November 2020

Call for inputs: Covid-19 and the business retail market – customer bad debt costs

Ofwat

Business Retail Market: Customer Bad Debt – Call for inputs

This Call for Inputs (CFI) seeks views on our approach to assessing whether and how revisions to regulatory protections may be warranted in the business retail market in respect of risks of elevated customer bad debt costs resulting from the effects of the Covid-19 pandemic. We particularly seek responses from customer groups and Retailers. We also welcome responses from other stakeholders and interested parties, particularly business customers and their representatives.

Contents

1. Introduction and background

The Covid-19 pandemic and measures to combat it have had significant effects on the UK economy as well as customers in the business retail market[1]. Ofwat, working in tandem with the Market Operator, MOSL, and with industry introduced a suite of measures aimed at protecting business customers, including from the risk of systemic Retailer failure.

Our work[2] recognised and highlighted the potential longer term risk that elevated levels of customer bad debt may materialise as a result of the economic conditions caused by Covid-19 measures. We noted that elevated levels of customer bad debt - resulting from business customers defaulting - could have potential consequential impacts for Retailers. In particular and unlike many other sectors of the economy, business Retailers are subject to price controls (for some customers), which could restrict their ability to recover some efficiently incurred bad debt costs from their customer base. We have also acknowledged that measures introduced in April and June 2020 to protect customers from disconnection, late payment fees, interest payment charges and enforcement for non-payment of invoices (via amendments made to the Customer Protection Code of Practice (CPCoP)) placed restrictions on the actions Retailers could take to collect outstanding amounts from certain business customers.

In our 30 April 2020 Decision document we:

- noted that in the business retail market, Retailers on average have seen historical bad debt costs at around 1% of their turnover;
- set out that, on that basis, a Retailer with historical bad debt costs of:
  - o up to 1% of turnover should expect to absorb any outturn bad debt costs up to 2% of turnover[3];
  - o over 1% should expect to absorb any outturn bad debt costs equal to their historical level plus 1% of turnover.
- said we will monitor the level of additional Covid-19 related bad debt emerging in the business retail market and if it looks like bad debt across the market is likely to exceed the 2% threshold, we will provide regulatory protections for a portion (but not all) of this additional exposure.

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[1] The business retail market refers to 1.2 million businesses, charities and public sector bodies ('business customers') in England and Wales who are eligible to choose their supplier of water and wastewater retail services.

[2] See in particular Ofwat's 16 April 2020 consultation on liquidity challenges and increases in bad debt, 30 April 2020 decision document, 30 July 2020 Covid-19 and the business retail market next steps decision document

[3] This was on the basis that industry doubtful debt costs in 2009/10, i.e. immediately following the financial crisis, were around 1.5% (see p.32 April 2020 Decision document).

We did not specify details of how protections might be revised so as to enable Retailers to recoup from their customers some portion of excess bad debt costs above what we expect them to absorb. This was on the basis that there remained a considerable degree of uncertainty about the potential scale of customer bad debt resulting from business customer default.

On 30 July 2020 we published our decision on next steps aimed at further protecting the interests of business customers in the water sector in the context of Covid-19. These included that we would in autumn 2020 publish a Call for Inputs on customer bad debt in the business retail market and would seek views on the range of possible approaches to amending any regulatory protections and mechanisms for refunding appropriate bad debt costs to Retailers.

In addition, following our April 2020 Decision document, we sought further information from Retailers concerning the potential for elevated levels of bad debt costs following the introduction of Covid-19 measures. We wrote to Retailers in July 2020 with a Request for Information (RFI) seeking data and information, including on their revenue, cash and debtor positions and indicators of the extent to which customers may be having payment difficulties. We have used information received from the July 2020 RFI to help formulate our thoughts for this CFI.

Note our policy concerns relate to Retailer activity in the England and Wales business retail water market, and the extent to which bad debt costs may have arisen for business customers eligible to choose their water and waste water Retailer in this market. Where we have requested information from Retailers who operate more widely – for example in Scotland - we have asked Retailers to exclude data and information not relating to business customers in England and Wales.

Where we are minded to enable retailers to recoup some portion of excess bad debt costs, there are a number of issues to consider, for example:

- definitional and timing questions for assessing and auditing bad debt costs;
- the parameters for sharing excess bad debt costs between retailers and customers;
- the need for a mechanism to collect from customers and distribute to retailers a portion of excess bad debt costs; and
- oversight of processes to ensure customer interests are best protected.

Accordingly, this Call for Inputs (CFI) invites views on the possible amendment of regulatory protections, in light of the potential for elevated levels of customer bad debt costs following the introduction of measures to combat the Covid-19 pandemic. We intend to use views and inputs received to this CFI to formulate and consult on a preferred option or options for revision to regulatory protections that may be warranted in light of elevated levels of bad debt costs. Our intention is to consult in the early part of 2021. We will also, in moving to consultation, seek further data and information from Retailers on indicators for the likely scale of outturn bad debt costs.

Following consultation on a preferred option, we would presently anticipate publishing a final Decision on our preferred option in spring 2021, with any revisions to regulatory protections, where warranted, taking effect from April 2022.

The document is structured as follows:

- Section 2 – sets out how bad debt costs may arise and how we may measure them; summary indicators we have received from Retailers, and relevant context on how these may be affected by the regulatory protections already in place in the business retail market.
- Section 3 – sets out two potential approaches for enabling Retailers to recoup some portion of any excess bad debt costs together with consideration of timing and sharing issues.
- Section 4 – sets out our next steps.

Responding to this Call for Inputs

We welcome views on the questions detailed in Appendix 1 of this CFI by **5pm on Friday 22 January 2021.**

Please submit email responses to covidbusinessretailmarket@ofwat.gov.uk, with the subject 'Customer Bad Debt Call for Inputs'.

Owing to the closure of the Ofwat offices we are currently unable to accept responses by post.

