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

Castle Water Response

This is the response of Castle Water Limited ("**Castle**", "**We**") to the Call for Inputs ("**CFI**") that Ofwat issued on 30 November 2020 alongside its Request for Information ("**RFI**") of the same date.

Introduction and Summary

Castle welcomes Ofwat's consideration of a methodology for measuring, and a mechanism for partial recovery of, 'excess' bad debt resulting from the impact of the Covid-19 pandemic on the ability of customers of water and sewerage retailers to pay their bills. The main points of this response are:

- We agree that the mechanism for recovery of bad debt should ultimately be based on audited provisioning and write-off, but note that the lead times for obtaining final numbers mean that any recovery mechanism that relied solely on them could not offer timely recovery.

- Factors such as aged debt and historic provisioning and write-off can cast a sidelight on the approach to measurement of bad debt, but say little about its recent and future course. The true impact of a unique (and continuing) event such as the Covid-19 pandemic is largely unknown. And the non-household retail water market (the "**NHH market**") had previously been in existence for less than three 'normal' years – or under half the statute of limitations period.

- We therefore welcome the acceptance in principle of basing the recovery mechanism on a measurement methodology involving a process of estimation and correction, or 'truing up', of emerging bad debt. This is essential to facilitate both a degree of early recovery and an acceptable degree of accuracy and fairness over time.

- While the true-up algorithm could be common among retailers, it is important for Ofwat not to adopt a prescribed method for the rolling estimation and correction of bad debt. That would cut across the methodologies that retailers employ within the parameters set by the relevant accounting standards, create arbitrary distortions between the resulting numbers with corresponding winners and losers, and give rise to contention.

- We do not think any perceived perverse incentive artificially to inflate estimates is a particularly plausible risk. To address this, however, whilst continuing to recognise that policies on accounting for bad debt may differ, we suggest introducing greater transparency in the methods used by companies to assess and write off bad debt within the parameters set by the appropriate accounting standards, and for conformity with these methods to be verified by their auditors.

- As for the recovery mechanism itself, we suggest that the administrative complexity, cost and likely contention attaching to a collection and redistribution of a bad debt 'levy' through the wholesale charge is unattractive, both for those reasons and from a cosmetic point of view. It may also require the partial re-opening of the PR19 settlement, and possibly legislation (under the 'Managing Public Money' rules).

- While recovery via an uplift to the Retail Exit Code ("**REC**") implies a degree of rough justice, it:
  - is capable of being implemented on an earlier timescale (i.e. so that recovery can begin in Q3 and Q4 2021/22, rather being delayed to FY 2022/23);
  - can be applied according to the REC customer groups; and
  - could be adjusted at the margin by a factor reflecting markedly different geographical and / or sectoral impacts, and thus to some extent the company-specific susceptibility of retailers to bad debt.

- While we note that Ofwat has declined to include a wholesaler contribution to bad debt, we nonetheless believe that this would not be out of place in the context of the overall system by which customers are served. This could be achieved by an offset component in wholesale area tariffs, carried through into the REC tariff bands. It would also go some way to recognising that, while wholesaler charges are otherwise being kept whole, retailers have to bear the costs of financing, as well as managing, bad debt.

CFI 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?

In principle this is the correct approach to the *measurement* of bad debt, as it provides certainty and financial propriety in the long run. It would, however, vitiate the purpose of allowing for recovery of an appropriate portion of 'excess' bad debt to base a *recovery mechanism* solely on these numbers, due to the length of the lags between the emergence of doubtful debt and its provisioning; its resolution through payment in whole or part; or ultimately its write-off.

Under the accounting standards, notably IFRS 9, provision for bad debt does not constitute hard evidence of what will crystallise. Even in normal times, but acutely exacerbated in a period in which Covid-19 subsists, such an assessment is affected by the inability of retailers definitively to categorise any particular debt *ab initio* as:

- Not economic to recover (cost of recovery exceeds the initial debt, but the debt may grow).

- Uncollectable due to bankruptcy or simple lack of customer money.

- Due to the customer having gone away and being uncontactable.

- Due to insolvency.

- Unenforceable, either because legal recourse is constrained or suspended by regulatory requirements; or because the customer is not the occupier and is thus not liable.

In order to write off a debt a substantive reason, such as an adverse court judgment, is required. This may take upwards of a year. Insolvency proceedings may take considerably longer, and may or may not result in part payment. In many cases write-off will not occur until recovery is statute-barred, i.e. six years.

