once bad debt levels exceeded the allowance in the retail margins, retailers are no better off than wholesalers in that neither of us has any provision in our price controls to meet the excess. Hence we question why retailers should continue to bear 100% of the cost, when more than 90% of the unpaid bill relates to wholesale charges.

There are a number of ways in which wholesaler support could be provided, the simplest of which would be akin to the 'pay-when-paid' mechanism used during summer 2020. More sophisticated approaches could link the level of support provided to forecast bad debt levels, either:

(a) at a market-wide level - providing all retailers with the option of relief on a proportion of wholesale charges equivalent to the aggregate excess bad debt forecast across the market. For example, if the bad debt position was forecast at 5% of revenues, the excess bad debt would be 3% and retailers would be able to seek a 3% reduction in wholesale charge payments;

(b) at an individual retailer level – where the percentage of wholesale charge relief allowed would be the forecast level of excess bad debt incurred by the individual retailer.

For both (a) and (b), the retailers' forecasts would be validated through their statutory accounts in the same way as proposed above, but could initially be based on a forecast. It would extend until the introduction of the regulatory support mechanism from 1st April 2022. In both (a) and (b), the percentage of relief provided could be adjusted by the sharing mechanism (see Q14 below). Wholesale charge relief could commence as soon as there was sufficient comfort in the forecasts, or, under a paid-when-paid approach, from April 2021.

Repayment of the relief provided by wholesalers would come from retailers from April 2022, as the bad debt is recovered, either from customers or through the recovery mechanism.

The suggestion above would mean that wholesalers and retailers temporarily share the cost of excess bad debt proportionately and more equitably until the excess bad debt recovery mechanism kicks in.

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Implementation Issues

Question 12 – What is your view of the appropriate timing for the measurement and recovery of (a portion of) any excess bad debt costs?

(i) **Time period over which bad debt costs are measured and assessed.**

Please see our response to Question 5 above.

(ii) Timing of the recovery.

As we said in response to Q1, there is a considerable cost of financing customer debt, so timing of the recovery is critical to retailers. Given that wholesalers will start recovering their COVID-19 costs from April 2021, we had hoped that regulatory support for retailers would also commence in 2021/22.

The timetable in the CFI for the implementation of the recovery mechanism implies that recovery would not be able to commence until a relatively advanced level of validation/audit had been completed, which meant that for debt relating to 2020/21, recovery wouldn't start until 2022/23. If data validation was the only constraining factor, we would suggest that the mechanism could be kicked-off on the basis of interim estimates. There is increasing evidence of the impact that COVID-19 is having on customers' payment behaviour and the levels of debt accruing (which will be reflected in retailers' RFIs). This could be used to:

(i) confirm/assess whether the 2% bad debt threshold is likely to be exceeded; and

(ii) provide an estimate of the level of recovery likely to be required, at both aggregate and individual retailer level, which would allow recovery to start in 2021/22, and be trued-up once accounts were audited.

However, Ofwat has indicated that even on an accelerated timetable, no decision will now be possible until April 2021, which would make it impossible to implement a support mechanism of any sort from the start of the 2021/22 financial year. As we have indicated above, a mid-year wholesale or retail price change is problematic from both customer and retailer perspectives, and the cost of implementing it would be excessive. Hence April 2022 appears to be the earliest practical date for implementation, but it creates additional cashflow issues for retailers. We have set out in Q11 above a proposal for wholesalers to support customers and retailers during 2021/22.

Question 13 - Do you agree that it makes sense to 'pool' recovery of (some portion of) excess bad debt costs across customer groups and/or regions?

We recognise the points raised by Ofwat around the potential for different levels of bad debt arising between regions or between groups of customers. Indeed, we know that generally our SME customers have been more significantly affected than most of our key customers. However, this is a generalisation and there will be notable exceptions in all categories and all regions. We agree with Ofwat that any attempt to recover pools of debt from specific groups or regions will be excessively complex and prone to error, for no real benefit. It would also seem slightly perverse to try and recover the greatest proportion of excess bad debt from the customer groups or regions worst affected, which may serve simply to make the debt situation worse.

We are in favour of a simple, uniform uplift to wholesale charges which is proportionate across all customers (e.g. a percentage of bill) and applied consistently by all wholesalers.

Question 14 - Where excess bad debt costs exceed 2% of turnover on an industry wide basis in your view, how should such excess bad debt costs be shared between Retailers and customers?

We recognise that the pandemic continues to have a severe impact on the business community and we have provided extensive support to customers who find themselves in difficulty.

However, the reality is that in other competitive markets (and indeed as the water wholesalers are apparently being allowed to do), suppliers would pass all increases in costs through to their customers. As 'customers' we will all be bearing the cost of COVID for many years to come – whether through increased taxes or the prices of the goods and services affected. The same principle applies for water and waste services, and we don't believe that customers would expect anything different.

However, we recognise that in a regulated environment, if all excess debt above 2% is recoverable through the support mechanism, there would be no incentive on retailers to continue trying to recover debt once the excess threshold had been reached. Hence we understand the principle of Ofwat's proposal that retailers bear a proportion of the excess bad debt, but we do not understand the rationale for a sliding scale, which would leave both retailers and customers with uncertainty.

Retailers cannot afford to bear a significant proportion of excess bad debt. At ~£50m, 2% bad debt already represents around a third of the total (gross) retail margin. There is no headroom in the retail margins, and retailers cannot simply absorb additional bad debt costs without consequences. Even at 2%, Ofwat is effectively asking retailers to borrow in order to fund the payment of wholesalers and protect them from any exposure to customer debt.

Hence we propose that where COVID bad debt costs exceed 2% (or a retailer's normal level +1%), the share of the excess (over 2%) cost borne by the retailer should be linked to the cost of debt recovery. This would provide the right incentive for efficient debt management, and would provide a greater degree of certainty than a sliding scale. On the basis of the approach set out below, it is proposed that retailers would only be able to recover 90% of excess debt through the regulatory support mechanism.

- The cost of debt recovery is based on the cost of using external agents/legal routes, which we suggest is the incremental cost to retailers of recovering COVID-19 debt and more expensive than standard resources, given that COVID-19 debt will be more difficult to collect (as explained in response to Q5(b) above;
- [redacted];
- given that the excess debt recovery through the regulatory mechanism would be assured, we believe that the 8% is the relevant proxy to incentivise debt recovery;
- if retailers were only able to claim £90 from the regulated mechanism for every £100 of excess debt, it would be worth spending £8 in order to try and recover the full £100.
- Where the retailer is successful, the £90 would effectively be repaid to the support mechanism through the true-up process.

We recognise that there will be lots of detail to work out as the recovery mechanism is developed. We are keen to remain involved and we'd be happy to discuss any of the above in more detail.