Responses to this CFI may be published on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the General Data Protection Regulation 2016, the Data Protection Act 2018, and the Environmental Information Regulations 2004. For further information on how we process personal data please see our Privacy Policy.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

In developing our thoughts for this CFI, we have used information and evidence already obtained, including via requests for information from Retailers. We welcome the constructive discussions thus far and this CFI is an opportunity for stakeholders and any interested parties to provide further views and perspectives.

2. Customer bad debt and existing regulatory protections

The Covid-19 pandemic and measures put in place to combat it have significantly affected the business retail market as well as the wider economy. For example, the first national lockdown announced in March 2020 created immediate challenges to the ongoing operation of the business retail market - it created a sudden reduction in demand among some business customers and meant some business customers could face difficulties in paying their bills on time, potentially creating consequential cash flow issues for Retailers. A number of business customers continue to be affected by the subsequent regional restrictions and by the second national lockdown. Costs for Retailers associated with delayed or defaulted business customer payments – i.e. bad debt costs - are likely to have increased if their business customers are less able or unable to pay.

This section sets out how bad debt costs arise and possible approaches to assessing and measuring them. It summarises some indicators of the extent to which bad debt costs may have accrued since the introduction of Covid-19 measures. We also summarise relevant business retail market regulation which may have affected and affect Retailers' abilities and incentives to manage bad debt costs.

This section is structured as follows:

- Customer bad debt costs – how these arise in principle, and how they may vary by customer group or geographic region. (section 2.1)
- Measuring and verifying outturn bad debt costs for the business retail market – including consideration of accounting and timing issues for objectively measuring bad debt costs. (section 2.2)
- Bad debt costs arising in the business retail market - indicators and views – summarises information we have received from Retailers concerning indicators on the extent to which elevated bad debt costs may be arising or expected to arise. (section 2.3)

2.1 Customer bad debt costs

Bad debt costs in general are a normal feature of commercial activity. Many companies will, in the usual course of their commercial activities, experience or anticipate some difficulties or delays with payments from some of their customers, including eventual non-payment. Accordingly most companies make allowances for bad debts to reflect the likelihood that not all sales and services provided will be paid for in full. Measures to contain the spread of Covid-19 – in particular the restrictions on some business' ability to operate and trade - are likely to have elevated the risks that companies will need to make such allowances.

Bad debt related costs arise for companies to the extent that they:

1. make accounting provisions for or write off debt where payment is not received or is not expected to be received;
2. need to hold additional working capital to ensure cash flow while awaiting payment of outstanding accounts; and
3. spend time or effort pursuing outstanding accounts.

In measuring and considering allowances for bad debt related costs in revising any regulatory protections, we presently consider that we will have regard to bad debt costs arising for Retailers only under (1) above. This is because it is these costs that are expected to be most affected by Covid-19 measures.

Concerning (2), Ofwat has introduced, separately, measures[4] designed to enable Retailers to access an additional source of liquidity support by deferring portions of payments to wholesalers. These measures are in place until March 2021 and were designed to give Retailers time to put in place more enduring liquidity arrangements to support their ongoing cash flow position.

Concerning (3), we would expect Retailers to manage these costs as a normal part of their commercial activities. Furthermore we note such costs would not be straightforward to disaggregate from a Retailer's other operating costs and it would therefore be difficult to objectively verify which of these costs had been efficiently incurred. We consider it would be disproportionate to attempt to do so given that bad debt costs under (1) are expected to be the costs most affected by Covid-19 measures.

Given the varied impacts of Covid-19 measures on different sectors of the economy, it is possible that the incidence of non-payment and the scale of any elevated bad debt costs arising for Retailers will vary by region, industry and/or customer type or size. Sectors which have seen more stable customer demand for example may have experienced less disruption in their ability to continue to make payments. Other sectors such as leisure and hospitality have seen significant disruptions in customer demand and business customers in such industries may be experiencing greater difficulties in paying utilities and water services as a result.

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

[4] See Ofwat 30 July 2020 Covid 19 and the business retail market next steps decision document

amounts due from customers that are appropriately provided for or written off. To what extent do you agree with our initial view here?

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

Regulation of the business retail market and bad debt costs

In the usual course of business, where companies incur bad debt costs they will seek both to minimise these and, where competitive pressures allow, adjust over time their pricing to reflect costs that arise. In order to protect the interests of business customers, the business retail market is subject to regulation which, among other things, may affect Retailers' abilities and incentives to manage and recover bad debt costs. The principal relevant protections are the price restraints set out in the Retail Exit Code (REC) and the obligations imposed on Retailers in the Customer Protection Code of Practice (CPCoP), as follows.

Price restraints

Under current market arrangements, Retailers bear the risk of bad debt from business customers not paying their bills, in view of the fact that they own the relationship with the business customer and are therefore best placed to manage this risk. Retail price restraints apply under the Retail Exit Code (REC) but include an allowance for a range of bad debt costs, set by reference to those costs current at the time of market opening. This provides an incentive for Retailers to manage bad debt costs, as those who do so will, all things being equal, be at a competitive advantage.

Customer Protection Code of Practice

The Customer Protection Code of Practice (CPCoP) sets out requirements on how Retailers must treat their customers and includes how they should seek to recoup any outstanding customer payments or debts. For example, there are requirements on Retailers to inform customers about the availability of a reasonable repayment plan for an outstanding debt.

Noting the potential impact of Covid-19 measures on business customers, Ofwat in early April 2020 amended the CPCoP[5] to strengthen the available protections. It introduced the following three additional protections for business customers from 8 April 2020:

[5] See Ofwat April 2020 Customer Protection Code of Practice CP0006 Decision

- Protection from disconnection;
- Suspension of debt enforcement; and
- Suspension of interest and late payment charges

We amended these protections through further amendments to the CPCoP to apply from 1 June 2020[6]. In particular, these amendments required that business customers that are operating normally and can pay should be subject to normal debt recovery processes, i.e. were no longer subject to three additional protections noted above. However, the Code amendments also required that business customers that are seriously affected by Covid-19 measures (a 'Covid 19 Affected Customer') should continue to be subject to these three protections. We defined a 'Covid-19 Affected Customer' by the fact that a temporary Covid-19 vacant flag is applied for all of the relevant customer's premises[7]. These protections were superseded at end September 2020 when the use of Covid-19 vacancy flags was unwound. In late October CCW proposed a further amendment to the CPCoP aimed at strengthening protections for business customers most affected by Covid-19. On 30 November 2020 we published a consultation proposing to amend the proposal put forward by CCW and expect to take a final decision whether to further amend the CPCoP by the end of the year.