It will therefore be impossible for Ofwat confidently to predict, within this financial year (or possibly the next) that the 2% industry-wide bad debt threshold for introducing a recovery mechanism will be met. But if no decisions and preparations, including the measurement and recovery mechanisms, are put in place it may subsequently be too late to avert systemic retailer failure.

Our conclusion is that, while only write-off of bad debt will ultimately provide hard evidence of excess bad debt, a rolling process of estimation and correction will be essential to providing a timely degree of relief. See further below.

Although Ofwat suggest that they are not disposed to make any allowance in the assessment for the carrying costs of bad debt, we believe that there would be equity in doing so, given that retailers are paying full wholesaler charges at the same time as being squeezed by customer bad debt. In that context it should also be noted that retailers continue to incur significant unnecessary costs due to market frictions resulting from the generally poor – and often abysmal – quality of wholesaler data in the market. This means that, where (as is often the case) customers refuse to pay bills until data issues are resolved, in addition to the costs of resolving these data issues retailers are also carrying higher levels of debt for such customers, and any *de facto* extension to payment terms while such errors are resolved increases the bad debt risk faced by retailers. If these customers were subsequently affected by Covid-19, retailers are receiving a double hit from the combination of poor inherited market data and Covid-19.

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

For the reasons given above, it is not yet possible to estimate the full extent to which such variance will give rise, but it is clear that the restrictions on business activity and personal movement have had significant differential effects, and that these are set to continue for at least the coming months.

These variances are principally due to:

- The density and types of business in a region or part of a region. The larger conurbations (or their equivalents such as large out of town sites), where there is a concentration of the non-food retail, hospitality and entertainment sectors, are being particularly affected. The consequent effect on London, in particular, underlines the reliance of the capital on the retail and casual dining sectors.[1]

[1] https://www.cityam.com/coronavirus-lockdown-central-london-retail-footfall-plunges-80-per-cent/

- There are already signs that this will prove a long term trend, as customers continue to forsake those areas in favour of online and other forms of remote interaction (e.g. collection and delivery), which has already caused the failure of many businesses and is causing the progressive failure of further businesses.[2]

- This effect is particularly acute in conurbations that are characterised by a high proportion of commuters, compared to residents. The Office for National Statistics ("**ONS**") has confirmed that the number of people travelling to work has more than halved and has recently further decreased.[3]

- Central London has a particular problem in this regard also:

> *"Footfall in central London has fallen more sharply than in the regions as Covid-19 restrictions keep office workers and tourists away. […] In the second week of December, it was down 51.7 per cent on the year, according to Springboard, which measures retail activity. That compared with a fall of 47.5 per cent in regional cities and 24.1 per cent in towns."* [4]

Even before the latest lockdown, The Federation of Small Businesses ("**FSB**") reported that the London economy was the worst hit:

> *"In Q3, almost two thirds (63%) of small businesses in London reported a decrease in revenue over the last 3 months, as the nationwide lockdown had a considerable impact on spending opportunities for consumers. […]*
>
> *Accordingly, with a net balance figure of -36% for Q3, London's small businesses' profits were the worst hit region in the country. Among the next lowest region, which was the North West, profits of -26% were recorded.*
>
> *A significant proportion of London businesses do expect a further decrease in profits for the coming quarter (53%), with negative expectations more widespread than the UK average (22%)."* [5]

The most recent assessment by the British Retail Consortium ("**BRC**") (8 January 2021) is that:

> "After an encouraging start to the month Christmas shopper numbers dwindled as December progressed, due in large part to the creation of Tier 4 in England and increased restrictions elsewhere in the UK. High streets and shopping centres continued to see the most substantial decline in shoppers, as their 'non-essential' tenants were forced to close their doors during the weeks leading up to and following Christmas. London, the South East and Wales were hardest hit, with footfall dropping by over four fifths in the final week.

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[2] https://www.standard.co.uk/news/uk/one-in-four-shoppers-could-abandon-high-street-by-christmas-2021-a4017571.html

[3] https://www.ons.gov.uk/peoplepopulationandcommunity/healthandsocialcare/conditionsanddiseases/bulletins/coronavirustheukeconomyandsocietyfasterindicators/3december2020

[4] Behind the story: Footfall higher in the regions, The Times, 16 December 2020.

[5] London Quarterly Small Business Index for Q3 2020, FSB.

