The voice for water consumers
Y corff sy'n rhoi llais i ddefnyddwyr dŵr

CCW response to the Water Services Regulation Authority (Ofwat) Call for Inputs - COVID-19 and the Business Retail Market: Customer Bad Debt Costs

CCW response **January 2021**

1. Introduction

1.1 The Consumer Council for Water (CCW) is the statutory body representing the interests of household and business customers of water and sewerage companies and licensed retailers in England and Wales.

1.2 We welcome the opportunity to respond to this call for inputs (CFI) on customer bad debt costs resulting from the impacts of the current pandemic.

2. General comments

2.1 The COVID-19 pandemic is highly likely to have caused the amount of unpaid debt from business customers to substantially increase. Given the current economic conditions, this may result in the level of bad debt increasing too. While we support the immediate need to determine how best to address this issue, we need to recognise the true level of bad debt is unlikely to be known until a significant point in the future. As such, it may not be possible to conclude what the exact impact will be on customers and the wider market at this current time.

2.2 On balance, we recognise that business customers may have to share a burden of any excess bad debt costs identified. However, any amendments to regulatory protection should not exacerbate the impact on those business customers who have already experienced significant financial hardship due to the pandemic. If customers are to bear a portion of bad debt costs, the recovery of these needs to be over a substantial period of time.

2.3 In addition, a robust process needs to be applied when determining recoverable costs to ensure that affected customers are treated consistently, and pay an amount that has been determined fairly.

3. Response to CFI Questions

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?

3.1 Broadly, we agree with Ofwat's view on measuring bad debt costs solely in terms of amounts due from customers where payment is not received, or expected to be. We acknowledge that we are unable to comment on the practical reality of retailers being able to access liquidity support, and the additional costs they may be incurring with regards to pursuing outstanding accounts. However, if allowances were provided which encompassed all three cost areas outlined on page 8 of the CFI document, this would potentially transfer a greater burden on to customers. A balance needs to be maintained between providing extra protection for one area of the industry, while ensuring the negative consequences for others, including customers, are limited.

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

3.2 We agree that the scale of bad debt costs will vary by region and customer type. Due to the government guidelines, we are likely to see the highest costs in those regions heavily reliant on the leisure and hospitality industries which have been closed during the lockdowns. In addition, certain regions of the country (such as the North West and areas of the Midlands) have been subject to almost uninterrupted restrictions since March 2020. The complexity of how to deal with elevated industry bad debt levels is likely to be increased by these factors.

3.4 Given the fact that some customers and regions are likely to have been impacted more than others, we would urge Ofwat to consider the effects that an amendment to regulatory protections may have on business customers who have suffered the most as a result of the COVID-19 pandemic. While we accept that some customers may have to share some of the burden of excess bad debt, we do not want to see this exacerbate the affordability concerns of those who have experienced, and those who are continuing to experience, financial hardship due to the pandemic.

Question 3 - What is your view on the best approach to measure bad debt costs arising, in ways that are objective, consistent and verifiable?

3.5 We are supportive of determining the level of retailers bad debt costs both prior to the COVID-19 pandemic, and those following the introduction of restrictions. This provides an objective and consistent approach of defining how each retailer's bad debt levels have been affected by the pandemic, and whether or not the 2% threshold has been, or is likely, to be exceeded.

3.6 A large number of business customers have suffered unprecedented financial hardship over the last 10 months, and will continue to do so for as long as pandemic restrictions continue. Before requiring customers to cover a portion of excess bad debt costs above the threshold, we agree that the measures need to meet the standards stated in this question. Affected customers will need to understand the objectivity behind any proposal, as well as why this has been deemed fair and reasonable.

3.7 When determining how to measure bad debt, it would be preferable for Ofwat to be prescriptive in order to avoid retailers reaching different conclusions of what would constitute 'bad' or 'doubtful' debt for the purposes of reporting. We do not want to see customers potentially disadvantaged as a result of inconsistent approaches.

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.

3.8 As stated in answer to Question 3, we believe that a more prescriptive basis for the determination of bad debt costs is appropriate, given the potential consequences for customers. On this basis, the ‘Non Statutory Accounts’ option would be our preferred method for reporting. This appears to strike a balance between allowing a degree of retailer judgment in determining the relevant provisions, while requiring this to be undertaken within certain parameters.

3.9 We agree that there may be a risk of retailers over-estimating their levels of bad debt, which could arise if there is more freedom for them to determine the basis on which they report. An overly pessimistic view of certain business customers’ ability to settle outstanding debt could easily be formed due to the ongoing pandemic restrictions. However, a more prescriptive approach as outlined in the ‘Non Statutory Accounts Basis’ option would help to safeguard against such over-estimation, and ensure that customers do not end up having to cover excess costs unnecessarily.

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?

3.10 While it is very likely that COVID-19 restrictions have caused an increase in ‘regular’ debt levels in 2020-21, it may take longer for a significant increase in ‘bad’ debt to materialise. The financial support on offer so far in 2020-21 (e.g. payment relief between March and September 2020 for some under the temporary vacancy scheme, access to government financial support etc.) may have enabled affected business customers to continue to make payments, albeit at a reduced rate. Therefore, bad debt will need to be monitored closely over the next few years, as the true cost is unlikely to be apparent at this stage. However, if there is evidence from retailers that the scale of bad debt is already at such a level that exceeds the 2% threshold, it would be appropriate to measure costs for 2020-21, being mindful that the scale will not yet be fully understood.