Amendments to the CPCoP to apply from 1 June 2020 also required that Retailers must, until 31 March 2021 (or such period at Ofwat notifies Retailers), have in place a 'Covid-19 Repayment Scheme'. This should set out the reasonable steps that the Retailer will take to enable business customers to pay where they can, over a time period that they are able to afford. Any Retailer action to disconnect a business customer for late or non-payment must comply with its scheme.

2.2 Measuring and verifying outturn bad debt costs for the business retail market

As we are considering allowing Retailers to recoup some portion of excess bad debt costs, we turn to the question of how we may measure such costs in an objective and verifiable way. This is in large part a question of accounting practice and interpretation of accounts- see box *Background: Standard accounting practice* for further details. We follow and build on this by drawing out three principal aspects necessary for

[6] See Ofwat May 2020 Customer Protection Code of Practice CP0007 Decision
[7] in accordance with section 3.1.6 of CSD 0104 of the Wholesale – Retail Code (WRC)

understanding and measuring bad debt costs - definition, timing issues, and verification.

We set out below the issues we need to consider when measuring outturn bad debt costs.

Background: Standard accounting practice

Companies recognise and record sales as services are provided to their customers with subsequent customer payment of the corresponding receivables being expected in accordance with agreed credit terms and industry practice. Amounts outstanding are recorded as trade debtors. The bad debt cost incurred by a company comprises the value of any debts which have been written off by the company as being non-recoverable, typically as a result of the customer ceasing to trade, along with the increase or decrease in the provision for any trade debtors at the balance sheet date which are deemed to be unlikely to be collected.

A provision for bad and doubtful debt represents a company's view on the likelihood of a customer payment not being received. It represents a view of current and future circumstances, including the economic and trading conditions. As such a company should review and adjust its provisions on a regular basis to reflect relevant experience and circumstances. Where it becomes clearer to the company that outstanding customer payments are likely to be made, a provision may be reversed.

2.2.1 Definition of outturn bad debt costs

Our April 2020 consultation document set out our starting point, noting that on the basis of Retailer information, average levels of bad and doubtful debt in 2018/19 and 2019/20 were around 1% of annual turnover[8]. Our measurement here was based on Retailers' stated bad and doubtful debt costs in respect of their activities in the business retail market.

We are now looking to measure bad debt costs for two purposes:

1. to establish each Retailer's baseline (historical) bad debt costs prior to the Covid-19 pandemic; and

[8] p.31. Note bad debt levels based on Retailers who reported data in April 2020

2. to establish each Retailer's, as well as the industry level of, outturn bad debt costs arising following the introduction of Covid-19 measures and – further - what we may regard as excess bad debt costs. These would be bad debt costs arising in the business retail market in the normal course of business, including where Retailers have seen customers delay or omit payment in respect of usage incurred from the beginning of 2020. This would reasonably exclude bad debt costs associated with older debt, arising from sales or services provided before January 2020.

Figure 1 illustrates the relationship between historical, elevated and 'excess' levels of bad debt costs that we will seek to have regard to. Across the market, we may see bad debt costs elevated above the 2% threshold we have set out. If this threshold is met, we have committed to provide regulatory protections for a portion (but not all) of this additional exposure above the threshold.

Note that, as we set out in our April 2020 Decision document[9], the position for individual Retailers may vary, depending on their historical bad debt positions prior to the introduction of Covid-19 measures. Figure 2 illustrates for a range of hypothetical Retailers, historical bad debt positions and outturn bad debt levels, the extent to which some portion of any elevated outturn bad debt costs would be judged as 'excess' bad debt costs[10].

Where warranted, any revised regulatory protections would then enable Retailers to recover from customers a portion (but not all) of excess bad debt costs. As we set out in our April 2020 Decision document, such revised regulatory protections would only be warranted where it looks like bad debt across the market may exceed 2% of turnover.

Given that the basis of measurement may be used to recover some costs from business customers and used to reimburse some Retailers, the definition and measurement of bad debt costs needs to be as objective, accurate and consistent between Retailers as possible. Customers should not be disadvantaged because of inaccurate or inconsistent approaches to defining and measuring bad debt costs. An individual Retailer should not be disadvantaged, compared against other Retailers, simply because of inconsistent approaches to measuring and reporting bad debt costs. We also note however that Retailers will need to exercise their judgement concerning risks of customer non-payment and the need to make provisions and write-offs.

[9] See in particular Appendix 2, April 2020 Decision document
[10] Figure 2 based on Appendix 2, April 2020 Decision document

Figure 1 – Illustration of hypothetical elevated and excess bad debt costs, relative to Business as Usual (BAU) & the 2% threshold: Across business retail market