> However, it has been a hard year for the entire country, with footfall down by 43% in 2020 compared to the previous year." [6]

It must also be borne in mind that the medium term prospect for a number of businesses has been positively impacted by the business support measures that HM Government has taken which, once withdrawn, could be followed by some further permanent business closures and insolvencies. A report released to the London Stock Exchange as recently as 21 January 2021 by Begbies Traynor, a corporate recovery and restructuring specialist in the UK, states that they have found:

- 630,000 businesses in 'significant distress', a 13% increase from Q3 2020) in light of another nationwide lockdown.

- Since Q4 2019, the number of significantly distressed companies have has increased by 38% in financial services, 39% in real estate and property services and 32% in hotels and accommodation.

> "However, it is likely that these figures are the tip of a very large iceberg. The coronavirus pandemic has reduced court activity limiting the number of CCJs and winding up petitions being issued against indebted companies and there has been a ban on winding up petitions for Covid-related debts.
>
> "Without the financial aid and support measures that the Government has put in place during the pandemic insolvency levels would have been much higher, however the sad truth is that for many companies this will provide little more than a stay of execution as debt levels become unmanageable and structural changes across many sectors take their toll."
>
> "The Capital's dependence on the financial services and hospitality sectors is laid bare in this research, with London businesses experiencing a huge 33% year on year increase in significant financial distress, and a 17% quarter on quarter increase."[7]

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

Given the lags described in reply to Question 1 above, it will be impractical to base a mechanism for timely *recovery* solely on audited write-offs. This suggests that a methodology for estimating and correcting for doubtful and bad debt is needed.

Whilst IFRS 9 leaves companies a degree of latitude in their judgments about provisioning and write-off, it sets broad parameters for those judgments within which each company will have developed its own policy. PwC notes that:

> *"Determining whether a significant increase in credit risk has occurred can require considerable judgment. While IFRS 9 provides extensive guidance on factors that should be*

[6] https://brc.org.uk/news/corporate-affairs/2020-sees-footfall-down-over-40/

[7] https://www.begbies-traynorgroup.com/news/business-health-statistics/news/firm-news/630000-uk-businesses-now-in-significant-financial-distress-as-new-lockdown-comes-into-effect

> *considered, we expect that entities often will have to establish an accounting policy as to when an increase in credit risk is significant within the context of its own internal credit risk management and reporting."* [8]

It would therefore be possible for a company's policy, and adherence to it, to be reported by its auditors as within the parameters of IFRS 9; and for the auditors to report, within the usual confines of materiality, that the policy has been properly applied.

We therefore suggest that audited provisioning, supplemented by transparency of company policies, forms the bedrock for measuring bad debt. Each year, movements in these provisions can then be sense-checked against write-off of bad debt. Aged debt and historic patterns of provisioning and write-off, while not dispositive in themselves, could be used as a means to identify and seek to explain any sudden changes.

Resultant increases or decreases in estimated bad debt, the accuracy of which would taper in over time, could then be used to adjust up or down the recovery allowed in the following year (after taking account of any wholesale charge changes – see below). This is similar in concept to the for under- and over-recovery correction factors used in price controls, and Ofgem's recently introduced bad debt addition to the pass-through component in network distribution charges arising from the insolvency of electricity suppliers that had deployed the network charge deferral scheme.

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.

The relevant accounting standards provide a common basis for assessing and reporting doubtful and bad debt and, within the guidance they provide, allow for companies to exercise an appropriate degree of judgment. To cut across this convention with a rigid 'one size fits all' set of prescribed requirements risks the recovery mechanism creating an arbitrary set of winners and losers; and casting unnecessary doubt over some of the modulations in accounting treatment that companies might legitimately have chosen.

There remains, however, an option to add a company-specific element to the chosen mechanism for recovery. We suggest below that this could be based on the assessed level of bad debt in each wholesale area, and the susceptibility of each retailer to it, represented by a positive or negative factor applied to an uplift component of the REC for each retailer in each area. This would combine a relatively simple industry-wide approach to bad debt in each area with a (suitably dampened) company-specific adjustment.

[8] IFRS 9, Financial Instruments – Understanding the Basics, PwC, 2017: https://www.pwc.com/gx/en/audit-services/ifrs/publications/ifrs-9/ifrs-9-understanding-the-basics.pdf

<u>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?</u>

We note that the CFI refers only to bad debt in respect of *services provided* on or after 1 January 2020. The bills whose payment was affected by Covid-19 will, however, include some that were either not rendered, or were rendered but still outstanding, when the Covid-19 period began. Accordingly, provisions relating to bad debt due to Covid-19 were being made towards the end of 2019/20. This should be reflected in the first year estimate in order to cover the period from the start of Covid-19 effects.