3.11 To accompany this, we would expect robust reporting and auditing processes to be in place, and for a time interval of six months after audit to verify bad debt costs in respect of usage to the end of March 2021. It is sensible to recognise that this might mean reviewing accounts from October 2021 at the earliest.

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.

3.12 As stated in our response to the earlier questions, there is a growing number of customers facing payment difficulties throughout the pandemic, some of which have faced financial hardship over the last 10 months. While we understand there are groups of customers whose premises have remained open and whose productivity has been maintained during the government restrictions throughout the pandemic, there are many customers whose businesses have ceased trading, or where trade has dramatically reduced. As we are now in the third lockdown, the scale of the financial difficulty for many customers will likely have increased.

3.13 Retailers must offer repayment plans to business customers struggling to pay as a direct result of the pandemic. As a requirement of changes made to the Customer

Protection Code of Practice in December 2020, retailers must report to us and Ofwat on a monthly basis the number of customers on repayment plans (both COVID-19 and other plans) as well as the number of customers that retailers are taking enforcement action against. This data will give us important insight into the number of customers facing payment difficulties, and the potential scale of bad debt costs across the industry.

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?

3.14 We support and agree the objectives set out in the CFI, in particular the protection of business customers. It is important for the right balance to be struck when amending regulatory protections, and for the amendments to be clear and as simplistic as possible.

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?

3.15 We believe an amendment to the REC may be the most straightforward option for recouping a portion of excess bad debt costs, as this will provide an allowance for bad debt cost recovery through default tariffs. The adjustment could be applied to the allowed retail cost per customer, which would differ for each wholesaler region depending on the level of bad debt.

3.16 An amendment to the REC also appears to be less complex and places less of an administrative burden (with an associated cost) on retailers and wholesalers. As a result, this may have lower risk of error.

3.17 However, if this is taken forward as the preferred option, consideration is needed for the time period the adjustment would apply to (i.e. the period over which retailers will recoup a portion of bad debt costs). We would support an adjustment that allows for recovery of the costs over a longer period than the usual timeframe for the REC price control, as this would lessen the impact on business customers.

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

3.18 As mentioned in our response to question 8, this option is potentially more complex and costly to apply, and could be more prone to error and dispute. It could also be disadvantageous to customers in that an uplift in wholesale charges to accommodate bad debt costs may mean wholesale charges increase more quickly than would be allowed under an adjustment to the REC (which we propose could be applied over a longer period of time). This is a risk to customers, regardless of whether retailers recoup their costs from a central fund or a rebate against future wholesale charges, as retailers may seek payment/rebate as soon as possible, which means the wholesale charges may increase at a faster pace.

3.19 If this option is to go forward, consideration is needed to define the period of time over which wholesale charges increase and retailers recoup costs, to spread the effect on business customers. There may also be an associated cost of establishing and operating this process with an independent administrator, a cost which may have to be recouped from customers 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?

3.20 Trading parties are better placed to identify specific costs in setting up and operating such an arrangement, but as we say in responses to questions 8 and 9, this approach appears to be complex and potentially costly.

3.21 In order to reduce the risk of error and dispute, an independent administrator would need to be funded to operate it, and audit the evidence of excess bad debt cost retailers apply. While Ofwat would also require assurance if the cost recovery is carried out through a REC adjustment, using an independent administrator appears to be a greater administrative (and cost) burden for the parties involved. This is a cost that may be eventually passed to customers.

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.

3.22 Our preferred approach is an adjustment to the REC, though we would like to see Ofwat set a longer period for costs to be recovered to lessen the impact on business customers. This would give some protection for customers at a time when many businesses are under strain (and may be for some time to come). We have no further suggestions for any additional mechanism for recovering bad debt costs whilst protecting customers beyond this.

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

3.23 It is important that the timing for the measurement and recovery of a portion of excess bad debt takes into account the need for robust reporting and auditing processes to be in place. Of key consideration is the fact that the true costs of bad debt are unlikely to be apparent at this stage.

3.24 Under question 8, we also state the need for an adjustment that allows for recovery of the costs over a longer period of time, as this would lessen the impact on business customers, and not to deliver monies to retailers immediately under the usual timeframe for the REC price control. We urge Ofwat to account for these factors when setting out the approach and timing.

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?

3.25 We support the principle of 'pooling' recovery across both customer groups and regions, but we question how straightforward this will be to administer. In order to prevent small and micro business customers paying a higher proportion of the bad debt costs than they have incurred, cost recovery via REC price restraints would be based on existing customer consumption bandings, so a customer's contribution will be relative to their size. Retailers could consider applying the tariff effect of the bad debt cost recovery in each band to customers' volumetric use, so that contributions are relative to usage.

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?

3.26 In principle we support retailers bearing a higher proportion of bad debt, however, until the scale of bad debt costs are determined we are unable to give a firm position on this. We want to see the right balance struck, as set out in the objectives under question 7.

3.27 It could also be said that wholesalers may be able to take a proportion of the bad debt costs due to their monopoly position, size, ownership, and access to current lower cost of financing. We would urge Ofwat to consider a possible alternative that includes wholesalers in any liability for excess bad debt costs, and ensure that this results in an equitable split between customers, retailers, and wholesalers.

Enquiries

Enquiries about this response should be addressed to:

Adam Boyns
Policy Manager, CCW
Email: [redacted]
Telephone: [redacted]
January 2021