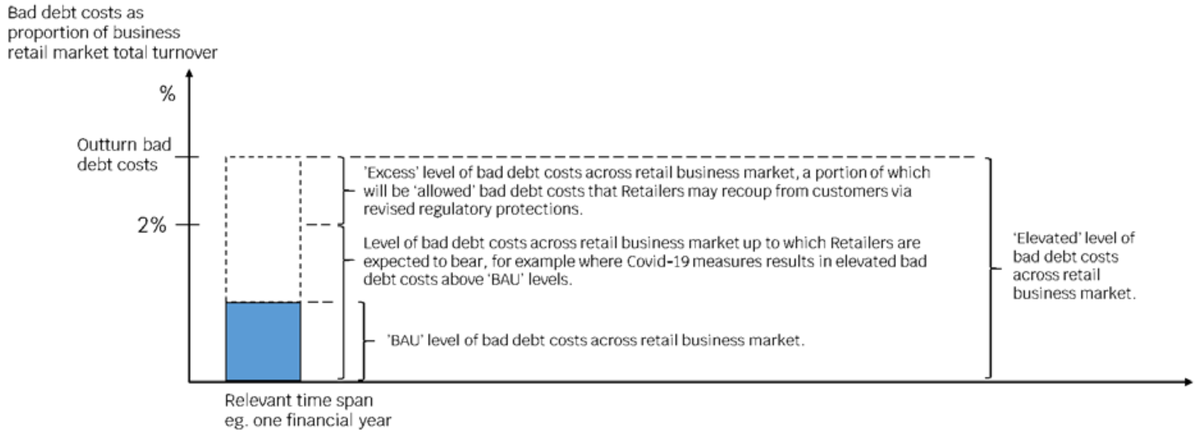
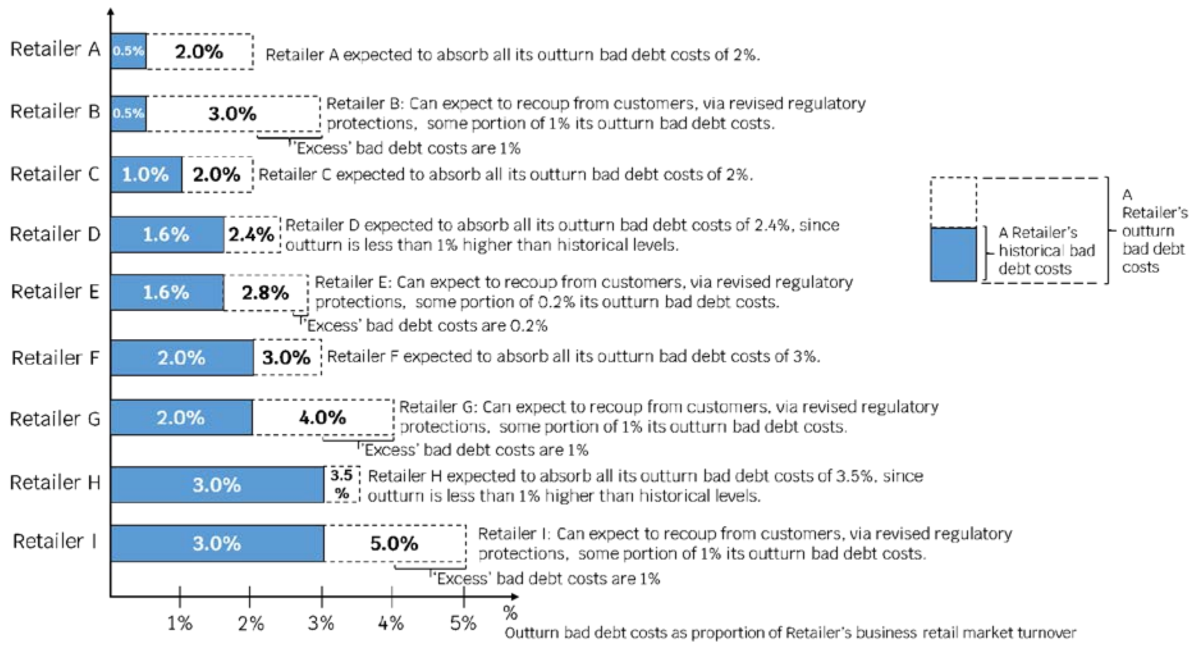


Figure 2 – Illustration of hypothetical elevated and excess bad debt costs, relative to historical and outturn bad debt costs: Individual Retailers



Proposed Approaches

We have identified two potential approaches to measure bad debt costs as set out below. We are also interested in stakeholders' views about whether there are other approaches that we should consider:

1. **Statutory accounts basis** - For the purposes of the revision of any regulatory protections we could, for the relevant accounting period, measure outturn bad debt costs arising for a Retailer using their accounting estimates and as the sum of reported:
    - bad debts written off to the profit and loss account (if any); and
    - the movement in the balance sheet bad and doubtful debts provision. This should include an appropriate provision for all customer debts recorded on the balance sheet where either there has been a notification of an insolvency process or there is doubt as to whether a full recovery of the amount due will be possible.

    All amounts should be stated net of any anticipated customer receipts and, if applicable, HMRC bad debt relief.

2. **Non statutory accounts basis** – alternatively we could define more explicitly the basis of the recognition of the bad debt expense. This would reduce the scope for a Retailer's own judgement to be applied in deriving the provisions for bad and doubtful debt. As a guiding principle, HMRC's bad debt relief for VAT purposes is based on amounts which are more than six months overdue and written off. Accordingly for each accounting period, the allowable amounts for bad debt recovery could be the sum of:
    - the total amount of debts which are unpaid, more than six months overdue and not subject to a payment plan; plus
    - Any un-provided amounts which are less than six months overdue but where the Retailer has an indication that payment is unlikely to be received such as notice of some form of insolvency.

    All amounts would be stated net of any HMRC VAT bad debt relief receivable.

Under either approach, business customers may pay outstanding arrears as economic conditions improve and recovery processes will continue. Accordingly there may need to be a subsequent recalculation incorporating for example business customer payments reported on an annual basis and other relevant updates (i.e. some form of 'true up')

Timing issues

Bad Debt Costs

We will need to decide the time period over which outturn bad debt costs may have accrued. Our present view is that, since Covid-19 measures were introduced from the end of March 2020, any consequent impacts on business customer ability to pay and elevated levels of bad debt would manifest principally in the financial year 2020/21.

We nevertheless recognise that it will take some time to see and understand the full impact of Covid-19 measures on customer payment difficulties and the extent to which Retailers are able to recover amounts outstanding. In part this is because, in response to Covid-19 measures and the current economic environment, some businesses are lengthening payment cycles. Consequently any final non-payment may take longer to materialise. For these reasons, it may take time to finalise provisions / losses as amounts are written off for non-payment.