If recovery of bad debt is to begin in Q3 and Q4 2021/22, and assuming that the mechanism for recovery has been consulted on and agreed in the meantime, the initial estimates for the period 2019/20 and 2020/21 would need to be submitted by the end of Q1 2021/22 and agreed in time for the REC adjustments to take effect from October 2021. Thereafter, the first true-up and the estimates of bad debt in 2021/22 should in place by 31 March 2022 and annually thereafter.

For the reasons given above it will be necessary to operate the recovery mechanism in respect of each year until at least 2026/27.

<u>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.</u>

As suggested in the CFI, this reply references data and information contained in our response to the parallel RFI.

It is still far too early to draw definitive conclusions on the likely scale of bad debts that may arise from events occurring before, or subsequent to, January 2020. Which debts will remain outstanding, and for how long and, if so, into which of the categories described above they will ultimately fall, will emerge only over the next several years.

It is, however, clear that the effects to date alone are likely to be significant.

<u>Evidence of payment difficulties</u>

The following table shows the trends to date in the types of indicator cited in the RFI as suggestive of payment difficulties:

[✂]

This highlights that:

- The number of Direct Debits ("**DD**s") cancelled or rejected increased [✂] at the outset of the first Covid-19 lockdown. These cancellations reduced and levelled off after May, in part because of the furlough and other financial support measures becoming available, and then the easing of restrictions on business. With the introduction of the Tier system, and regions in and around London moving to tighter lockdown, and the subsequent national lockdowns, the numbers have started to rise again.

- The number of billing accounts in arrears also increased [✂] at the outset of the first Covid-19 lockdown. This was attributable, to a similar or greater degree as to Covid-19, to the measures taken by Ofwat through the Customer Protection Code of Practice ("**CPCoP**") preventing retailers from instigating their normal and effective debt collection strategies such as disconnection and litigation. Once these activities were permitted once more, the number of debtors in arrears fell, but the impact was muted because of the backlog and the effect of changed customer expectations about their payment responsibilities. The fact that the subsequent lockdowns have not (as yet) showed another spike in customer numbers in arrears serves to underline the adverse impact of the previous restraints on debt collection activity, given that there is no suggestion that retailers' collection activity has otherwise been slack (indeed the latest CPCoP reporting requirement suggests the opposite).

Trends in debt

At the end of FY 2019/20 aged debt and net debt were both slightly lower than at the end of 2018/19, as the effect of the pandemic had not by then fed through to these figures to a significant extent, given that we were entering the first lockdown only at the end of the period. This does, however, suggest that subsequent increases in debt are likely to be due to the effects of Covid-19 on customer payments. It is also reflected in the increased provisioning in the FY 2019/20 accounts at £[✂], compared to £[✂] at 2018/19; the end-December 2020 provision of £[✂]; and the forecast for FY2020/21 of £[✂].

Our debt levels since the first lockdown have consistently been c. £[✂]-[✂] higher than in FY2019/20. See the graph immediately below. This probably understates the true impact as the billing level has been lower.

[✂]

This shows that total debt at the end of December 2020 shows an increase of £[✂]-[✂] compared to the same period in December 2019. Debtor days for these same time periods shows an increase from [✂] days to [✂] days. During the first lockdown, however, the measures that were taken to suspend effective debt collection processes caused debt to rise [✂], to levels in the range of £[✂]-[✂]. While debt levels have reduced since this peak, the year on year comparison shows a consistent difference of c. £[✂]-[✂]. Since this has coincided with the occurrence of Covid-19 and the lockdown measures, there is clear potential for a portion of this ultimately to become bad debt.

Cash receipts for the nine month period to December 2020 are £[✂] lower than our modelled forecasts, a figure broadly in line with the additional £[✂]of debt noted above. (Note this model was already adjusted downward from our original FY20/21 forecasts to reflect the impact of Covid-19 and the first lockdown, so the cash shortfall against our original budget is significantly greater.)

Prospective insolvencies

When we last reported we noted having that Castle Water had a list of potential insolvencies being worked through, with total debt value of £[✂]. Updated working now shows this to be £[✂]of potential insolvencies. As noted in reply to Questions 1 and 2 above, insolvencies usually lag periods of financial crisis by some time. The Covid-19 event is no exception.