We are presently minded to measure bad debt costs, and amend any regulatory protections, in respect of the financial year 2020/21. However, we remain open to alternative views and evidence in light of the uncertain time period over which Covid-19 effects could manifest, particularly as the situation is evolving, and hence the time period for consideration of any elevated bad debt costs. If the time period impacted by Covid-19 measures extends to more than one financial year then we would expect the basis of the calculation to be applied to each financial year.

Time intervals

It takes time for Retailers to determine whether outstanding amounts will need to be provided for or written off, and therefore the time interval for this to happen before we measure costs that have arisen in 2020/21 will need to be determined.

For this reason, our current position is that it will be reasonable to wait for audited 2020/21 accounts, and for a time interval of six months following this to verify provisions and write off for bad debt in respect of usage to end March 2021; together this points to October 2021 at the earliest.

Furthermore we note that, in the light of the accounting practices outlined above (p.10), it may not necessarily be appropriate to treat identified costs as a onetime adjustment. For this reason we believe some form of subsequent 'true up' is likely to be appropriate. We discuss this further in section 3.

Auditing and accuracy

As our description of the possible accounting bases above outlines, Retailers may exercise judgement concerning the extent to which they make provisions and write offs for outstanding or delayed payments, and hence the extent to which bad debt costs are measured.

Given that we are considering revision of regulatory protections to enable Retailers, under the conditions specified in our April 2020 decision document, to recoup some portion (but not all) of any excess bad debt costs, there is a risk that Retailers are incentivised to over- rather than under- estimate bad debt costs. This could include for example a Retailer choosing to make provision for, or write off debt that accrued prior to 2020/21, or simply choosing to take a more conservative and pessimistic approach in making provisions for invoices issued during 2020/21.

We would therefore, in measuring outturn and 'excess' bad debt costs, require auditor confirmation that such provisions and write-offs relate to customer usage and services provided since, at the earliest, January 2020 and that the relevant accounting basis has been correctly applied.

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.

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?

Bad debt costs arising in the business retail market - indicators and views

Since April 2020, we have, and continue to, collect data from Retailers with the intention of helping to establish the emerging scale of customer payment difficulties and potential bad debt costs as the pandemic and measures to combat it have evolved. In July 2020 we asked Retailers to complete a request for information (RFI) with data to end June 2020 and some forecasts into 2021.[11] The RFI sought data and information including on Retailers' revenue, cash and debtor positions and indicators of the extent to which customers may be having payment difficulties.

Indicators

Responses to our July 2020 RFI suggest that, to June 2020, measures to contain the spread of Covid-19 have been accompanied by clear impacts on the business retail market overall. Industry revenue and cash received – likely reflecting reduced consumption from premises being closed or operating in a reduced capacity – fell markedly over April to June, though Retailers (in aggregate) were in July 2020 generally forecasting some recovery in the latter part of 2020.

The potential impacts of Covid-19 measures in terms of payment issues and early indicators of bad debt costs have to date been mixed, for both business customers and Retailers. In part this is likely to be because we have only assessed data and indicators to end June 2020, and this is still a relatively early date at which to gauge the form and scale of impacts. Owing to usual billing cycles for example, some business customers will not have been invoiced over this period and any payment issues may not yet have become evident.

Analysis of Retailer data for the period January to June 2020 suggests some business customers may have been experiencing payment difficulties, as evidenced for example by an increase in direct debit cancellations during March and April. However, elevated levels of customer payment difficulties did not translate for all Retailers into significant increases in the number of business customers in arrears over the January to June period.

Some Retailers have indicated that they are not anticipating an adverse impact on their debt recoveries while others are already indicating that collection of outstanding payments will be more difficult. Furthermore, while Retailers reported an increase in the number of business customers in arrears across all customer groups, the increase was larger for smaller lower consumption business customers.

As a number of Retailers have noted, it will take time for the form and scale of customer payment difficulties, and hence bad debt costs, to arise. Retailers have also noted that any payment difficulties arising as a result of Covid-19 measures may not have

[11] Alongside the publication of this CFI, we have in November 2020 sent a second RFI to Retailers seeking updates on indicators and actual data to end September 2020, and revised forecasts for some indicators into 2021.

manifested for customers who as part of their normal billing cycle were not billed during April-June and/or were benefitting from some form of government support.

Baseline bad debt indicators

We set out in our April 2020 decision document that Retailers should expect to absorb – in full – incremental bad debt costs up to an amount equal to an additional 1% of their annual turnover. So a Retailer already carrying industry average bad debt of 1% should expect to fully absorb outturn bad debt costs up to 2% of annual turnover. We said we will monitor the level of additional Covid-19 related bad debt emerging in the business retail market and if it looks like bad debt across the market is likely to exceed the 2% threshold, we will provide regulatory protections for a portion (but not all) of this additional exposure.

Concerning the level of bad debt costs incurred on a historical basis by Retailers, we have as a first point of reference measured these in terms of the proportion of total retail turnover accounted for by bad and doubtful debt. On this basis, our analysis of detailed information provided by Retailers to the July 2020 RFI gives a bad debt cost of 0.9% of turnover for 2018/19 and 2.2% for 2019/20. Figures for 2019/20 suggest that Retailers have already begun to anticipate the impact of Covid-19 measures on bad debt costs. We will need to undertake further work, data collection and analyses to determine, challenge and confirm the base line outturn bad debt cost positions for industry and for Retailers for the most recent financial year pre-dating the introduction of Covid-19 measures. This work will include the definition and measurement of bad debt costs, the extent to which these have arisen in 2018/19 and subsequently on a consistent basis and if and to what extent on an industry wide basis bad debt costs may be exceeding 2% of turnover.

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.[12]

[12] Note Ofwat will in November 2020 send Retailers a revised Request for Information (RFI) seeking updated data and information on indicators of the potential scale of bad debt arising since March 2020. Retailers responding to this CFI may wish to reference data and information contained in their response to the RFI in support of any views they may have in relation to Question 6.

3. Revision of regulatory protections

Our April 2020 decision document said that, were we to amend regulatory protections in respect of industry bad debt levels exceeding 2%, we could do this either by making an adjustment to the price cap put in place for most customers via the REC, or by capping Retailer bad debt exposure, with some portion of bad debt above this cap being recovered from non-household (i.e. business) customers over time. We also said that we would consider whether there are other mechanisms to provide regulatory protection for Retailers.

This section sets out:

- Our objectives in considering any amendment of regulatory protections (section 3.1);
- Possible mechanisms to recover costs from customers (section 3.2);
- Timing (section 3.3);
- Pooling bad debt costs across customer groups or geographic regions (section 3.4); and
- Sharing of incremental bad debt costs between Retailers and customers (section 3.5).

3.1 Objectives

Our principal objective, and in accordance with our statutory duty to further the consumer objective[13], is to protect the interests of customers. In considering revisions of regulatory protections that effectively recompense Retailers for a portion (but not all) of excess bad debt costs arising as a result of Covid-19 measures, we are seeking to protect customers, including from the risk of systemic Retailer failure. We are not looking to protect Retailers against, nor expecting customers to finance, commercial risks, including bad debt costs that arise in the usual course of business. A well-managed and adequately financed business should be well placed to navigate these. In addition we are not seeking to prevent individual Retailers from exiting the market, as some supplier exit is a feature of any functioning market.

Note, as set out in our April 2020 Decision document[14], any recovery by Retailers from customers of some portion of excess bad debt costs should be confined to

[13] The consumer objective, as set out at section 2 of the Water Industry Act, being to protect the interests of consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the provision of water and sewerage services.
[14] Eg. see p.32 April 2020 Decision document

non-household i.e. business - customers. That is, we expect any cost recovery mechanism to be confined to business customers and to exclude household customers.

In considering whether any amendments to regulatory protections may be warranted, we will have regard to set objectives. Our proposed objectives are set out below:

1. Protect customers' interests

We want to protect business customers, including from the risk of systemic retailer failure.

2. Promote efficiency

Any approach should minimise perverse incentives, unforeseen consequences, and any distortions to competition – including by ensuring transparency. For example it should maintain incentives on Retailers to minimise bad debt costs arising now and in future. Any approach or mechanism should not distort competition or competitive outcomes. Any approach or mechanism should be capable of being audited or checked, to ensure that Retailers submit accurate and verifiable data.

3. Provide clarity and minimise implementation costs

Any approach or mechanism for reimbursing monies to Retailers should be clear and as simple as possible. It should also seek to minimise implementation costs.

We recognise that there is a balance to be struck between some of the proposed objectives. For example, the objective to minimise implementation costs must be weighed against the need to promote efficiency and ensure that any mechanism is suitably robust and subject to the right checks and balances.

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?

3.2 Possible mechanisms to recover costs from customers

Our April 2020 Decision document noted that, in the event that amendments to regulatory protections were warranted to allow a Retailer to recover a portion (but not all) of excess bad debt costs, these could take the form of:

1. Making an adjustment to the price cap put in place for customers via the REC, or

2. Capping Retailer bad debt exposure with some portion of bad debt above this cap (i.e. excess bad debt costs) being recovered from business customers over time, for example through wholesale charges.

Note that, as we have outlined above in Section 2 (p.6/7), in a standard commercial environment, we would expect companies to respond to industry wide increased bad debt costs either by responding to and managing these further or differently and/or, to the extent competitive pressures allow, through price increases. In the business retail market and as we outlined in Section 2 (p.8/9), price restraints apply, meaning Retailers are prevented from responding to increased bad debt costs with price increases for some customers.

Option (1) – adjusting the REC price caps – may be seen as a regulatory mandated adjustment to prices that – absent the price caps – is likely to occur in a competitive market. (Note, since price restraints do not apply to business customers with annual consumption exceeding 50Ml or to customers on negotiated contracts, this option by default enables Retailers to pursue a standard commercial response in respect of any elevated bad debt cost levels for these customer groups.)

Option (2) is more akin to the type of intervention traditionally used in sectors subject to price controls / economic regulation, where customers cannot switch supplier.

We also noted we would also consider whether there are other mechanisms to provide regulatory protection for Retailers. We have for the purposes of this CFI outlined approaches for (1) and (2). We remain open to comments and views about whether other mechanisms or approaches may be viable and warranted.

(1) Amending the REC

The REC applies to all customers who are on default tariffs – being those who have not switched or re-negotiated their contract since market opening, or who have returned to default terms. The current REC provisions apply from 1 April 2020 and contain both price and non-price protections for customers on default tariffs.

The REC price protections specify the maximum price that Retailers may charge a customer. The specification of the maximum price depends on the size of customer, as set out in Table 1. No maximum price is specified for customers with annual consumption exceeding 50Ml, but prices must be reasonable and non-discriminatory.

Table 1 – Summary REC price protections

Customer type		Price protections
Type 1	Unmeasured customers and customers with annual consumption below 0.5Ml	Default tariffs not to exceed the wholesale charge, plus a specified regional cost to serve and a net margin.
Type 2	Customers with annual consumption between 0.5Ml and 50Ml	Default tariffs not to exceed a level equal to the wholesale charge, plus 8% gross margin for clean water services and 10% gross margin for waste water services.
Type 3	Customers with annual consumption exceeding 50Ml	Retailers must ensure the default tariffs are reasonable and non-discriminatory.