- In this case, however, a number of other factors will contribute to a delayed translation of the Covid-19 economic shock into insolvencies: The impact of lockdown on business courts will create additional lags and delays in official registrations of insolvencies.
- The many emergency government interventions to prevent a liquidity crisis for corporates (tax deferrals, state loans and guarantees, wage subsidies and debt moratoria) will, in many cases prove to have artificially kept businesses solvent that would otherwise have failed; and even where their current underlying condition is solvent, they may not survive the continuing effect of Covid-19 once these measures are removed.
- The temporary changes in insolvency regimes designed to give time and flexibility to companies before they resort to filing for bankruptcy. These include the suspension of the obligation to file for bankruptcy under certain conditions, the extension of deadlines, moratoria to prevent certain creditor actions against a company, and the raising of the threshold limit of unpaid debt to initiate a bankruptcy and winding up application.

These factors mean that the bulk of insolvencies due to Covid-19 are not likely to be recorded until beyond 2021/22.

In assessing whether the true extent of bad debt has met or will meet the 2% threshold, Ofwat will therefore need to aim off for the above uncertainties and lag factors.

Conclusion

For the reasons given above it would be reasonable to attribute the vast majority of the rise in debt levels we have experienced to the impact, direct or indirect, of Covid-19, although how much might prove irrecoverable will emerge only over time.

Any preliminary assessment is, of course, also subject to further imponderables such as how long the pandemic will continue materially unabated, how quickly the vaccination programme will progress; and the timing and extent of any economic recovery and the measures taken to promote it.

Broadly, if the pandemic is under an advanced degree of control by October 2021, while bad debt is not at present quantifiable with confidence, consistently with the assumptions made in Castle Water's response to the RFI (and used in its predecessor) our current best estimate is that it could be up to [✂]% of current annual revenues.

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 stated objectives, with the following supplementary observations:

- *Protect business customers, including from the risk of systemic retailer failure.*

  The NHH market is for the most part a business market and customer protections should not be applied, explicitly or implicitly, on the same criteria as they might be in the household market.

  We therefore suggest adding the following codicil to this objective:

  > *"; in particular, by taking timely decisions and proportionate measures to that end".*

- *<u>Promote efficiency by retaining incentives on Retailers to minimise bad debt costs, not distorting competition and being capable of being audited and checked</u>*.

  We believe that it is integral to achieving this objective that, whilst customers in difficulty should be treated with understanding, Retailers are equally prevented from deploying all legitimate collection methods for customers who are able to pay; and that such customers recognise this.

- We therefore suggest adding the following codicil to this objective:

  > *"; and by retaining statutory mechanisms to encourage payment on the part of customers who are able to pay."*

  We also note the reference in the CFI to the need to guard against the method of measuring bad debt being used by companies artificially to inflate their bad debt in order to benefit from the recovery mechanism. We believe the correct way to do this, and to achieve this objective, is through proper use of existing and tried methods of assessment, which are auditable. In addition we note that, while it might be thought that the incentive to inflate might most likely apply to a company in financial stress, such a company is also less able to sustain excess provisioning in its P&L account, and excess write-offs in preference to robust collection activity. The presence of wholesale charges and lags in recovery also militate against this incentive.

- *<u>Provide clarity and minimise implementation costs.</u>*

  We endorse the need for clarity and simplicity. We believe that the use of known methods of measurement and a straightforward mechanism for recovery offers the most robust solution. While external support might well be required to assist in the assessment and calculation of the bad debt to be recovered, a mechanism (such as Approach 2) that involves a central agency for the collection and redistribution of a kind of bad debt levy would be cumbersome, resource-intensive and expensive.

<u>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?</u>

In order to be fair to the generality of customers who are not bad debtors but will need to make some contribution to the sustainability of the sector, amending the REC (Approach 1) offers a reasonable way to spread the costs between different classes of customer.

The amendments to the REC should:

- provide for an initial estimate of 2019/20 and 2020/21 bad debt, with an interim uplift to the 2020/21 REC, and thereafter for annual estimates / corrections / REC adjustments to match the tariff change cycle and thus minimise the complexity for customers, and the costs for Trading Parties, of making changes; and

- be smeared equally across each tariff band, not applied differently for each band (as to which see above), or customer by customer. The leak allowance process tells us that the time taken to complete such an action on a customer by customer basis is 6-12 months.