We consider that recovery of (a portion of) excess bad debt costs via amendments to the current REC price restraints could be achieved as follows (note this is a straw man for illustration only and many aspects of this could be modified):

1. Estimate the excess bad debt costs resulting from customers subject to maximum price restraints under REC price protections[15].
2. Calculate an average excess bad debt cost per customer, based on customer numbers applying at the end of the relevant period, and after applying relevant sharing factors.
3. Convert this average to:
    a. A per customer cost in respect of customers with annual consumption below 0.5Ml
    b. An amended gross margin in respect of customers with annual consumption between 0.5Ml and 50Ml.
4. Temporarily and correspondingly amend the figures in the charges formulae set out in the REC, so facilitating Retailers to recoup a portion of excess bad debt costs, where customers remain on default tariffs.
5. Given the absence of price controls applying to customers with annual consumption exceeding 50Ml and customers on negotiated contracts, retailers are able – in the context of competition with other Retailers - to recover excess

[15] NB - this would exclude customers with annual consumption exceeding 50Ml, since no maximum price restraints apply to this customer group

bad debt costs from these customers in the absence of further regulatory amendments.

(2) Recovery from business customers via wholesale charges

An alternative to amending the REC is to recover a portion of excess bad debt costs from business customers and to disburse monies collected to Retailers. As illustrated in figure 2 in Section 2, where bad debt costs for a Retailer exceed its historical levels plus 1% of turnover, it should expect to bear a portion of this excess in line with sharing factors (see below).

One mechanism for implementing this approach could be to recoup costs via an uplift to wholesale charges as follows (note this is a straw man for illustration only and many aspects of this could be modified):

1. Estimate the aggregate level of outturn excess bad debt costs that Retailers are allowed to pass through to end customers, after applying sharing factors.
2. Calculate an average excess bad debt cost per customer, based on the number of customers a Retailer has at the end of the relevant period.
3. Uplift wholesale charges to all Retailers by the average calculated under step 2.
4. Disburse amounts due to each Retailer through one of two methods:
    a. Via a central fund. Wholesalers would invoice Retailers for the wholesale charge which would include the uplift applied to recover (the portion of) excess bad debt costs. Wholesalers would pay the portion of the wholesale charges that relates to the uplift into a central fund. The administrator of the central fund would disburse monies to Retailers in respect of the bad debt costs to be recouped. (Note the identity of the administrator is yet to be determined).
    b. Via a rebate to wholesaler charges collected from Retailers. Wholesalers would invoice Retailers for the wholesale charge including the uplift applied to recover (the portion of) excess bad debt costs. Instead of paying into a central fund, monies owed to Retailers in relation to excess bad debt costs would be netted off future wholesale charges to provide a rebate to Retailers. Again this would be on the basis of the pass through each Retailer is warranted to collect.

This approach would likely need to be contained within a process where each Retailer seeking some reimbursement for an agreed portion of excess bad debt costs would need to submit an application to Ofwat for these costs to be considered and reimbursed. This process would look to verify and confirm amounts claimed. This approach would also require relevant facilitating mechanisms and processes to be established, including cooperation with wholesalers to administer the uplift, a mechanism for collecting and disbursing monies, and due process for audit and verification. We may need to look to external providers to establish and/or manage relevant mechanisms and processes and depending on the complexities and costs involved, we would look to Retailers collectively to meet some or all of these costs.

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?

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

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?

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.

3.3 Timing

It typically takes time for companies to recognise and realise bad debt costs. A customer who has difficulty paying for example may defer payment or remain in arrears with the company for some time before the company either receives payment or decides to make a provision for or write off the debt. The economic consequences of measures to combat the Covid-19 pandemic and impacts on business are likely to compound these effects; for example it is not yet clear to what extent some business customers may find themselves in payment difficulties following the winding down of government support schemes or where the economic situation further deteriorates in some sectors.

Consequently we note that the question of amending regulatory protections for Retailers in respect of excess bad debt costs will have two key timing issues:

1. The time period over which bad debt costs are measured and assessed;
2. The timing of the recovery of (some portion of) excess bad debt costs.

On (1), and we have set out in Section 2, for a number of reasons the effects of Covid-19 measures on business customers are not yet fully clear and continue to develop. Our working assumption is that these effects will have become clearer by the end of the financial year 2020/21. On this basis we suggest assessing bad debt costs on the basis of provisions and/or write offs made by Retailers in respect of invoices due to end March 2021. Note that we anticipate that such invoices, and any provision and/or write offs for bad debt, would relate for usage of water and waste water services dating back to, at the earliest, January 2020.

Concerning (2), in implementing any amendment to regulatory protections aimed at allowing Retailers to recoup some portion of excess bad debt costs, we will need to determine the timing of this.

We also recall, as we set out in Section 2, that we need to have regard to the audit and veracity of the measurement and determination of bad debt costs and that it may not necessarily be appropriate to treat identified bad debt costs as a onetime adjustment. Hence we believe some form of subsequent 'true up' is likely to be appropriate. Such a 'true up' would involve checks and confirmations on measured bad debt costs and amounts recovered by Retailers. Where subsequent checks suggested too much or too little had been recovered under option (1) or (2), we would make adjustments for the balance to be refunded or passed through to customers in a subsequent period.

These considerations suggest to us, as a starting point for discussion, that the following timeline may be appropriate:

Apr 2021 – Mar 2022

Determination of whether industry outturn level of bad debt costs is likely to have exceeded 2% of industry turnover.

Where yes:

- confirmation of 'baseline' bad debt levels for Retailers;
- determination and confirmation of portion of excess bad debt costs to be passed through to business customers via revisions to regulatory protections
- confirm via regulatory Decision and set in place revised regulatory protections (eg. via increased REC price protections or wholesale charges), to take effect in 2022/23.

Apr 2022 – Mar 2023

Retailers recoup relevant portion of excess bad debt costs. Note recoupment via option (1), revised REC price restraints, delivers monies to Retailers immediately. Under option (2), recoupment via wholesale charges, a further and subsequent step would be disbursement of central funds to Retailers.

	Further audits and checks regarding levels of bad debt costs incurred in 2020/21. Formulation where warranted of 'true ups' to apply in 2023/24.
Apr 2023 – Mar 2024	Regulatory protections revised to reflect 'true ups'.

Note the above timetable is likely to represent the earliest through which Retailers can expect to recoup any warranted portion of excess bad debt costs. For example, option (2), recovery from business customers via wholesale charges, would likely need to be contained within a process where each Retailer seeking some reimbursement for an agreed portion of excess bad debt costs would need to submit an application to Ofwat for these costs to be considered and reimbursed. The establishment and operation of such an approach could potentially (but not necessarily) result in Retailers recouping their relevant portions of excess bad debt costs later than suggested by the above timetable.

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

3.4 Pooling

As set out above, both our approaches to amending regulatory protections to allow the recovery of (some portion of) excess bad debt costs anticipate calculating an average uplift – either to the maximum prices allowed under the REC or to wholesale charges.

A drawback of such an approach could be that where bad debt costs particularly or significantly arise for a particular customer group or region, all customers would be asked to contribute to the recoupment of such costs. This could be a particular drawback if for example significant bad debt costs arise in respect of larger consumption customers; it could be considered unfair were a portion of such costs borne by micro-business or smaller SME customers.

The question therefore arises of whether it may be appropriate to group customers together – either by customer characteristic or geographic region – such that (some portion of) excess bad debt costs arising for a customer group are recouped across that customer group. We have in mind two broad groupings:

1. By customer size. A practical approach here would be to group customers according to the bandings used for the REC price restraints, set out in table 1.
2. By geographic region. A practical approach here may be to assess, and enable the recoupment of, (some portion of) excess bad debt costs arising in each wholesaler region.

Advantages of some form of pooling include that costs are recouped from customer groups or regions where such costs arise, that other customer groups do not bear such costs, meaning for example that any risks that small customers end up paying for large customers' bad debt costs are mitigated.

Drawbacks of pooling include that – noting it is not in any case straightforward to assess bad debt costs arising - it is particularly unlikely to be straightforward to assess any such differences across customer groups or regions. In turn such an approach would require more detailed data from Retailers and carry a higher risk of error in estimating relevant excess bad debt cost recovery. We also note that inaccuracies in recouping excess bad debt costs from different customer groups have the potential to distort prices and hence competition. It could also increase implementation costs. For these reasons we currently see greater merit in pooling the recovery of (some portion) of excess bad debt costs across customer groups and regions. Note that under option (1), recovery via REC price restraints, we would nevertheless favour retaining customer bandings, as set out.

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?

3.5 Sharing

Our April 2020 Decision document set out that we will provide regulatory protection should outturn bad debt exceed 2% of revenue across industry. Furthermore, and as illustrated in figure 2 in Section 2, we set out that where bad debt costs for a Retailer exceed its historical levels plus 1% of turnover, it should expect to bear a portion of this excess in line with sharing factors. That is, we set out that any revision to regulatory protection could take the form of sharing such excess bad debt costs between Retailers and business customers, according to some sharing parameter(s).

We noted that such an approach to sharing would balance our desire to provide a degree of certainty to Retailers in terms of the (portion of) excess bad debt costs they should expect to bear in full, but avoid committing customers to bearing an undue share of excess bad debt costs above a certain threshold, when it is as yet unknown to what degree these costs will exceed the threshold, and how and on whom bad debt costs may crystallise.

This remains our view. We have not yet set out possible values for such sharing parameters, but we would anticipate setting these with the following factors in mind:

1. Where the likely scale of customer excess bad debt costs is relatively modest, we see a case for Retailers bearing a high proportion of these. This is on the basis that this reinforces incentives on Retailers to manage bad debt costs arising and to ensure customers are not exposed to these.

2. Where the likely scale of excess bad debt costs is significant and more enduring – for example relative to typical margins in the retail water sector – it may be appropriate for the proportion borne by retailers to be lower than under (1). This is on the basis that it is also in the longer term interests of customers not to see systemic Retailer failure.

3. Given continuing uncertainty over the likely scale of outturn bad debt costs, a pragmatic approach may be to adopt a graduated scale of sharing parameters.

We would anticipate adopting a sharing factor regime to apply to all Retailers, but applicable only to the excess bad debt costs we deem relevant for each Retailer.

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?

4. Next steps

We are seeking inputs and views to inform our approach to assessing whether and how changes to regulatory protections may be warranted in light of the potential for elevated levels of customer bad debt costs in the business retail market following the introduction of measures to combat the Covid-19 pandemic. Please provide, to the extent you can, information and evidence to support any views you may have.

Any response to this CFI may be sent to covidbusinessretailmarket@ofwat.gov.uk with the subject 'Customer Bad Debt Call for Inputs'.

All responses should be submitted by **5pm Friday 22 January 2021.**

In the meantime, to help us understand developments and the ongoing effects of Covid-19 measures on Retailers, the possible scale of bad debt costs, and to ensure that any regulatory response we make is based on the most recent information available, we are also writing on 30 November 2020 to Retailers with a further Request for Information (RFI). This RFI will seek updates through to December 2020, plus some forecast indicators, on the information and indicators Retailers provided in their responses to our July 2020 RFI.

In the light of responses received to this Call for Inputs and further information provided through responses to the November RFI, we plan to consult in early 2021 on the options and way forward for any revision of regulatory protection in respect of customer bad debt in the business retail market.

We will also need to undertake further work, data collection and analyses to determine and confirm the base line outturn bad debt cost positions for industry and for Retailers for the most recent financial year pre-dating the introduction of Covid-19 measures. This work will include the definition and measurement of bad debt costs, the extent to which these have arisen in 2018/19 and subsequently on a consistent basis and if and to what extent on an industry wide basis bad debt costs may be exceeding 2% of turnover.

Appendix 1 – Full list of 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?

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

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.

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?

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.[16]

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?

[16] Note Ofwat will in November 2020 send Retailers a revised Request for Information (RFI) seeking updated data and information on indicators of the potential scale of bad debt arising since March 2020. Retailers responding to this CFI may wish to reference data and information contained in their response to the RFI in support of any views they may have in relation to Question 6.

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?

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

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?

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.

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

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?

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?

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Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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