Any more granular approach - e.g. attempting to attribute the IFRS 9 provision or resultant bad debt charge in the P&L account to individual customers or customer categories - would require a complex but largely subjective apportionment exercise that would be ultimately be unlikely to generate a reliable or meaningful result.

For sector stability, Ofwat's underlying method of assessing bad debt and determining the recovery and sharing factors should, in the absence of exceptional circumstances, endure for the period and not be subject to annual change. This would cause discontinuity in the estimation and adjustment trajectory and make the corresponding processes of recovery and truing up hopelessly complicated.

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

For the reasons given above, we accept that the collection and redistribution of an uplift on the wholesale charge risks creating a 'levy industry' that is likely to be disproportionate in terms of cost and other burdens, and ultimately not in the interests of customers or retailers.

We do, however, encourage Ofwat to consider, alongside the REC changes, offsetting a small proportion of the uplift that would otherwise be imposed, in the form of a wholesaler contribution. Retaining incentives on Retailers to minimise bad debt costs ultimately helps to sustain the financial health of wholesalers. Given that wholesale charges in respect of customers who may become bad debtors are not otherwise reduced, and that wholesale costs constitute the vast majority of retail charges, it is equitable that wholesalers bear some portion of the excess bad debt costs. Customers are ultimately served by the sector as a whole, not just Retailers.

Question 10 – Concerning the 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 comments about a possible application process and the data and audit requirements to accompany this?

The costs of implementation for trading parties are best minimised by maintaining the objective of clarity and simplicity in the design of the recovery mechanism. As noted above, a customer by customer approach is inefficient, time and resource consuming, and expensive (c.f. the temporary vacancy scheme). Accepting that the REC is the appropriate means by which to alleviate the agreed company-specific portion of excess bad debt, and that it is right in principle that the costs should be borne according to the wholesale area, we suggest that the bad debt portion to be borne by wholesalers should be applied to the underlying wholesale tariffs and carried through into the REC via an adjustment to the wholesale tariffs.

This will mean that all retailers operating in a given wholesale area will be assumed to have a similar level of bad debt. We suggest below how this might be refined to a degree below by adding an area- and company-specific element to an uplift in the REC.

This 'wholesale area' approach would also avoid the need for a cumbersome and resource-intensive application and assessment process. Aiming for the degree of precision that this implies would give rise to a need for the assessor (Ofwat? An external agency?) to make continual judgments of Solomon, and invite contention from one side or the other.

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.

The single most important mechanism for keeping bad debt to a minimum is effective collection. This ensures that those who can pay, do; and that only those who are proven to be unable to pay end up as bad debts. In that context, continual 'stop/start' and other changes to the collection and enforcement measures that may be deployed at any time serve to undermine this message.

Like the Covid-19 tiers themselves, these changes are not fully understood; they foster a belief on the part of customers that they do not need to pay; and are of widespread impact because the resulting misleading messages spread rapidly through social media. Any dilution of the statutory right to collect debt therefore increases the risk of bad debt and the costs to other customers.

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

See above the reply to Question 5 for the suggested timing of measurement, start of recovery in 2021/22 and the duration of the mechanism until at least 2026/27.

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?

In respect of customer groups, yes, banded as per the REC and as referenced in the CFI.

Although pooling across wholesaler regions provides a starting point, we consider that there are some marked differences in geographical impacts that should be reflected in part in the quantum of bad debt to which each company is exposed by virtue of its portfolio.

These could be represented in broad terms by a damping factor applied to the component of bad debt ascribed to each wholesaler area according to wholesale revenue - e.g. (for illustration only):

- Establish the national total of bad debt.
- Distribute the national total of bad debt among areas in (inverse) proportion to the amount of bad debt incurred in each area.
- Calculate each retailer's share of each area's assigned proportion of the total national bad debt, according to its area market share in that area.

- Select a 'dead band' within which a retailer's share of the bad debt assigned to a region is less than X% more or less than the average value for retailers in that region (in which case its uplift would not be affected).

- For variations of more than X%, an adjustment factor (e.g. *0.9, *1.1, etc.) would be applied to the uplift to compensate in part for the discrepancies in bad debt across areas and retailers.

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?

Since a bad debt comprises both wholesale charges and retail charges, if there is to be no wholesaler contribution to retailer bad debt it would be appropriate for the sharing ratio to reflect the proportion of each charge in the end-user's bill – that is c. 90:10 (customer to retailer).

Castle Water Limited

22 January 2021